



Latvia

ECONOMIC Outlook

No. 3 • August 2008

Since the beginning of the year the economic growth of Latvia due to the interplay of external and internal factors has been slowing down faster than expected. The fall from the high economic growth results of the 2nd half of 2007 to the meagre figures of this year's first half was very fast indeed indicating fundamental changes in the country's economy. Both external (global slow-down, rising inflation and credit interest rates), and internal driving factors (con-

end of this year or in the first half of 2009.

With a certain delay, the economy of Latvia is going through a restructuring process caused by the falling growth rate of the domestic demand industries while the export industries slowly become attractive for investments. Some industries have shown sufficient resilience to find new sales markets and thus offset the impact of declining turnover in their major markets. The fast fall of domestic demand has sub-

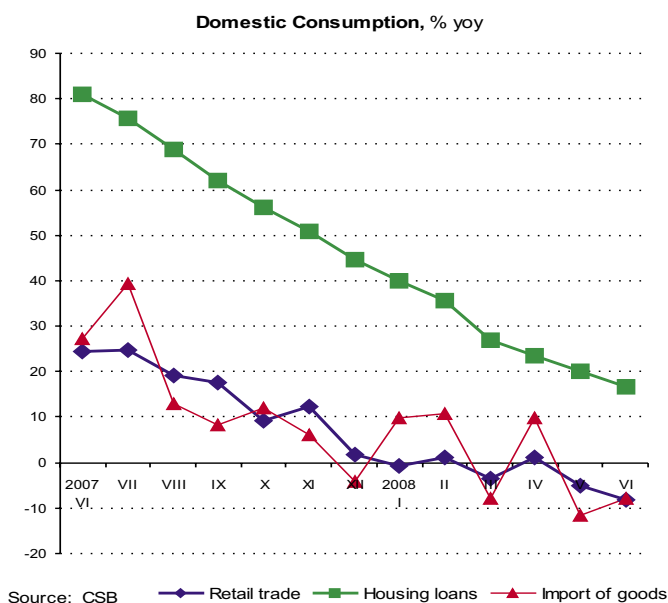
The economic growth rate keeps rapidly slowing down while certain indicators signal the beginning of restructuring

tinuously high inflation, growing pessimism of households and businesses, stagnating real estate market, rising interest rates for loans and stricter creditworthiness requirements) have deteriorated which means that Latvia's economic growth rate will continue to slow down considerably. The Association of Latvian Commercial Banks (ALCB) foresees substantial decline of domestic consumption and exports remaining the main life force of business activity. The lowest point in this cycle will, most likely, be reached at the

stantially improved the foreign trade balance and reduced the current account deficit in the balance of payments. The peak point in inflation was reached this year in May and from now on it is going to decrease gradually. Nevertheless, restructuring of economy will require time, and the ALCB is of the opinion that in the coming two or three years the GDP growth rate will fall behind the sustainable medium-term GDP growth rate of 5–7% per year.

ECONOMY WILL KEEP COOLING WHILE FIRST VISIBLE SIGNS OF RESTRUCTURING APPEAR

Annual GDP growth in the 1st quarter of 2008 fell to 3.3% from 8.1% of the previous quarter. At the same time, the preliminary data show that economic growth in the 2nd quarter has plummeted to 0.2%. In Q1 the growth rate was pulled down by domestic demand falling by 0.3%, mostly due to the decrease of stocks by 40%, year on year. Nevertheless, investments in gross fixed capital still grew by 5.1%. According to the data of the CSB, the rise in non-financial investments was determined by the public sector (11% per year), while in the private sector the signs of decline were visible (-3%). The largest drop in non-financial investments was observed in such domestic demand sectors as real estate, lease and rent and other commercial service activities (-34%); considerable growth was seen in public administration, defence and obligatory



social insurance (27%), as well as in export industries: transport, storage and communications (15%) and manufacturing (14%). With employment and wages and salaries on the rise, in the first three months of this year the annual growth of household spending reached 2.4%. It should be noted though that the high inflation forced households to „eat up” part of their savings to cover the increase in spending. (Since January 2008 the household deposit growth rate has been lagging behind the inflation rate).

As domestic consumption grows weaker, imports in comparable prices have decreased by 1.6% per year (6.2% growth in actual prices). The real exports growth dropped to 6.5% (15.6% growth in actual prices). The deficit of foreign trade balance in Q1 decreased to 18% of GDP (24.3% last year), while the current account deficit went down to 19.4% (26.6% last year). Preliminary data for April and May show that these trends were persistent. For example, in May current account deficit dropped to LVL 157 million which is the lowest level since April 2006.

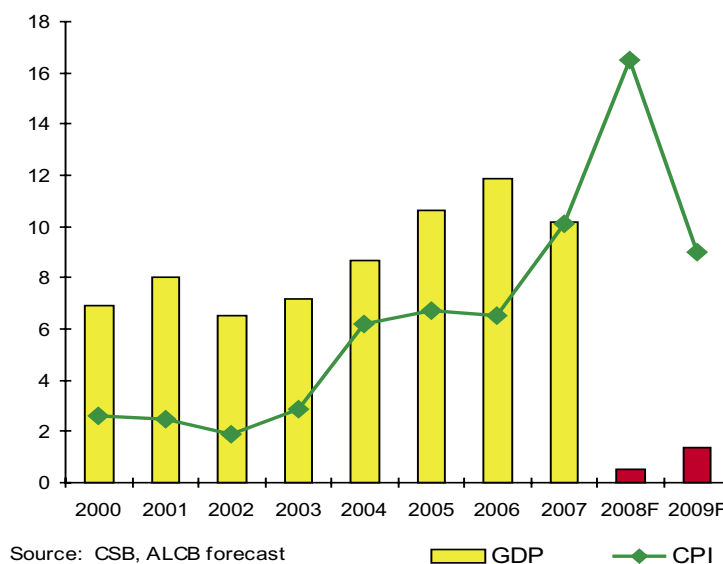
In the first quarter of 2008 in all the sectors of economy the growth rate was substantially

ALCB forecast for GDP growth in 2008 – 2009 is lowered accordingly to 0.5% and 1.4%

slower than in the 4th quarter of 2007, with the exception of education, health care and social work. Among the major industries, the decline was observed in manufacturing (4.1% per year), and in retail and wholesale trade (0.8%). The currently available data for the 2nd quarter indicate further decline of the growth rate in all the major industries (e.g., retail turnover in comparable prices has decreased by 4.5%). The growth rate is slowed down by the dwindling domestic consum-

ption, while the external demand and the public sector are offsetting the fall of economic activity. The ALCB forecast for GDP growth in 2008 – 2009 is lowered accordingly to 0.5% and 1.4%. In the coming two or three quarters the growth of GDP is likely to be negative.

Growth of GDP and CPI, %



Despite the fact that the official growth rate of remuneration in the 1st quarter remained high (30% annual growth) and employment rose (4.2%), the labour market is visibly cooling. The share of job vacancies has decreased while the number of jobseekers grows and several companies have announced their intention to downsize. According to the CSB data, the average productivity of one employed individual in the 1st quarter of 2008 decreased (for the first time since the early 90ies) which is a sign of the declining profit margins of the enterprises. This situation cannot continue indefinitely and, given the declining economic growth rate, we forecast the rise in unemployment. It will decrease the growth rate both of remuneration and consumption.

BANKS CONTINUE TO FINANCE THE ECONOMY

The banking business is a reflection of all the development in the economy. At present the economy is going through serious restructuring affecting the businesses and households. Although the commercial banks of Latvia operate in the environment that has become more complicated and less predictable, they continue to finance the economy. The data characterising the credit volumes are more modest, yet they do not tend to deteriorate. On the contrary, certain stability has set in crediting and the results of Q2 are

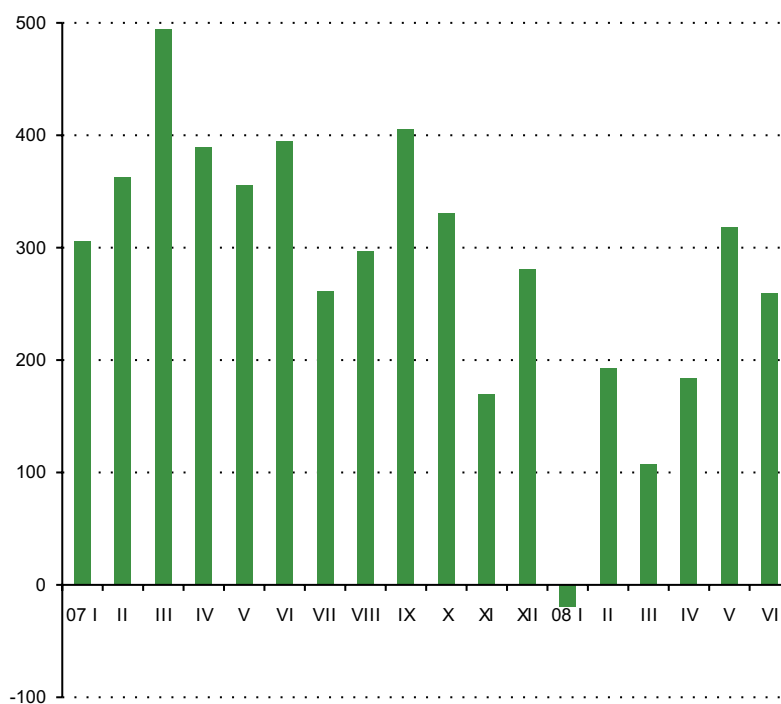
better than at the beginning of the year. It shows that the banks have understood the trends of the new economic cycle and see the possibility to continue lending to the businesses and households in this downturn phase of the cycle. Currently, the biggest growth is created by the loans to businesses (annually +24%), while the growth of credits to private individuals has slowed down due to the dormant real estate market and the dim prospects of future spending opportunities and income. The banks are prepared to increase

financing of businesses, particularly the exporters, if they are encouraged by the government with various support mechanisms, that would help distribute and diminish the risks.

Although with the cooling of the economy the number of delinquent loans increases, the share of non-performing credits in the first half of 2008 was only 0.5% of the total credit portfolio. This indicator in Latvia still is far behind several Western economies where commercial banks are facing very serious problems indeed. However, as the economy of Latvia in the coming year is going to experience quite a painful phase of transformation, the ratio of non-standard loans is sure to rise. It is very essential for the economy of Latvia that the banks have no shortage problem of credit resources at reasonable price, that the banks understand the economic situation and continue to play an important role in development and stabilisation of the economy. A

very significant stabilising factor for the banking sector and the entire national economy is the decisive action and rhetoric of the foreign parent banks pledging long-term strategic plans in the Latvian and Baltic market.

Bank Credit Portfolio, LVL m, month by month



Source: ALCB

PEAK INFLATION IN MAY

As expected, the annual consumer prices inflation reached its peak in May (17.9%), and in July it was down again to 16.7%. The consumer prices inflation has slightly exceeded the forecasts due to the rise of the

ment of the gas tariff rise from July to October and the massive rise of the prices globally (mostly for food and energy) will keep inflation up longer than expected, therefore we raise our price inflation forecast for 2008

The ALCB considers that we have reached a significant breakpoint and over the next months we will see a distinct downward curve in the inflation trend.

regulated prices and the pressure of the global prices. Until now the retailers have not reacted flexibly enough with their discount policies in order to stop the falling consumption. At the same time, the slowing growth rate and the slackening labour market shows that the inflation rate is sure to decline despite the coming rise of tariffs (e.g. from 1st October the natural gas tariff will rise by 38%). We have to admit that the postpone-




ment of the gas tariff rise from July to October and the massive rise of the prices globally (mostly for food and energy) will keep inflation up longer than expected, therefore we raise our price inflation forecast for 2008

WHAT SHOULD BE DONE?

The ALCB is of the opinion that the government who has undertaken to solve the macroeconomic pro-

blems should focus still more on several crucial long-term development aspects.

The ALCB urges:

-  to the extent possible to direct the government economic policy to the increase of competitiveness and promotion of exports;
-  to establish business-friendly environment and tax policy in the region;
-  the government to revise the expenditure of the state consolidated budget in order to raise the efficiency of the public sector; to increase expenditure in the areas that contribute to the country's competitiveness and sustainable development.

ALCB FORECASTS

	2006	2007	2008(f)	2009(f)
GDP, %	12.2	10.3	0.5	1.4
Inflation (CPI), %	6.5	10.1	16.5	9.0
Coordinated employment level, %	6.8	6.0	6.9	7.9
Net actual rise of wages and salaries, %	15.5	21.9	4.8	2.2
Current account deficit, % of GDP	-22.5	-22.9	-15.3	-11.8
Fiscal balance, % of GDP	-0.2	0.0	-1.2	-1.6



ASSOCIATION OF LATVIAN COMMERCIAL BANKS

Perses street 9/11, Riga, Latvia
 Tel.: +371 6 7284528
 Fax: +371 6 7828170
 E-mail: office@bankasoc.lv
 www.bankasoc.lv

This Outlook is prepared by the
Economic and Monetary Affairs Committee