

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

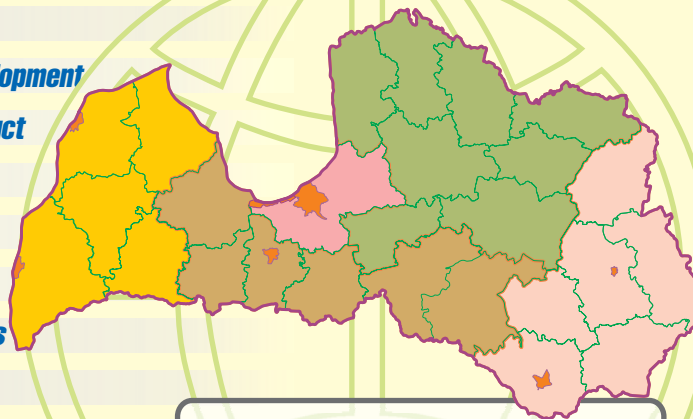
Monetary indicators

Budget and central government debt

Personal income

Employment and unemployment

*Main socio-economic indicators
of the Baltic countries*



Latvia: 2005

Territory, thsd km ²	64.6
Population (as of 01.01.2005, thsds)	2306
of which:	
Urban area	1567
of which Riga, the capital city	732
Rural area	739
National currency: lats (LVL)	

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	6.0
(% 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				2005
	I	II	III	IV	I	II	III	IV	I
(increase over the corresponding period of the previous year, in per cent)									
Gross domestic product	8.8	6.2	7.3	7.5	8.7	7.7	9.1	8.6	7.4
Consumer prices	1.9	2.9	3.5	3.5	4.3	5.8	7.4	7.3	6.7
(% of GDP)									
General government budget fiscal balance	1.0	-0.9	0.6	-6.4	2.4	-1.5	4.3	-8.3	3.3
Current account balance	-5.0	-8.8	-9.3	-9.3	-9.5	-19.0	-13.6	-7.7	-10.7
Exchange rate, LVL per US dollar	0.585	0.573	0.574	0.554	0.538	0.548	0.545	0.530	0.531
Exchange rate, LVL per euro	0.627	0.649	0.646	0.658	0.673	0.660	0.666	0.685	0.703
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	9.9

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 of the European Economic and Monetary Union (EMU) already in the nearest future. Latvia's joining the European Exchange Rate Mechanism II on May 2, 2005 marks the first step on the road to EMU. After a two-year performance within the EERM II the EU institutions will make an evaluation of the preparedness of Latvia to join the EMU. The government has scheduled the first of January 2008 as the target date for the introduction of the EU common currency into Latvia.

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 the upgrade of 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. The utilisation 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. Since 2000 the average GDP growth rate has been 7.6% per year. In recent years the high growth rates have been based on the steady increase of domestic demand and export growth.

Rapid economic growth continues also in 2005. Compared to the 1st quarter of 2004, GDP in the 1st quarter this year rose by 7.4%. The increase in the 1st quarter was attained mainly on account of the strong domestic demand and the high investment level. Trade and construction continued to grow vigorously and transport indicators also improved. Mainly due to the negative after-effects caused by the storm in January growth in the manufacture of wood and articles of wood, the largest exporting sector, decelerated. It is expected that in the second half of 2005 growth rates in industry will accelerate. A forecast of the Ministry of Economics puts the GDP increase in 2005 in Latvia at 7.5%.

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. In the first half of 2005 inflation rose at a more moderate pace than in the corresponding period last year.

The general government budget deficit in 2004 was 1.1% of GDP. The Parliament has confirmed the general government budget deficit for 2005 at 1.68% of GDP. In the first 5 months of 2005 there was a fiscal surplus of 111 mln lats in the budget. 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 14.4% 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; 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.

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	15.7
Public services ³	15.0
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 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.

Growth at the beginning of 2005 was also vigorous despite the slightly less spectacular progress in the 1st quarter of 2005 (by 7.4%). The slackening growth was mainly due to the stagnating manufacturing output in this period.

The development of the services sector and construction was, in turn, remarkable. Construction output in the 1st quarter of 2005 was 16.2% higher than in the 1st quarter a year ago. The construction of private and multi-dwelling residential houses as well as public buildings is increasing rapidly.

The stable domestic demand accounts mainly for the growth of trade as a sector while slightly more than one tenth is related to intermediary trade services provided to non-residents. This segment is rising year by year.

In the second half of 2004 following EU accession, freight transport grew particularly quickly and passenger transport services including air transport services were also on the rise.

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, %)

	2004				2005	2002	2003	2004
	I	II	III	IV	I			
GDP	8.7	7.7	9.1	8.6	7.4	6.4	7.5	8.5
Agriculture ¹	6.6	3.7	2.9	3.4	1.3	4.4	1.0	4.0
Industry	10.6	7.3	6.2	5.4	0.1	8.1	7.8	7.4
Construction	13.0	12.0	11.4	15.7	16.2	10.8	13.7	13.0
Trade ²	11.2	8.2	10.4	11.2	15.2	11.9	11.6	10.3
Transport and communications	8.3	10.9	17.0	15.8	11.1	3.4	8.9	12.9
Public services ³	4.5	4.1	3.5	3.8	2.7	2.4	2.9	4.0
Other services	7.5	7.4	9.3	6.7	5.5	5.4	4.4	7.7

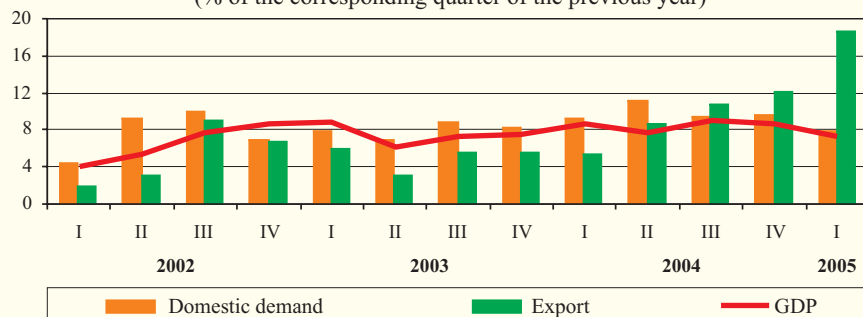
¹ Including forestry and fishing

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 chemical industry (by 22%) and in the manufacture of construction materials (12%). Growth in other industries was less conspicuous.

In January-May 2005 industrial production output in the sector was slightly above the level of the previous year (by 2.5%). Despite the rather considerable increases in several industries such as the manufacture of construction materials (23.6%), chemical industry (8.7%) and the manufacture of furniture (4.9%), output constraints in the largest manufacturing sectors (wood processing and the manufacture of basic metals and metal products) accounted for a minimum growth in the total manufacturing output.

Output of the food industry, the biggest manufacturing sector of Latvia contributing on average a quarter of the total value added in manufacturing, increased in the first five months of 2005 by 1.2% compared to the corresponding period of the previous year. The export volume within the sector has expanded.

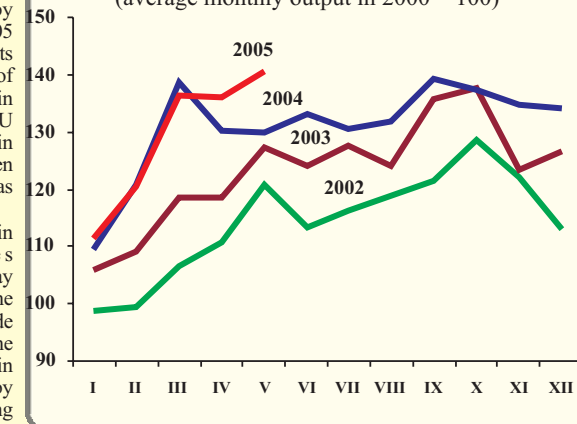
Wood processing is the second largest industrial sector in Latvia (approximately one fifth of the total value added in manufacturing). About 70% of the production output of this sector are exported. The output volume is therefore basically determined by external demand. In January-May 2005 the export of wood processing products declined accounting for a decrease of 2.2% 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 constitutes approximately 3.4%. In January-May 2005 74% of the output volume of the sector were 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.

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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.

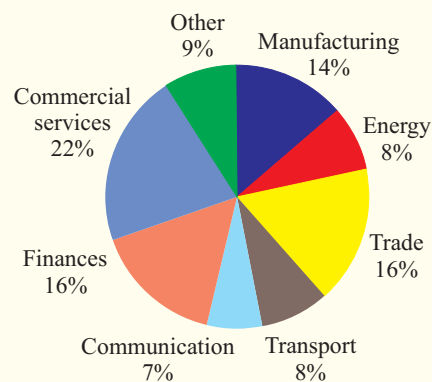
In 2004 the investment level in the economy stayed high. Gross fixed capital formation in 2004 increased by 17.3%. The investment process was favourably influenced by better accessibility to financial resources, gradual reduction of interest rates on long-term loans and the high growth rates.

At the end of March 2005 foreign direct investment stock in Latvia totalled 2449.5 mln lats or approximately 30% 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 investment covered nearly one fifth of the fixed capital formation. The largest investments were made in energy, financial intermediation and communications. The inflow of FDI in the 1st quarter of 2005 was by nearly one and half times higher than in the 1st quarter of the previous year, with a substantial increase in the company capital and reinvested profit.

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 -	10.9
Chemical goods and articles of plastics -	7.9
Agricultural and food products -	9.8
Other goods -	16.4

The value of commodity exports from Latvia in 2004 was much higher (by 30.3% at current prices) than in the previous year.

The sharp increase in the export unit value in 2004 and in the 1st quarter of 2005 (17.5% in the 4th quarter of 2004 and 14.2% in the 1st quarter of 2005 compared to the corresponding period last year) made a favourable impact on commodity exports. 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.

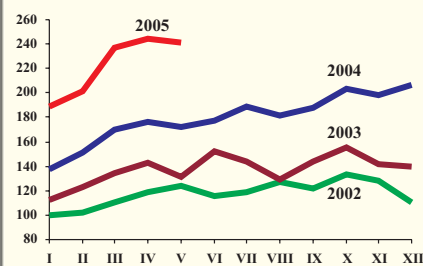
Exports increased considerably on all the markets trading Latvian goods both in the direction of the EU and CIS countries as well as in other countries worldwide.

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 rose in 2004 by one third compared to the previous year.

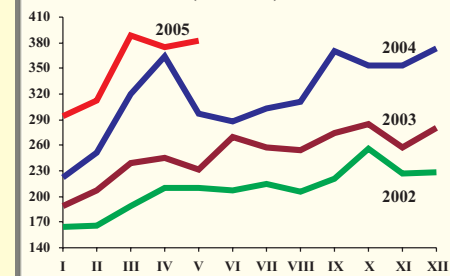
Imports in this period also considerably exceeded the level of the previous year (by 27.3% at current prices). The most substantial increase in imports observed in March-April 2004 was due to the entrepreneurs' desire to import in the last months before EU accession as many as possible intermediate and 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 (23% of the total import growth) and in the machinery group (15%).

The value of exported products (in lats) in the five months of 2005 exceeded the level of the corresponding period of the previous year by 38%. Imports, in turn, grew at a relatively slower pace (by 21%).

Commodity Exports by Month (mln lats)



Commodity Imports by Month (mln lats)



Balance of payments

2004

Current account balance

mln LVL: -908.0

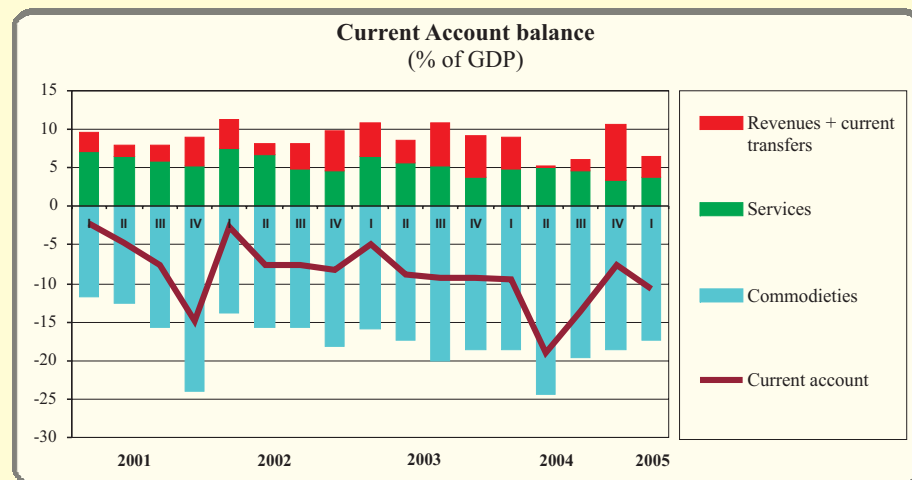
mln US dollars: -1673.3

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.

In 2004, the current account deficit of the balance of payments 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.



Inflation

June 2005

(12-month inflation)

CPI: 6.3%

PPI: 7.0%

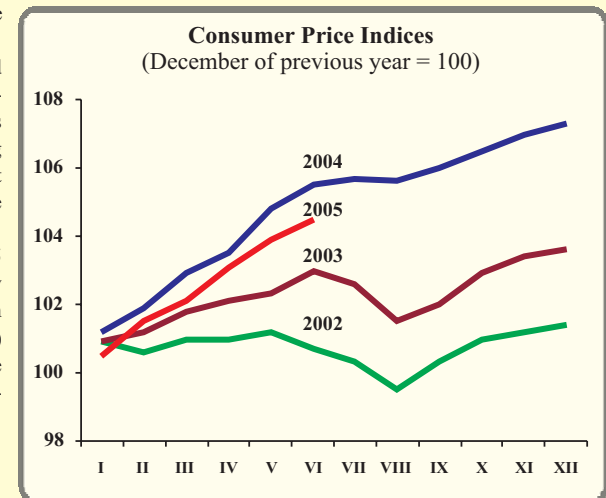
In 2004, the rate of inflation accelerated sharply in Latvia: in December the 12-month inflation reached 7.3% and the annual average inflation in 2004 was 6.2%. Price growth in 2004 more than doubled in comparison to 2003.

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 reached 0.9 percentage points compared with the inflationary pressure in 2004. 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 first six months of 2005 prices grew at a slower pace (by 4.5% comparing the price level in June 2005 with that in December) than in January-June of the previous year (by 5.5%, respectively).



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 May 2004, the amount of broad money M2X in May 2005 rose by 25.6%, currency in circulation increased by 13.9% and deposits rose by 29.0%. In the same period credits to enterprises and private persons continued to increase (by 51.1%). 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

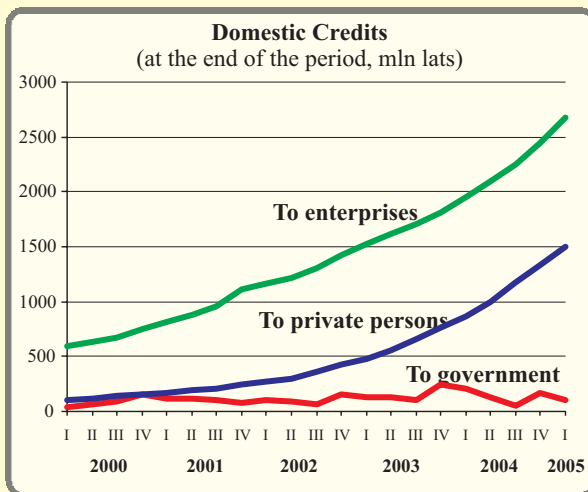
income in the total number of loans was only 1.2%.

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 May 2005 the average weighted interest rate on short-term credits in lats was 5.8% but on long-term credits 9.1%; for credits in the currencies of foreign countries these rates were 4.7% and 5.7%, respectively.

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, 78.4 ml 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.

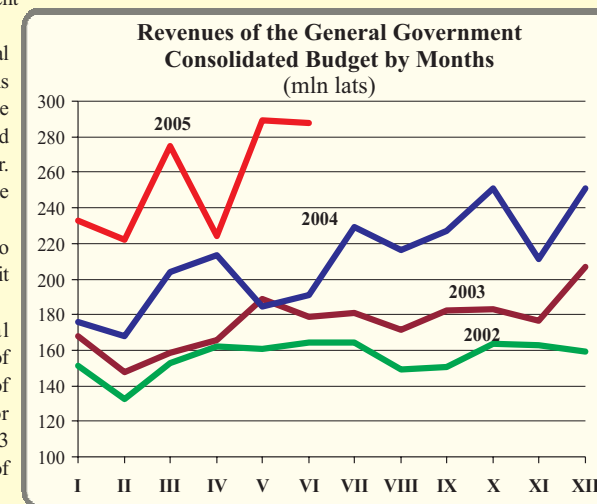
The Parliament has confirmed the general government budget for 2005 with a deficit of 1.68% of GDP. In 2005, the priorities of the budget are: restructuring of the healthcare system, integration into the EU and NATO fully utilising the opportunities provided by these organisations and protecting national 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 five months of 2005 were 31.4% higher than in the corresponding period a year ago and expenditures were 25.8% higher. There was a fiscal surplus in the budget comprising 111 mln lats.

The government is planning to draw up the 2006 budget with a deficit of 1.5%.

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 approximately 13.2% of GDP (846.3 mln lats or 13.4% of GDP at the end of 2003).



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 8.7%. However, with inflation taken into account, the real income of employees has increased only minimally, by 2.4%.

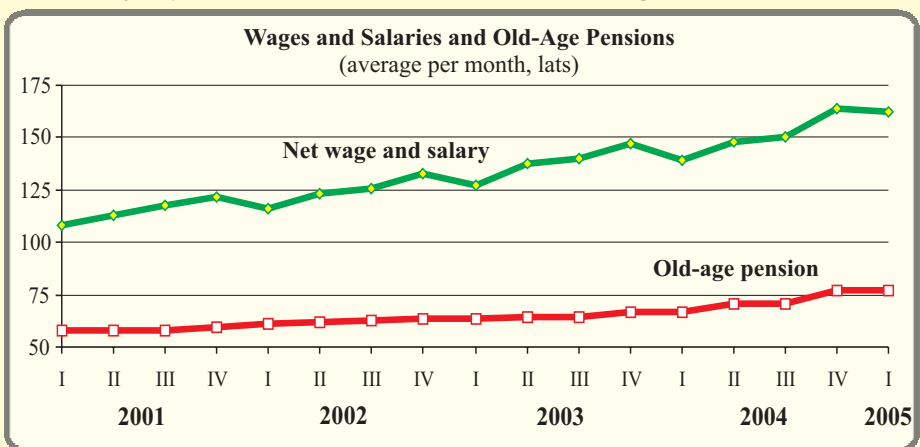
One of the reasons for the increase in the average wage is the raising of the minimum wage by 10 lats. The minimum wage in 2003 was 70 lats but since 1 January 2004 the minimum wage has been fixed at 80 lats.

At the beginning of 2005, responding to the sharp rise in prices, there was a substantial increase in wages and salaries. The average gross wage in March was 37 lats higher than in March of the previous year (by 18.5%). The increase in real wages in this period was 12.8%.

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.

Compared to the 1st quarter of the previous year there was a rather significant increase in the old-age pension (nearly by 15%) in the 1st quarter of 2005.

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.



Employment and unemployment¹

2004

Unemployment rate (rate of job seekers aged 15-74): 10.4%

Registered unemployment rate (at end of year): 8.5%

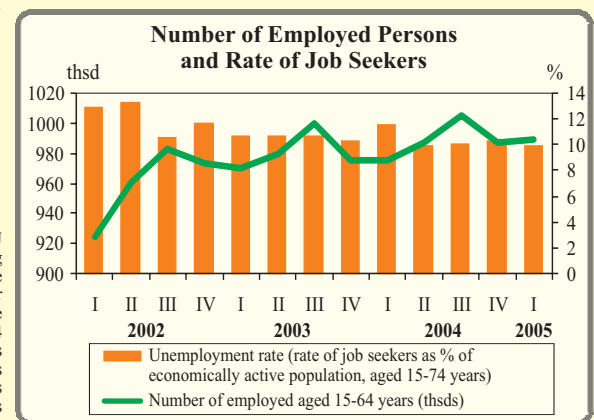
Economic development in recent years has made a positive impact on the situation in the labour market. Although the number of population of working age decreases, the number of economically active population is rising, as is the rate of employment.

In the period between 2001 and 2003 the employment rate in Latvia increased by 4.4 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 CSB Labour Force Survey data, the unemployment rate in 2004 decreased from 14.4% to 10.4% in comparison to 2000 but in comparison with the 1st quarter of 2004 it decreased by 0.6 percentage points in the 1st quarter of 2005. 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 8.5% at the end of 2004. Besides, it is worth nothing that in comparison with the last quarter of the previous year it increased in the 1st quarter only by 0.1 percentage points, as opposed to the customary increase from 0.4 to 0.6 percentage points in the last quarter a year ago. The registered unemployment rate at the end of 2004 was approximately 1.2 times lower than 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 if 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 according to legislation the status of unemployed is not granted to persons over the working age.

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.



Baltic countries

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			
2004	107.8	108.5	106.7
2004: 1 st quarter	109.3	108.7	107.1
2 nd quarter	107.3	107.7	107.3
3 rd quarter	108.3	109.1	105.8
4 th quarter	106.6	108.6	106.7
2005: 1 st quarter	107.2	107.4	105.7
Industrial output index, %			
2004	107.9*	106.0*	110.8
January-April 2005 against January-April 2004	108.7	101.2	103.6
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)			
2004	9.7	10.4	11.4
2005: 1 st quarter	9.5	9.9	10.2
Consumer price changes, % against previous year			
2004	3.0	6.2	1.2
May 2005 against May 2004	2.8	6.3	2.0
Producer price changes in industry, % against previous year			
2004	2.9	8.6	6.0
May 2005 against May 2004	1.7	8.2	7.6

* Short-term statistics for 2004.