

THE NATIONAL ECONOMY OF LATVIA: A MACROECONOMIC REVIEW

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of the Baltic States*



Latvia: 2008

Territory, thsd km ²	64.6
Population (as of 01.07.2008, thsds)	2 266
of which:	
Urban area	1 538
of which Riga, the capital city	715
Rural area	728
National currency: lats (LVL)	

Key indicators of economic development

	2004	2005	2006	2007	2008 f
(increase over the previous year, in per cent)					
Gross domestic product	8.7	10.6	12.2	10.3	0.2
Consumer prices	6.2	6.7	6.5	10.1	15.8
(% of GDP)					
Central government sector deficit or surplus	-1.0	-0.4	-0.2	-0.1	0.1
Central government debt	14.9	12.4	10.7	9.5	8.5
Current account balance	-12.8	-12.5	-22.5	-23.8	-15.0
Exchange rate, LVL per US dollar	0.540	0.565	0.560	0.514	0.460
Exchange rate, LVL per euro	0.671	0.703	0.703	0.703	0.703
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	10.4	8.7	6.8	6.0	6.5

	2006				2007				2008	
	I	II	III	IV	I	II	III	IV	I	II
(increase over the corresponding period of the previous year, in per cent)										
Gross domestic product	12.9	11.7	12.5	11.9	11.3	11.0	10.9	8.1	3.3	0.1
Consumer prices	7.0	6.3	6.6	6.3	7.6	8.6	10.3	13.7	16.4	17.7
(% of GDP)										
Central government sector deficit or surplus	1.4	2.5	4.1	-7.4	3.0	4.1	3.0	-8.2	0.8	-1.3
Current account balance	-16.1	-19.4	-24.9	-27.2	-26.4	-24.9	-25.8	-19.3	-18.3	-15.6
Exchange rate, LVL per US dollar	0.585	0.560	0.551	0.546	0.536	0.522	0.512	0.485	0.470	0.450
Exchange rate, LVL per euro	0.703	0.703	0.703	0.703	0.703	0.703	0.703	0.703	0.703	0.703
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	7.8	7.2	6.2	6.1	6.9	6.0	5.9	5.3	6.5	6.3

f - forecast of the Ministry of Economics

Economic policy

Reforms done in the previous decade have strengthened private sector. Private initiative and capital enlargement are the main driving forces for development. Protection of foreign investment is guaranteed by the law, non-residents can repatriate profit and capital freely and equal terms are provided to domestic and foreign entrepreneurs. The Bank of Latvia implements *de facto* the policy of the fixed exchange rate of the national currency. This reduces uncertainty, averts the currency risks and provides a stable ground to entrepreneurs for planning.

Accession to the EU provided Latvia with new opportunities for economic growth. By joining the EU single market Latvia can benefit from the advantages provided by a broad and stable market, free movement of goods and services, labour and capital, i.e., the most favourable terms in the EU market.

The government has identified three main priorities for further economic development of the country in the period 2007-2013: an educated and creative individual, technological excellence and flexibility of enterprises and advancement of scientific research and development.

Taking into account current trends of economic development in the world, for the stabilization of national economy the government has developed several activities for the next 2 years the aim of which is the change of private capital flow direction to exports related activities, as well as development of knowledge-based economy.

In order to establish stimulus for reinvestment, significant amendments are being developed in law „On Corporate Income Tax (CIT)”. Already now the CIT rate in Latvia (15%) is one of the lowest in the EU. The proposed amendments to law, which will come into force on January 1, 2009, stipulate prolonged depreciation procedure of special fixed assets for new manufacturing technologies up to five years, increasing the coefficient by which value of fixed assets is multiplied up to 1.5 for this period. Moreover, it is envisaged to exempt CIT profit which is obtained from sales of depreciated technological equipment if it is replaced with new technological equipment, as well as to consider opportunity of CIT reliefs on depreciation of intangible investment value by applying coefficient 1.5 to expenses for development and implementation of new technologies and products and registration of patents and trade marks.

In order to promote availability of financial resources to small and medium enterprises, in May 13 this year government has confirmed *Enterprise Competitiveness Support Programme*. Particularly enterprises orienting to external demand, producing goods or providing services with high value added will be assisted, as well as technologically capable manufacturing enterprises and foundation of new enterprises will be assisted. In the framework of the programme, value of supported loans in 2008-2009 is foreseen to be up to 200 mln lats, of which in 2008 – almost 50 mln lats.

With the support of the EU structural funds there has been created Holding fund with the total financing of 128 mln lats which will provide support to small and medium enterprises to receive warranty, exports loans, risk capital and other financial instruments.

Attracting financing of the EU in the amount of more than 200 mln lats, several programmes have been started or it is planned to start them in the next few months, including the following programmes: *Support for Introduction of New Products and Technologies into Production, Competence Centre Programme, Technology Transfer Contact Points Programme, Innovation Centre and Business Incubator Development Programme*. These programmes are directed to promotion of knowledge-based economy, i.e., promotion of knowledge and technologies transfer to production in order to ensure manufacture of higher value added production.

Successful implementation of the structural reforms in Latvia will ensure the stability of economic growth, promote the convergence process and deeper integration into the European and global economy.

Macroeconomic development

In the period of 2005-2007 rapid development has been observed in Latvia, GDP on average increased by 11% annually, of which in 2007 – by 10.3%. Fast development was mainly ensured by domestic demand.

Since the middle of 2007 growth rates has started to decrease and that was determined both by internal (decline of domestic demand stimulus) and external (decrease of global growth) processes impacting economics.

In the 1st half of 2008, compared to the 1st half of 2007, the GDP volume has increased by 1.6%. The decrease of domestic demand has affected development of trade, construction and real estate market. In the 1st half of 2008 impact of these three fields on growth comprised only 0.7%. In 2007 the growth of these sectors contributed to GDP growth by almost 6%, or by more than a half of total growth.

Output in manufacturing is gradually decreasing. Decrease of production volume growth rate started at the end of 2006, but in the 2nd half of 2007 decrease of output volume was already observed. At the same time it must be noted that in Latvia financial intermediation and transport and communication services are continuing to develop. In the 1st half of this year they increased by 7.2% and 5.3% respectively. The development of transport services is largely related to increase of transit services. Construction also continues to show positive increase. In the 1st half of this year it increased by 7.2 percent.

Due to reduction of domestic demand the external disbalance has shrunked. The current account deficit of the balance of payments has decreased from 25% of GDP in the 3rd quarter of 2007 to 15.6% in the 2nd quarter of 2008. It must be noted that positive increase rate of Latvian goods and services exports has been observed, although, overall economic growth rate is decreasing – in the 1st half of 2008 it was 4.4% higher than in the 1st half of 2007.

Inflation of consumer prices in the 1st half of 2008 remained at high level because there were significant supply-side factors – increase of administratively-regulated prices (electricity, natural gas and heat), increase of fuel prices, excise increase on tobacco and fuel, increase of food prices. Total consumer price increase in May 2008, compared to May of previous year, comprised 17.9% which is two times faster than a year before (8.2%). However, since June inflation pace has started to slow down and in September 2008 inflation was 14.9%. It is expected that inflation will continue to decrease and in December annual inflation might be 13.7%.

Economic development in recent years in Latvia has positively influenced the situation on the labour market. During the period of 2005-2007 the number of employed on average increased by 2.9% annually, but unemployment level has decreased from 8.7% in 2005 to 6% in 2007. Observing employment indicators it cannot be stated that there is a decrease of economic growth rate. In the 2nd half of 2008 unemployment level can increase if economic growth trends do not change.

Main growth risks are related to high inflation and problems of disbalances in external sector, global financial market disbalances and the situation in Latvian export markets. Growth in 2008 and 2009 is expected to be more moderate than in previous years. The Ministry of Economics forecasts GDP increase of 0.2% in 2008, but in 2009 it can decrease slightly.

Gross domestic product

2007

GDP, at current prices

mln lats	13957
mln US dollars	27154
mln euro	19854

GDP per capita

lats	6132
US dollars	11930
euro	8723

GDP by sector, %:

Agriculture ¹	3.3
Industry	13.6
Construction	8.4
Trade ²	22.2
Transport and communications	10.8
Public services ³	13.8
Other services	27.8

In 2007 economic growth still accelerated at high speed (increase by 10.3%) but followed downward trend which was more explicit in the 4th quarter. Main stimulus of the rapid growth in previous years was significant increase of investment and private consumption. The rapid dynamics of investment mainly was caused by the wider availability of financial resources determined by the two main factors: firstly, intensive flow of foreign capital since accession to the EU, and secondly, improvement of financial situation created by relatively low tax burden and high domestic demand. In its turn, rapid growth of private consumption was influenced by significant increment of salaries and wages of employees, increase of employment, good conditions of crediting, especially, mortgage and accessibility of leasing. In the 2nd half of 2007 with the decrease of crediting volume investment did not increase anymore and private consumption did not grow that rapidly as well. It negatively influenced volumes of trade and construction.

In the 1st quarter of 2008 decrease of growth rate continued. In the 1st quarter of 2008, compared to the same period of previous year, GDP increased by 3.3%, but in the 2nd quarter of 2008 economic growth in Latvia has stopped.

Decrease of domestic demand has directly influenced increase of production volume, especially, in the sector of services. It must be noted that impairment of external demand, especially, in industry and transport services, is becoming more distinct. This

means that two important factors boosting economic growth are in decline at the same time and create a negative impact on current economic development.

Slow-down of world's economic growth, which was primarily impacted by disbalances in the US financial markets and changes of financial flows, as well as price increase on fuel and food, has negatively influenced our main exports market – the EU.

¹ Including forestry and fishing

² Including hotels and restaurants

³ Public administration including healthcare and education

Gross domestic product

GDP by Sectors

(growth over the corresponding period of the previous year, %)

	2007				2008		2005	2006	2007
	I	II	III	IV	I	II			
GDP	11.3	11.0	10.9	8.1	3.3	0.1	10.6	12.2	10.3
Agriculture ¹	5.4	7.5	12.2	5.0	-2.8	0.3	9.3	-5.2	8.1
Industry	1.7	1.0	0.7	0.2	-3.1	-4.6	5.5	5.7	0.9
Construction	17.0	15.9	13.2	12.4	9.1	5.7	15.5	21.5	14.4
Trade ²	15.6	13.8	13.7	6.3	-0.7	-5.5	16.7	17.9	12.3
Transport and communications	7.6	9.4	10.4	11.6	9.6	2.0	13.7	5.5	9.8
Public services ³	3.6	3.4	5.6	5.6	4.8	3.1	4.6	4.7	4.6
Other services	13.1	13.1	14.2	13.6	8.1	3.9	10.3	18.2	13.5

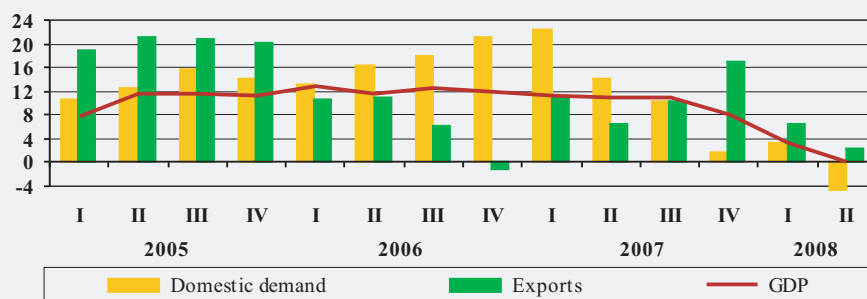
¹ Including forestry and fishing

² Including hotels and restaurants

³ Public administration including healthcare and education

Quarterly Changes in Real GDP and Major Expenditure Items

(% of the corresponding quarter of the previous year)



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Manufacturing

2007

Growth rate: -0.3%

Share in GDP: 10.8%

In 2007 average output in manufacturing comprised 1% less than in the previous year. There was no growth in several manufacturing sectors such as manufacture of food products, manufacture of chemicals and chemical products, machinery, and wood processing, which is one of the major sectors of the Latvian economy. At the same time increase in such export oriented industry sectors as manufacture of metals and metal articles and manufacture of electrical and optical equipment should be mentioned.

Decrease of growth in manufacturing is mainly related to reduction of external demand, as well as to loss of competitiveness of manufacturing enterprises in labour-consuming sectors due to significant increase in wages and salaries. In 2007 wages and salaries in manufacturing increased by 30.1%, however, producer prices – by 16.1% on average.

In 2008 manufacturing output continued to decrease (in eight months average output reduced by 6.5%, compared to the same period of the previous year) due to rapid decrease of external demand, mainly in the EU-15 and Estonia. Most significantly output decreased in the manufacture of textiles, construction materials, machinery and equipment. In its turn, output increase was observed in the manufacture of electrical and optical equipment and in the manufacture of transport vehicles.

Manufacturing Output

(average monthly output in 2000 = 100)



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Investments

2008

Foreign direct investment stock per capita, at the end of the 2nd quarter: 5616 US dollars

During the recent years rapid investment dynamics was characteristic for Latvia. During the period of 2004-2007 investment grew by 18% annually, i.e., almost four times faster than in the EU member states on average.

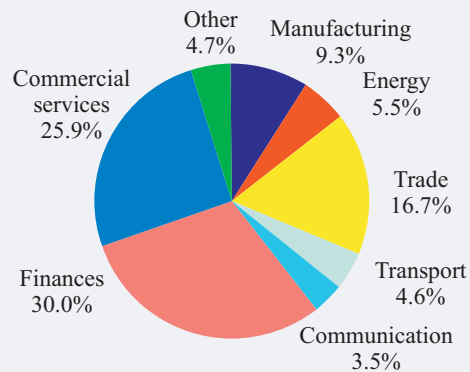
In 2007 investment growth rate decreased, mainly in the 2nd half of the year, which was mostly determined by decrease of economic activity due to reduction of domestic demand. Compared to the same period of the previous year, in the 1st quarter of 2008 investment increase was rather moderate – by 5.1%, but in the 2nd quarter investment decreased by 6.7%.

At the end of 1st half of 2008 the value of foreign direct investment (FDI) stock in Latvia was 5721.5 mln lats. Compared to June 2007, it has increased by 11.1%.

Since 2004 geopolitical structure of FDI stock has not changed significantly. Mainly those are investments of the EU member states. At the end of 1st half of 2008 almost 80% of FDI were coming from EU member states. Major investors are enterprises from Estonia (at the end of 2nd quarter of 2008 16.1% of FDI stock), Sweden (14.2%), Denmark (8.5%) and Germany (8.3%). 5.2% are Russian investment outflows to Latvia.

Investment in the services sector account for the largest share of the FDI stock. In the 2nd quarter of 2008 one third of attracted FDI were invested in the real estate sector.

Foreign Direct Investment Stocks by Industry
(end of 2nd quarter of 2008, per cent)



Foreign trade

2007

Structure of export, %:

Wood and products of wood -	22.5
Metalworking, machine building and transport equipment -	32.5
Light industry goods -	7.3
Chemical goods and articles of plastics -	10.4
Agricultural and food products -	14.4
Other goods -	12.9

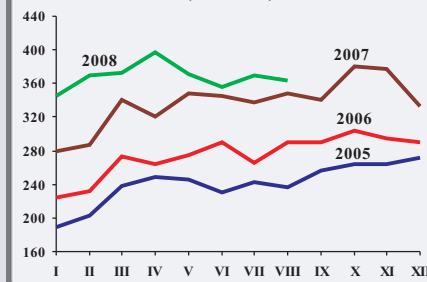
Typically negative Latvian trade balance started to improve in the 4th quarter of 2007 when imports decreased and exports increased. Similar trend was observed in the beginning of 2008.

In the first four months of 2008 exports of goods increased, but starting with May its volume started to decrease. Re-exports had larger impact on the increase of exports of goods than increase of exports of Latvian industry products.

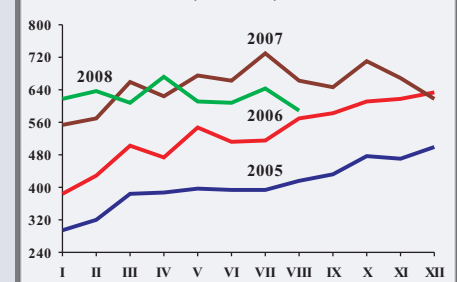
In the following months exports volume did not increase due to external demand decreased significantly. However, as the domestic demand and manufacturing production volume decreased, imports also decreased.

In the first eight months of 2008 exports of textiles, wood and articles of wood have decreased significantly. In its turn, exports of food products, metals and articles of metals, machinery, as well as of chemical industry has increased.

Commodity Exports by Months
(mln lats)



Commodity Imports by Months
(mln lats)



Balance of payments

2007

Current account balance

mln LVL: -3200.7

mln US dollars: -6231.2

Following positive changes in trade balance, current account deficit of Latvian balance of payments also decreased. From 26.7% of GDP in the 3rd quarter of 2007 it decreased to 15.6% in the 2nd quarter of 2008.

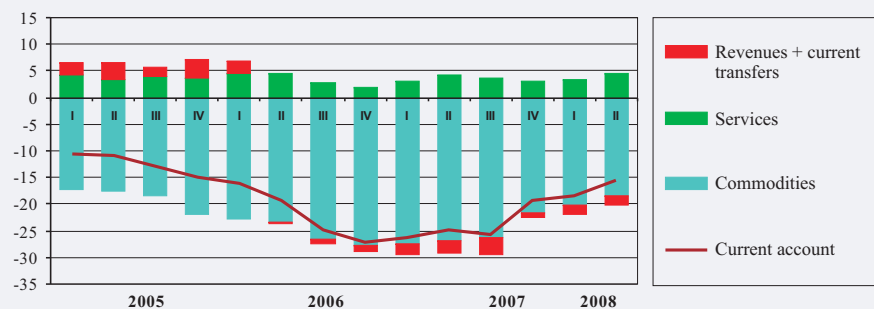
Decrease of current account negative balance mainly reflects the slowdown of Latvian national economy growth rate. Also in the financial account of balance of payments significant changes have occurred during last two quarters – the amount of

foreign financial resources attracted by commercial banks has decreased. In the 1st quarter of 2008 increase of portfolio investment is related to auction of government securities.

In the 1st half of 2008 inflow of FDI remained at high level. They comprised 7.5% of GDP (in 2007 – 8.3%).

In general in the 1st half of 2008 Latvian balance of payments was positive with capital inflow exceeding current account deficit.

Current Account Balance
(% of GDP)



Inflation

September 2008

(12-month inflation)

CPI: 14.9%

PPI: 13.1%

Consumer price increase in December 2007 (by 14.1%, December over December) doubled compared to the previous year (by 6.8%). Prices for services rose more rapidly (by 16.4%) while the increase in the prices of goods was more moderate (13.2%). Annual average price changes in 2007 were 10.1% (in 2006 – 6.5%).

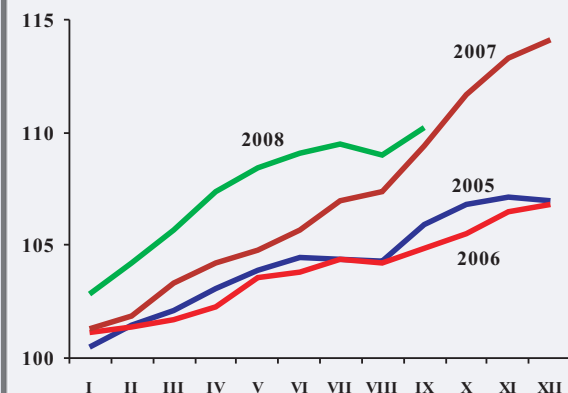
Similarly as in the previous three years, the main reason for price growth in 2007 was the increase in the prices of food products. In 2007 it increased overall price level by 5.1%.

Second largest group which determined price increase in 2007 was maintenance of housing and utilities payment. Price increase in this group was mainly determined by administratively-regulated price increase of heat energy, water supply, waste collection, sewerage services, rent and payments for property management.

Also in the first five months of 2008 prices increased more rapidly than in previous years. In May 2008 12 month inflation reached 17.9%. After the sharp rise of prices in May later the rate started to decrease. Consumer price increase in September 2008, compared to September of the previous year, was 14.9% (of which on goods – by 14.5% and on services – by 15.9%) which was 3.5% faster than a year before (11.4%).

Main drive of price increase in 2008 is supply-side factors – increase of administratively-regulated prices (electricity, natural gas and heat), increase of fuel prices, excise increase on tobacco and fuel, increase of food prices.

Consumer Price Index
(December of previous year = 100)



Monetary indicators

2007

Domestic enterprises and private persons

Loans: 93.5% of GDP

Deposits: 37.8% of GDP

From the 2nd half of 2007, decrease in growth rate of monetary indicators has been observed. After the news on crisis in the US real estate market, situation in world's financial markets, as well as in macroeconomic development in Latvia has slowed down the fast growth of basic monetary indicators observed in previous years.

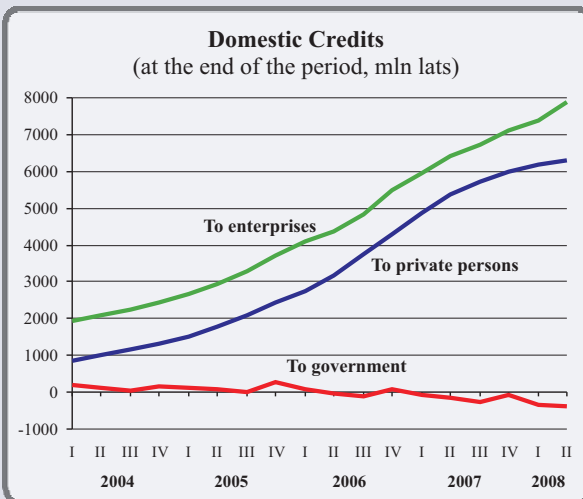
In 2008 crediting growth rates continue to decrease as well. In the 2nd quarter of this year, compared to the 1st quarter, increase of loans given to residents was 4.1% or almost 2.5 times less than in the 2nd quarter of 2007.

Annual growth rate of mortgages given to households have decreased significantly which in July 2008 decreased to 14.4% or which

is 4.5 times slower than in July 2007. Main factors slowing down loan increase are expectation of further real estate price decrease, increase of loan burden for households which is mainly caused by high interest rates of loans.

Slow down of crediting dynamics is mainly influenced by the decrease of mortgage growth rate. However, it must be noted that in the 1st half of 2008 growth rate of industrial loans and commercial loans also decreased. It must be noted that since the crediting volume has increased, the quality of loans has not worsened.

In 2007 rates on loans issued in lats increased rapidly, but the increase of interest rate on loans issued in euros was significantly moderate. In the first seven months of 2008 interest rates on loans issued in lats slightly decreased, but since August – they increased again. After decrease in the beginning of 2008, since April interest rates on loans issued in euros are increasing again. Weighted mean interest rate of short-term loans issued to enterprises and private persons in lats in the August 2008 was 10.5%, but for the long-term loans – 16.8%, for loans issued in euros – respectively, 7.2% and 7.7%.



Budget and central government debt

2007

General government budget (% of GDP):

Revenues: 38.5

of which taxes: 31.3

Expenditures: 37.7

of which capital investment: 5.4

General government budget balance followed improving trend. In 2004 general government budget deficit was 1% of GDP, but as the financial situation gradually improved, in 2007 it was surplus of 0.1% of GDP.

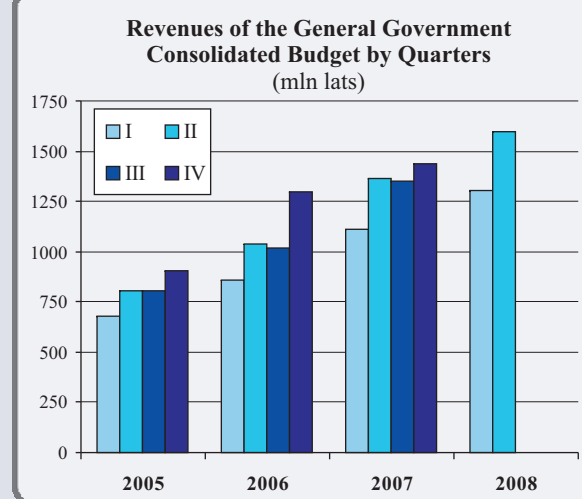
In autumn 2007 the Parliament approved budget for 2008 with the surplus of 1% of GDP. However, taking into account macroeconomic situation in the country and assessing forecast of government budget revenues, in summer 2008 amendments regarding government budget 2008 were adopted. The amendments have been adopted in order to ensure budget surplus of 0.05% of GDP or 8 mln lats.

In order to ensure government budget implementation with surplus, ministries and other central governmental institutions have reduced their budget expenses for 2008, decreasing current expenses. Budget expenses on the EU fund acquisition, social benefits and pensions, etc. were not cut down.

In the 1st half of 2008 consolidated budget surplus was 165.8 mln lats, i.e. 4.4% of GDP which is by almost 3 percentage points less than in the 1st half of 2007.

In 2009 planned government budget deficit is 1.85% of GDP which is grounded in generally accepted business cycle theory. In the case of decline of economic situation, especially, when it is influenced by the decrease of domestic consumption growth rate, it is necessary to use instruments of stimulating character which in this case is budget balance. In 2009 the government plans to stimulate national economy ensuring budgetary resources for acquisition of the EU funds and carrying out investment projects.

The level of the central government debt in Latvia is one of the lowest in the EU. At the end of 2007 it was 1331.3 mln lats or 9.5% of GDP (1190.5 mln lats or 10.7% of GDP at the end of 2006).



Personal income

2007

Average monthly net wage:

lats 286
US dollars 556

Average monthly old-age pension (paid):

lats 111
US dollars 216

The average net monthly wage in 2007 was by 69 lats or 32% higher than in the preceding year. There was also a substantial rise (by 19.9%) in the level of real wages despite the considerable price increase. The overall wage upward trend was to a great degree influenced by the high inflation level in previous years, as well as by the increasing demand for the employees in response to rapid economic growth.

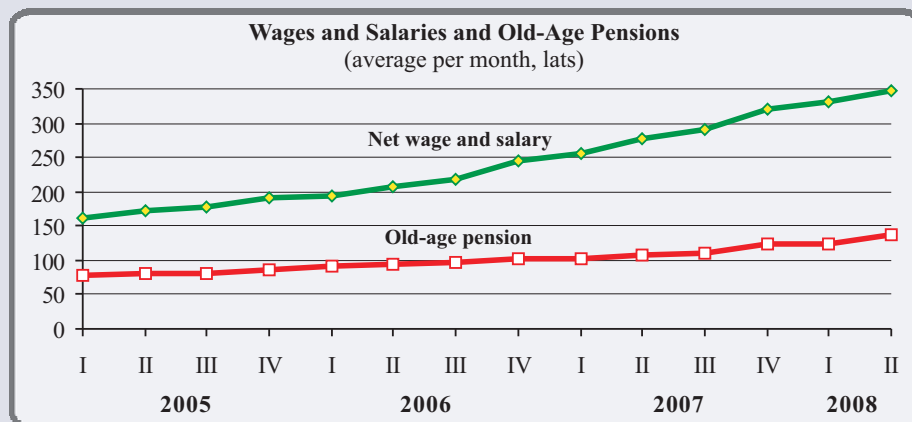
The average size of old-age pension in December 2007 was 124 lats, i.e., 21 lats more compared to December 2006.

Wages and salaries represent almost 70% of the household disposable income and social benefits comprise approximately 24%.

On January 1, 2008 the minimum monthly wage was raised from 120 to 160 lats and the monthly minimum non-taxable exemption for personal income tax – to 80 lats (from 50 lats), as well as the tax

concession for a dependent person increased to 56 lats (from 35 lats).

In the 2nd quarter of 2008, compared to the same period of previous year, average monthly net wage increased from 277 lats to 348 lats. The largest wage increase was observed in financial intermediation, public administration, transport, storage and communications, real estate and other business activities, as well as education.



Employment and unemployment¹

2007

Employment rate (aged 15-64) 68.4%

Unemployment rate (rate of unemployed, aged 15-74): 6.0%

Rapid economic development in recent years in Latvia has positively influenced situation on the labour market – the employment has increased, unemployment has decreased and number of economically active population has grown. Over the last three years (2005-2007) the number of employed on average increased by 2.9% annually, but unemployment level has decreased from 10.4% in 2004 to 6% in 2007.

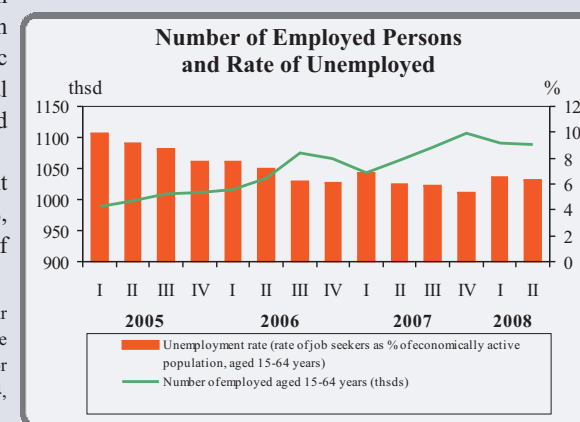
Employment level has increased, respectively. In 2007 it was 68.4% opposite to 62.3% in 2004. In 2004 employment level in Latvia was 0.6 percentage points lower than in the European Union member states, but in 2006 it already exceeded the EU average by 1.8 percentage points.

The decrease of economic growth rate has made little impact on employment indicators. Statistical data shows that employment continues to increase.

In the 2nd quarter of 2008, compared to the 2nd quarter of 2007, the number of employed population increased. The number of employed decreased in such sectors as agriculture, hotels, restaurants and transport. In construction, real estate, health and social care, as well as in public utilities, social and individual services the number of employed has increased.

However, the unemployment level has increased to 6.3%, compared to the 2nd quarter of 2007 (6.0%).

¹ In the analysis of employment and labour market, indicators for employment are given for persons aged 15-64, but for unemployment – for persons aged 15-74, which corresponds to the EU practice.



Baltic States

Main socio-economic indicators of the Baltic States

	Estonia	Latvia	Lithuania
Territory, thsd km ²	45.2	64.6	65.3
Population as of January 1, 2008, thsd	1340.9	2270.9	3366.4
Gross domestic product, % of corresponding period of the previous year			
2007	6.3	10.3	8.9
2008: 1 st quarter	0.2	3.3	6.9
2008: 2 nd quarter	-1.1	0.1	5.2
Industrial output index, % of corresponding period of the previous year			
2007	-0.2*	0.9*	4.0*
2008: 1 st quarter	0.3*	-3.1*	7.3*
2008: 2 nd quarter	-3.5*	-4.6*	7.6*
Unemployment rate (the percentage share of unemployed persons in the total number of economically active population aged from 15 to 74 years)			
2007	4.7	6.0	4.3
2008: 1 st quarter	4.2	6.5	4.9
2008: 2 nd quarter	4.0	6.3	4.5
Consumer price changes, % of corresponding period of the previous year			
2007	6.6	10.1	5.7
2008: 1 st quarter	11.1	16.4	10.6
2008: 2 nd quarter	11.4	17.7	12.1
Producer price changes in industry, % of corresponding period of the previous year			
2007	8.3	16.1	7.0
2008: 1 st quarter	6.0	10.9	21.7
2008: 2 nd quarter	4.2	12.3	22.0

* Short-term data.

** Eurostat data: <http://epp.eurostat.ec.europa.eu>