



Macroeconomic Review of Latvia

November 2010

In Focus

- The government has finished work at the next year's budget. Fiscal consolidation is envisaged in the amount of 290.7 million lats. Revenues are to be increased by 157 million lats and expenditure cut by 88.8 million lats. 44.9 million lats will be gained by not increasing contributions to Tier II pensions, which will be kept at the level of 2%. The changes planned in taxation will drive inflation up and make recovery of spending and economic growth more difficult. The budget of 2012 will have to be cut by 310 million lats. However, we expect further changes that will be introduced by international creditors.
- In the 3rd quarter of 2010 GDP in annual terms rose by 2.7% considerably exceeding the forecasts. If this trend persists in Q4 the fall of GDP this year could be close to zero.
- The current account (CA) of Latvia's balance of payments in the nine months of this year showed a surplus of 498.9 million lats or 126.8 lats (20.3%) less year on year. With the growth of imports and decreasing losses of investment companies the surplus in the CA will keep shrinking and by the second half of 2011 may become negative.
- In ten months the state budget deficit had reached 389.8 million lats.
- The losses of Latvia's commercial banks in ten months of 2010 amounted to 314 million lats or 50.7% less than for the same period of 2009.

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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	-0.3
GDP at current prices (mln LVL)	14780	16190	13080	5996	I-VI	12500
Consumer prices index (% annual average)	10.1	15.4	3.5	-1.6	X	-1.1
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	87	IX	120
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	4111	X	4300
Manufacturing output (% yoy)	-1.0	-8.3	-17.7	13	I-IX	11.5
Retail trade turnover (% yoy)	18.8	-8.2	-28.0	-4.2	I-X	-3.0
Unemployment rate (% , end of period)	4.9	7.0	16.0	14.3	X	13.8
Job seekers rate (% , end of period)	5.3	9.9	19.7	18.0	VII-IX	17.5
Average gross salary growth (% yoy)	32.0	20.4	-3.9	-1.9	VII-IX	-4.5
Real wage and salary index (% yoy)	19.9	6.2	-5.6	-4.9	VII-IX	-7.0
Standard & Poor's long-term credit rating	BBB+	BBB-	BB	BB	-	-

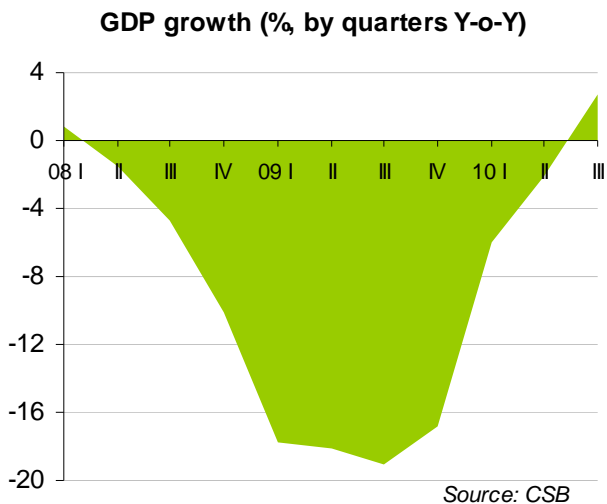
* Provisional data. Sources: Central Statistical Bureau of Latvia, the Bank of Latvia. SEB banka's forecasts.

Economy ahead of forecasts

The economy is exceeding the forecasts. In the 3rd quarter GDP has gained 0.8% compared with Q2, and after the fall that continued for nine quarters it is on the rise again in annual terms. In Q3, year on year, GDP was 2.7% up.

The result is surprisingly good and also quite logical. The economic recovery that began in the first months of 2010 is going on. In the first two quarters the rise of economic activity, compared with the previous periods, was mostly due to the industrial growth driven by exports. However, its volume and ratio was too weak to lift GDP up in annual terms. Q3 saw a stronger recovery of spending that gave a decisive push to the economy. Exports in September showed equally impressive progress. These trends are reflected also in the sentiment indicators for some industries. It should be noted that the base effect, too, has a significant role as in Q3 of 2009 the drop of GDP

was worse than predicted. Thus for the source of current economic growth we have to look back at the last year's elections and the subsequent wrangling over the state budget that brought about uncertainty and cast gloom over economic activity, public sentiment and consumption. In the coming quarters consumption is likely to show a good growth rate, which will be reflected in a healthy rise of GDP in Q4. Nevertheless, we still have to question the sustainability of growth in medium term and its driving forces. The economy will be greatly affected by the processes of budget consolidation and their influence on spending. Next year, provided that political stability is preserved, the country's rating will be upgraded. It will be an important precondition for attracting of investments.



The volatility of the external environment and its risky future prospects also has to be considered. Therefore the current data should be taken with a grain of salt. Excessive optimism and underrating of risks may be fatal for long-term development. The trends in the global economy and particularly in the euro area as well as in other EU member states that are significant Latvia's export markets will have their say in our economy.

Taxes will rise

The government is toiling away at the budget for 2011. The total amount of fiscal consolidation is 290.7 million lats. Revenues are to be raised by 157 million lats, expenditure cut by 88.8 million lats, and 44.9 million lats are planned to be obtained additionally by keeping contributions to Tier 2 pensions at the level of 2%.

The proposed budget consolidation measures for 2011 cannot be straightforwardly assessed. Only one third of the consolidated amount is to be gained by cutting expenses while the biggest part is expected to come from raising of taxes. The reason behind this situation is „the red lines” drawn in the pre-election period that lie in the way of drastic reforms and slashing of social, health care, education and public administration budgets.

The government must be prepared that some of its measures may bring smaller results than planned (e.g. the amounts gained from the company vehicle tax and motorcycles). A positive decision is the increase of the non-taxable minimum (from 35 to 45 lats) and dependents' relief from 63 to 70 lats. At the same time the decrease of the residents' income tax from 26% to 25% together with the rise of employers' social insurance contributions from 9% to 11% does not alleviate the tax burden of the workforce, although such alleviation is badly needed in order to encourage the employers to create new jobs.

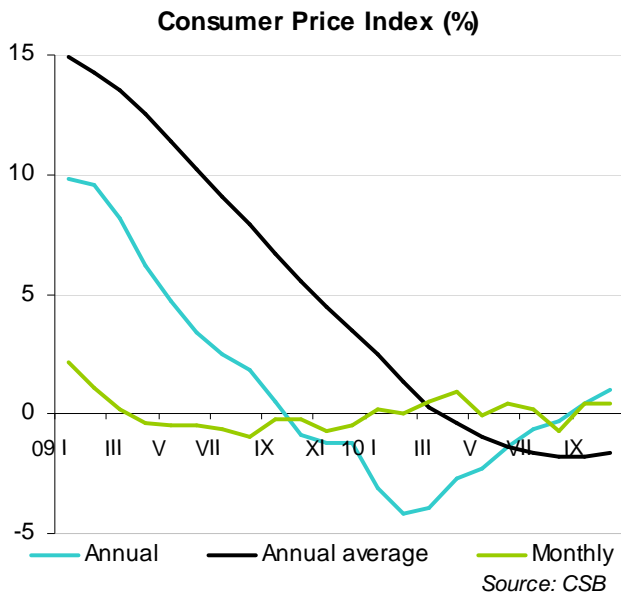
The tax increase will not draw the businesses out of the gray economy. Rather the reverse may happen and hence the question: how tough the government will be in suppressing the growth of the gray economy.

The planned tax changes will influence different groups of the population in different ways: some will be affected more, some less. The incomes of small earners will slightly increase whereas the net incomes of those earning more will drop. Thus the small income group will receive a tiny compensation for the rise of prices due to bigger VAT rates.

The increase of the VAT rate and the housing tax rate is the opportunity to collect taxes from those who hide their real incomes. Therefore, instead of raising the social tax it would probably be wiser to raise the housing tax more drastically by retaining the principle of progressiveness. The doubling of the housing tax will be mostly felt by the owners of bigger and more expensive residences whereas for those living in modest circumstances it would mean an extra expense of 5-10 lats a year. Therefore this housing tax will not be decisive in people's plans to take housing loans. These decisions will depend on the general economic trends, the changes in people's incomes and expenses, their sentiments and future outlook.

Inflation of prices for goods

In October the course of inflation was determined by the rising prices for goods (0.6%) while service prices dropped (-0.3%) thus resulting in average price rise by 0.4%.



Consumer price changes in October were mostly due to more expensive food products that have given the biggest contribution to the price rise (+1%). The impact of non-food goods was smaller: only 0.3%. The decisive factor was the rise of footwear and clothes' prices as the new collections appeared in the shops as well as more expensive home furnishings that probably reflect the slight revival of spending in this segment. Inflation was curbed a bit by the falling prices of thermal energy.

In October average price level continued to rise also in annual terms gaining 1.0% year on year. Prices for goods rose by 2.6%, whereas prices for services were 3.2% down.

Consumer prices have embarked on their upward climb already since the beginning of 2010 and this trend will persist, albeit moderately. There may occur

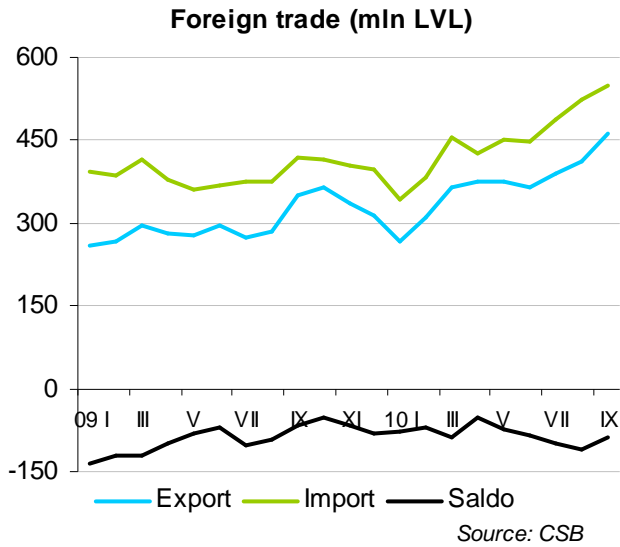
Exports at new heights

Similarly to GDP data for Q3, foreign trade also pleasantly surprises. In September Latvia's export volumes have reached a new and dizzy peak of 460.7 million lats, which is 30.7% more than in the same

some price shocks in certain groups of goods, but their influence on the general price level will not be significant. At the same time, there are factors that will continue to drive inflation and cause great uncertainty about its prospects. A great role will be played by the leading global economies and fluctuation of their currencies. At present high inflation expectancy is observed in the developed countries due to the monetary policy pursued and resulting speculations. The monetary policy of the USA is exerting additional pressure on raw material prices and creating inflation threat in the fast-growing economies. Another important factor will be the progress of those fastest growing economies (Brazil, Russia, China, and India). These states will determine further rise of demand and consequently price trends. Yet they will not be able to offset the drop of demand in the developed countries, hence there is no reason to expect a sharp general leap of prices. However, in some product (raw material) groups the prices may rise quite swiftly depending on the changes of demand.

Irrespective of the external factors, domestic influences, too, will be of great importance. The largest price rise will be observed in the food product group. Prices will be greatly affected by the tax changes (VAT, excise etc.). The recovery of the national economy also will push the prices up. It cannot be excluded that the expectation of tax rise and other processes may exert additional influence on the price rise. The year 2011 will see price corrections due to the rising price of electric energy that has a significant share in the consumer basket. It is hard to predict the indirect impact of growth on the prices of goods and services. Therefore the current forecasts are quite uncertain, considering various development scenarios and a wide range of possibilities.

period of 2009. Imports, too, have risen to 547.5 million lats (+30.3%).



The robust export data reflect the consecutive expansion of the Latvian companies into the foreign markets. However, the impressive growth figures could hardly be achieved only by exports of local goods. A large share in the rise of export volumes belongs to re-exports. For example, the turnover in the foreign trade balance is improved by Incukalna natural gas storage facility that at certain periods both increase imports and improve export volumes. In the same way, imports and exports of traffic and aircraft

demonstrate active transit flow of goods through Latvia. Therefore exports are closely followed by imports reflecting recovery of private spending and rising activity of the industrial sector. In September the deficit in the balance of payments decreased to 86.9 million lats.

In general the nine months' balance of goods shows the deficit of 764 million lats. This negative balance has been created by more than 70% of groups of goods whose total negative balance amounts to 1.66 billion lats. The biggest negative balance is shown by energy resources (-447 mln lats), electric goods (-125.4 mln lats), mechanisms and mechanical appliances (-111.4 mln lats), plastic and plastic goods (-104 mln lats). The greatest contribution to reduction of this deficit is provided by the positive balance of wood industry (+597 mln lats) covering approximately 36% of this deficit. It is followed by the balance of cereals trade showing the surplus of 54 mln lats. It must be concluded that the current rise in exports is determined by the positive trends in foreign markets, price rise and re-exports. In the longer perspective the export growth will slow down under the influence of stabilising prices and the anticipated consolidation measures in the EU, e.g., in the UK.

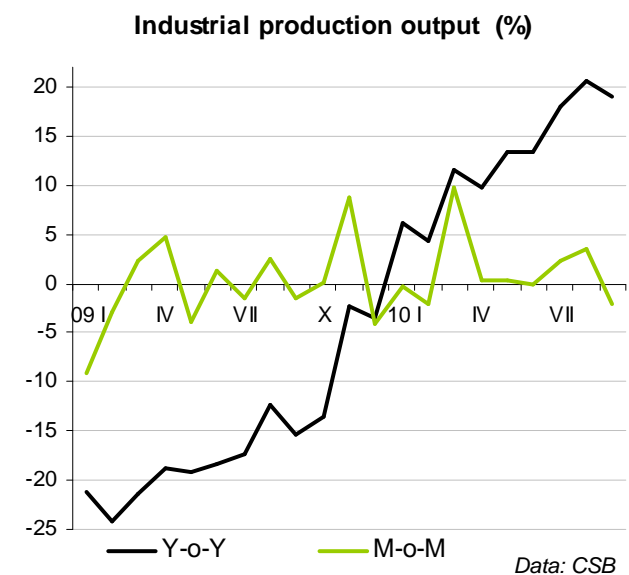
In September the pace slackens

Compared with August 2010, in September the industrial output fell by 2.1%. Manufacturing industry volumes decreased by 1.7%, while electric energy and natural gas supply was down by 4.7%. The drop of manufacturing volumes was caused by the plummeting pharmaceuticals output -50% down, electrical equipment -15% down, and wood industry output (-2.3%).

However, compared with September 2009, industrial output rose by substantial 19% including manufacturing that gained 19.7%.

Currently industry keeps growing mostly thanks to exports. Meanwhile the local market also is beginning to support it. Latvia has raised competitiveness of its exports, which allows it to strengthen both its export potential and industrial output. However, the same trends of expansion are observed in most countries of

the region. In the eurozone manufacturing activity in October exceeded the forecasts.



This gives reason to expect that the fast growth of industry in Latvia this year will continue. In 2011 it will keep growing, yet the pace will be slower. The growth will invariably depend on investment friendliness and stability of macroeconomic environment and taxation system. The results of financial austerity measures and upgrading of the country's rating, too, will be crucial. Therefore the biggest risk lies in the ability to sustain the expansion

and capacity development in the long term. It is easier to raise the volumes by falling into the general trend, yet the fast growth of global industry may decline and then the development will have to be maintained at the competitors' expense.

The input of the industrial sector is the main driving force of economic recovery in Latvia and elsewhere. In Q3, year on year, industry has grown by 19.4%.

Jobs less scarce

According to the survey data of the CSB the number of the employed is growing and unemployment decreasing.



In Q3 of 2010 the share of jobseekers among the economically active population was 18% or 1.4 percentage points less than in Q2 and 0.4 percentage points less than in Q3 of 2009. The number of jobseekers has decreased to 210.2 thousand. This reduction has not happened only at the expense of emigration. Therefore it is another sign of economic stabilisation.

In Q3 of 2010 the number of the employed population rose by 24.5 thousand to 960.4 thousand or 6.5 thousand more, year on year. From the lowest point at the beginning of 2010 the number of the employed has

climbed up by slightly more than 40 thousand indicating some improvements in the labour market.

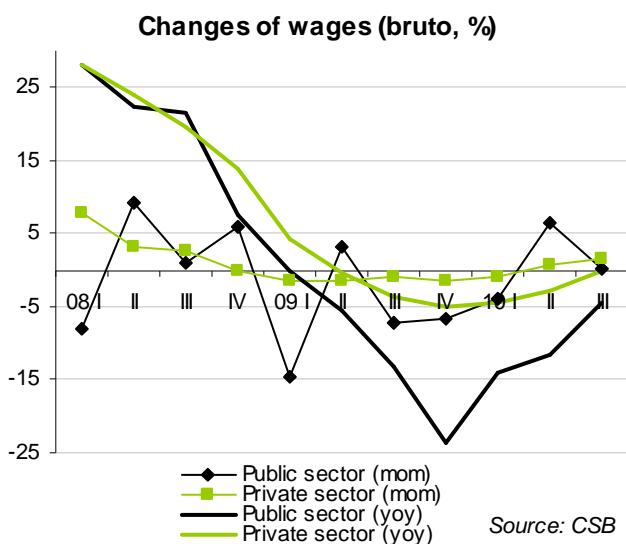
Nevertheless, the economic recovery is a slow process and next year it is hardly going to accelerate so as to create tens of thousands of new jobs. Of course, the number of the unemployed will continue to shrink and new jobs will appear, yet, compared with the pre-recession period, the unemployment level in Latvia will stay comparatively high.

The unemployment issues will remain on top of the agenda, particularly in the situation when the number of long-term unemployed keeps growing. 97.9 thousand or 46.6% of the total number of the jobless are long-term unemployed, of which 36.7 thousand have been out of work for more than two years. There is another relatively big number (47.4 thousand) of those who have despaired of the hope to find a job and are not accounted for as jobseekers, although part of them would be willing to work. The reserve is big enough and the worries about the disastrous lack of workforce in the near future are somewhat exaggerated. Yet there is another serious problem: that of structural unemployment. Prolonged stay out of work poises a threat of losing knowledge and skills which means higher barriers and expenses in reintroducing these people into the labour market. From the point of view of the country's economic development, the long-term unemployed should be motivated by the state to acquire new professions, upgrade their skills and join the workforce. It could be achieved by state-subsidised jobs and tax relief instruments, particularly in the regions with the highest unemployment.



Shrinking of wages stops

The statistical data show that the employees' wages and salaries have stopped shrinking further. In Q3 average gross wage rose by 0.8%: in the private sector – by 1.6%, and in the public sector – by 0.1%. Year on year, the rate of decrease of wages and salaries has dropped by 1.9%, besides, over the year in the public sector it fell by 4.5% and in the private sector - only by 0.1%.



The companies are gradually returning to their incentive schemes and in future they will more closely link the employees' salaries to the business performance thus increasing the share of this component in the total labour cost. It is confirmed by the results of Q3 when in electricity, natural gas, thermal energy supply and air conditioning industries wages rose by 15.7% compared with Q2 due to bonus payments for the previous year's results.

The rise of gross wages in annual terms is already observed in manufacturing industry, agriculture and forestry. These industries are growing thanks to exports. Henceforth we will see different trends in comparison of various businesses. In some industries wages and salaries will go up while in others the average wage will not rise. As a matter of fact, Latvia is 2 – 3 quarters of a year behind Estonia where a small annualised rise of wages has been registered for two quarters already. In Latvia, too, average gross wage may show some increase already in the last quarter of this year or in Q1 of 2011. Next year the pay rises will not be big and, given the tax changes and return of inflation, the real wage will grow slower.

Spending stabilises

Retail turnover in October (seasonally adjusted data in constant prices) dropped by 1.7% compared with September.

Non-food product sales decreased by 2.4%, and food product sales stabilised – over the month they dropped by 0.3%. The total turnover figure is pulled down by the motor fuel sales that over the month fell by 5% compared with the previous month. The general situation in retail trade now can be characterised as stabilising after last year's plummet.

Despite the shrinking of volumes, in annual terms retail turnover has been bigger than in the same period of 2009. The total rise by 4.9% has mostly been achieved at the expense of non-food products (in these groups the volumes have grown by 7.6%). The turnover in the food product group was 0.4 % less

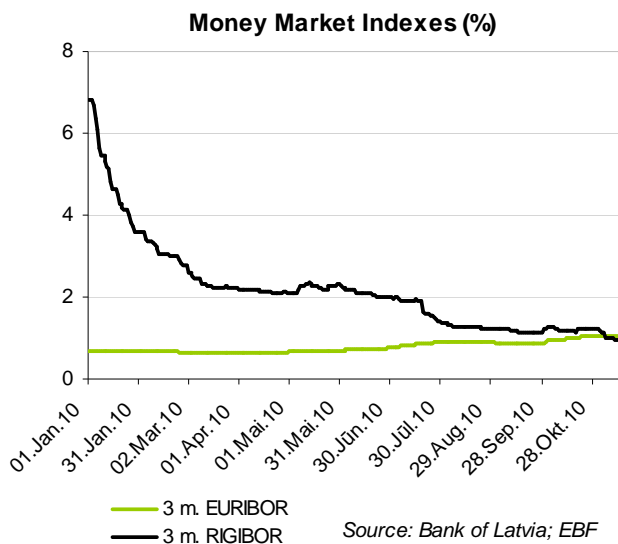
than in October 2009. Besides, excluding petrol retail trade results, in non-food products segment the rise by 13.6% compared with the previous year has been registered. In the trade of motor fuel the work-day adjusted data in comparable prices show a drop of 6% that can be explained by the rise of fuel prices over the year (the population cannot afford to buy more expensive petrol) and by the relatively big share of smuggled petrol that undermine the legal petrol trade.

The last months of 2010 will see good pluses in retail trade in annual terms due to comparatively low base of the previous year and bigger spending in anticipation of bigger VAT rates in 2011. As the base effect disappears, we will see a moderate rise in retail volumes next year.



RIGIBOR slips under EURIBOR

There is still a large surplus of lats in the money market. Commercial banks have deposited one billion of lats with the Bank of Latvia (BL) and the demand for lats remains low.



The BL at the beginning of November decided to decrease its interest rates for the banks' overnight lats deposits from 0.375% to 0.25%, and for seven days' deposits - from 0.5% to 0.375%. With this measure the Central Bank tries to divert this surplus liquidity into

crediting. The previous BL decisions to decrease its deposit interest rates have not had any visible influence judging from the commercial banks' rising deposit volumes with the BL. Obviously, this measure has not been effective as the demand for credits remains weak, and both companies and individuals prefer to borrow loans in euros. One of the obvious reasons of not borrowing in lats is a precaution against the huge RIGIBOR fluctuations over the last years and the comparatively high lat credit rates that make people doubtful if the rates will remain low in the foreseeable future.

After the BL's decision to decrease the rates of the commercial banks' deposits with the Central Bank the lat rates kept falling to new record low levels. At the end of November the 3-month RIGIBOR rate dropped to 0.82% rate slipping under the 3-month EURIBOR, which is not typical as historically RIGIBOR has almost always stood above the EURIBOR rate. If the current *status quo* stays in place and the demand for lats and their spending opportunities do not materially improve, the lats rates will remain below EURIBOR.



Baltic macroeconomic data

	Latvia LV	Lithuania LT	Estonia EE	Period
Population (mln)	2.25	3.33	1.34	2010 I
GDP growth (% yoy)	2.7	1.1	4.7	VII-IX
GDP (mln EUR, at current prices)	8566	12842	6822	I-VI
CPI (% yoy)	1.0	2.7	4.7	X
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)	-1092	-1412	-476	I-IX
Foreign trade balance (% of GDP)	-7.4	-6.4	-5.4	I-VI
Exports of goods (mln EUR)	4756	11031	6110	I-IX
Exports of goods (annual growth, % yoy)	28.7	28.4	28.1	I-IX
Imports of goods (mln EUR)	5848	12443	6586	I-IX
Imports of goods (annual growth, % yoy)	17.4	28.8	23.1	I-IX
Industrial output (% yoy)	13.0	3.1	31.1	LV; LT I-IX EE IX
Retail trade turnover (% yoy)	-4.2	-9.0	1.0	LV; LT I-X EE X
Assets of commercial banks (mln EUR)	30284	25335	19728	X
Average weighted long-term annual interest rates on deposits in national currency in commercial banks (%)	3.8	3.7	2.4	X
Average weighted long-term annual interest rates on credits in national currency in commercial banks (%)	9.8	6.8	10.0	X
Average gross monthly wage (EUR)	639	604	759	VII-IX
Growth of average gross salary (% yoy)	-1.9	-2.8	0.9	VII-IX
Official unemployment rate (%)	14.3	14.2	10.4	X
Job-seekers rate (%)	18.0	17.8	15.5	VII-IX
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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