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Ministry of Economics of the Republic of Latvia

Central Statistical Bureau of Latvia

THE NATIONAL ECONOMY OF LATVIA: A MACROECONOMIC REVIEW

Latvia: 2005

Territory, thsd km²	64.6
Population (as of 01.01.2005, thsds)*	2307
of which:	
Urban area	1563
of which Riga, the capital city	732
Rural area	743
National currency: lats (LVL)	

* Estimate of the Central Statistical Bureau

Key Indicators of Economic Development

	2001	2002	2003	2004	2005 f
(increase over the previous year, in per cent)					
Gross domestic product	8.0	6.4	7.5	8.5	7.5
Consumer prices	2.5	1.9	2.9	6.2	5.5
(% of GDP)					
General government budget fiscal balance	-2.0	-2.3	-1.6	-1.1	-1.7
Central government debt	13.8	13.3	13.4	13.2	13.3
Current account balance	-7.6	-6.7	-8.2	-12.3	-9.8
Exchange rate, LVL per US dollar	0.628	0.618	0.571	0.540	0.530
Exchange rate, LVL per euro	0.563	0.583	0.645	0.671	0.703
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	13.1	12.0	10.6	10.4	10.0

	2003				2004			
	I	II	III	IV	I	II	III	IV
(increase over the corresponding period of the previous year, in per cent)								
Gross domestic product	8.8	6.2	7.3	7.5	8.7	7.7	9.1	8.6
Consumer prices	1.9	2.9	3.5	3.5	4.3	5.8	7.4	7.3
(% of GDP)								
General government budget fiscal balance	1.0	-0.9	0.6	-6.4	2.4	-1.5	4.3	-8.3
Current account balance	-5.0	-8.8	-9.3	-9.3	-9.5	-19.0	-13.6	-7.7
Exchange rate, LVL per US dollar	0.585	0.573	0.574	0.554	0.538	0.548	0.545	0.530
Exchange rate, LVL per euro	0.627	0.649	0.646	0.658	0.673	0.660	0.666	0.685
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	10.7	10.6	10.7	10.3	11.5	9.9	10.0	10.3

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.

To achieve this goal, a stable macroeconomic environment is maintained and structural reforms implemented to raise productivity and economic activity and to improve the business environment, infrastructure and the manpower potential, etc. 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.

Becoming a full-fledged member state of the European Union on 1 May 2004 Latvia has also joined one of the world's largest single markets with more than 450 mln consumers. Latvia can thus 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.

Latvia's aim is to become a full-fledged member participant of the European Economic and Monetary Union (EMU) already in the nearest future. The re-pegging of the lats from SDR to euro from the 1st of January this year marks the first stage on the road to EMU which is followed by Latvia's joining the European Exchange Rate Mechanism II on May 2, 2005. The Bank of Latvia and the government have scheduled the beginning of 2007 as the target date when all necessary criteria for the adoption of the euro should be met.

Private initiative and capital are the main driving forces for growth. The privatisation of state property is basically completed. 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. Latvia is consistent in its efforts to liberalise the monopoly markets in telecommunications, electricity and gas supply as well as in post and railway to stimulate competition. The Commercial Law testifying to a fundamental reform of the business environment became effective in 2002. Currently the corporate income tax rate in Latvia is among the lowest (15%) in the EU. Legislation provides special corporate income tax relief for large-scale investment projects as well as to enterprises operating within the special economic zones.

The government continues to upgrade the infrastructure, with special attention paid to the development of the energy sector, building of the electronic communications and information systems, improvement of the quality of transport infrastructure and creation of an effective network. Use of EU structural funds and the Cohesion Fund offer broader opportunities to improve infrastructure. The aim of the government is to ensure full absorption of the EU funds.

Successful implementation of structural reforms in Latvia will ensure the stability of economic growth, promote the catch-up process and deeper integration into the European and world economy.

Macroeconomic development

The reforms carried out in the country and integration into the EU have made a positive impact on economic development. Growth rates in Latvia are among the highest in the EU. In the period between 2001 and 2003 the average GDP growth rate was 7.3% per year. In 2004 GDP rose even at a faster pace by 8.5%. The high growth rates are based on the strong domestic demand and increase in exports.

Economic activity is increasing in all main sectors of the economy. The rise in domestic demand promotes the development of services especially trade and construction. High growth rates are also observed in the transport and communications sectors. Since 2001 manufacturing output has been rising by 9-10% annually (7.9% in 2004). The competitiveness of Latvian manufacturers is based on productivity growth, which was spurred by the investments made in previous years. Export dynamism attests to the competitiveness of several industries on the external markets where conjuncture conditions are not quite favourable.

Economic growth in Latvia was achieved in a stable macroeconomic environment. Except in 2004, inflation in recent years has been around 2-3%. Inflation in 2004 mounted to a higher level primarily owing to a combination of several one-off effects (an increase in the administratively regulated prices, harmonisation of the indirect tax rates, inflation expectations due to joining the EU and the high oil prices on the global scale). According to a forecast, due to the diminishing influence of the aforementioned factors, inflation in the next years will gradually return to its previous level.

The general government budget deficit is lower than allowed by the Maastricht Treaty. In 2004 it was 1.1% of GDP. The Parliament has confirmed the general government budget deficit for 2005 at 1.68% of GDP. The level of central government debt in Latvia is among the lowest in the EU. At the end of 2004 it was 975 mln lats or 13.2% of GDP. Although the current account deficit is comparatively large it should not be considered today as critical as it is covered by foreign direct investment and long-term loans. Net foreign reserves of the Bank of Latvia fully cover the reserve money.

The employment and unemployment indicators are gradually improving. In recent years the number of employed has been rising every year by approximately 2% but the unemployment rate has fallen from 14.6% in 2000 to 10.4% in 2004.

The reforms carried out in the previous decade have strengthened the private sector and created favourable macroeconomic conditions, and the business environment is also improving. Investments continue to grow rapidly promoting the modernisation of production and transition to new and more productive technologies. Accession to the EU will have a particularly positive impact on the development of the economy. 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% in the medium term. A forecast of the Ministry of Economics puts the increase in GDP in 2005 at 7.5%.

Gross domestic product

2004

GDP, at current prices	
mln lats	**7359**
mln US dollars	**13629**
mln euro	**10968**
GDP per capita	
lats	**3182**
US dollars	**5892**
euro	**4742**
GDP by sector, %:	
Agriculture[1]	**4.3**
Industry	**17.2**
Construction	**5.8**
Trade[2]	**19.8**
Transport and communications	**15.4**
Public services[3]	**15.7**
Other services	**22.2**

Latvia is characterised by high GDP growth rates, which in recent years (2001-2004) have been on average 7.6%. Growth in 2004 accelerated strongly, by 8.5%.

Similarly as in the previous year, the main reason for growth was the stable domestic demand and, to a lesser degree, the increasing export of commodities and services.

The favourable financial situation (low interest rates on loans and expanding mortgage lending) encourages investing. Compared with the previous year, gross fixed capital formation in 2004 rose by 17.3%. The expansion of crediting had a favourable impact also on private consumption, which in 2004 increased by 8.9%.

The development of the services sector accounted for almost three quarters of the overall growth where the major contribution was due to increases in the sectors of trade, transport and communications.

The development of trade is mainly accounted for by domestic demand. The sector while slightly more than one tenth is related to intermediary services in trade provided to non-residents. This segment is growing year by year.

The stable domestic demand, accelerating in recent years faster than the external demand, determines at least by two thirds the total demand within the transport and communications sector. In the second half of 2004 following EU accession, freight transport grew particularly quickly; passenger transport services including air transport services were also on the rise.

The rapid investment increase had a favourable impact on the development of construction where growth rates substantially exceeded the average growth indicators in the economy.

Growth in manufacturing has been somewhat slower than in the previous year and this can be partly explained by the adjustment to new conditions following EU accession.

[1] Including forestry and fishing
[2] Including hotels and restaurants
[3] Public administration including healthcare and education

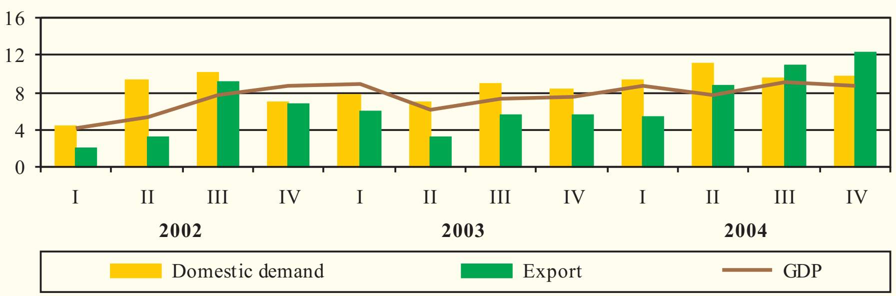
Gross domestic product

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

	2003				2004				2002	2003	2004
	I	II	III	IV	I	II	III	IV			
GDP	**8.8**	**6.2**	**7.3**	**7.5**	**8.7**	**7.7**	**9.1**	**8.6**	**6.4**	**7.5**	**8.5**
Agriculture[1]	4.5	0.7	-1.8	2.5	6.6	3.7	2.9	3.4	4.4	1.0	4.0
Industry	9.6	7.3	8.6	6.1	10.6	7.3	6.2	5.4	8.1	7.8	7.4
Construction	17.5	10.3	20.4	7.4	13.0	12.0	11.4	15.7	10.8	13.7	13.0
Trade[2]	16.9	9.8	8.5	11.1	11.2	8.2	10.4	11.2	11.9	11.6	10.3
Transport and communications	7.8	7.6	10.1	10.3	8.3	10.9	17.0	15.8	3.4	8.9	12.9
Public services[3]	2.5	2.7	2.8	3.5	4.5	4.1	3.5	3.8	2.4	2.9	4.0
Other services	4.5	3.2	3.4	6.2	7.5	7.4	9.3	6.7	5.4	4.4	7.7

[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)



Manufacturing

2004

Growth rate: 7.9%

Share in GDP: 14.0%

The period from 2001 to 2004 witnessed a steady increase in manufacturing, with the annual average growth rate of 9% considerably exceeding the average growth rates in the economy. Growth was largely accounted for by export expansion.

Manufacturing output in 2004 exceeded the level of the previous year by 7.9%. The sharpest acceleration was in the growth of the chemical industry (by 22.2%) and in the manufacture of construction materials (12.4%). Growth in other industries was less conspicuous.

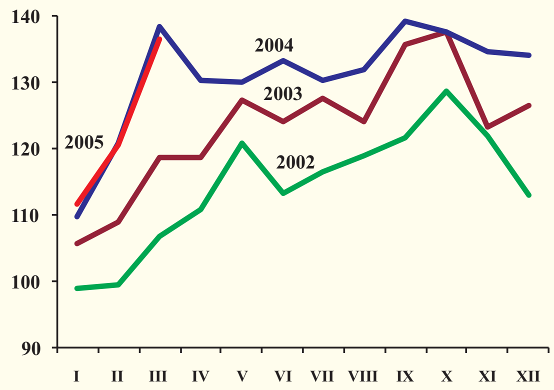
At the beginning of 2005 (in January-March) industrial production output in the sector stayed at the level of the previous year. Although in several sectors such as construction materials industry (an increase of 30.6%), chemical industry (8.6%), manufacture of furniture (7.8%) and printing industry (7%) growth was considerable, yet output constraints in the major manufacturing sectors (food production, wood processing, textile industry and metal industry) were accountable for zero increase in the total manufacturing output.

Output of the food industry, the biggest manufacturing sector of Latvia that contributed a quarter of the total value added in manufacturing, in the 1st quarter of 2005 was 1.2% lower than in the corresponding period of the previous year. Over the same period export volume within the sector has expanded.

Wood processing is the second largest industrial sector in Latvia (approximately one fifth of the total value added in manufacturing). About 70% of the production output of this sector are exported. The output volume is therefore basically determined by external demand. In the 1st quarter of 2005 the export of wood processing products declined representing a decrease of nearly 7% in production output. The main export markets are located in the EU countries. It is worth noting that in recent years market expansion has been also directed to other countries such as Lithuania, Estonia and Russia.

The share of the textile industry in manufacturing represents approximately 10%. Almost 85% of the output volume of the sector are exported, the main trade outlets being in the countries of the European Union. Production output in the textile industry is decreasing year by year owing to the sharply toughening competition within the sector.

Manufacturing Output
(average monthly output in 2000 = 100)



Investments

2004

Foreign direct investment stock per capita, at the end of the year:	**1856 US dollars**
Gross fixed capital formation (% of GDP):	**25.9**

In recent years (2001-2004) the share of fixed investments in GDP constituted on average almost one quarter. This indicator is one of the highest among the EU countries.

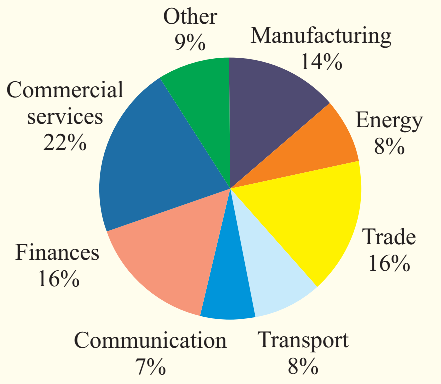
In 2004 the investment level in the economy stayed high. Gross fixed capital formation in 2004 increased by 17.3%. The investment process was favourably influenced by better accessibility to financial resources, gradual reduction of interest rates on long-term loans and the high growth rates.

At the end of 2004 foreign direct investment stock totalled 2318.3 mln lats or approximately 31.5% of the GDP.

In 2004 the inflow of foreign direct investment doubled in comparison to the total for 2003 and was 350.2 mln lats (4.8% of GDP). The incoming foreign direct investments covered nearly one fifth of the fixed capital formation. The largest investments were made in energy, financial intermediation and communications.

In comparison with the previous year, the interest of EU investors in Latvia has increased. Investments from the EU countries accounted in 2004 for 85% of the incoming foreign direct investment. In this period the most noteworthy foreign direct investments came from Germany, Russia and the Netherlands.

Accrued foreign direct investment by industry
(at end of 2004, per cent)



Foreign trade

2004

Structure of export, %:

Wood and products of wood -	**30.5**
Metalworking, machine building and transport equipment -	**24.5**
Light industry goods -	**11.0**
Chemical goods and articles of plastics -	**7.9**
Agricultural and food products -	**9.7**
Other goods -	**16.4**

The value of commodity exports from Latvia in 2004 was much higher (by 29.1% at current prices) than in the previous year.

The sharp increase in the export unit value in 2004 reaching 17.5% in the last quarter made a favourable impact on commodity exports in comparison with the fourth quarter of the previous year. The price increase was accounted for by the advantageous changes in the exchange rate as well as by the increase in global prices for several commodity groups, especially for base metals and articles of base metals.

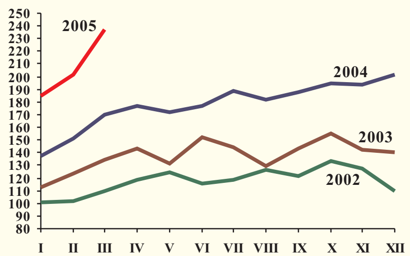
Exports increased considerably on all the markets trading Latvian goods both in the direction of the EU and CIS countries as well as in other countries worldwide.

The exports of base metals and articles of base metals (23% of the total export growth to EU-25) and exports of wood (18%) contributed most to the rising volume of exports. The increase in the export of food products is also noteworthy. Exports of food products to the EU countries in 2004 rose by one third compared to the previous year.

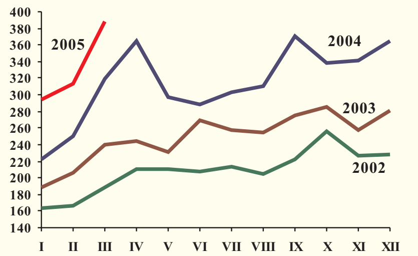
Imports in this period also considerably exceeded the level of the previous year (by 26.1% at current prices). The most substantial increase in imports observed in March-April 2004 was due to the entrepreneurs` desire to import in the last months before EU accession as many as possible intermediate and consumer goods in compliance with the old terms of trade. An increase in imports was observed in all commodity groups; the steepest being in the mineral products group (24% of the total import growth) and in the machinery group (15%).

The volume of exported products (in lats) in the two months of 2005 exceeded the level of the corresponding period of the previous year by 34.4%. Imports, in turn, grew at a relatively slower pace (by 28.5%).

Commodity Exports by Month
(mln lats)



Commodity Imports by Month
(mln lats)



Balance of payments

2004

Current account balance

mln LVL:	**-908.0**
mln US dollars:	**-1673.3**

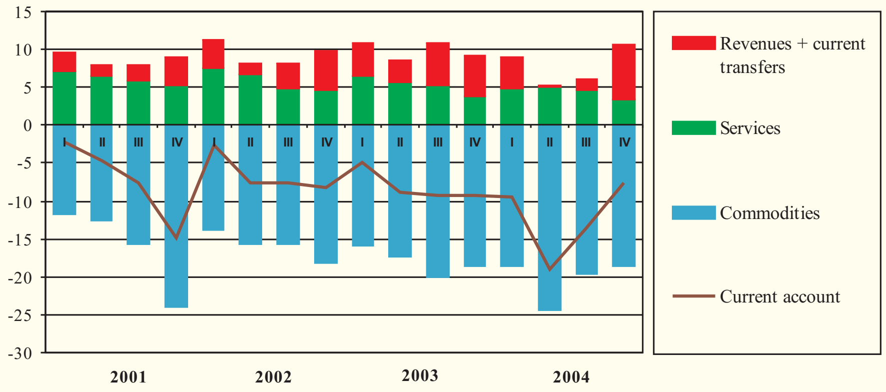
There is a relatively large current account deficit in Latvia. The main source of the deficit is the markedly negative trade balance. Slightly less than one third of the deficit is covered by the positive balance on services, as there is a large share of transit services in the economy.

Following a slight improvement in the trade balance in 2002, it worsened again in 2003 due to the faster growing commodity imports in comparison with exports. Trade balance in 2004 continued to worsen.

In 2004 the current account deficit was 12.3% of GDP, an increase of 4.1 percentage points compared to 2003. This was due to the worsening of the trade balance (by 2.2 percentage points) and the decrease in the balance on services (by 0.8 percentage points). It is worth noting that the balance of revenues has worsened (by 1.4 percentage points) due to the rising direct investment income whereas the increase of the reinvested profit should be assessed positively.

Foreign direct investment and long-term flows cover the largest part of the current account deficit. In 2004 foreign direct investment in Latvia constituted 38.6% of the current account deficit. Net flows from the capital and financial account exceeded the current account deficit, and reserve assets have increased.

Current Account balance
(% of GDP)



Inflation

March 2005

(12-month inflation)

CPI:	**6.4%**
PPI:	**10.1%**

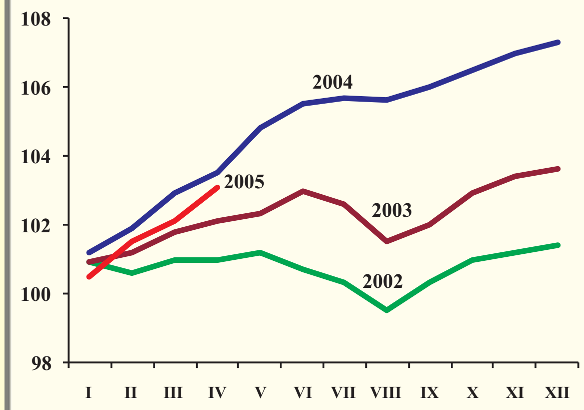
In 2004, the rate of inflation accelerated sharply in Latvia: in December the 12-month inflation reached 7.3% and the annual average inflation in 2004 was 6.2%. Inflation growth in 2004 more than doubled in comparison to 2003.

There was a substantial price rise nearly in all basic groups of goods and services except communications. The price increase was mainly caused by some factors on the supply side gradually strengthening their influence during the whole year. The increase in the administratively regulated prices was caused mainly by a rise in electricity prices. The impact of the regulated prices to the average consumer price increase in 2004 reached 0.9 percentage points compared. The increase in the prices of oil and in the excise on oil products in 2004 resulted in a substantial overall price increase by 0.8 percentage points. Due to unfavourable weather conditions and increasing costs in the second half of the year the prices of food products saw a substantial rise accounting for approximately one third of the average consumer price increase.

The high domestic demand that was stimulated by a susceptible wage rise in previous years and the brisk growth of crediting intensified the second-phase effect of inflation caused by the aforementioned factors.

In the four months of 2005 prices grew at a slower pace (by 3.1% comparing the price level in April 2005 with that in December) than in January-April of the previous years (by 3.5%, respectively).

Consumer Price Indices
(December of previous year = 100)



Monetary indicators

2004

Domestic enterprises and private persons

Loans:	**50.8% of GDP**
Deposits:	**30.2% of GDP**

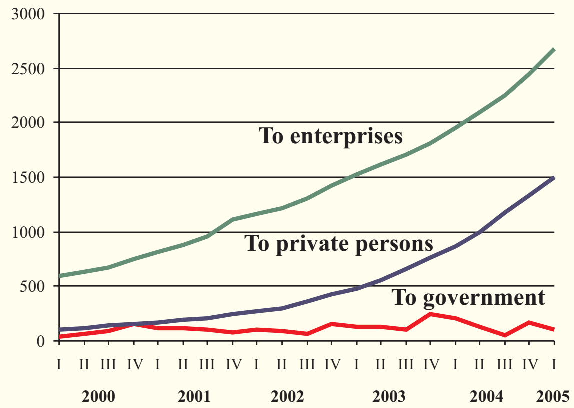
The stability of the banking sector, the rising welfare and economic activity of the population are the reasons stimulating steady growth of the basic monetary indicators of the banking system of Latvia.

Compared with March 2005, the amount of broad money M2X in March 2005 rose by 28.3%, currency in circulation increased by 10.5% and deposits rose by 34.1%. In the same period credits to enterprises and private persons continued to increase (by 49.5%). The share of short-term loans in the overall credit structure is decreasing while that of long-term loans is increasing. Although the amount of crediting is rising the quality of loans has not deteriorated. At the end of 2004 the share of loans generating no income in the total number of loans was only 1.2%.

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%. However, the effectiveness of these measures in Latvia has been 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 March 2005 the average weighted interest rate on short-term credits in lats was [1]7.3% but on long-term credits 10.4%; for credits in the currencies of foreign countries these rates were [1]5.2% and 6.4%, respectively.

Domestic Credits
(at the end of the period, mln lats)



[1] Short-term and with a changing interest rate.

Budget and central government debt

2004

General government budget (% of GDP):

Revenues:	**34.4**
of which taxes:	**27.5**
Expenditures:	**35.9**
of which capital investment:	**3.5**

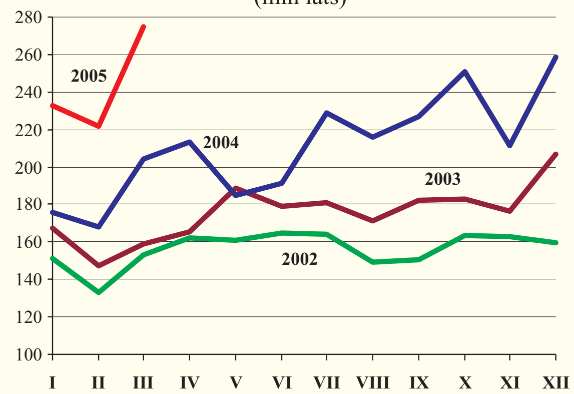
The budget deficit in 2004 was lower than planned, 79 mln lats or approximately 1.1% of GDP (102.4 mln lats or 1.6% of GDP in 2003). The revenues of the general government budget in 2004 were 20% higher than in 2003 and, accordingly, expenditures were 19.3% higher.

The Parliament has confirmed the general government budget for 2005 with a deficit of 1.68% of GDP. In 2005, the priorities of the budget are: restructuring of the healthcare system, integration into the EU and NATO fully utilising the opportunities provided by these organisations and protecting national interests; extensive use of the EU political instruments allotted to Latvia with an aim to effectively ensure the country's development and prosperity and the development of its scientific potential. In pursuance of a socially responsible policy, the minimum untaxable income of the population has been raised as of 1 January 2005 from 21 lats to 26 lats and the monthly allowance for a dependent from 10.5 lats to 18 lats.

The revenues of the general government budget in the three months of 2005 were 33.2% higher than in the corresponding period a year ago and expenditures were 33.7% higher. There was a fiscal surplus in the budget comprising 61.0 mln lats.

The level of the central government debt in Latvia is one of the lowest in the EU. At the end of 2004 it was 975 mln lats or 13.2% of GDP (846.3 mln lats or 13.4% of GDP at the end of GDP).

Revenues of the General Government Consolidated Budget by Months
(mln lats)



Personal income

2004

Average monthly net wage:

lats	**150**
US dollars	**278**

Average monthly old-age pension (paid):

lats	**71**
US dollars	**131**

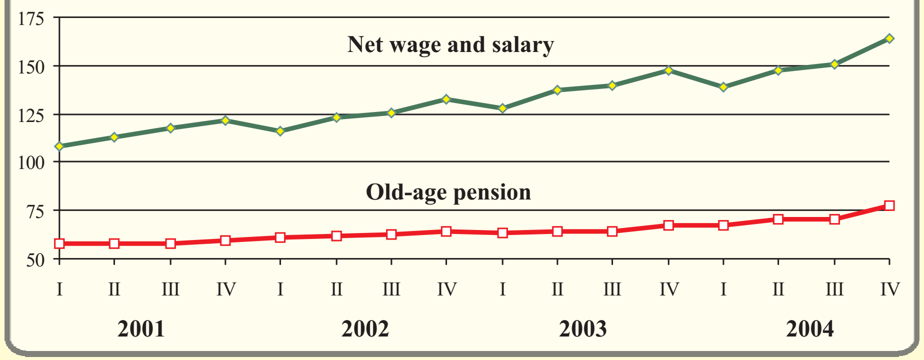
Compared with the previous year, the average net monthly wage in 2004 increased by 12 lats or 8.8%. However, with inflation taken into account, the real income of employees has increased by 2.4%.

One of the reasons for the increase in the average wage is the raising of the minimum wage by 10 lats. The minimum wage in 2003 was 70 lats but since 1 January 2004 the minimum wage has been fixed at 80 lats.

Compared with the previous year, the average size of the monthly pension paid in 2004 to old-age pensioners registered with the social security institutions increased by 6.55 lats or 10.2%. The minimum pensions have been raised as of 1 December 2003.

In recent years the structure of household disposable income has changed little: the share of labour remuneration has decreased a little representing on average 64% of the total income. The share of income from business activity and property income reaching nearly 9% of the total income has, in turn, increased. Pensions make up 1/5 of the total household income.

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



Employment and unemployment[1]

2004

Unemployment rate (rate of job seekers aged 15-74):	**10.4%**
Registered unemployment rate (at end of year):	**8.5%**

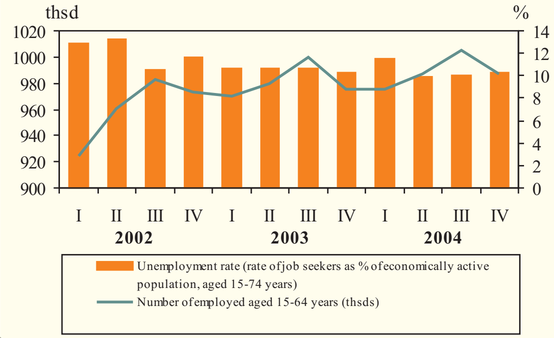
Economic development in recent years has made a positive impact on the situation on the labour market. Although the number of population of working age decreases, the number of economically active population is rising, as is the rate of employment.

In the period between 2001 and 2003 the employment rate in Latvia increased by 4.3 percentage points. In parallel with the number of employed rising by 6.7 thsd in 2004, the employment rate increased by another 0.5 percentage points reaching 62.3%.

According to the CSB Labour Force Survey, compared with 2000, the unemployment rate in 2004 decreased from 14.4% to 10.4%. The highest unemployment prevails in the Latgale region (12.8% in 2004). The poorly developed entrepreneurship, the low number of self-employed and bad traffic infrastructure account for the high unemployment level.

The registered unemployment rate in Latvia was 8.6% at the end of 2003 and 8.5% at the end of 2004. The registered unemployment rate is approximately 1.2 times lower that the rate of job seekers which was estimated according to ILO methodology. There are several reasons behind that. Not all individuals can get the unemployment benefit since no social contributions have been made (declared); many persons are not interested in or capable of mastering the re-qualification programmes, especially the pre-retirement age persons; quite frequently it is embarrassing to meet all the duties of a registered unemployed person. It should also be taken into account that the status of unemployed is not granted to persons over the working age according to legislation.

Number of Employed Persons and Rate of Job Seekers



[1] To achieve compliance with EU requirements, various changes including those in the age of respondents were made in the organisation of the CSB Labour Force Survey beginning from 2002. The age of the respondents was set at 15-74 years; previously the age of respondents had been 15 years and over. The analysis of employment and market trends deals with people aged 15-64 years and this corresponds to the EU practice.

Main socio-economic indicators of the Baltic countries

	Estonia	Latvia	Lithuania
Territory, thsd km^2	45.2	64.6	65.3
Population as of January 1, 2005, thsd	1347.0	2306.4	3425.5
Gross domestic product, % of corresponding period of the previous year			
2003	105.1	107.5	109.7
2004	106.2	108.5	106.7
2004: 1st quarter	106.8	108.7	107.1
2nd quarter	105.9	107.7	107.3
3rd quarter	106.1	109.1	105.8
4th quarter	105.9	108.6	106.7
Industrial output index, %			
2003	111.0**	106.5**	116.1
2004	107.9**	106.0**	110.8
Unemployment rate, %*			
2003	10.0	10.6	12.4
2004	9.7	10.4	11.4
Consumer price changes, % against previous year			
2003	1.3	2.9	-1.2
2004	3.0	6.2	1.2
Producer price changes in industry, %			
2003	0.2	3.2	-0.5
2004	2.9	8.6	6.0

* Persons aged 15-74 years.
** Short-term statistics for 2003 and 2004.

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