

**THE NATIONAL
ECONOMY OF LATVIA:
A MACROECONOMIC
REVIEW**

Key indicators of economic development

Economic policy

Macroeconomic development

Gross domestic product

Manufacturing

Investments

Foreign trade

Balance of payments

Inflation

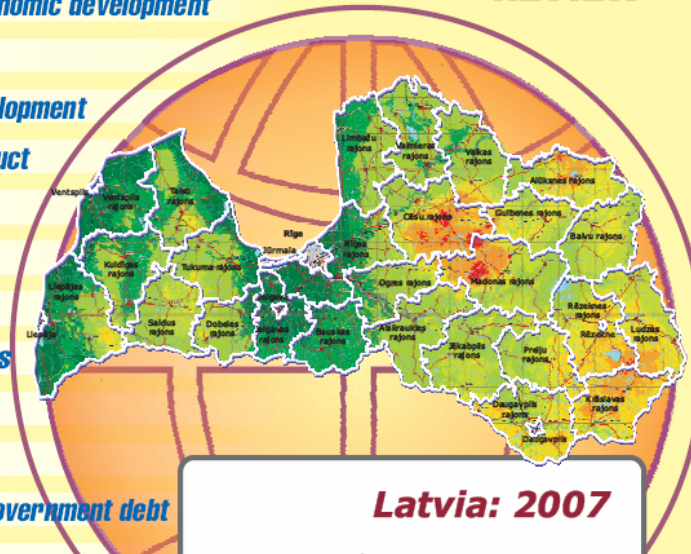
Monetary indicators

Budget and central government debt

Personal income

Employment and unemployment

*Main socio-economic indicators
of the Baltic States*



Latvia: 2007

Territory, thsd km ²	64.6
Population (as of 01.01.2007, thsds)	2281
of which:	
Urban area	1550
of which Riga, the capital city	722
Rural area	731
National currency: lats (LVL)	

Key indicators of economic development

	2003	2004	2005	2006	2007 f
(increase over the previous year, in per cent)					
Gross domestic product	7.2	8.7	10.6	11.9	9.0
Consumer prices	2.9	6.2	6.7	6.5	6.5
(% of GDP)					
General government budget fiscal balance	-1.6	-1.1	-1.2	-0.3	0
Central government debt	14.4	14.5	12.0	10.0	9.0
Current account balance	-8.2	-12.9	-12.6	-21.1	-19.8
Exchange rate, LVL per US dollar	0.571	0.540	0.565	0.560	0.540
Exchange rate, LVL per euro	0.645	0.671	0.703	0.703	0.703
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	10.6	10.4	8.7	6.8	6.0

	2005				2006			
	I	II	III	IV	I	II	III	IV
(increase over the corresponding period of the previous year, in per cent)								
Gross domestic product	7.7	11.5	11.6	11.4	13.1	11.1	11.9	11.7
Consumer prices	6.7	6.5	6.5	7.3	7.0	6.3	6.6	6.3
(% of GDP)								
General government budget fiscal balance	3.3	3.1	2.9	-11.5	5.9	3.3	3.5	-11.0
Current account balance	-10.4	-10.9	-12.8	-15.2	-14.6	-17.6	-23.5	-26.3
Exchange rate, LVL per US dollar	0.535	0.557	0.576	0.591	0.585	0.560	0.551	0.546
Exchange rate, LVL per euro	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)	9.9	9.2	8.7	7.8	7.8	7.2	6.2	6.1

f - forecast of the Ministry of Economics

Economic policy

The aim of the government's economic policy is to ensure sustainable and balanced economic and social development, to implement transition from a labour-intensive economy to a knowledge-based one reaching in this way the EU average GDP per capita level within the next 20-30 years.

The reforms that were carried out in the previous decade have consolidated the private sector and good macroeconomic conditions have been created to foster growth. Private initiative and capital are the main driving forces for development. The law guarantees the protection of foreign investment, non-residents can repatriate profit and capital freely and equal terms are provided to domestic and foreign entrepreneurs.

Accession to the EU provides Latvia new opportunities for economic growth. By joining the single EU 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 on the EU market.

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

One of the main challenges for the Latvian economic policy is to set up an effective and competitive industry structure by implementing structural reforms to boost productivity and to support research and development and innovation, improving the efficiency of the educational and training system, its quality and accessibility.

In recent years the business environment in Latvia has been substantially improved by introducing the requirements of the EU body of legislative acts (*acquis communautaire*) and implementing the *Action Plan for Improvement of Business Environment*. The *Commercial Law* testifying to a fundamental reform of the business environment came into force in 2002. Currently, the corporate income tax in Latvia is among the lowest (15%) in the EU. Legislation provides special corporate income tax relief to enterprises operating within the special economic zones. In order to create an optimal local government administrative and organisational structure and to raise its capacity, the administrative territorial reform is under way in Latvia and it is intended to complete it before the local government elections in 2009.

Latvia is consistent in its efforts to open to competition the monopolist markets such as telecommunications, electricity and gas supply, post and railway. The government continues to improve the basic infrastructure paying close attention to the development of the energy sector, building of the electronic communications and information systems, as well as to the improvement of the quality of transport infrastructure and creation of an effective network. The utilisation of EU structural funds and the Cohesion Fund offers broader opportunities to improve infrastructure.

To ensure balanced development, the government is resolved to implement in 2007 and 2008 a non-deficit budget, with further plans to introduce in 2009 and 2010 the budget with a surplus. The general government debt in Latvia is among the lowest in the EU and it is expected that in the medium-term its level will remain considerably below the criterion set by the Maastricht Treaty.

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. The goal of Latvia is to become a full-fledged member of the European Economic and Monetary Union (EMU) already in the nearest future.

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

Growth rates in the Latvian economy have been very rapid in recent years. The reforms carried out in the country and integration into the EU have made a positive impact on economic development. In the period between 2001-2006 GDP grew on average by 8.8% annually and by 11.9% in 2006. These growth rates are the highest in the European Union.

GDP growth in Latvia is ensured mostly by the sharp increase of productivity spurred by investments made in previous years. Economic activity is accelerating in all main economic sectors. Domestic demand fosters the development of services, especially in trade, business services and construction. High growth rates can also be observed in the transport and communications sectors. The dynamics of domestic demand has been stable due to the rising incomes, stability of the financial system, expansion of crediting, joining NATO and the EU and predominance of positive future expectations. Output in manufacturing in the period between 2001-2006 increased on average by 7.3% per year (by 6.2% in 2006).

The general government budget deficit in Latvia is low and does not exceed the reference level set by the Maastricht criteria. The government is resolved to implement in 2007 and 2008 a non-deficit budget, with further plans to introduce in 2009 and 2010 a budget with a surplus. The current account deficit is comparatively large and it is covered by foreign direct investments (FDI) and long-term loans. The reserve assets of the Bank of Latvia are increasing and net foreign reserve fully covers the reserve money. After accession to the EU the inflow of foreign direct investments into Latvia has increased.

A relatively high inflation level has been observed in recent years. Its sharp rise in 2004 was primarily accounted for by a combination of several one-off effects (an increase in the administratively regulated prices, harmonisation of the indirect tax rates, inflation expectations due to EU accession and the high oil prices on the global markets). Inflation in 2005 and 2006 remained on a high level owing mainly to the rises in the global oil prices and the second phase of inflation (spiral). It is expected that inflation in 2007 will likewise be on a relatively high level due to the anticipated rises in the administratively regulated prices and in the excise tax rates on tobacco goods and fuel.

By contrast, due to the diminishing influence in the medium term of the abovementioned price-raising factors and the government's efforts to combat inflation, it will gradually decrease. The most substantial inflation-cutting measures supported by the Cabinet of Ministers on March 6, 2007 are associated with the budget and tax policy, crediting and other undertakings that can improve the situation in the real estate market, labour market, productivity and the competition policy.

The employment and unemployment indicators are gradually improving. In recent years the number of employed has been rising annually by 1-2% (in 2006 by 5.0%), while the unemployment rate decreased from 14.4% in 2000 to 6.8% in 2006.

The economic growth potential is best characterised by investment growth. In comparison with 2000, gross fixed capital formation in 2006 increased by 2.6 times and in 2006 it increased by 18%. The investment growth rate and its share in GDP are among the highest in the EU. If there are no external shocks GDP in the medium-term can be expected to grow by 6-8% annually. The Ministry of Economics forecasts, that the GDP in 2007 will increase by 9%.

Gross domestic product

2006

GDP, at current prices

mln lats	11265
mln US dollars	20116
mln euro	16024

GDP per capita

lats	4923
US dollars	8791
euro	7002

GDP by sector, %:

Agriculture¹	3.7
Industry	14.7
Construction	6.8
Trade²	22.4
Transport and communications	13.0
Public services³	14.4
Other services	25.0

In recent years Latvia has witnessed high GDP growth rates. The main reason for growth was the rising domestic demand in parallel with expanding export opportunities.

The reasons behind the rapid increase of domestic demand are both the rising private consumption and investment increase. The volume of private consumption rose not only due to the annual wage rise, but also due to the availability of consumer loans to private persons at acceptable interest rates as well as loans for dwelling purchase and repair. Private consumption in 2006 exceeded the level of the previous year by 20%. The favourable financial situation (low interest rates on loans and expanding mortgage lending) also encouraged investment. Gross fixed capital formation in 2006 was considerably higher (by 18.3%) than in the previous year.

Nearly 80% of GDP growth was contributed by the growth of the services sector fostered mainly by trade and business service sectors. Construction is growing fast, while industrial growth has been more moderate.

According to Eurostat's estimation, GDP per capita in Latvia in purchasing power standards represented 53.4% of the EU-25 average level in 2006. In comparison with 2000, the backwardness vis-à-vis the average level of the EU member states was successfully reduced by 18 percentage points.

The increasing productivity and, to a lesser degree, the rising employment were the main factors contributing to the GDP growth in Latvia. Productivity in the past three years has increased on average by 7.7 per cent.

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, %)

	2005				2006				2004	2005	2006
	I	II	III	IV	I	II	III	IV			
GDP	7.7	11.5	11.6	11.4	13.1	11.1	11.9	11.7	8.7	10.6	11.9
Agriculture ¹	4.8	14.5	10.1	5.8	0.9	-3.3	-1.3	4.0	3.4	9.3	-0.3
Industry	-0.2	7.6	7.7	7.3	9.3	4.0	7.4	3.1	6.4	5.5	5.8
Construction	16.2	15.8	15.6	14.4	17.5	16.1	12.2	10.3	13.3	15.5	13.6
Trade ²	14.7	18.1	17.0	17.0	17.4	18.4	17.9	15.5	12.7	16.7	17.3
Transport and communications	8.7	16.3	15.9	13.4	6.0	10.9	12.1	7.7	10.1	13.7	9.3
Public services ³	4.5	5.8	3.2	4.0	2.9	4.4	2.1	7.9	3.4	4.0	4.4
Other services	7.7	10.6	12.3	11.0	18.3	14.8	16.3	17.2	9.4	10.3	16.7

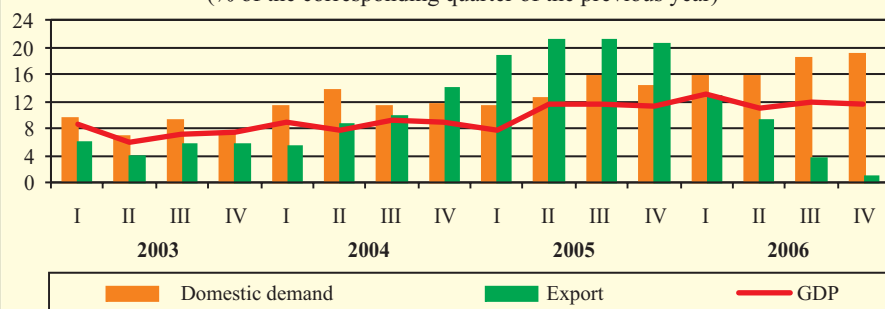
¹ Including forestry and fishing

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)



6

Manufacturing

2006

Growth rate: 6.2%

Share in GDP 11.8%

Recent years have witnessed steady growth in manufacturing. Manufacturing output has been rising on average by 6.7% annually (2002-2006), at a slightly slower pace than the overall economic growth.

The growth trend in manufacturing has been stable, without considerable acceleration or decline. The falling growth rates in selected industries have been countervailed by accelerated growth rates in other industries. In comparison with 2000, results of almost

all manufacturing sub-sectors in 2006 (with the exception of the manufacture of transport vehicles) point to an increase in output.

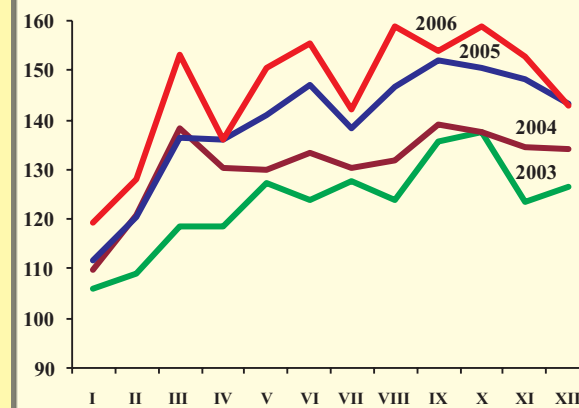
Straight after EU accession growth rates in manufacturing decreased, as some time had to pass until the enterprises adjusted to the new trade conditions. A noteworthy indication of growth could again be witnessed in mid-2005.

In 2006, growth in manufacturing was slightly more rapid than a year ago and production output exceeded the level of the previous year by 6.2%. High growth rates persisted in those industries, where sales markets were relatively less linked to exports. The wood processing industry, one of Latvia's main export industries, has demonstrated weaker growth for already a second year and in 2006 it even had a slight fall in production output.

The fastest export growth in the post-accession period was observed in the direction of Estonia and Lithuania and export increase to these countries occurred on a larger scale than to the other EU member states. There was also a rapid increase in the export of products of the manufacturing industry to the CIS countries.

Manufacturing Output

(average monthly output in 2000 = 100)



7

Investments

2006

Foreign direct investment stock per capita, at the end of the year: 3299 US dollars

Investment growth rates in Latvia remain stable for several years already. This is due to the influence of several factors, especially such as financial stability, continuous improvement of the business environment, high domestic demand and rather low real interest rates, inflow of foreign capital, etc. At the same time the relatively low tax burden and the increasing product sales due to the rising demand have positively impacted the financial position of enterprises expanding the opportunities of investment.

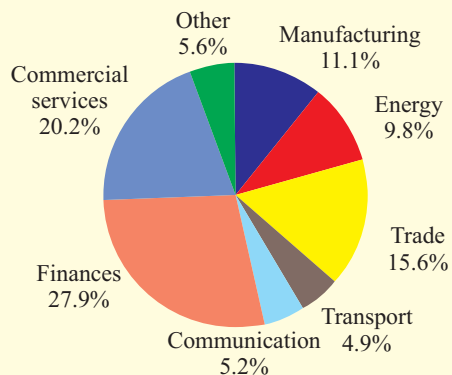
In 2006 fixed investments in Latvia more than doubled (by 2.5 times) in comparison with 2001. Investments that were made each year within this period have increased by 15.7% and in 2006 represented 29.8% of GDP.

Foreign direct investment stock per capita in Latvia at the end of 2006 was 1768 lats or 3299 US dollars.

Investments in the services sector account for the largest share of the foreign direct investment stock (FDI). In 2005 and 2006 the biggest investments were made in the banking sector.

Three quarters of FDI came from the EU member states and the major investors were the entrepreneurs from Sweden (17% of the FDI stock at the end of 2006), Estonia (13.1%) and Germany (11.7%). Investments from Russia comprised 7.7%.

Foreign Direct Investment Stocks by Industry
(end of 2006, per cent)



Foreign trade

2006

Structure of export, %:

Wood and products of wood -	22.6
Metalworking, machine building and transport equipment -	30.7
Light industry goods -	8.9
Chemical goods and articles of plastics -	9.7
Agricultural and food products -	13.4
Other goods -	14.7

The value of commodity exports from Latvia in 2006 rose more moderately (by 13.3%, at current prices) than in 2005, whereas the value of imports increased at a more rapid pace (by 29.4%).

The increase in the export unit value in 2006, which in comparison with the previous year exceeded 9.7% and the rising world prices for several commodity groups, in particular for base metals and articles of base metals, as well as for transport vehicles, made a favourable impact on commodity exports.

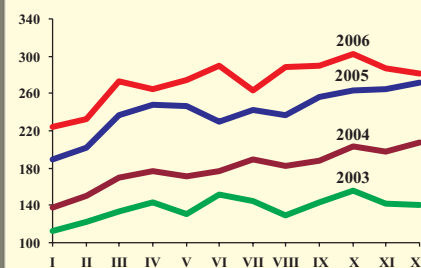
Exports in 2006 rose in almost all commodity groups, especially in the group of fabricated metal products accounting for nearly 30% of the total export growth. The exports of mineral products that had witnessed very rapid growth last year, decreased in turn considerably (mainly to the EU member states). Exports of wood and articles of wood also did not increase.

After accession to the EU, Latvia's foreign trade with Lithuania and Estonia as well as with the other new EU member states has increased very rapidly. A comparison with the EU pre-accession period shows that within two years Latvia's foreign trade with the other Baltic States has more than doubled.

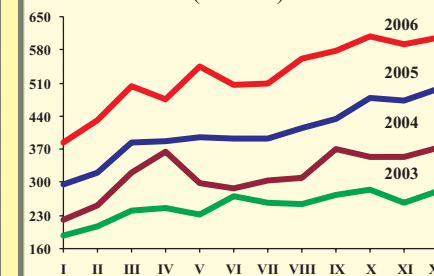
Exports to the CIS countries in 2006 witnessed the most rapid growth and its value was higher by nearly one third in comparison with the previous year, with substantial increases in the exports of food products, chemical goods and various machinery and equipment.

Exports to the EU member states grew by 11%, with increases in the exports of food products, machinery and equipment accounting for the largest share in export growth.

Commodity Exports by Months
(mln lats)



Commodity Imports by Months
(mln lats)



Balance of payments

2006

Current account balance

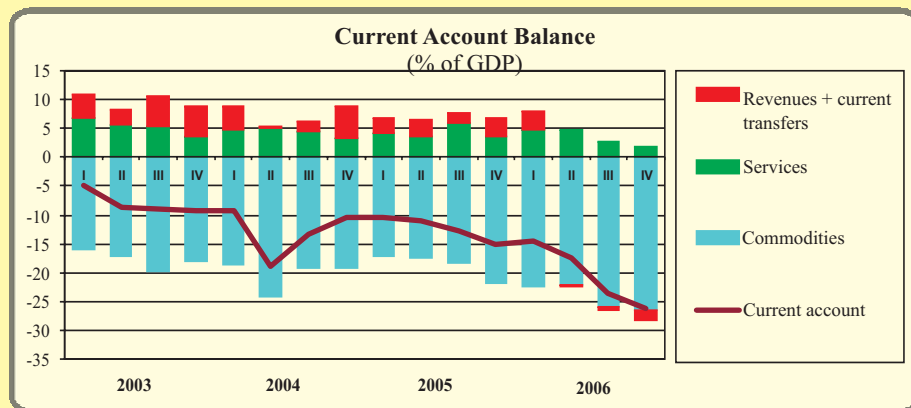
mln LVL: -2376.0

mln US dollars: -4280.4

The current account deficit of the balance of payments accelerated sharply in 2006. The main source of the deficit is the markedly negative trade balance.

For several years already Latvia has been characterised by a relatively high current account deficit. So far this has not created any problems for economic stability as the deficit is to a great extent covered by the flows not raising the level of debt and the reserve assets of the Bank of Latvia are increasing annually. The ratio of the debt raising flows in 2006 increased.

Domestic demand in Latvia is higher than domestic supply and this is the reason for the growth of the current account deficit. It means that in order to finance domestic investments, foreign savings should also be used. In recent years the level of saving in relation to GDP has been actually constant, approximately 20%. By contrast, the rate of investments in the economy is rising rapidly, especially after EU accession (36% in 2005 and almost 40% in 2006). The banking sector absorbs the major part of foreign capital.



Inflation

February 2007

(12-month inflation)

CPI: 7.3%

PPI: 15.5%

The overall price increase in 2006 (6.8%, December over December) was slightly less conspicuous than in the previous year (7.0%). Prices for services rose more rapidly (by 7.9%), while the increase in the prices of goods was more moderate (by 6.4%). In the result, the average annual inflation in 2006 was 6.5% (6.7% in 2005).

Similarly as in the previous two years, the main reason for price growth in 2006 was the increase in the prices of food products. This increase raised the overall price level by 2.6 percentage points in 2005 and slightly less, by 2.5 percentage points, in 2005.

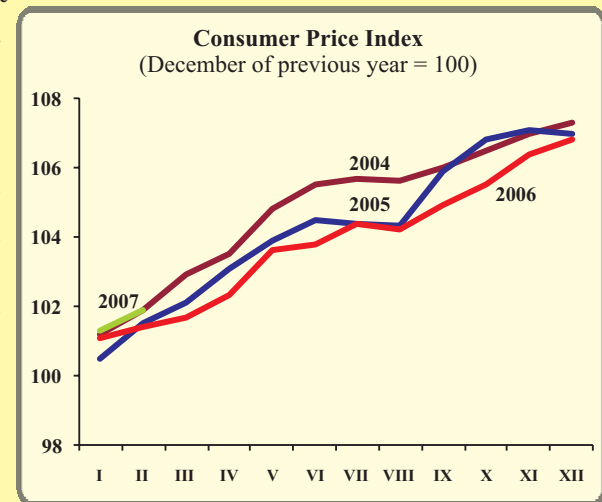
The second largest group accounting for price growth in 2006 was the increase in the dwelling prices (1.8 percentage points in 2006 and 1.2 percentage points in 2005). The increase in the administratively regulated prices for heating, natural gas, electricity, dwelling rent, water supply, waste disposal and sewerage services accounted mostly for price increases within this group. The costs of dwelling maintenance and repair also went up sharply.

The third relevant group comprises price increases for hotel and restaurant services (by 0.65 percentage points) owing to a substantial increase in the prices of catering services.

There was a fall of prices for communications services, reducing the overall price level in 2005 by 0.3 percentage points.

Thus it is worth noting that the high rates of price growth in 2006 were accounted mostly by two main factors: the sufficiently high second-phase effect of inflation of 2004 and 2005 and the rise in the administratively regulated prices. The second-phase effect was intensified both by the high mortgage lending rates and the substantial wage increase of employees.

In the first two months of 2007 prices rose by 1.9%, and this is a slightly faster rate (by 1.4%) compared to January-February 2006.



Monetary indicators

2006

Domestic enterprises and private persons

Loans:	86.3% of GDP
Deposits:	40.0% of GDP

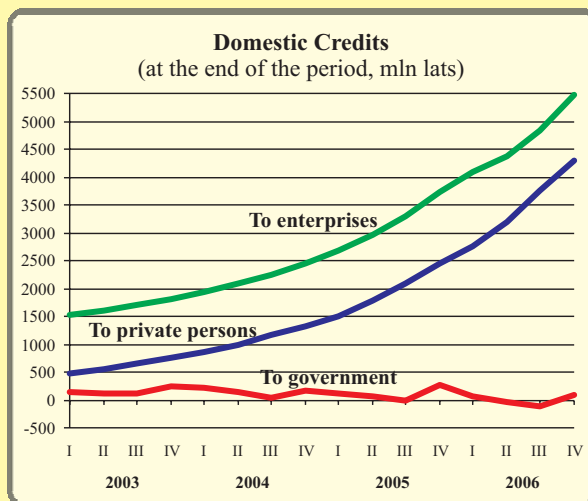
The stability of the banking sector, the rising welfare and economic activity of the population are the reasons stimulating steady growth of the basic monetary indicators of the banking system of Latvia. Compared with December 2005, the amount of broad money M2X in December 2006 rose by 37.5%, currency in circulation increased by 22.4% and deposits rose by 41%. In the same period loans to enterprises and private persons also continued to increase (by 58.4%). Although the amount of crediting is rising, the quality of loans does not deteriorate. At the end of 2006 the share of loans generating no income in the total number of loans granted by non-banks was only 0.7%.

Reacting to the increasing domestic demand and in order to slacken the growth of crediting, the Bank of Latvia has raised several times since March 2004 its re-financing rate and reserve requirement. However, the effectiveness of these measures in Latvia is limited by the fixed exchange rate regime and several other specific factors.

On March 6, 2007 the government gave support to a plan for combating inflation, which among others, envisages a variety of measures to strengthen control over the expansion of crediting. Thus a compulsory first payment of up to 10-15% of the credit will be fixed and the maximum credit against the value of the mortgage will be determined. It was likewise decided to set up a general register of borrowers covering both the financial institutions (both the mortgage loans and consumer credits) so that the financial institutions would be aware of the real size of debts of their clients.

In December 2006 the average weighted interest rate on short-term credits in lats was 7.3%¹ but on long-term credits 11.3%. For credits in the currencies of foreign countries these rates were 5.8%¹ and 5.7% respectively.

¹ Short-term and with a changing interest rate.



Budget and central government debt

2006

General government budget (% of GDP):

Revenues:	35.8
of which taxes:	29.3
Expenditures:	36.9
of which capital investment:	5.0

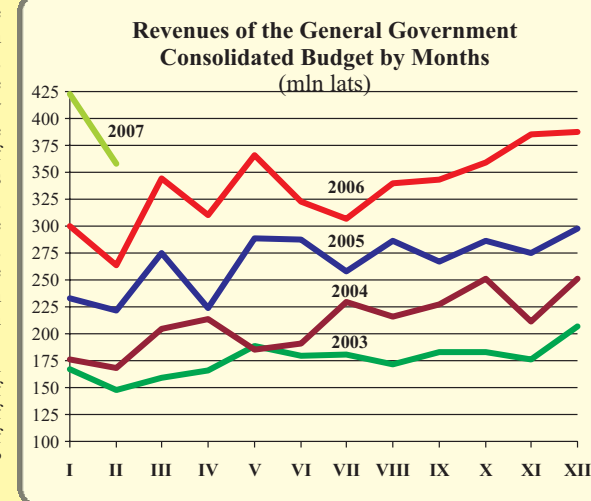
The budget deficit in 2006 was lower than planned, 31.4 mln lats or 0.3% of GDP. The revenues of the general government budget in 2006 were by 25.9% higher than in 2005 and expenditures were by 25.2% higher.

The Parliament has confirmed the general government budget for 2007 with a deficit of 177.8 mln lats or 1.4% of GDP. Revenues are projected at 5 billion lats and expenditures 5.2 billion lats. Compared to 2006, the increase in the general government budget in 2007 is more than 1 billion lats or 27%.

On March 6, 2007, providing support to the planned measures for combating inflation, the government decided to reach a non-deficit budget for 2007 and not adopt such amendments to the budget law that would raise budget expenditures, but allocate the revenue surplus to the reduction of the budget deficit.

The main expenditure priorities of the budget for 2007 are: development of a functioning health care system; crisis management within the system of interior affairs; improvement of the educational system; modernisation of the social security system; strengthening of the administrative and institutional capacity of law enforcement institutions; effective planning, absorption and utilisation of financial resources of the EU funds and European Economic Zone; transition of the country's defence system to professional armed forces; creation of a qualitative and up-to-date cultural infrastructure; modernisation of the public administration system and strengthening of its capacity.

The level of the central government debt in Latvia is one of the lowest in the EU. At the end of 2006 it was 1128.3 mln lats or 10% of GDP (1084.6 mln lats or 12% of GDP at the end of 2005).



Personal income

2006

Average monthly net wage:

lats 216
US dollars 387

Average monthly old-age pension (paid):

lats 96
US dollars 171

The average net monthly wage in 2006 was by 41 lats or by 23% higher than in the preceding year. There was also a substantial rise (by 15.6%) in the level of real wages despite the considerable price increase.

The overall wage increase was to a great degree influenced by the high inflation level in previous years and in 2006, as well as by the wage increase for the employees of several budget-financed institutions, for example, teachers and doctors.

Since January 1, 2006 both the minimum monthly wage was raised from 80 to 90 lats and the minimum monthly untaxable income of the population from 26 lats to 32 lats. The monthly allowance for a dependent person increased from 18 lats to 22 lats. Since January 1, 2007 the minimum wage is 120 lats, the minimum monthly untaxable income of the population is 50 lats, as well as monthly allowance for a dependent person is 35 lats.

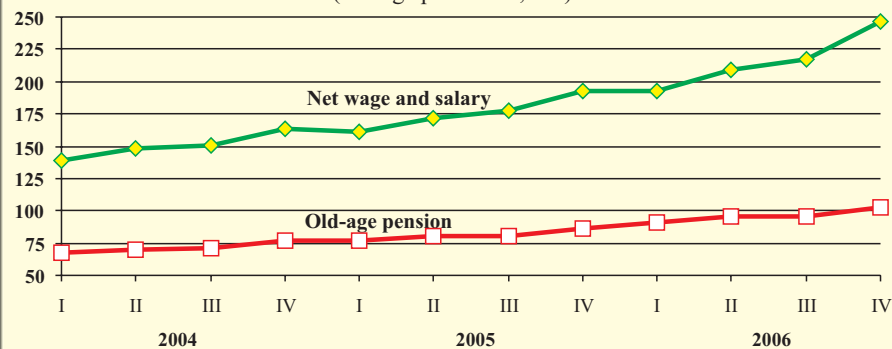
Wages and salaries represent on average 65% of the household

income and social benefits comprise 18%.

The increase in the size of old-age pensions in 2006 was also considerable. Pensions in December 2006 were by 19% or 15 lats higher than in 2005. In this period the level of real pension rose by 12%

Real income of the population whose main source of income in 2006 was either wages and salaries or pensions was by 15% higher than in the previous year.

Wages and Salaries and Old-Age Pensions
(average per month, lats)



Employment and unemployment¹

2006

Employment rate (aged 15-64) 65.9%

Unemployment rate (rate of unemployed, aged 15-74): 7.1%

Economic development in recent years in Latvia has positively influenced the situation in the labour market. Although the number of population of working age is decreasing, the number of economically active population is rising and the employment rate is also increasing.

In the last six years (2001-2006) the employment rate has increased by 8.6 percentage points. In comparison with the EU average, the employment rate in Latvia was lower by 4.9 percentage points whereas in 2005 it lagged behind only by 0.5

percentage points, but in 2006 it has already exceeded the level of EU average.

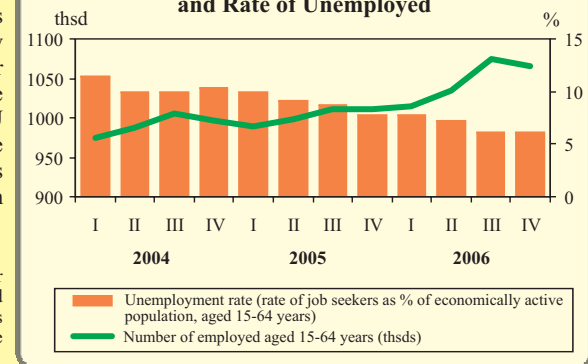
The level of female employment in Latvia is higher than the EU average and this difference tends to increase: the female employment level in 2002 was by 2.1 percentage points higher than in the EU and in 2005 - by 3 percentage points higher.

The male employment level, in turn, although tending to rise annually, still lags behind the EU average level (by 6.7 percentage points in 2002 and 3.7 percentage points in 2005).

The rapid economic growth in 2006 stimulated a substantial increase in the number of employed (by 5%), thus reducing the unemployment level to 6.8%.

The number of unemployed decreases not only due to the increase of the employment level. In the last years after Latvia's accession to the EU, labour outflow takes place to some old EU member states, where labour markets are open to the citizens of the new EU member states. Therefore, shortage of labour force in several sectors is starting to develop in the Latvian labour market.

Number of Employed Persons and Rate of Unemployed



¹ The analysis of employment and labour market trends deals with people aged 15-64 years, but unemployment trends with 15-74 years, that 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, 2007, thsd	1344.7	2281.3	3403.3
Gross domestic product, % of corresponding period of the previous year			
2005	110.5	110.6	107.6
2006	111.4	111.9	107.5
2006: 1 st quarter	111.7	113.1	108.5
2 nd quarter	111.7	111.1	108.4
3 rd quarter	111.3	111.9	106.4
4 th quarter	110.9	111.7	106.9
Industrial output index, %			
2005 against 2004	110.9	105.6	111.5
2006 against 2005	107.0	104.8	107.4
Unemployment rate (the percentage share of unemployed persons in the total number of economically active population aged from 15 to 74 years)			
2005	7.9	8.7	8.3
2006	5.9	6.8	5.6
2006: 1 st quarter	6.4	7.8	6.4
2 nd quarter	6.2	7.2	5.6
3 rd quarter	5.4	6.2	5.7
4 th quarter	5.6	6.2	4.8
Consumer price changes, % against previous year			
2005	4.1	6.7	2.7
2006	4.4	6.5	3.8
Producer price changes in industry, % against previous year			
2005 against 2004	2.1	7.8	11.5
2006 against 2005	4.5	10.3	7.4