



# Macroeconomic Review of Latvia

June 2010

## In Focus

- Unemployment keeps decreasing. By the end of June the monthly unemployment level had dropped by 0.5 percentage points to 15.7% of economically active population
- The Ministry of Finance of Latvia has developed a plan consisting of more than 60 measures to combat the gray economy. The plan envisages sanctions, control, efficiency and cooperation activities targeted at minimisation of the gray economy and increase tax collection. It is expected to bring additional 3% - 5% of GDP in tax revenues
- In 2009 household confidence indicator declined. The CSB survey shows that in the 4th quarter of 2009 83% of Latvia's households were of the opinion that their economic situation had deteriorated
- Export boom continues. In the first four months of 2010 export volumes rose by 19.1%, while imports gained 0.1%
- For the first five months of 2010 profits of 4.7 mln lati were posted by six commercial banks of Latvia and one branch of a foreign bank. Total losses of the banking sector amounted to 207 mln lati and were due to provisions for doubtful loans. The banks' income before provisions and taxes at the end of May amounted 48.9 mln lati.
- By the end of May 2010 total deposits in the commercial banks of Latvia had reached 10.3 billion lati or 1.8% up from the April result

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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	-2.2
GDP at current prices (mln LVL)	14780	16240	13244	2853	I-III	12550
Consumer prices index (% annual average)	10.1	15.4	3.5	-1.0	V	-2.0
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	9.2	I-III	7.0
Foreign direct investment flow (mln LVL)	1193	607	36	-95	IV	50-100
Cumulative foreign direct investment (mln LVL)	5247	5711	5734	5785	I-III	5900
Foreign trade balance (% of GDP)	-25.3	-19.0	-8.0	-7.3	I-III	-5.0
Government foreign debt (mln LVL)	635	1260	3253	3881	V	5100
Manufacturing output (% yoy)	-1.0	-8.3	-17.7	5.6	I-IV	6.5
Retail trade turnover (% yoy)	18.8	-8.2	-28.0	-10.7	I-V	-7.0
Unemployment rate (% , end of period)	4.9	7.0	16.0	15.7	VI	14.5
Job seekers rate (% , end of period)	5.3	9.9	19.7	20.4	I-III	17.5
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.

### Taking the right direction. Risks remain

In the 1st quarter of 2010 the growth of GDP, compared with Q4 of 2009, gave the reason to formally announce the end of recession. Nevertheless, Latvia has yet to walk a long and bumpy road to full recovery. Uncertainty and risks are still looming. Therefore it is too early to celebrate rebounding of the economy. It has to be confirmed by improvement of other indicators, for example, a steadier fall of unemployment and the first signs of wage increase. Whether the positive trends in the world and the eurozone persist and risks are brought under control, we will most probably see some signs of recovery it in the third, and more clearly – in the fourth quarter of this year. Yet many questions regarding the driving forces of long-term economic growth will still have to be answered.

In Q1 of 2010 GDP was still down by 6.0% in annual terms. The data reflect different situation in different

industries meaning that recovery will continue to be uneven. The visible activity in industry branches is created by export growth. Thanks to internal devaluation, some of the competitiveness lost in the previous years has been regained. With the rising economic activity in the external markets new opportunities are created for development of industry and exports. It is also true regarding the exports of services. At the same time, the share of industry and export volumes is relatively small and therefore their impact on the entire economy is not as big as in other export-oriented economies. GDP is gaining from the improving trade balance. There is a possibility, though, that toward the year end the trade balance may again deteriorate and consequently will have effect on GDP. Private spending keeps shrinking albeit slower than before and is unlikely to improve in the nearest quarters. It will be influenced by wage



cuts and the envisaged tax changes. Minuses will be smaller mostly due to the base effect. On the other hand, as the consumers' sentiment remains positive or even improves, consumption may become livelier. The government spending, too, will be affected by the further consolidation of the state budget. Still, it would be wrong to expect that budget deficit can have some positive influence on the economy in the long term. The instability and risks associated with the budget deficit will create additional uncertainty and costs hampering recovery of the economy. The issue of productivity and structural reforms in the private

and public sector is high on the agenda as a precondition of long-term development. The current positive trends have only a short-term effect. The deep fall of investments is worrying indeed as it shows that the growth will not be steady if investments will stay at the present low levels. On the contrary, it will be curbed or even stopped, with a long-term consequence. In the coming periods most of the improvements will be due to the low base effect and thanks to the export-oriented industries. A great role is to be played by Latvia's most important markets.

**Too early to wave recession good-bye**

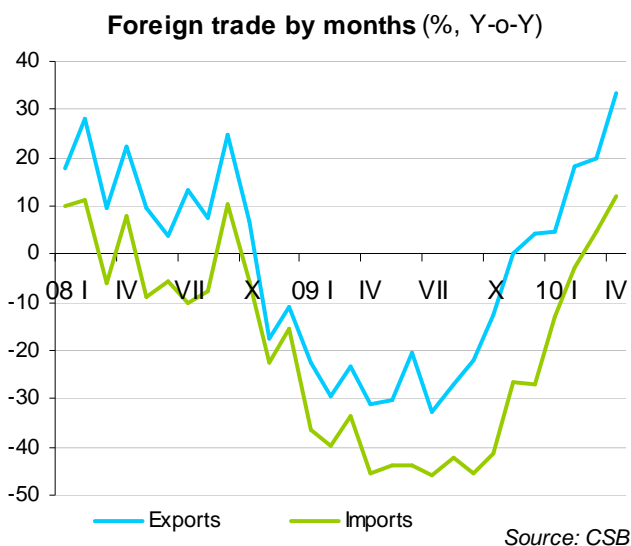
In the first quarter of 2010 Finland saw a fall of its GDP by further 0.4% following decline in the last quarter of 2009. It was the first country in the eurozone experiencing double dip recession. Concerns of a similar scenario are rife in the United Kingdom. The background to these worries is the crisis in Greece and struggle under the heavy government debts in the major part of the eurozone and other EU member states. That of course raises question if the eurozone and the EU will slide back into recession. The answer to this question and scenarios are contradictory yet the possibility cannot

be dismissed. In the meantime the euro currency weakened by the general uncertainty and debt crisis has made its favourable impact on the exports and the economy. In April 2010 industry in the eurozone, although slowly, continued to grow. However, as long as the government finances are not straightened out, the growth will be weak. The economy has not yet entered a stable growth cycle. While the causes of risk and uncertainty are not eliminated, there is always a threat of new recession. If this scenario comes true in Latvia's biggest market, it will hit our exports and shatter our attempts to recover.

**Export boom goes on**

Exports boom continued as it soared in April by 33.4% year-on-year to 374.2 million lati.

That pulled imports up as well by 12.1% to 425.3 million lati. Notably, the negative trade balance has shrunk further to 51.1 million lati. The exports rose at this rate due to the spectacular growth in the major groups of export goods: wood products (+78.6%), metal (+54.3%) and mineral products (electric energy, +50.4%). In other goods, too, growth was considerable. However, the big increase can indicate some risks arising from excessive focussing on separate industries. Changes in demand may considerably affect the overall export results and the economy in general. Also, the weakness in the export structure is the large share of intermediate goods exported. These are long-term risks hidden behind the impressive export growth and they demand to be tackled by serious structural changes. In the export structure the share of consumer and capital goods with high added value must go up. Only increase of

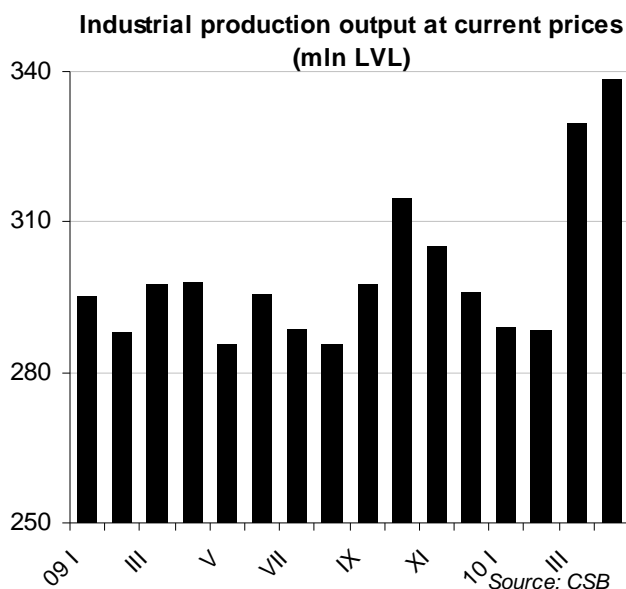


the products with high added value in the export structure can make exports sustainable and their

impact on the economy and society – beneficial.

### Growth continues. Is it sustainable?

The impressive industrial output's March performance continued in April too. Nevertheless, the misgivings about the stability of growth remained. In April, compared with March, the total industrial output according to seasonally adjusted data in comparable prices rose by 0.1%. This growth was achieved by the increased supply of electric energy and natural gas (+4.2%), while decrease was registered in manufacturing (-0.7%) and mining and quarrying (-3.6%). It shows that industry was kept from slipping back, month on month, by the opportunity to use the excessive water in the rivers and raise the output of electricity.



In April, year on year, industrial output rose by 9.7%. Manufacturing gained 8%, mining and quarrying - 1.9%, and electric energy and natural gas supply - even 20.2%. In manufacturing industry the largest growth was observed in wood products (+36.3%) and chemical industry (+27.6%) while pharmaceuticals kept falling (-23%).

The rise in competitiveness and the difference in purchasing power of the domestic and foreign markets is beneficial for those industries who are already producing goods for exports. Ability to keep and increase sales in export markets will be one of the preconditions to the development of manufacturing industry. The development of the industry will be uneven, with sharp fluctuation and stagnation in some branches. It was seen in the year-on-year growth of the textile and garments industry in March followed by a slip back in April. In the food industry year on year the drop in March was followed by a rise in April. As the local demand will remain very weak, the developments in the foreign markets will be of great importance, meaning the ability to restrict and handle the current situation in the eurozone and the progress in strengthening of competitiveness. It is crucial that the current problems in eurozone do not undermine the processes of economic recovery pushing consumption and purchasing power over the cliff.

### Exports - the key to success

In April 2010, year on year, turnover in manufacturing industry rose by 5.7%. Focus on exports kept bringing fruits as the turnover of exported goods rose by 29.3%. It was also due to the rising prices for export products. At the same time, in the domestic market turnover dropped by 11.1%.

As usual, the satisfaction with the overall growth is somewhat cautious. The situation in various branches of manufacturing industry differs. While some of them are booming and recovering from the crisis, in others turnover is stagnating or falling both in the

domestic and the foreign markets. For example, wood, paper and graphic industries have achieved growth at home and abroad. Meanwhile, the turnover of local and export products in garments and furniture industries has dropped.

The current trends indicate how significant the further development of exports and accordingly that of manufacturing industry is to be. It will largely influence the outlook for the entire economy. In the coming time there is a reason to expect further rise of turnover. The prices of export products keep growing

and foreign markets in the general mood of uncertainty are showing some positive trends. If the current trends persist, it will be gradually reflected in rising employment figures. At the same time, there are risks in the eurozone warning that the development scenarios should not be overly optimistic and some fluctuations and slack periods

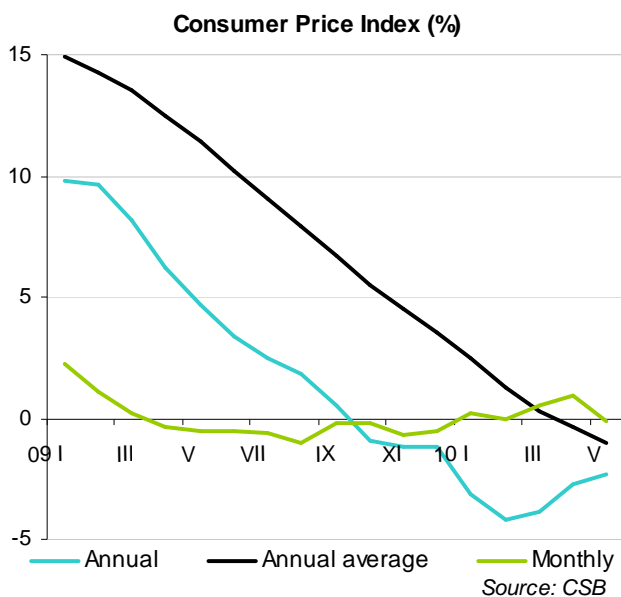
should be allowed for. Also, the low investment level is a serious threat to export competitiveness, reducing the possibility to develop products with high added value, which is bound to have impact on medium- and long-term development of exports and the entire economy. Therefore the issue of investments is high on the agenda.

### Prices slip down in May

Instead of the anticipated rise, in May prices slipped down by 0.1%. To a great extent it was caused by a vast scale of decline across various consumer groups dictated by price decrease for food, clothes and footwear. Competition brought down communication prices while health service prices continued to adjust to falling purchasing power. Under the influence of the shrinking construction market the prices of household furniture decreased too. At the same time, in several groups of goods prices did not change over the month (hotels, transport, and education). The vast fall of prices was not offset by the rise in housing price (heating), alcohol and tobacco, air fares, land transport, tourism and financial services.

In May 2010, year on year, prices had shed 2.3% and now are gradually moving towards inflationary levels. More conspicuously the largest share in the fall of the consumer price index belongs to the decrease of service prices (-5.6%). Prices for goods have fared better (-1.0%). Despite the drop in prices over the month, in annual terms the rate of the fall is decreasing. Deflation in Latvia is slowly retreating, which to a great extent is dictated by global processes. On the other hand, the falling domestic purchasing power will keep pressing the prices down. However, this trend and the influence of external factors can be curbed by the fluctuation under the impact of the debt crisis that may slow down the global rise of prices considerably. The prices will also be kept down by the vast austerity measures in the EU. The drop of consumer price index in May is not a sufficient reason to change the current trend of prices moving toward inflation. As a matter of fact, it has balanced the soaring of prices in the previous months. We can expect resumed rise of prices in the last months of 2010.

The climb of prices in Latvia in May has fallen out of the common Baltic context. In Lithuania and Estonia in May prices were going up. Until recently, prices in all the three Baltic states have been more or less similar. Estonia for some time already has been demonstrating the rise in consumer prices, which in May reached 3%. In Lithuania the prices started to grow in April reaching a 0.7% growth rate in May.



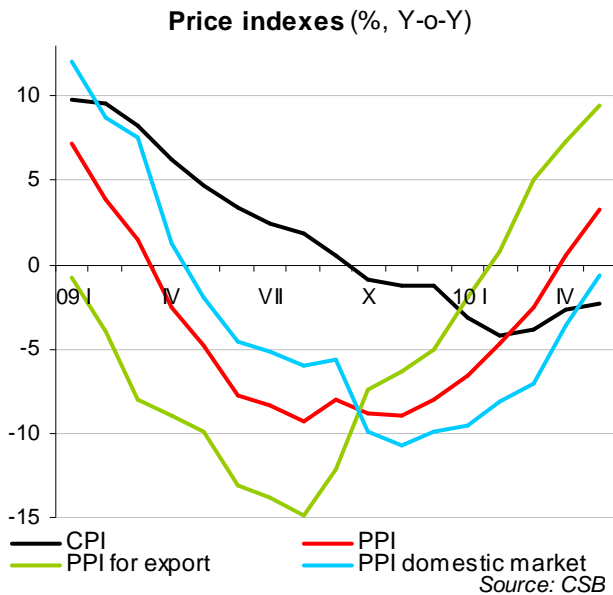
### Signal for consumer prices strengthens

Similarly to April, in May, too, producer prices rose significantly – by 1.8% over the month. The rise was more conspicuous in the prices of export products (3.1% up over the month), and less so in the products manufactured for the domestic market (par 0.9%). In

annual terms, producer prices for exported products have already grown at the rate of 9.4%, whereas in the domestic market in annual terms there is still a slight deflation of 0.6%, yet the trend is upward too. Thus in the nearest months the producer prices for the goods



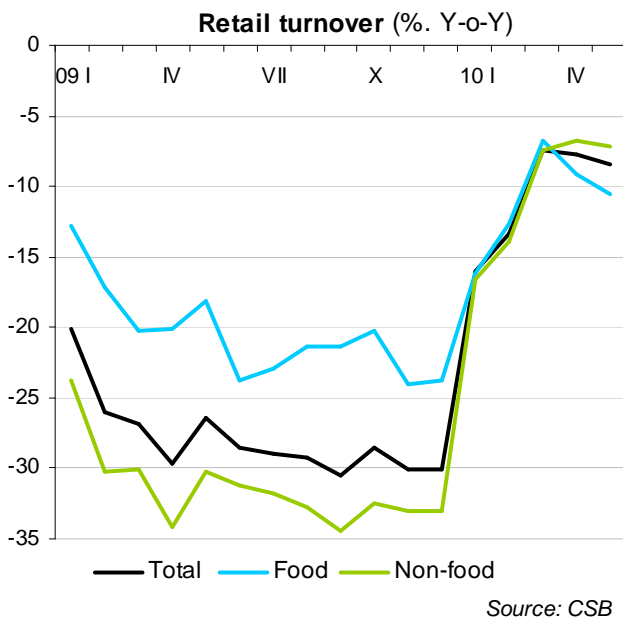
sold in the domestic market from minuses might climb into pluses. This growth will be partly calculated into consumer prices thus reducing their deflation.



Producer prices are pushed up by the rise of prices for resources and raw materials in the global markets and

**Consumption remains weak**

With the positive signs in the economy still being rather uncertain and unable to stop the momentum of decline, consumption keeps falling too.



by the world's economic recovery that allows producers to sell their products abroad for higher prices than at home. The manufacturers notice the rise of the raw material prices faster than the consumers; therefore this effect is sooner reflected in the producer price statistics. At present similar trends of rising producer prices are observed in the other Baltic states and the European Union, therefore there is no reason to worry about the competitiveness of Latvia's businesses declining under the influence of this factor. Weak growth in Latvia's main trade partner countries and the limited purchasing power in the domestic market will be the factors restricting the growth of producer prices at the same rate as in April and May. In annual terms producer prices will keep growing albeit at a slower rate and there probably will be months when the producer prices will not rise, but may even decrease.

Wages and salaries are shrinking while unemployment still at high levels. In May retail turnover, compared with April, according to seasonally adjusted data in comparable prices fell by 0.4%. Turnover of food products decreased by 0.9%, and of non-food products - by 0.2%. The decline certainly shows the persistent negative trend in retail trade. Nevertheless, the seasonal adjustment effect should also be taken into account. The overall retail trend in real prices is similar to those observed in the previous years when after relatively weak January and February data, starting from March turnover kept climbing up month by month.

The comparison of May 2009 and May 2010 shows that retail turnover has dropped by 8.4%. It has been aggravated by the decrease in fuel turnover, excluding which; the drop in turnover is 6.8%. Obviously, car trips are planned with greater care and petrol is rationed more strictly. In the nearest months retail turnover in annual terms will keep falling, yet this trend will stabilise. On the one hand, stabilisation



will happen due to the low base, the improving sentiment and contribution of the employees in the businesses showing increased activity. On the other hand, rapid improvements can hardly be expected. Consolidation of the state budget will continue bringing along changes in taxes, rise in tariffs and other costs. By the end of 2010, provided that the recovery continues, consumption might bottom out. It should be noted that retailers operating in the „gray market“ are also contributing to this decline. Crisis has made visible corrections in the habits of the population. People increasingly grow their own

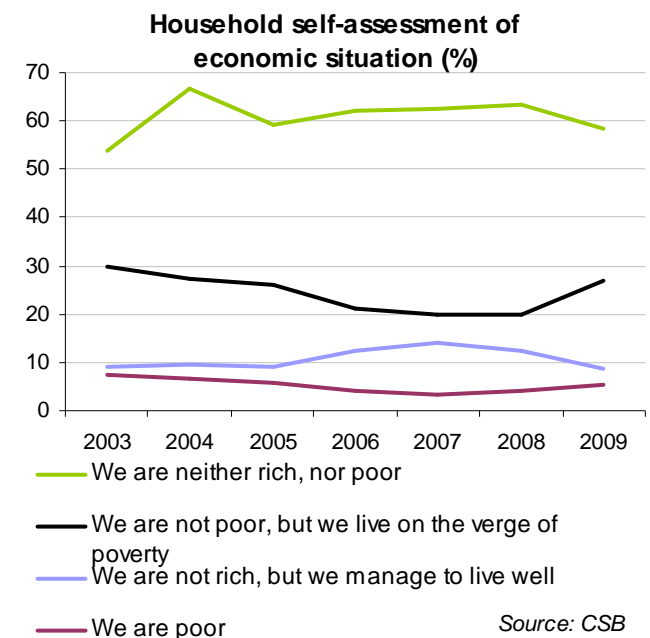
agricultural products and revise the necessity for new consumer goods. Therefore the corrections in retail turnover will continue also with regards to the demand structure. Consumers will give preference to practical purchases instead of luxury goods. Pricing policy and the retailers' ability to adjust to the consumers' purchasing power will be crucial. Crisis has not changed the consumers' needs and appetites and they will seek other ways to satisfy them by going on shopping trips to other countries or exploring the offers of internet shops.

**Household confidence reflects the scale of crisis**

Under the influence of the economic downturn the economic confidence of Latvia's households has deteriorated. The household budget survey conducted by the Central Statistical Bureau shows that in the 4th quarter of 2009 83% of households considered that their economic situation had declined, 15.2% responded that it had not changed and 1.8% told that it had improved. The greatest decline in household confidence was observed in Latgale where it is explained by the bigger drop in incomes (in Latgale wages in Q4 of 2009 dropped by 20% compared with 10% in Riga) and a bigger growth rate of unemployment. In the regions of Latvia economic deterioration was more pronounced than in Riga and it is reflected in the households' responses about the changes in their economic situation over the year.

The economic decline and falling incomes have considerably impaired the households' finances, for example, the number of the unemployed over the year has increased by more than 100 thousand, average wage in Q4 of 2009 shrunk by over 12% (in the regions even by 19-20%) compared with Q4 of 2008. Cutting of pensions and some benefits in 2009 cast a gloom on the general household confidence. Despite the fact that, in parallel with the drop of income, the prices went down too, the primary concern in the assessment of the economic situation by the population is, of course, decrease of incomes. The results of this survey confirm that in 2009 the public sentiment was affected by the abundance of negative information and the mood was pessimistic also in

those households whose income had not conspicuously decreased.



If we look at the changes taking place over several years, the household material confidence in 2009 can be compared with the situation in 2005 when more than 30% of respondents admitted that they were poor or close to the poverty threshold. 5.5% considered themselves poor, while 27.1% felt that they were approaching the poverty line. 8.8% of the population were satisfied with their economic situation although did not consider themselves rich whereas the majority of the respondents (58.6%) answered that they were neither rich nor poor. Actually, the assessment of the residents' financial



status in 2005 corresponds to the change of the GDP in Latvia: after the fall in the period of more than two years GDP will be approaching the level of 2005.



## 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	-2.0	I-III
GDP (mln EUR, at current prices)	4076	6047	3230	I-III
CPI (% yoy)	-2.3	0.7	3.0	V
Current account balance (mln EUR)	375	12.7	12.2	I-III
Current account balance (% of GDP)	9.2	0.2	0.4	I-III
Foreign direct investment flow (mln EUR)	-142	-12	240	I-III
Foreign direct investment stock (mln EUR)	8232	9692	11813	III
Foreign direct investment stock per capita (EUR)	3659	2911	8816	III
Foreign trade balance (mln EUR)	-396	-615	-207	I-IV
Foreign trade balance (% of GDP)	-7.9	-6.8	-6.1	I-III
Exports of goods (mln EUR)	1871	4259	2450	I-IV
Exports of goods (annual growth, % yoy)	19.1	17.2	23.0	I-IV
Imports of goods (mln EUR)	2267	4874	2657	I-IV
Imports of goods (annual growth, % yoy)	-0.1	21.8	13.3	I-IV
Industrial output (% yoy)	8.0	-0.8	18.4	LV; LT I-IV EE IV
Retail trade turnover (% yoy)	-10.7	-13.1	-5.0	LV; LT I-V EE V
Assets of commercial banks (mln EUR)	30630	25617	20240	V
Average weighted long-term annual interest rates on deposits in national currency in commercial banks (%)	5.8	4.4	2.9	V
Average weighted long-term annual interest rates on credits in national currency in commercial banks (%)	13.8	8.8	14.7	V
Average gross monthly wage (EUR)	613	589	758	I-III
Growth of average gross salary (% yoy)	-8.3	-7.4	-2.3	I-III
Official unemployment rate (%)	16.2	15.1	13.2	IV
Job-seekers rate (%)	20.4	18.1	19.8	I-III
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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