

THE NATIONAL ECONOMY OF LATVIA: A MACROECONOMIC REVIEW

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*Main socio-economic indicators
of the Baltic States*



Latvia: 2006

Territory, thsd km ²	64.6
Population (as of 01.07.2006, thsds)	2288
of which:	
Urban area	1555
of which Riga, the capital city	726
Rural area	733
National currency: lats (LVL)	

Key indicators of economic development

	2002	2003	2004	2005	2006 f
(increase over the previous year, in per cent)					
Gross domestic product	6.5	7.2	8.6	10.2	11.0
Consumer prices	1.9	2.9	6.2	6.7	6.0
(% of GDP)					
General government budget fiscal balance	-2.3	-1.6	-1.1	-1.2	-1.5
Central government debt	13.5	14.4	14.6	12.0	11.0
Current account balance	-6.6	-8.1	-12.9	-12.4	-12.5
Exchange rate, LVL per US dollar	0.618	0.571	0.540	0.565	0.575
Exchange rate, LVL per euro	0.583	0.645	0.671	0.703	0.703
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	12.0	10.6	10.4	8.7	8.0

	2004				2005				2006
	I	II	III	IV	I	II	III	IV	I
(increase over the corresponding period of the previous year, in per cent)									
Gross domestic product	8.9	7.8	9.1	8.8	7.6	11.2	11.4	10.6	13.1
Consumer prices	4.3	5.8	7.4	7.3	6.7	6.5	6.5	7.3	7.0
(% of GDP)									
General government budget fiscal balance	2.4	-1.5	4.2	-8.2	3.3	3.1	3.0	-11.7	6.0
Current account balance	-9.4	-18.8	-13.4	-10.0	-10.9	-10.6	-12.6	-15.0	-14.6
Exchange rate, LVL per US dollar	0.538	0.548	0.545	0.530	0.535	0.557	0.576	0.591	0.585
Exchange rate, LVL per euro	0.673	0.660	0.666	0.685	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)	11.5	9.9	10.0	10.3	9.9	9.2	8.7	7.8	7.8

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, implement the transition from a labour-intensive economy to a knowledge-based one attaining 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 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.

In October 2005 the government adopted the *National Lisbon Programme of Latvia for 2005-2008*, which describes Latvia's mid-term priorities and measures aimed at fostering growth and employment. The goal is to ensure GDP growth at 6-8% annually in the next years and to increase the employment rate up to 67 per cent by 2010.

To ensure balanced development the government has planned to reduce the budget deficit gradually intending in this way to reduce also the current account deficit.

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

One of the main challenges to the economic policy of Latvia is to set up an effective and competitive sectoral structure by implementing structural reforms to boost productivity and to support research and development and innovation, improving 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 became effective 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 with the intention to complete it before the local government election 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.

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

The reforms carried out in the country and integration into the EU have made a positive impact on economic development. In the period between 2001-2005 GDP grew on average by 8.1% annually and by 10.2% in 2005. Rapid economic growth also continued in 2006. Compared to the corresponding period of 2005, GDP in the 1st quarter this year rose by 13.1%. These growth rates are the highest in the European Union. The high growth rates in Latvia are ensured by the steady increase of domestic demand and export growth.

Economic activity is accelerating in all main economic sectors. Domestic demand fosters the development of services, especially trade and construction. High growth rates can also be observed in the transport and communications sectors. Output in manufacturing in the period between 2001-2005 increased on average by 7.6% per year. In 2005, mainly due to the negative impact of the storm in January on the largest exporting sector manufacture of wood and of articles of wood, growth rates in manufacturing increased at a slightly lower pace, by 6.3%. The competitiveness of Latvian manufacturers can be explained by the rapid rise in productivity spurred by the investments that were made in previous years.

Economic growth in Latvia has been achieved in a stable macroeconomic environment. The general government budget deficit in Latvia is low and does not exceed the reference level set by the Maastricht criteria. In 2005, according to the methodology of the European System of Accounts ESA 95, there was a budget surplus in Latvia. Although the current account deficit is comparatively large, it should not be considered today as critical because it is covered by foreign direct investments and long-term loans. Net foreign reserves of the Bank of Latvia fully cover the reserve money.

A relatively high inflation level has been observed in recent two years. Its rise in 2004 was 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 the EU accession and the high oil prices on the global markets). Inflation in 2005 remained on a high level owing mainly to the rises in the global oil prices and the second phase of inflation (spiral). According to forecasts, due to the diminishing influence of the aforementioned price-raising factors, inflation will gradually decrease. In the six months of 2006 inflation increased at a more moderate pace than in the corresponding period of the previous two years.

The employment and unemployment indicators are gradually improving. In recent years the number of employed has been rising every year by 1-2% while the unemployment rate decreased from 14.4% in 2000 to 8.7% in 2005.

The economic growth potential is best characterised by investment increase. In comparison with 2000, gross fixed capital formation in 2005 doubled and in 2005 it increased by 19%. The investment growth rate and its share in GDP are among the highest in the EU. Investment continued to accelerate rapidly also in 2006 promoting the modernisation of production and transition to new more productive technologies. This strengthens confidence that growth in the coming years will also be sustainable. If there are no external shocks GDP can be expected to grow by 6-8% annually in the medium term. The Ministry of Economics puts GDP growth in 2006 at 11%.

Gross domestic product

2005

GDP, at current prices

mln lats	8935
mln US dollars	15818
mln euro	12713

GDP per capita

lats	3885
US dollars	6877
euro	5527

GDP by sector, %:

Agriculture ¹	4.1
Industry	15.7
Construction	6.3
Trade ²	22.1
Transport and communications	15.6
Public services ³	14.2
Other services	22.0

In recent years Latvia has shown high GDP growth rates. The growth rate in 2005 was even more rapid reaching 10.2%.

The main reason for growth in 2003 and 2004 was the stable domestic demand. Export growth in 2005 played a more important role, with domestic demand continuing at the same time on a considerably high level.

The export of goods as well as that of services accelerated sharply in 2005 and Latvia's trade balance improved. The volume of private consumption increased driven not only by the annual wage increase but also by the availability of consumer loans to private persons at acceptable interest rates as well as loans for dwelling purchase and repair. Private consumption in 2005 exceeded the level of the previous year by 11.4%. The favourable financial situation (low interest rates on loans and expanding mortgage lending) also encouraged investing. Gross fixed capital formation in 2005 was considerably higher (by 18.6%) than in the previous year.

Nearly 80% of GDP growth was on account of the development of the services sector fostered mainly by the development of the trade, transport and communications sectors. Construction is growing fast while industrial growth has been more moderate. Construction output in 2005 was 15.5% higher than in 2004.

Growth rates in the 1st quarter of 2006 were even higher than in the preceding year, with high growth rates persisting in the majority of service activities and manufacturing output increasing at a more rapid pace in comparison with the previous year. There are high growth rates in nearly all sectors of the economy, especially in construction, transport and communications.

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	2003	2004	2005
	I	II	III	IV	I			
GDP	7.6	11.2	11.4	10.6	13.1	7.2	8.6	10.2
Agriculture ¹	1.2	5.7	8.4	4.7	2.7	-2.4	3.4	5.5
Industry	0.2	8.0	8.0	7.7	9.3	6.0	6.4	5.9
Construction	16.2	15.8	15.6	14.4	17.5	13.7	13.3	15.5
Trade ²	15.2	18.7	17.5	17.6	17.3	10.9	12.7	17.2
Transport and communications	11.1	18.8	18.4	15.9	6.0	8.9	12.9	16.2
Public services ³	2.7	4.0	1.5	2.8	2.9	3.8	3.4	2.7
Other services	5.4	8.2	9.9	8.7	17.5	5.7	7.7	8.0

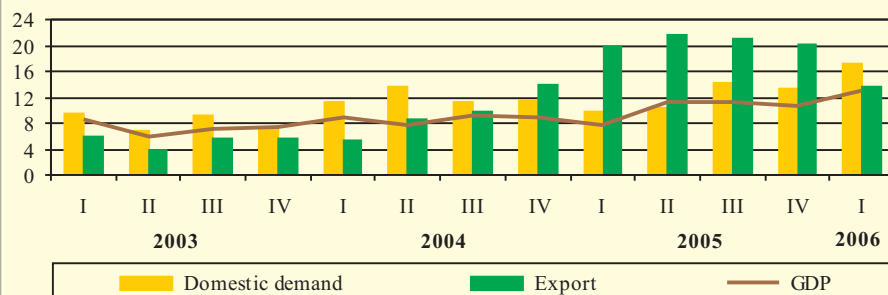
¹ Including forestry and fishing

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

2005

Growth rate: 6.5%

Share in GDP 12.8%

Recent years (2001-2005) have witnessed steady growth in manufacturing. Manufacturing output has been growing by 7.6% per year so the increase in manufacturing can be put nearly on the same level as the overall economic growth. The largest part of products manufactured within the majority of subsectors is exported and this is why the development of the sectors depends to a great extent on the expansion of export opportunities.

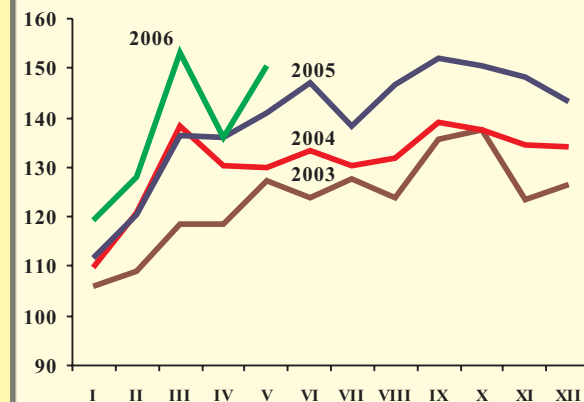
Straight after EU accession growth rates in manufacturing decreased as enterprises had to adjust to the new trade conditions. A noticeable upward trend started again in May 2005. Those sectors, where trade outlets were relatively less connected with exports, witnessed faster growth in 2005, except the food industry; for example, the growth rates were about 25% in the manufacture of construction materials, 12% in printing and 15% in the chemical industry. The fastest export growth in the post-accession period was observed in the direction of Estonia and Lithuania and the export increase to these countries occurred on a larger scale than to the other EU countries. The export of the products of the manufacturing to the CIS countries has also increased rapidly.

The growth trend of the manufacturing industry has on the whole been steady, without marked acceleration or decline. The falling growth rates in selected industries have been countervailed by accelerated growth rates in other industries. In comparison with 2000, the results of almost all manufacturing sub-sectors in 2005 (with the exception of the manufacture of transport equipment) point to an increase in output.

In the five months of 2006 manufacturing output exceeded the level of the corresponding period last year by 6.4%. High growth rates persisted in the manufacture of textiles, the chemical industry and in several machinery sectors, especially in the manufacture of electrical machinery and equipment. More moderate growth was observed in the food industry and wood processing, the biggest sub-sectors of manufacturing in Latvia.

Manufacturing Output

(average monthly output in 2000 = 100)



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Investments

2005

Foreign direct investment stock per capita, at the end of the year: 2074 US dollars

Gross fixed capital formation (% of GDP): 29.8

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

Fixed investments in Latvia in 2005 were twice bigger than in 2000, i.e., they have annually increased by 15.7% on average in this period.

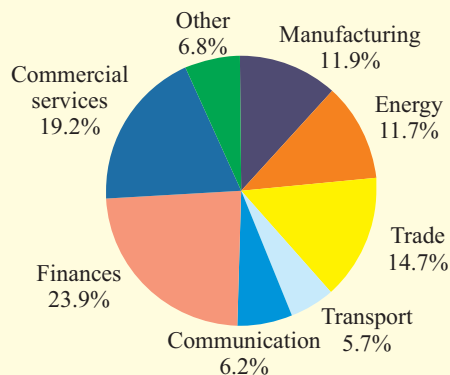
At the end of 2005 the incoming foreign direct investment

made by non-resident entrepreneurs totalled 1230 lats or 2074 US dollars per inhabitant.

Investments in the services sector account for the largest share in the sectoral structure of the foreign direct investment stock. By contrast, in 2005 and in the 1st quarter of 2006 the largest investments were made in the energy sector, financial intermediation and communications.

Three quarters of FDI came from the EU member states and the major investors were the entrepreneurs from Sweden (16.5% of the FDI stock at the end of March 2006), Germany (13%) and Estonia (11%). 8.3% of the investments were from Russia.

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



Foreign trade

2005

Structure of export, %:

Wood and products of wood -	24.8
Metalworking, machine building and transport equipment -	26.3
Light industry goods -	9.3
Chemical goods and articles of plastics -	8.1
Agricultural and food products -	12.2
Other goods -	19.3

The value of commodity exports from Latvia in 2005 was much higher (by 34%, at current prices, in lats) than in the previous year. The increase in the value of imports was, in turn, slightly less conspicuous, by 28%.

The sharp increase in the export unit value in 2005, which in comparison with the previous year exceeded by 10%, the increasing exchange rate of the euro and the rising world prices for several commodity groups, in particular for food and mineral products, made a favourable impact on commodity exports.

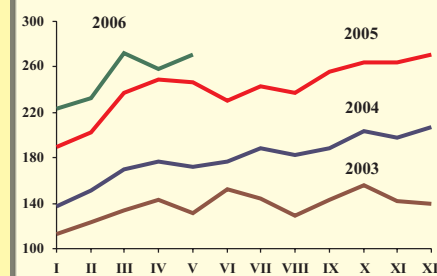
Exports in 2005 increased substantially on all the markets trading Latvian goods, especially in the direction of the new EU member states.

Imports in 2005 also considerably exceeded the level of the previous year. The import of mineral products, mainly from the CIS countries, rose particularly quickly (one third of the total import growth), as did the import of machinery and food products.

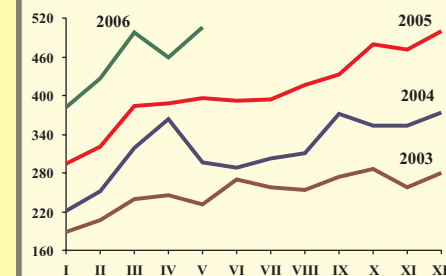
After accession to the EU, Latvia's foreign trade with Lithuania and Estonia as well as with the other new EU member states has increased very rapidly. A comparison with the EU pre-accession period shows that within two years Latvia's foreign trade with the other Baltic countries has more than doubled.

The value of exports in the five months of 2006 exceeded the level of the corresponding period last year by 12% while that of imports increased at a much faster rate, by 27.4%. This was mainly accounted for by an increase in the imports of investment goods.

Commodity Exports by Months
(mln lats)



Commodity Imports by Months
(mln lats)



Balance of payments

2005

Current account balance

mln LVL: -1112.4

mln US dollars: -1959.5

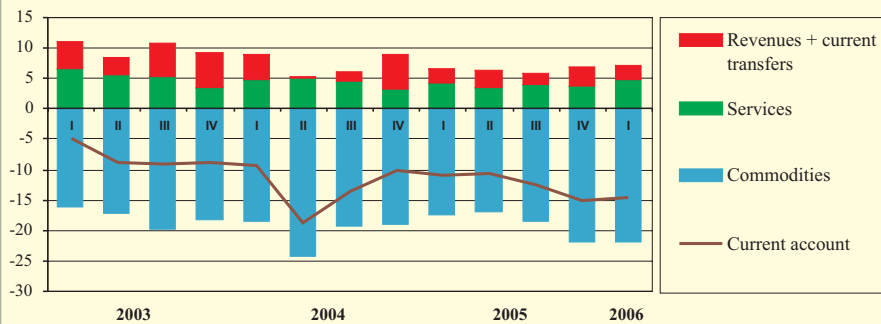
There is a relatively large current account deficit in Latvia. The main source of the deficit is the markedly negative trade balance. Mainly, the negative current account balance is covered by foreign direct investment and other long-term capital flows. The reserve assets of the Bank of Latvia are increasing.

The positive balance on services covers approximately one fifth of the negative trade balance. The balance on services is slightly worsening year by year despite the improvement of the traffic balance due to the more rapid increase in the expenditures of resident travellers abroad than in the expenditures of foreign tourists in Latvia; the export of various other services (communications, construction, financial, information and computer services) likewise increased at a slower pace than imports.

The sharpest fluctuations in the current account balance are nevertheless determined by changes in the trade balance. On the whole, the negative current account balance in 2005 decreased due to the improvement of the trade balance but data for the 1st quarter of 2006 testify to the worsening of the current account due to the increasing trade deficit.

Domestic demand in Latvia is higher than gross domestic product and this is the reason for the emergence of current account deficit. It means that in order to finance domestic investments foreign saving should also be used. In recent years the level of saving in GDP in the economy of Latvia has been actually constant, approximately 20%. The rate of investments in the economy is, in turn, high, especially after EU accession (33% in 2004 and 34% in 2005).

Current Account Balance
(% of GDP)



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Inflation

June 2006

(12-month inflation)

CPI: 6.3%

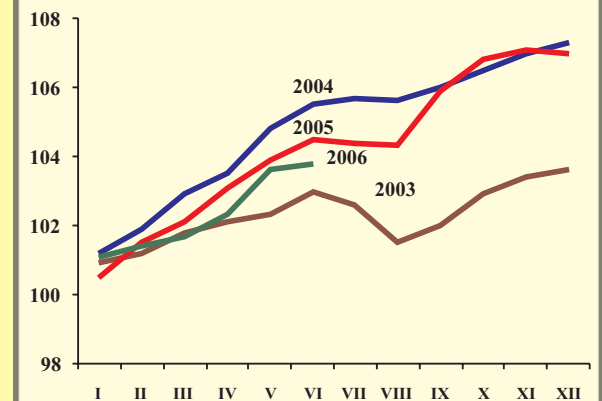
PPI: 9.7%

In 2004 the inflation rate accelerated sharply in Latvia: in December the 12-month inflation reached 7.3% and the annual average inflation in 2004 was 6.2%. Inflation growth in 2004 more than doubled in comparison with 2003. The price increase was mostly caused by some factors on the supply side gradually strengthening their influence during the whole year.

The high domestic demand that was stimulated by a perceptible wage rise in previous years and the high growth of crediting intensified the second-phase effect of inflation. This is why high inflation persisted also in 2005 affected in addition by the continuously rising fuel prices on the global market. In 2005 the 12-month inflation was 7% and the average for the year was 6.7%.

Although still relatively high, the inflation rate in the six months of 2006 was declining gradually. The main reasons behind the price growth are the same as in the previous year: inflation expectations caused by the high inflation in the previous two years, intensive mortgage lending, the steep rise in the administratively regulated prices (for electricity, gas and also for heating at the end of the year) and a wage increase in the private sector; this was a consequence of the high inflation in 2005 and of the wage rise for the teachers, doctors and other public sector employees.

Consumer Price Index
(December of previous year = 100)



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Monetary indicators

2005

Domestic enterprises and private persons

Loans:	68.7% of GDP
Deposits:	35.8% 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. A high growth rate of the monetary indicators persisted also at the beginning of 2006.

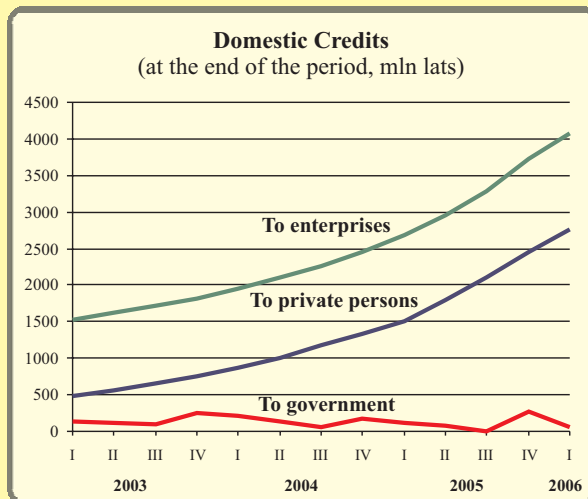
Compared with April 2005, the amount of broad money M2X in April 2006 rose by 40.4%, currency in circulation increased by 20.2% and deposits rose by 45.8%. In the same period credits to enterprises and private persons also continued to increase (by 61.7%). Although the amount of crediting is rising, the quality of loans does not deteriorate. At the end of 2005 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 in March and November 2004 raised its re-financing rate by 0.5 percentage points to 4% and increased in July its reserve requirement from 3% to 4%, in August 2005 to 6% and in December 2005 to 8%. However, the effectiveness of these measures in Latvia is limited by the fixed exchange rate regime and several other specific factors, such as the low share of loans granted to resident borrowers in GDP, the relatively easy access by the banks to foreign resources and the relatively large share of loans issued in foreign currency in the total structure of loans.

In April 2006 the average weighted interest rate on short-term credits in lats was ¹ 6.8% but on long-term credits 8.9%; for credits in the currencies of foreign countries these rates were ¹ 4.9% and 5.9%, respectively.

¹ Short-term and with a changing interest rate.



Budget and central government debt

2005

General government budget (% of GDP):

Revenues:	36.0
of which taxes:	28.6
Expenditures:	37.3
of which capital investment:	2.9

The budget deficit in 2005 was lower than planned, 105.2 mln lats or 1.2% of GDP (in compliance with the methodology of the European System of Accounts ESA 95 the budget surplus in Latvia in 2005 was 0.2% of GDP). The revenues of the general government budget in 2005 were 26.9% higher than in 2004 and, accordingly, expenditures were 26.9% higher.

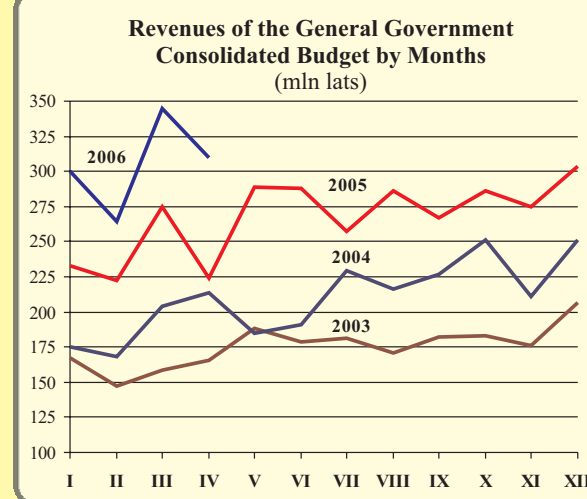
The Parliament has confirmed the general government budget for 2006 with a deficit of 145.2 mln lats (1.5% of GDP). The priorities of the budget for 2006 are: raising the welfare level of the population, integration into the EU and NATO, effective and full absorption of the allotted resources from the EU funds balancing it at the same time with the government's support to the social needs of the society. The major budget priorities include the resources envisaged for the national co-funding in connection with EU funds. By means of rational and effective utilisation of the money coming

from the EU funds, strong support will be provided for the encouragement of business activity and the development and improvement of the country's infrastructure.

By implementing a socially responsible policy, the minimum monthly wage has been raised as of 1 January 2006 from 80 to 90 lats, the minimum monthly untaxable income of the population from 26 lats to 32 lats and the monthly allowance for a dependent person from 18 lats to 22 lats.

The revenues of the general government budget in the five months of 2006 were 27.6% higher than in the corresponding period a year ago and, accordingly, expenditures were 17.4% higher. There was a fiscal surplus in the budget totalling 248 mln lats.

The level of the central government debt in Latvia is one of the lowest in the EU. At the end of 2005 it was 1073 mln lats or 12% of GDP.



Personal income

2005

Average monthly net wage:

lats 176
US dollars 311

Average monthly old-age pension (paid):

lats 81
US dollars 143

The average net monthly wage in 2005 was by 26 lats or 17% higher than in the preceding year. However, with inflation taken into account, real wage in 2005 rose by 9.7%.

The overall wage increase was to a great degree influenced by the high inflation in 2004 and 2005, as well as by the wage increase for the employees of several budget-financed institutions, for example, the teachers and doctors.

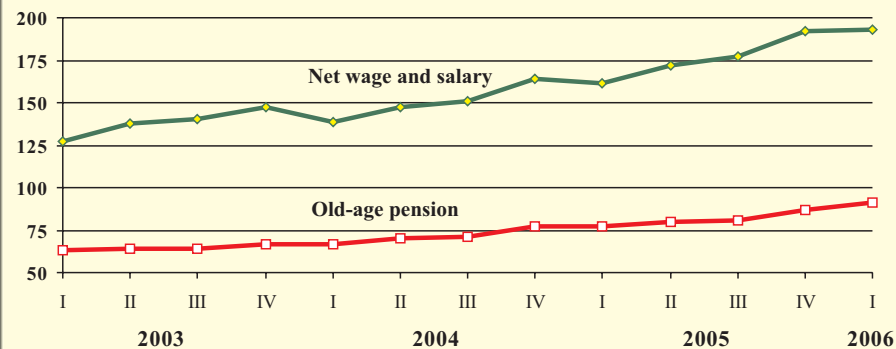
Also in the 1st quarter of 2006 the data of the average wage speaks about its fairly rapid increase (a 19.2% increase in the net wage compared with the 1st quarter of the previous year).

By implementing a socially responsible policy, the minimum monthly wage has been raised as of 1 January 2006 from 80 to 90 lats, the minimum monthly untaxable income of the population

from 26 lats to 32 lats and the monthly allowance for a dependent person from 18 lats to 22 lats.

The increase in the size of old-age pensions in 2005 was also noteworthy. Pensions in December 2005 were on average almost 12% or 9 lats higher than in December 2004 and in March 2006 they even exceeded the average size of pensions in March 2005 by 18.9% or nearly 15 lats.

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



Employment and unemployment¹

2005

Unemployment rate (rate of unemployed, aged 15-74): 8.7%

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

In the last five years (2001-2005) the employment rate has increased by 6.1 percentage points. In comparison with EU average, the employment rate in Latvia in 2000 was lower by 4.9 percentage points whereas in 2005 it lagged behind only by 0.5 percentage points.

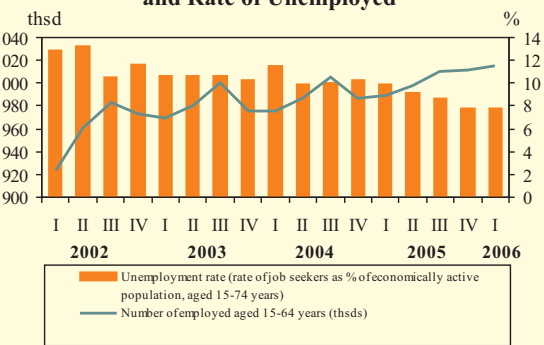
The level of female employment in Latvia is higher than the EU average and this difference tends to increase. This can be explained by the small share of manufacturing in the economy and the dominance of sectors with higher female employment (trade, hotels, restaurants and other services).

Despite the increasing trend year by year, the male employment rate still lags behind the EU average (by 6.7 percentage points in 2002 and 3.7 percentage points in 2005).

According to CSB Labour Force Survey data, the unemployment rate has decreased from 14.4% in 2000 to 8.7% in 2005. The unemployment rate at the end of 2005 was 7.4%, a considerably lower level than a year ago (8.5%).

The number of unemployed is decreasing not only on account of the rising employment rate. In recent years after Latvia's accession to the EU an outflow of workforce has been observed to the old EU member states (Ireland, Great Britain and Sweden) where labour markets are open to the citizens of the new EU member states. The labour market of Latvia begins therefore to show signs of a labour force shortage in several sectors.

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, 2006, thsd	1344.7	2294.6	3403.3
Gross domestic product, % of corresponding period of the previous year			
2005	109.8	110.2	107.5
2005: 1 st quarter	107.2	107.6	104.4
2 nd quarter	109.9	111.2	108.4
3 rd quarter	110.6	111.4	108.0
4 th quarter	111.1	110.6	108.8
2006: 1 st quarter	111.7	113.1	108.8
Industrial output index, %			
2005	109.1	105.6	107.3
January-May 2006 against January-May 2005	107.3	106.5	112.4
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)			
2005	7.9	8.7	8.3
2006: 1 st quarter	6.4	7.8	6.4
Consumer price changes, % against previous year			
2005	4.1	6.7	2.7
June 2006 against June 2005	4.3	6.3	0.2
Producer price changes in industry, % against previous year			
2005	2.1	7.8	11.5
June 2006 against June 2005	4.6	9.7	9.9