Macroeconomic Review of Latvia

October 2010

In Focus

- In the first 6 months GDP has dropped by 3.9%. Already in the 3rd quarter we can expect a slight growth in annual terms.
- September saw the end of deflation. Consumer price level over the year rose by 0.4%.
- Exports keep soaring and imports following. Next year the growth of exports is expected to slow down.
- Exports keep driving industrial growth. In the 8 months of 2010 industrial output has grown by 12.2%.
- After a long interval retail trade is rising. In September retail turnover was up by 6.1% in annual terms.
- Total losses of Latvia's banking sector in the nine months of 2010 amounted to 314 million lats, which was 45.7% less than in 2009. The balance of the total credit portfolio at the end of was 12.81 billion lats or 7.7% less than in the previous year.
- On 20 October under the international bail-out programme Latvia received another tranche of the EU loan in amount of 200 million euros. Latvia has already received 4.4 billion euros (from the IMF 1.1 billion euros, EC 2.9 billion euros).
- Last year, according to ESA95 methodology, state budget deficit was 10.2% of GDP instead of the previously reported 9%. The major changes in the data are due to the government investment in the share capital of Parex banka.
- Registered unemployment keeps falling for the seventh consecutive month. By 25 October it had dropped to 14.4% of economically active population.
- There was a surplus of 498 million lats in current account for the 8 months of 2010, which is 20.4% less year on year. The surplus will keep shrinking and may become negative in the second half of 2011.
- The Latvian ports in the nine months of this year have transhipped 45.5 million tons of cargo or 3.4% less year on year. Big improvements in the transit sector can hardly be expected. A lot will depend on the coming changes in the government and the country's policy in general.

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Latvia's key economic data and forecasts

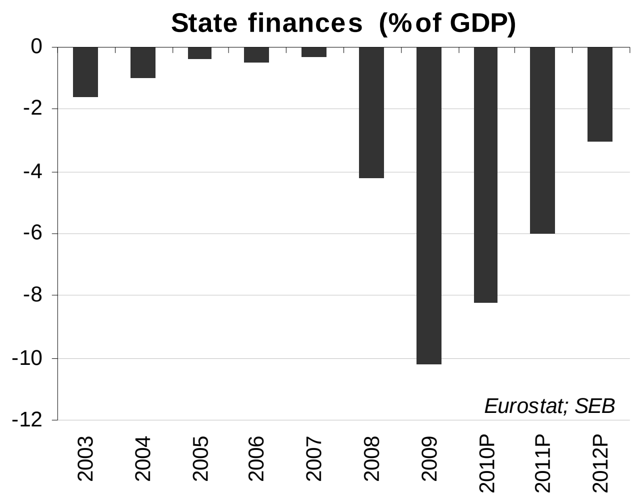
	2007	2008	2009	2010	Period	2010P
GDP growth (%)	10.0	-4.2	-18.0	-3.9	I-VI	-1.3
GDP at current prices (mln LVL)	14780	16190	13080	5996	I-VI	12550
Consumer prices index (% annual average)	10.1	15.4	3.5	-1.8	IX	-1.2
Fiscal deficit, surplus of the Government consolidated budget (ESA 95, % of GDP)	-0.4	-4.2	-10.2	-	-	-8.5
Current account balance (% of GDP)	-22.5	-12.6	9.4	7.2	I-VI	5.0
Foreign direct investment flow (mln LVL)	1193	607	36	30.9	VIII	50
Cumulative foreign direct investment (mln LVL)	5247	5711	5734	5947	VI	5970
Foreign trade balance (% of GDP)	-25.3	-19.0	-8.0	-7.4	I-VI	-10.0
Government foreign debt (mln LVL)	635	1260	3253	3976	IX	4300
Manufacturing output (% yoy)	-1.0	-8.3	-17.7	11.5	I-VIII	10.5
Retail trade turnover (% yoy)	18.8	-8.2	-28.0	-5.2	I-IX	-3.0
Unemployment rate (%, end of period)	4.9	7.0	16.0	14.6	IX	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.*

Last year's budget deficit bigger

The latest statistical data of the state finances show that the government budget deficit in 2009 according to ESA95 methodology has been bigger than reported in the April notification, meaning that the budget deficit last year reached 1340.5 million lats or 10.2% of GDP (earlier reported 9%), and the general government sector debt amounted to 4801.9 million lats or 36.7% of GDP (earlier reported 36.1%).

The budget deficit was influenced by several important factors. Firstly: revised and downward corrected deficit volumes. Secondly: reduced base, GDP in real prices down from 13244 million lats to 13083 million lats. Thirdly: substantial increase of the deficit due to the government investments into Parex banka's share capital. According to the crisis terminology this must be viewed as a regular expense and is added to the government expenditure.



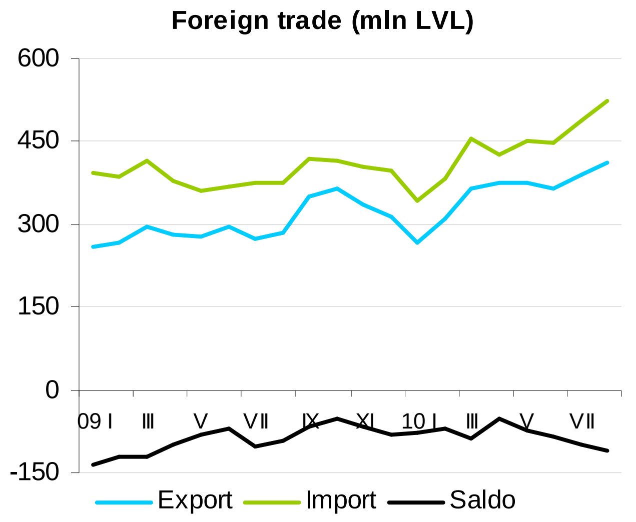
Consolidated total budget deficit for the 9 months of this year has reached 294 million lats. It may seem a fairly comfortable figure meeting the requirements of the international creditors that envisage deficit target

8.5% of GDP. Nevertheless, toward the end of the year government spending is sure to rise. There is a risk that deficit may exceed the allowed maximum level. It should be noted that this year, too, the government investments into the banks' share capital will be included into the government expenses. Next year the possibility of privatisation of the state banks or the necessity for additional investments may cause corrections of the necessary consolidation volumes. Therefore the privatisation issues of the state-owned banks must be addressed and the Ministry of Finance must strictly monitor spending. Clearly, reduction of the budget deficit according to the agreement will be more difficult job than it seems at present given the budget fulfilment and the pace of economic recovery. In further perspective it may affect the deadline set for introduction of the euro.

Exports soaring to new heights

Latvia's export volumes have soared to a new peak of 400 million lats. Latvia has attained the level it had reached in September and October, 2008, from which in the subsequent months it tumbled down to the very bottom. Already in August 2010 exports gained 44.2% or 126.3 million lats. It is a spectacular achievement, yet imports, too, have started growing faster. Thus in August, year on year, imports rose by 39.1% or 147.3 million lats. This leads to a slow increase of foreign trade balance deficit that in August reached 111.8 million lats. This deterioration of the foreign trade balance is making its adverse effect on GDP.

Exports have triggered the economy and will remain one of its chief driving forces. Now the situation is very favourable in terms of prices and the trends of foreign demand. Similar growth rates are observed in Lithuania and Estonia. Manufacturing industry is recovering and demanding input of raw materials and equipment imported from abroad. Consumption, too, is slowly picking up, unemployment is reluctantly decreasing while incomes are rising and will also make their impact on imports. Therefore it will be essential to keep control over the trade balance so that imports do not prevail over exports in an excessive and unhealthy way. An important role is and will be played by the energy policy that should be focussed on decreasing of energy imports that create the biggest deficit in the balance sheet.

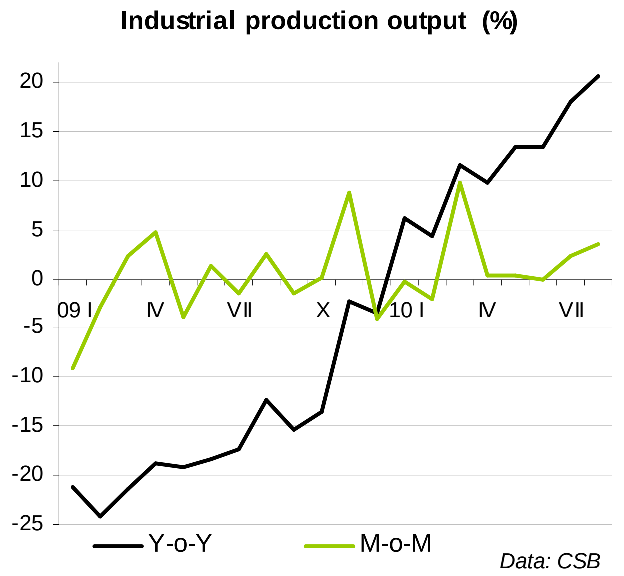


Source: CSB

Currently the manufacturing industry growth driven by the exports in Eastern Europe has matured, which may bring a possible slowdown in the nearest future. Latvia's main export market – the EU – is expected to grow rather moderately; therefore it is worth exploring other, faster growing markets. Latvia's manufacturing industries have almost reached the limit of their capacity. In the coming months, due to the base effect, exports will most probably continue to rise less impressive. Yet next year the growth rate will slow down together with the rise of prices and market vitalisation. In the longer perspective a lot will depend on the solution of such issues as capacities, new markets and product development. Even though the progress is good, the factors that ensure export growth, including market shares and competitiveness, must be closely monitored. The growth that is based on the price rise can be volatile and inconsistent. According to the data of the European Commission, Latvia in 2009 managed to raise its market share by 3.7%. Hopefully, also the raise of competitiveness and focusing on exports will bring their fruits to the economy.

Industry booms on

Industry shows a gratifying rate of growth. In August, year on year, industry rose by 20.5%, including manufacturing industry that gained 20.4%. The best results were observed in manufacturing of electric appliances (+76.7%), pharmaceuticals (+56%), metal products (+37%) and textiles (+34.8%). At the same time, manufacture and exports of furniture are still declining.



In the eight months of 2010 industry turnover has grown by 12.2%, including manufacturing industry – with 11.5% growth. Industry keeps recovering healthy thanks to the export opportunities. Competitiveness has lately improved yet it has been achieved mainly at the expense of wages and salaries. Now it must be boosted by rising productivity. Meanwhile the local market is slowly gaining strength and giving additional stimulus to industry development. As the growth of the EU economy is expected to be rather modest, we should follow the example set by the industrially developed countries and look in the direction of the emerging markets. Despite the attractive growth figures the share of the industry must still be raised until it is able to give a more substantial contribution to the general development and to reduction of unemployment. In 2010 industry is going to demonstrate robust growth. Next year may come with new issues, solution of which will affect further development. Such issues may include access to investments, development of existing and new capacities, tax policy, changes in competitiveness and wages as well as availability of the necessary workforce.

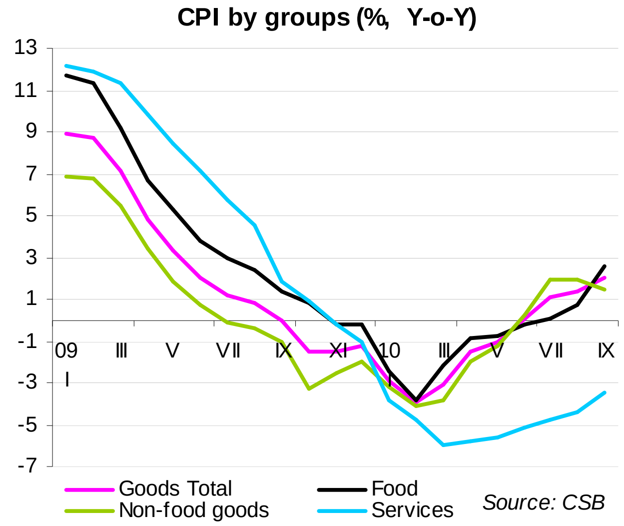
Inflation is back

Prices climb up again in Latvia. In September, for the first time in eleven consecutive months, the consumer price index rose, year on year.

As predicted, in September the prices over the month were up by 0.4%. This was mainly seen in the prices of goods (+0.6%), while the prices of services in September remained unchanged.

Quite surprisingly, the growth of prices was brought by the new autumn/winter collections of clothing and footwear in the shops. Hopefully, the new prices will be adequate to the consumers' purchasing power and the goods will not remain lying on the shelves. The growth of prices was also boosted by food products (cereals, bread, milk, eggs, cheese and vegetables). The prices are expected to go further up due to various factors of which the least predictable are rumours and speculations. According to the available information, the stocks and capacities are sufficient to avoid a new global food crisis. Therefore the population should not give in to panic, particularly if it arises in other countries. We should avoid artificial price increase in specific groups of goods, because they are often unjustified as it happened in respect of buckwheat, salt, vinegar etc. Prices still rise in education yet it is mostly due to the contracts signed in the previous years that will gradually expire. Over the month the prices of natural gas and heating have dropped.

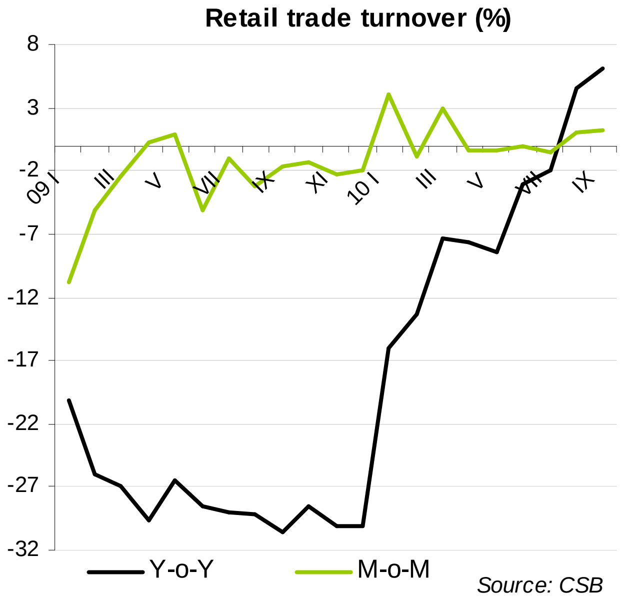
In September the prices in annual terms rose by 0.4%. Goods became 2% more expensive while service prices still remained deflated (-3.5%), but are slowly going up.



The Consumer Price Index is on the rise and this trend will persist. There is no reason to expect that the prices might soar. The inflation forecast is moderate yet it may be affected by internal and external factors. Big influence on the price level will be exerted by the possible changes in taxes (VAT, excise), growing electricity tariffs and revised prices for natural gas. Although incomes will rise slightly, purchasing power will stay weak yet to boost service prices. Nevertheless, as the economy continues to recover, the temptation to raise the prices, irrespective of weak spending, will be great. Inflation to a great extent will be imported under the influence of the global and regional trends of economic development and the prevailing public sentiments.

Retail trade in September

In September retail trade turnover grew by 1.2%. It was due to the 2% rise of non-food product sales while food product sales dropped by 0.2%.



In annual terms total retail turnover has shown vigorous growth by 6.1%. As usual, the growth was somewhat pulled down by the falling rate of fuel sales. Excluding those, the overall retail growth reached 7.7%. The brisk performance of retail against the general economic background makes one enquire into the reasons of this trend and its persistence. According to the statistics, the industry data are driven up by the rise in non-food products (+9.4%), while food product sales are still slightly down (-0.3%). The causes most probably should be looked for in the sentiments and subjective factors. The retail sales sentiment index, though slightly lower than in summer (June, July), is still optimistic enough and is back at the level reached at the beginning of 2008. It shows that the consumer has relaxed and is looking with greater hope into the future. Another explanation is that consumption has been cramped more than actual incomes and now it is slowly expanding back to normal. The rebound we are observing now is the result of last year's uncertainty. Retail trade also reflects the workings of the shadow economy, which launders its income in retail. Besides, the rumours about the returning inflation and the low yield on investments also make people visit the shopping centres. However, in future the development of the retail industry will depend to a great extent on the consumers' fairly unpredictable estimates of economic processes. They will be dictated by irrational factors. The anticipated rise of VAT may provoke people to make extra provisions which will be reflected in the peak retail results for some months. Despite the weak purchasing power that will improve quite slowly, in the coming months we can expect good results in retail trade. Food sales will grow and give their positive contribution to the rise in non-food retail trade. On the other hand, risks will still be looming next year and they may change moods and future outlook: the state budget consolidation and other factors, unknown yet, may weaken the current upturn.

Baltic macroeconomic data

	Latvia LV	Lithuania LT	Estonia EE	Period
Population (mln)	2.25	3.33	1.34	2010 I
GDP growth (% yoy)	-3.9	-0.4	0.3	I-VI
GDP (mln EUR, at current prices)	8566	12842	6822	I-VI
CPI (% yoy)	0.4	1.8	4.0	IX
Current account balance (mln EUR)	612	395	128	I-VI
Current account balance (% of GDP)	7.2	3.1	1.9	I-VI
Foreign direct investment flow (mln EUR)	-41	-5	578	I-VI
Foreign direct investment stock (mln EUR)	8461	9482	12029	VI
Foreign direct investment stock per capita (EUR)	3760	2847	8977	VI
Foreign trade balance (mln EUR)	-974	-1186	-483	I-VIII
Foreign trade balance (% of GDP)	-7.4	-6.4	-5.4	I-VI
Exports of goods (mln EUR)	4093	9595	5244	I-VIII
Exports of goods (annual growth, % yoy)	28.3	27.9	25.8	I-VIII
Imports of goods (mln EUR)	5067	10781	5727	I-VIII
Imports of goods (annual growth, % yoy)	15.7	27.3	21.5	I-VIII
Industrial output (% yoy)	12.2	2.5	22.8	LV; LT I-VIII EE VIII
Retail trade turnover (% yoy)	-5.2	-10.0	1.0	LV; LT I-IX EE IX
Assets of commercial banks (mln EUR)	30140	25583	19777	IX
Average weighted long-term annual interest rates on deposits in national currency in commercial banks (%)	4.7	3.8	2.5	IX
Average weighted long-term annual interest rates on credits in national currency in commercial banks (%)	11.4	9.7	9.8	IX
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 (%)	14.6	14.8	10.7	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.*