



Latvia ECONOMIC Outlook

No. 1 • August 2007

The economic growth in Latvia in the first half of 2007 continued its fast and uneven upward stride. GDP outgrew the expectations and so did inflation, current account deficit, consumption and wages and salaries. After the period of volatility at the beginning of the year the financial market has calmed down. With the phased introduction of the government's

anti-inflation plan certain signs of stabilisation have appeared: in the 2nd quarter the growth of retail sales and crediting has slightly decreased and the prices for standard apartments have dropped, which should cool down the appetite for consumption and balance the scales of economic growth in favour of exports. However, it is too early to speak of successful phased

slowdown and only closer to the end of the year it will be seen whether we have managed to avoid the risks connected with sharp deceleration of the economy. Currently it is crucial to continue consistent implementation of the anti-inflation plan with particular emphasis on the supply factors (such as labour market, export potential etc.).

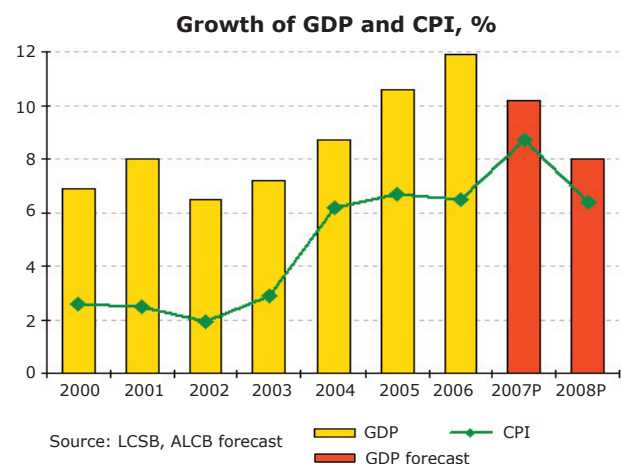
TOO FAST GROWTH OF GDP

The Association of Latvian Commercial banks (ALCB) is of the opinion that the economy is still growing too fast and in some segments the risks of overheating have increased. In the first six months of 2007 GDP rose by 11.2% (Q2 - 11.3%). Similarly to the previous period, the excessive consumption boosted domestic services and construction. This structure of GDP is not sustainable as the potential for further growth of domestic demand at the present rate has already been exhausted. Sadly, the growth of manufac-

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turing keeps declining (annual growth of 1.2%, including -0.1% in Q2), threatening to curb the current exports growth rate and dampening the optimism with regards to its acceleration. These developments are increasing the risks of a sharp slowdown in the situation when the domestic demand is expected to decline.

The strain on the labour market has increased with registered unemployment in July falling to 5.7% (in Riga 3.4%) and employment reaching



the highest peak in the decade. The rise in salaries (by 33% in Q2, yoy) well above the productivity levels undermines the competitiveness of businesses and is a serious factor supporting the upward spiralling of inflation.

The ALCB expects that in the nearest months to come the accents will be shifted from the euphoria of consumption to more balanced and calculated economic development enhanced by the government's anti-inflation plan, the activities of commercial banks and more frugal spending on the part of businesses and the public. The market barometers indicate the drop in the optimism of

businesses and households. In the retail turnover the share of car sales has slumped (annual growth from 114.9% in January to 26.4% in June) which is another symptom of increasing caution. Due to the momentum of consumption the economic activity will remain high, yet the GDP growth rate by the end of the year should drop below 10%.

A positive phenomenon is the decrease of the current account deficit in the balance of pa-

yments from 25.7% in Q1 to 21.5% in Q2. It was supported by the growing volumes of exported goods, services and current transfers. The rise in exports was stimulated by the substantial increase of export prices and exported services as Russia redirected its transit from the Estonian to the Latvian ports. We have to watch with some concern how long the Latvian businesses will be able to withstand competition with costs rising so fast.

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INFLATION CLIMBING UP

In July the annual inflation of consumer prices has reached 9.5%, which is the highest rate since 1997. Let us remember that last year the rate was 6.9%. The consumer prices are driven up by a wide range of factors of which the leading are domestic consumption, persistent inflation expectations, rising prices of energy and fuel, regulated

prices and tax harmonisation with the EU.

So far, the government's anti-inflation plan has not shown any positive impact on inflation as the implemented measures primarily concern the segments that are not answerable for the greatest fuelling of inflation (such as food products, restaurants, transport, public

utilities). However, in the second half of the year the scheduled measures should reduce the spending spree and consequently make some price corrections in several groups of goods and services. An important role will be played by inflation expectations depending on how deep root they have taken in households and businesses.

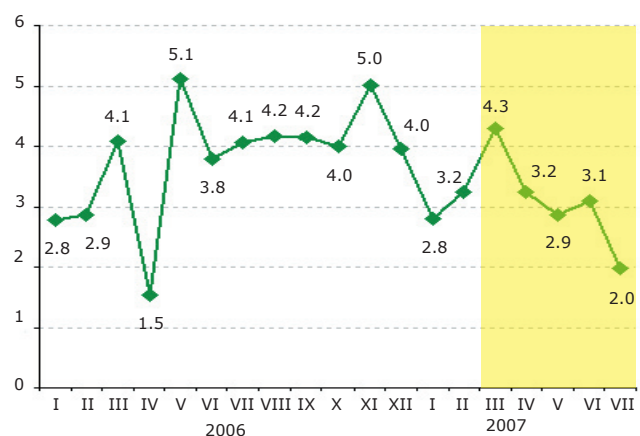
IMPLEMENTATION OF THE ANTI-INFLATION PLAN DELAYED

Despite the fact that the plan of inflation containment or balancing of economy was adopted already at the beginning of March, so far it has been

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mostly associated with the activities of commercial banks and namely, with decreasing of lending and legalisation of the residents' income. The commercial banks have become more conservative in lending both to households and to businesses. If at the beginning of the year the housing loans grew at the rate of around 4-7% per month, in July this rate dropped to 2% and is expected to further decline to the annual rate of 35-45% (55.6% in 2006).

Monthly Lending Growth, %



Source: LCSB

Although the implemented measures are undoubtedly necessary to cool the economy down,

the ALBC maintains that it is wrong and imprudent to put the equal sign between lending and the anti-inflation plan. The banking sector is not receiving adequate support – it appears that the other items of the plan have either been forgotten or lost their priority status for the government. In our opinion, the plan is being implemented in a one-sided and inconsistent way focusing only on the reduction of domestic demand. These are short-term stabilisation measures and taken alone they cannot ensure sustainable economic development. The commercial banks insist on the necessity to immediately address the problems

on the supply side: the labour market, education, science, exports, business environment etc. The amendments of the budget for 2007 recently approved by the Cabinet of Ministers again are in conflict with “the strict budgetary discipline” proposed in the plan. The inefficient fiscal policy was among the chief stumbling blocks, which lead to downgrading of Latvia’s sovereign credit rating. Even though the foreign investors still keep their faith in Latvia and allow it to live extravagantly beyond its means (FDI this year have already reached 9.4% of GDP), it is naïve to hope that the credit of trust is inexhaustible.

WHAT SHOULD BE DONE?

The ALCB insists that the anti-inflation plan should be given a top priority status and all the measures should be immediately implemented, thus establishing the confidence in Latvia’s ability at short notice to refo-

cus on the economic issues, achieve the trust of the general public and the business community, and maintain the faith of foreign investors in the good future prospects of the state.

Therefore the ALCB is urging:

- ✎* To support the Bank of Latvia initiative of setting more ambitious goals for the government to achieve a substantial surplus in the state budget already this year and in the years to come.
- ✎* To immediately develop and implement realistic and tangible export promotion measures.
- ✎* To revise the taxation policy towards decreasing of workforce taxes and raising the axes for consumption with the aim to decrease spending, including the government expenditure.
- ✎* To find solutions for the tension in the labour market that brings about an inadequately drastic pay rise and excessive optimism. To relieve the pressure of the public sector on the labour market (e.g. the rapid rise of salaries and the great number of vacancies) by raising the efficiency of public institutions.
- ✎* In order to reduce the consumption to keep promoting and encouraging the saving habits of households.
- ✎* To maintain unchanged the monetary policy in respect of the lats exchange rate.

Effective implementation of the plan is unfeasible without energetic involvement of the general public and achievement of compromises as the experience of other countries shows. The

ALCB urges all the relevant parties to immediately engage in the implementation of the plan and assume full responsibility for the results.

ALCB FORECAST*

	2006	2007(f)	2008(f)
GDP, %	11.9	10.2	8.0
Inflation (CPI), %	6.5	8.7	6.4
Harmonised unemployment level, %	6.8	5.7	5.4
Real growth of average net monthly wage, %	15.5	15.0	10.0
Current account deficit, % of GDP	-21.1	-22.0	-18.5
Fiscal balance, % of GDP	0.4	0.7	1.0

* - Assuming that the anti-inflation plan will be consistently implemented



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