Macroeconomic Review of Latvia

August 2010

In Focus

- According to the flash estimate of the CSB, in the Q2 of 2010 GDP dropped by 3.0% year on year, whereas, in comparison with the previous quarter, it rose by 0.1%.
- In the first seven months of this year the state budget deficit amounted to ~2% of GDP or 238 million lati. There exists a possibility to close the year 2010 with a smaller budget deficit, although the approaching elections and anticipated increase in spending towards the year end will interfere with reduction of the deficit.
- The surplus in the current payment account in the first half of the year was 472.2 million lati or 48.7 million lati less than in the same period of 2009.
- In Q2 the number of travellers accommodated by hotels and other tourist establishments reached 320 thousand rising by 8.3% over the year.
- In the first half of 2010 the cargo turnover in the ports amounted to 30.9 million tonnes which is 4.3% less year on year, yet 4% more than in the second half of 2009.
- Passenger traffic at Riga International Airport is rising. In the first half of 2010 2.1 million passengers arrived at and departed from Riga Airport, which is a 15.1% increase year on year. In the same period, at Riga Passenger Sea Port 323.4 thousand passengers arrived and departed or 11% more than in the first half of 2009.
- The number of jobseekers in Q2 reached 19.4%, decreasing by one percentage point compared with Q1 of 2010.

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	-4.2	-18.0	-4.5*	I-VI	-1.7
GDP at current prices (mln LVL)	14780	16190	13080	2853	I-III	12550
Consumer prices index (% annual average)	10.1	15.4	3.5	-1.6	VII	-1.0
Fiscal deficit, surplus of the Government consolidated budget (ESA 95, % of GDP)	-0.4	-4.1	-9.0	-	-	-8.0
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	-59	VI	50
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	3857	VII	4300
Manufacturing output (% yoy)	-1.0	-8.3	-17.7	8.7	I-VI	6.5
Retail trade turnover (% yoy)	18.8	-8.2	-28.0	-7.7	I-VII	-5.0
Unemployment rate (%, end of period)	4.9	7.0	16.0	15.0	VIII	14.5
Job seekers rate (%, end of period)	5.3	9.9	19.7	19.4	IV-VI	17.5
Average gross salary growth (% yoy)	32.0	20.4	-3.9	-6.3	IV-VI	-4.5
Real wage and salary index (% yoy)	19.9	6.2	-5.6	-9.1	IV-VI	-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.*

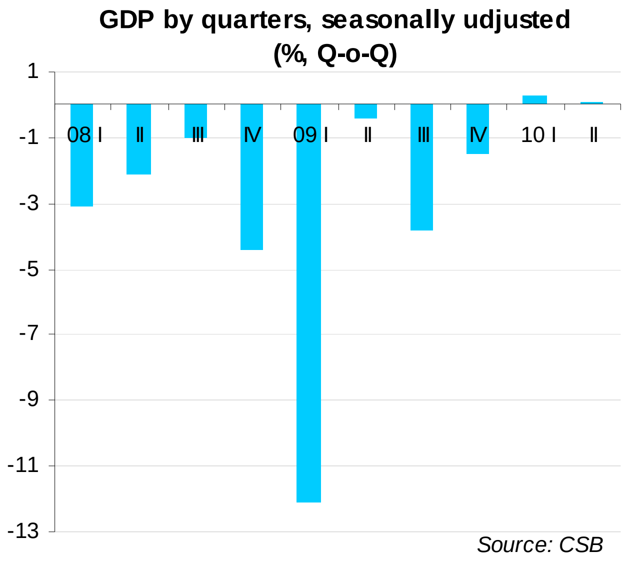
Growth continues

The flash estimate of the Central Statistical Bureau shows that in the second quarter of 2010 GDP in a year's time has dropped by 3%. There are positive symptoms in several - mostly export-oriented - sectors. Stable growth this year continues in manufacturing. However, it has not yet gained sufficient momentum to pull out the entire economy. Results remain weak in service industries due to feeble purchasing power. The biggest drop still is observed in construction.

In Q2, compared with the previous period, the economy, though at a slower pace than predicted, kept rising. The seasonally non-adjusted data show an increase of 13.4%, which after the seasonal adjustment is estimated to be only 0.1%.

According to the available data, both industry and retail trade are on the increase compared with the previous period. Other industries, too, are reporting positive changes and strengthening of hopeful trends. Nevertheless, the calculation made by the CSB does not support this observation; therefore the data may still be revised. The factors behind these trends will be identified when acquiring more precise data. It should be also remembered that the part of the economic activity hidden „in the shadows" does not appear in the statistics.

The second quarter of 2010 has registered continuation of the positive trends. And yet, the unconvincing performance makes us stick to our cautious forecasts for the coming periods. They will be greatly influenced by external factors, such as the debt crisis management in the euro area, the recovery of the global economy and the success of Latvia's export expansion. Notably, the optimism regarding the outlook of the leading economies has somewhat deflated lately while the forecasts have become less certain. Still, Latvia's economy has the basis for further movement towards growth.



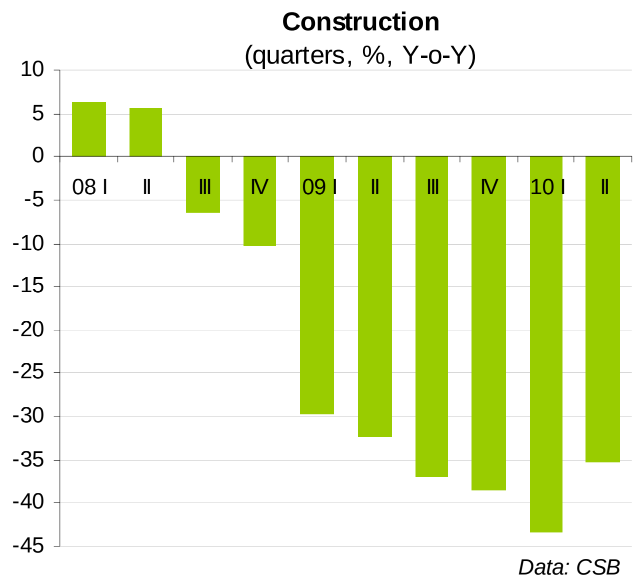
The rise will continue to be uneven; therefore it is crucial to keep the progress steady in order to prevent new imbalances and to solve the employment issue. The greatest activity will be seen in the export-oriented industries while the situation in the local market will remain difficult. In autumn there will be no visible improvements, yet the drop will slow down. In annual terms we should hardly expect positive results in Q3, they will appear in the last quarter of 2010. Although it can be said now that the economy has rebounded and will keep sending us positive signals, the population will not begin seeing the changes as yet. Greater certainty will come in a year with a clearer outline of the budget, taxes, the rise of wages and salaries and greater stability in the labour market. The biggest challenge now is long-term development as even small yet unstable growth threatens with stagnation in the labour market and continuing emigration of workforce.

Construction in deep trouble yet

The output of the construction industry keeps falling. In Q2, year on year, its decline reached 35.3%. Construction of buildings dropped by 36.7%, that of engineering structures – by 34.5%.

The comparison of Q1 and Q2 of 2010 shows that the volume of construction works has shrunk by 19.5%. Construction of buildings has fallen by 26.7%, whereas engineering structures are up by 7.7%. The rate of fall compared with Q1 indicates that construction was one of the main industries pulling down the aggregated GDP data.

Thus, the forecast that building of engineering structures would be the first to recover has come true. It shows the first results of reviving of economic activity and utilisation of the EU co-financing by the central and local governments.

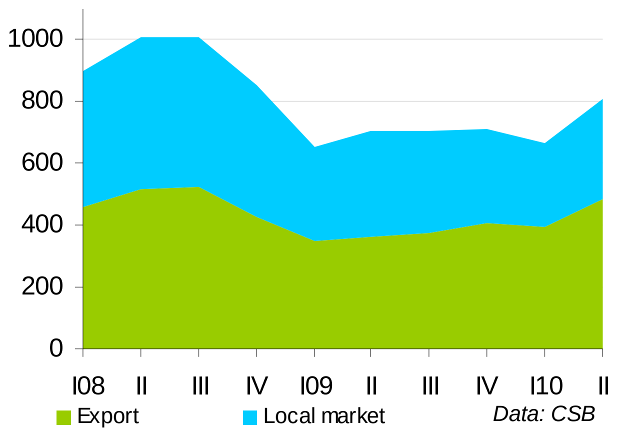


In 2010 the results in the industry generally will remain negative while in the engineering structures they might keep improving. It will happen due to the opportunities provided by the EU funding, the state and local government procurements and industrial commissions. Construction of buildings will stay comparatively low. The data may change drastically due to the low base and individual projects. The industry will be kept alive by state and local governments' procurements. Construction will be the last to exit recession and start recovering.

Manufacturing on the rise

In June, compared with May, turnover in manufacturing rose by 1.6%. Unusually, it happened on the account of the domestic market (+3.7%) while exports decreased (-0.6%). It does not mean though that the situation in export markets is deteriorating, but merely shows that growth is not going to be smooth and volatility is to be anticipated. For a few months already the growth rate in global manufacturing has been slowing down. This trend is observed in the world's biggest manufacturer China that has decided to close down its energy wasting plants in the attempt to economize on resources even despite the slowdown in growth brought about by this decision.

Manufacturing production turnover by quarters (thsd LVL)



In general, turnover in Q2 rose by 7.2% compared with Q1. It was mostly boosted by exports (+12.3%). Turnover grew in the domestic market too (+2.7%). In annual terms, in June manufacturing turnover grew by 10.1%: it rose by 28.7% in exports while in the domestic market it dropped by 2.5%.

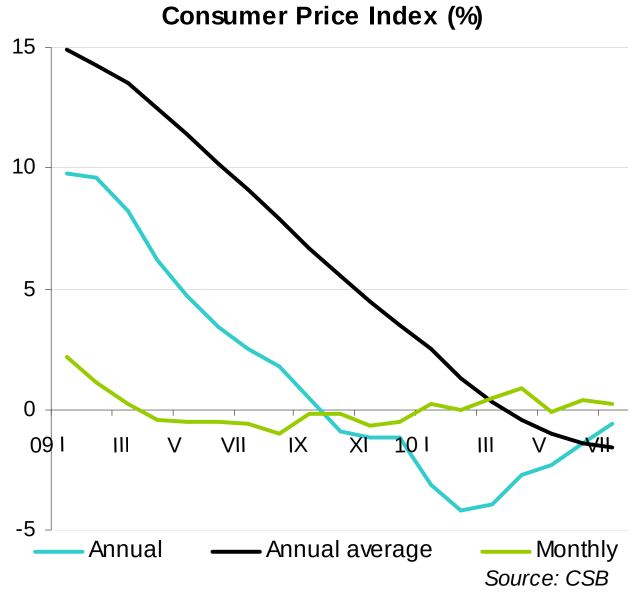
Currently we are going through a phase of improvement in the domestic market compared with the previous period, although in annual terms the trend is still negative. The coming months already will see this trend reverse and the first small positive results will appear. Meanwhile the contribution of exports to manufacturing will keep growing. In Q2 it has already reached 60% of the total turnover. In the coming months turnover in manufacturing is most likely to keep growing supported by rising volumes and prices. Stabilisation of the situation in the domestic market will also help. Development of manufacturing is both capital- and time-consuming and does not promise immediate returns. Therefore, the low investment level is a continuing warning sign of the risks threatening long-term sustainability of the current growth.

Deflation period close to its end

In July prices kept rising. Over the month their level was up by 0.2%. It was the sum of small increments across the most groups of goods and the price changes were dictated by a great number of factors. Under the influence of external factors and taxes, in July prices grew for housing and transport and under the seasonal influence and after sales campaigns – also for food products. Due to the growing numbers of tourists and the hot summer, the tourist industry also managed to raise the prices. The sales of clothes and footwear brought down their prices. Weak purchasing power dictated price decreases for entertainment, while competition – for communications, which dropped over the month.

In annual terms we still observe the fall of prices, which is rapidly coming to the end. Annually, inflation may return already next month and by the end of the year it will have become quite strong.

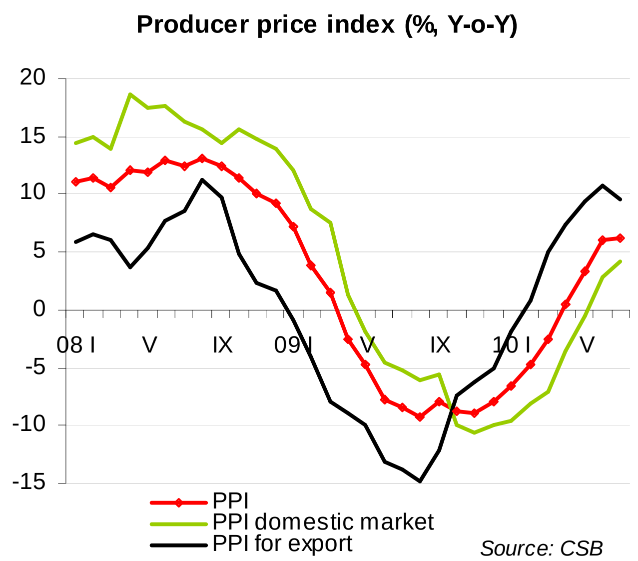
Currently the negative result is maintained only by the falling service prices, yet this fall is also slowing down. At present the external factors are determining the price increase of imported resources.



Yet this price increase may decline. In anticipation of more modest growth of the global economy these prices may even slightly drop. However, in Latvia's case the most important factor will be the terms of the agreements signed with the suppliers of energy (natural gas). The prices may also be affected by the imminent tax changes. It remains to be seen how the current price rise of natural gas and other resources will be reflected in the prices of various products and how much the consumer will be able to absorb. Good news for exporters, but not for consumers, is coming in respect of the food products. Most probably, they will go up in price, yet the amounts are hard to predict while there is no certainty about the available global reserves. The greater the turbulence, the steeper the rise of prices is expected. It should also be noted that the Asian economies have been growing and their swelling population is in need for more and more food.

Producer prices go up

Producer prices in July, compared with June, did not change after a steady climb of seven months. However, in annual terms, producer prices in industry have been rising for a fourth consecutive month already - in July 2010 producer prices were up by 6.2%, compared with July 2009. In the month's time the prices for goods sold in the local market rose by 0.4% and for export products dropped by 0.7%.
Over the year the prices for exported goods have risen by 9.5%. It is slightly less than in June when the prices climbed up by 10.8%. After the decline that continued for several years, in the local market, too, in June producer prices showed annualized growth of 2.9% that in July increased to 4.1%.
The growing producer prices will hold inflation under pressure which will gradually be reflected in consumer prices. As the uncertainty regarding the sustainability of economic growth in the euro zone and worldwide increases, the rise of producer prices in the global export markets of resources and raw materials may soon stabilise and even decrease.

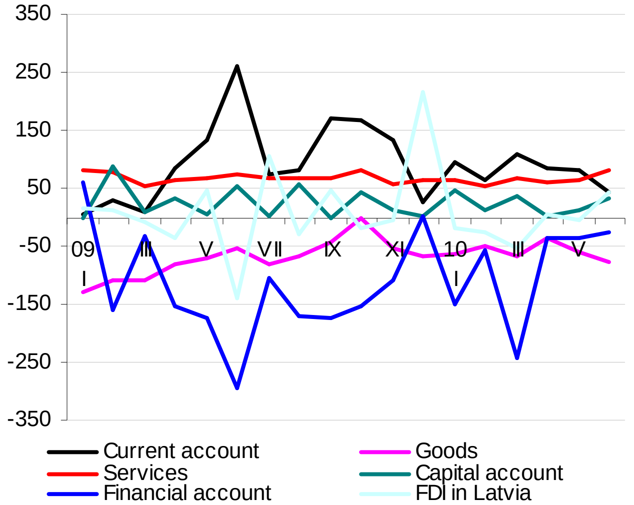


In the domestic market producer prices will be held down by the weak local demand.

Surplus shrinks

There is no volatility observed in the balance of payments and it develops according to the forecasts.

Balance of Payments (monthly data, mln lati)



The surplus in the current account (CA) is shrinking. In the first half of 2010 the negative balance of goods has decreased by 199 million lati, year on year. There is a tiny drop in the service balance surplus. However, export of goods and services in the first half-year has exceeded imports by 34 million lati whereas last year there still was a deficit of 136 million lati. The surplus of the income account is down by half, mostly due to the decreasing losses of the investment companies. The current transfers account shows the same surplus as last year reflecting the flows of EU funding and payments. The surplus on CA will slowly continue to decrease. The positive impact of the investment companies' losses on the CA surplus will gradually disappear, being more or less a formal improvement artificially inflating the size of the CA surplus. It is to be expected that revival of industry will bring about increase of imports and subsequent deterioration in the balance of goods. In the meantime the surplus in the CA will keep shrinking and quite possibly in the 2nd half of 2011 will become again negative.

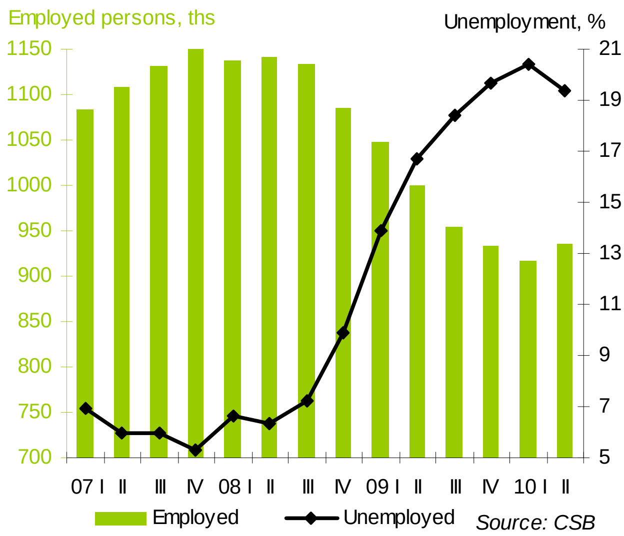
Unemployment – the burning issue

According to the results of the CSB survey, in Q2 of 2010 there were 225.8 thousand jobseekers in Latvia, which is 19.4% of the economically active population. During the quarter the unemployment level had dropped by one percentage point, yet it was 2.7 percentage points up, year on year.

The rise of economic activity reflected in the industrial data for the previous period has allowed unemployment to decrease a little. A great role belongs to the seasonal work, by the end of which unemployment may rise towards the level of Q1. Yet the unemployment „records" will hardly be broken. Nor can we expect fast improvements that will follow the general economic trend by a certain interval in time. Unemployment reached its peak in the first quarter of 2010 (20.4%), when the economy had bottomed out already and was starting to climb up again.

According to the statistical data, the number of long-term jobless has grown sharply – it has almost doubled (by 45.5 thousand) year on year. Besides, the number of experienced jobseekers is still very big.

Employment and unemployment



Source: CSB

Most probably, those are workers of the industries that experienced the most dramatic fall and will hardly take their employees back in the nearest future. A share of the unemployed comes from the public sector. Therefore a crucial role will be played by the employment policy and the active position of the government providing the opportunities of re-qualification and careers in other professions and setting new conditions for the labour market.

It should be noted that the number of economically non-active population is stabilising. It has grown by 4.1% year on year. In this group 44.1 thousand people can be viewed as potential jobseekers that have despaired of finding jobs or do not know where to look for them. It is a resource that can be counted upon and addressed before they begin to contemplate emigration. Compared with Q2 of 2009, the number of people who have lost their hope to find work has increased by less than a thousand only. Now contradictory trends are observed and in the coming years the situation is going to be paradoxical. As the economic growth gains strength, which may happen already next year, the unemployment issue will come to the foreground. Despite the economic recovery, unemployment will still be great, people will discuss emigration in various forums and the employers will complain of the shortage of workforce. This will go on for several years and the solution should be found in the reform of education and the ability to educate the population according to the needs of the economy.

Households spend less

The economic downturn is reflected also in the reduced expenses of households that in 2009, percentage-wise, were close to the decrease of GDP. The households had to cut their expenses predominantly because of the shrinking incomes, although in the pessimistic mood prevailing last year spending was likewise postponed by those people whose finances had not seriously suffered. The results of the household budget survey show that in 2009 the majority of Latvia's households revised their expense items and cut down on their essential necessities as well as other goods and services. Major reductions were made in purchases of durable goods, including household appliances, as well as clothes and footwear. In the same way, people less frequently go to restaurants and cafes as well as places of recreation and entertainment.

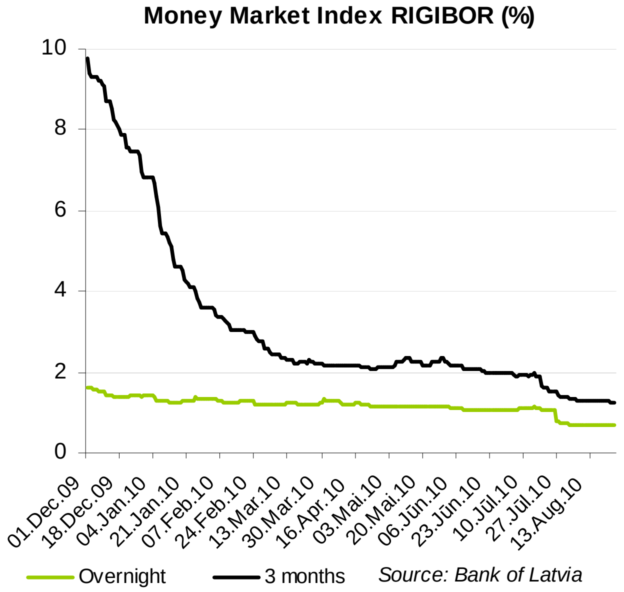
In the consumer spending structure the share of food products has increased from 25.6% in 2008 to 26.7% in 2009. There is a substantial rise in the housing costs: from 11.9% to 15.5%. The aggregate decrease of household expenses and the rising ratio of essential goods and services (food, housing, transport) is a classic picture of a falling standard of living. It should be noted that in Latvia the economic downturn has hit the economically active people hardest and loss of jobs and wage cuts have forced them to economize on their everyday needs while the economically passive part of the population, such as pensioners, did not lose their income so rapidly. Thus the household expenses of the retired people have stayed roughly at the level of 2008.

In 2010 the overall household costs in lati will keep decreasing further down from last year’s level, in some positions the reduction will be due to price decreases, in others - due to saving on goods and services. Even though in the first half of this year the household expenses of many residents of Latvia were lower year on year, due to the rising price of natural gas, and consequently – heating – in autumn household expenses will go up again. Thus the share of household costs in the total expense structure will be relatively big in 2010.

RIGIBOR record low

The decision made by the Bank of Latvia (BL) in July - to decrease the rates of commercial banks' deposits with the BL - have resulted in the still lower RIGIBOR rates in the money market.

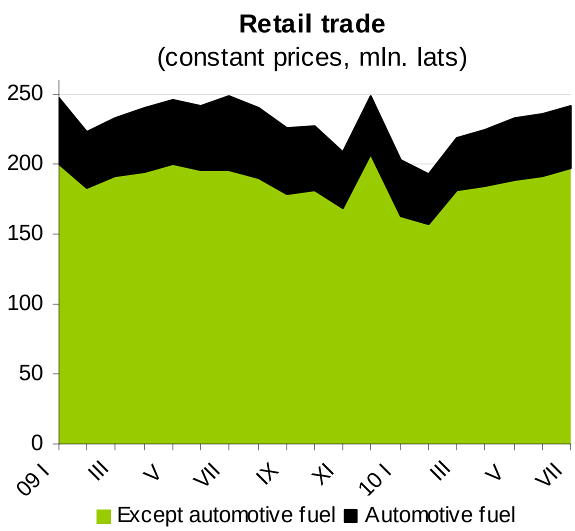
This year saw the increase of corporate and private deposits with commercial banks, which boosted their lati resources. On the other hand, the possibility to place these lati resources are limited. The supply greatly exceeds the demand therefore the RIGIBOR indices have dropped to historically lowest levels. The 3-month RIGIBOR rate has fallen to 1.25% and this record, too, may soon be broken. The 3-month RIGIBOR now is approximately 0.36 percentage points above the current EURIBOR rate. Historically this difference has been bigger and in the future it may grow again. In autumn RIGIBOR rates can be affected by the results of *Saeima* elections and the tumult caused by the consolidation of the state budget for 2011.



However, if we are spared big surprises, there will be no drastic changes in RIGIBOR and it might only slightly move away from the historically record low levels.

Consumption gaining confidence

In July the overall turnover of retail outlets decreased by 0.5%, while in annual terms the decrease is slowing down. Thus in July, year on year, retail turnover fell by 2% only. Major reduction of volumes was seen in non-food products (-2.2%), whereas the turnover of food products dropped by 1.8%.



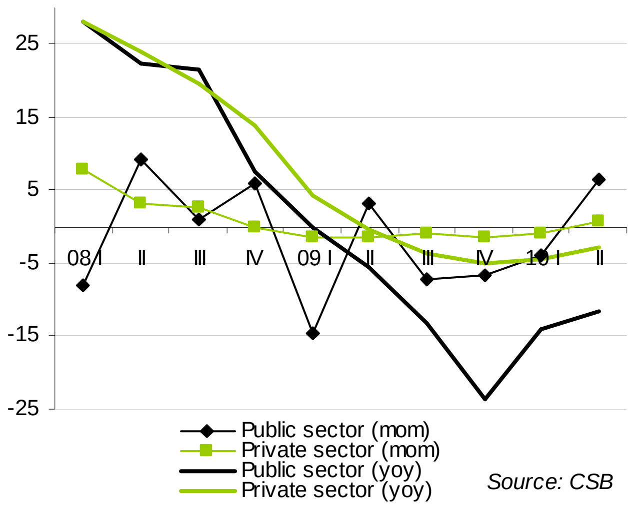
The data for the last months show a positive trend in consumption: it is gradually recovering and retail trade is doing not so badly, compared with some other industries. Nevertheless, the situation varies in different segments. For example, trade reflects the frozen state of construction by a 2.8% drop in the sales of building materials and plumbing goods. At the same time, some sectors are already picking up admirably: retail turnover of furniture, lighting fixtures and other household appliances has grown by 13.7%, while retail trade in non-specialised shops selling predominantly non-food products is up 8.8%.

The current fall in retail trade is due to the decrease in fuel consumption, which in July dropped unexpectedly low by 12.6%. Excluding petrol consumption, in July retail sales volumes in annual terms rose by 0.7%. Consumption is getting livelier and going up even despite the high unemployment and reduced incomes. The signs of economic recovery in the last two quarters that are not reflected by other indicators yet are appearing in consumption. Notably, the general economic environment has become more resolute, conditions clearer and the situation more stable, therefore people are becoming less cautious about spending their money. If the current trends in the economy persist, we might soon notice a slight rise in consumption. Good sales figures are expected for August. Nevertheless, towards the end of the year heating bills, budget consolidation measures and general sombre autumn mood will make their corrections in consumption trends that are difficult to predict at present.

Wages and salaries stabilising

In Q2 of 2010 average gross wage rose by 2.9%, compared with Q1. It was the effect of the gross salary changes in the public sector, including payment of occasional bonuses and pay rises, for example, in education. In the public sector Q2 brought pay rise by 6.4% on average, whereas in the private sector the rise was only by 0.6%. In annual terms gross wages and salaries are still falling – in Q2 they dropped by 6.3%, year on year. In the public sector this fall is even more conspicuous as the salary fund has been corrected mostly at the expense of salary cuts (-11.5%) as opposed to the private sector (-2.7%) where the salary fund was reduced mainly by slashing jobs. Gross salary is decreasing at a slower pace in annual terms and in some industries, such as agriculture, forestry, extraction and electric energy supply, there is even a small rise in wages and salaries observed. It shows that even in the situation of severe unemployment highly qualified workforce is scarce and wage cuts are hardly in order. So far Latvian businesses have improved their competitiveness by reducing the labour costs, yet this source of raising competitiveness has been exhausted and now the competitive edge must be sought in boosting of productivity. In annual terms, the percentage of decrease of wages and salaries in the next quarter will be smaller, and quite likely, in the last quarter of 2010 the private sector will show a slight increase in gross wages. Of course, the wage and salary trends will be different in different sectors of the economy. The export industries will do better in this respect.

Changes of wages (bruto, %)



Source: CSB

It should be noted that after the increase of the residents' income tax and reduction of the non-taxable minimum income at the beginning of 2010 net wages and salaries have suffered a bigger decrease (-11%), which shows that the real income of the population has shrunk much faster than gross wages and in the coming quarters will remain in the minuses. Net wages and salaries may go up in 2011 when we will see a small rise in gross wages and salaries and probably some changes in the size of non-taxable minimum income that will have a positive impact on net wage trends.

Baltic macroeconomic data

	Latvia LV	Lithuania LT	Estonia EE	Period
Population (mln)	2.25	3.33	1.34	2010 I
GDP growth (% yoy)	-3.0	1.3	3.5	IV-VI
GDP (mln EUR, at current prices)	4076	6047	3230	I-III
CPI (% yoy)	-0.6	1.9	2.9	VII
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)	-638	-816	-390	I-VI
Foreign trade balance (% of GDP)	-7.9	-6.8	-6.1	I-III
Exports of goods (mln EUR)	2940	7666	3818	I-VI
Exports of goods (annual growth, % yoy)	22.9	24.2	22.2	I-VI
Imports of goods (mln EUR)	3577	6850	4208	I-VI
Imports of goods (annual growth, % yoy)	8.3	23.7	19.7	I-VI
Industrial output (% yoy)	9.8	0.8	20.7	LV; LT I-VI EE VI
Retail trade turnover (% yoy)	-7.7	-11.8	-1.0	LV; LT I-VII EE VII
Assets of commercial banks (mln EUR)	30174	25673	20017	VII
Average weighted long-term annual interest rates on deposits in national currency in commercial banks (%)	5.1	3.2	2.2	VII
Average weighted long-term annual interest rates on credits in national currency in commercial banks (%)	13.6	12.9	11.9	VII
Average gross monthly wage (EUR)	634	596	822	VI-VI
Growth of average gross salary (% yoy)	-6.3	-5.4	1.2	VI-VI
Official unemployment rate (%)	15.3	15.3	11.7	VII
Job-seekers rate (%)	19.4	18.3	18.6	IV-VI
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.*