



Latvia ECONOMIC Outlook

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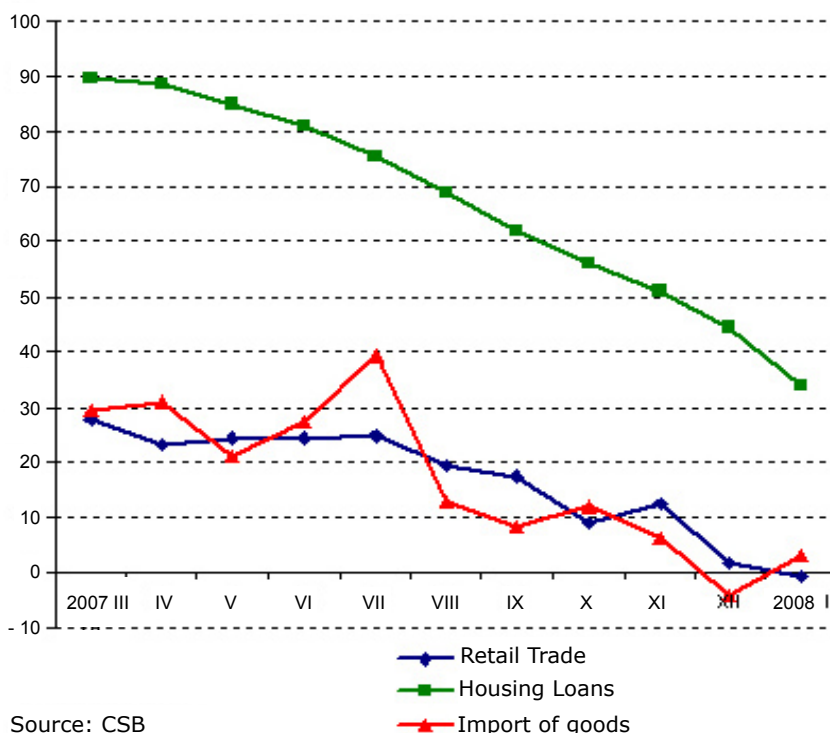
The Latvian economy in the 2nd half of 2007 kept the momentum of very fast development and yet the curbing influence of the anti-inflation plan introduced by the government in spring and summer was increasing. A drop in crediting rate and significant decrease of trading volumes in the real estate market signalled a new trend of reduced consumption. The forecasts of the previous macroeconomic survey of the Association of Latvian Commercial Banks (ALCB) became true about the rate of economic growth starting to descend at the end of summer and the government's plan failing to effectively restrain inflation. The anti-inflation measures implemented by the government failed to reduce inflation due to imbalances in the plan, to its focus on reduction of domestic

demand and also due to the stubborn optimism of the businesses and the population. Also the rise of the world prices for energy resources and food had a stronger impact than expected.

The last months' macroeconomic data and developments show that the national economy has entered a new cycle. The boom sustained mostly by domestic demand will be replaced by slower growth and much more prudent consumption. The anticipated decline in domestic demand and worsening of external factors call for the programme of economic stabilisation strong enough to change the accents in the economic development and direct it into a more balanced channel.

ECONOMY COOLS FASTER THAN EXPECTED

Slowing Consumption, % yoy



Source: CSB

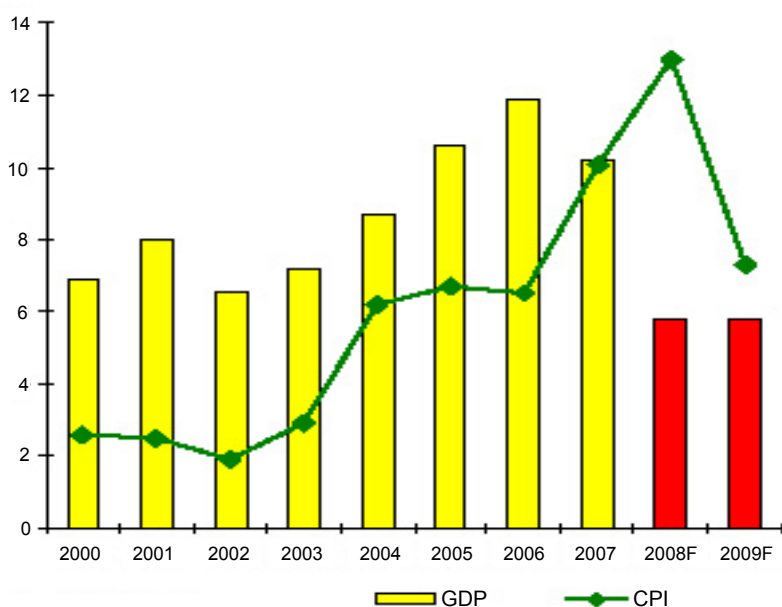
In the last quarter of 2007 the growth of GDP dropped to 8%, which is the lowest figure in the last two and a half years. Due to the anti-inflation measures and volatility of the global financial markets economic growth was falling faster than expected. The growth of domestic consumption over the year dropped to 3.7% (from 13.1% in Q3), which was the smallest since Q2 of 2000. The rate of private consumption literally shrank (to 4.3% in Q4 from 14.5% in Q3), while the generation of gross fixed capital practically stopped (0.5% from 12.7% in the previous quarter). In fact, since the middle of summer the private spending indicators have gone steadily down month by month. The actual

annual increase of retail trade in Q4 diminished to 6.8% (from 26% in 1st six months), for the no-

Falling into pessimism already now would be an overreaction

minimal imports of goods these figures were respectively 3.4% and 32.1%, whereas in housing loans the growth rate was cut by half. As we stressed in the previous issue of this review, the potential

Growth of GDP and CPI, %



Source: LCSB, ALCB forecast

of rapid growth nourished by domestic consumption has dried out. At present there is a great risk of the growth rate to become temporarily negative, particularly regarding the investments in fixed capital. Last year manufacturing showed very weak performance, which contradicts the increase in the exports of goods. Even though the stabilisation of the economy required some cooling of the excessive optimism, this abrupt change to pessimism in some sectors at present is somewhat exaggerated and may trigger a too rapid and unjustified drop in domestic demand and consequently in the growth of GDP.

So, what has happened in the Latvian economy since autumn? The economy has responded to the anti-inflation activities which has led to the decrease of cash in the market. The banks are consistently implementing a more conservative credit policy. The government, too, has braced up

and found a surplus in the state combined budget, albeit, at the expense of the social budget. The anti-inflation plan, even before it was actually launched, scared the red-hot real estate market to such an extent that its activity has slowed down by more than half and the housing prices keep falling. On the one hand it has brought some order into the construction sector and development of new projects, yet, on the other had, it is creating confusion among the market participants. The dwindling amount of available funds, inflation higher than expected, worsening of external factors and a generally more sober look on the situation was pulling domestic spending down month by month, although, from a very high peak indeed. As the inflation remains high in the coming months while economic activity keeps declining, the growth rate of domestic consumption and consequently of GDP will decrease. The spending euphoria is over and the Latvian economy is entering a new development cycle. The ALCB expects a gradual slow-down of the economic growth rate reaching the lowest point of the cycle at the end of 2008/ the beginning of 2008. In the opinion of the ALCB, the decision of the Bank of Latvia to reduce the reserve ratio for

bank liabilities with a maturity of over 2 years was an important measure to help the economy follow the soft landing scenario. This decision gives us hope of further proactive stabilising monetary

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policy which is an important reassuring signal for our foreign investors.

In the labour market the tension will slowly decrease although it will continue to be quite hot. While unemployment goes slightly up (in Q4 it was 5.3%), it will still be relatively low despite the possibility that a growing number of companies may wind up or reduce their operations because many sectors are suffering from acute shortage of

labour. The situation could significantly improve if the businesses could use the state investments and the EU structural funds for retraining of the unemployed

and teaching them the necessary professional skills. The growth of wages and sa-

laries will become more moderate and it will differ in various industries depending on productivity and the previously reached base rate. In the overheated industries (such as construction and commercial services) the salaries will drop as they have been unreasonably inflated.

The commercial banks are aware of their role in the development of the economy and will continue to provide the necessary financing for economic growth. However, their volumes will depend on the condition of the Latvian and global market. The annual growth by several tens of percent has gone for good and this year it could be about 15-20%. The commercial banks will pur-

The ALCB is of the opinion that the decision of the Bank of Latvia to reduce the obligatory reserve was an important measure to help the economy follow the soft landing scenario

sue a prudent credit policy and comply with the requirements under the anti-inflation plan. It has clearly helped in the legalisation of income yet this

example should be followed by other institutions too.

With the declining rate of economic

growth the number of delinquencies in credit repayments has gone up. Nevertheless, this increase is from a very low base, and compared with international standards it is still quite small. In terms of historical comparison the number of delinquencies is not high either – at the end of 2007 it was even slightly lower than at the end of 2004 which was a rather good year for the Latvian economy. Of course, the ratio of substandard loans is going to increase as the economy slows down, yet without fatal consequences for the banking system. A good instrument in this respect is the Creditors Register supervised by the Bank of Latvia launched in 2008.

WILL EXPORTS SUPPORT THE LATVIAN ECONOMY?

Last year exports significantly contributed to the economic growth and it is important to continue in the same way. The nominal growth of exports and imports last year exceeded 20%. The figures seem quite similar yet in the last months of 2007 two completely different trends were observed. While exports in the 4th quarter maintained the solid 20% growth rate year on year, imports under the influence of declining consumption, dropped to 3%, and in December by 6%. Even knowing that exports were boosted by the rising export prices, the real growth of export volumes cannot be overlooked. Despite the lack of the state programmes for support of exports and the soaring costs as well as the unfavourable situation in the foreign markets the Latvian goods remained competitive enough. It is quite puzzling to see the

good export results and at the same time the zero growth in industries which may mean that not all the manufactured output is accounted for. Quite possibly exports this year, too, might grow by a two-digit figure. Nevertheless, the rising global risks must be considered as the economic slowdown will reduce demand and bring down the prices.

The rise in exports together with falling imports have improved the negative foreign trade balance and consequently, the current account of the balance of payments. If in the results for 9 months it accounted for almost 25% of GDP, then in the 4th quarter of 2007 it could further decrease to 20%. It is essential to mention the stable flow of foreign direct investments which last year even increased to 1.2 billion lats or 8.5% of GDP.

INFLATION TO GO DOWN IN THE 2ND HALF OF THE YEAR

Despite the measures taken under the anti-inflation plan, at the end of 2007 and the beginning of this year inflation continued its relentless rise

reaching 16.7% in February! What's the use of reducing the crediting rate and activities in the real estate market if the administratively regulated

prices soar together with the global fuel and food prices, the competition is weak and the pricing mechanism – inadequate – while inflation expectations continue to be strong? The households facing the rocketing prices and the coming leap of the utility payments will continue to cut down on their expenses which will make inflation decrease in the second half of this year. The ALCB expects the peak of inflation at the beginning of summer

followed by its gradual decline due to limited purchasing power and more frugal spending. At the end of the year inflation may drop to 10-11% provided that economy follows our suggested scenario. If the growth turns out to be significantly weaker or, on the contrary, stronger, then inflation will either gain or lose 1-2 percentage points. Our forecast for average annual inflation is 13%.

WHAT SHOULD BE DONE?

The ALCB considers that the government should develop a well-substantiated action plan for the balanced and sustainable economic development and implement it without further delay.

The ALCB calls for the following measures:

- ✂ Full focus of the state economic policy on the increase of competitiveness;
- ✂ Development of a more business-friendly environment and taxation policy in the region;
- ✂ Immediate implementation of the export support instruments, such as credit guaranties and tax relief for those companies who may start or raise the exports of their goods or services;
- ✂ Support to the Bank of Latvia initiative to make the cost structure of the state budget more effective;
- ✂ Revision of the necessity and expedience of continuing to restrict the crediting rate in accordance with the anti-inflation plan;
- ✂ Readiness of the government to promptly correct the expense side of the state budget if the latter does not perform as planned due to the economic slow-down.

ALCB FORECASTS

	2006	2007	2008(F)	2009(F)
GDP, %	11.9	10.2	5.8	5.8
Inflation (CPI), %	6.5	10.1	13.0	7.3
Harmonised unemployment level, %	6.8	6.8	6.3	7.0
Real growth of average net monthly wage, %	15.5	21.9	4.0	4.0
Current account deficit, % of GDP	-21.1	-23.3	-17.5	-14.0
Fiscal balance, % of GDP	-0.3	0.7	0.4	0.4



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