



Latvia

ECONOMIC Outlook

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The autumn months of 2008 saw significant deterioration and sliding of the Latvian economy deeper into recession. On top of domestic problems of overheating built up during 2006 – 2007 Latvia received additional blows dealt by the global financial crisis and recession in

The sharp fall in GDP is driven by too slow restructuring of the Latvian economy, aggravation of the credit crunch and recession in the leading global economies.

many important export markets or investor countries. The situation was further aggravated in November when the government rescued Parex Bank and it became clear that Latvia would not be able to cope with the rising budget deficit already in the coming months. In summer the government had started cutting expenditures and revising earlier forecasts, yet implementation of reforms crucial for the national

economy was too sluggish and irresolute for the country and its businesses to be able to sustain the coming shock single-handedly. In November talks were commenced with the International Monetary Fund and the European Commission

for granting of financial support.

The support programme envisages a 5.3 billion lats loan to Latvia to be disbursed over the period of 3 years which is good news as the loan will help overcome the budgetary crisis, throw a lifeline to the businesses, and, not least important, will compel the government to implement the structural reforms in order to put the Latvian economy on the track of balanced development.

DELAY OF STRUCTURAL REFORMS INVITES RECESSION

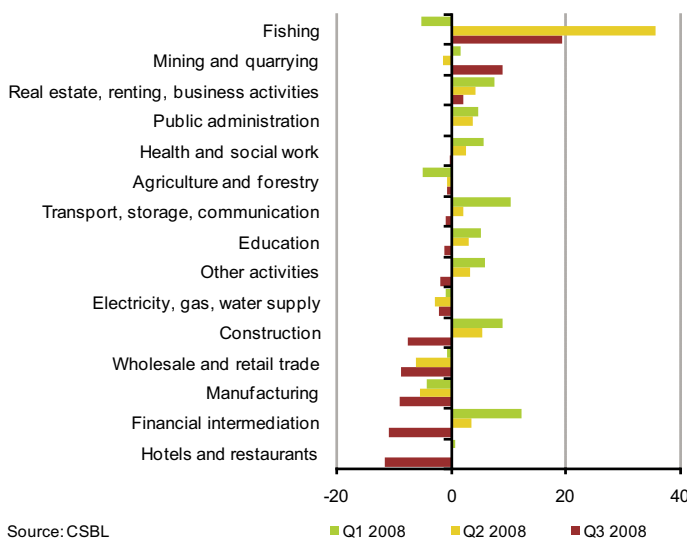
The Latvian economy is going through recession; the seasonal- and working day-adjusted real GDP has been declining quarter by quarter already since the beginning of 2008. So far the sharpest drop has been registered in 3Q 2008 as GDP fell by 1.2% vis-à-vis the previous quarter or 4.6% in comparison with 3Q 2007. The fall was anticipated yet its actual speed was astonishing – since the beginning of 2008 the annual growth dynamics of GDP had plunged from +3% to almost -5%. It was due to relatively slow restructuring of the Latvian economy and the rapid deterioration in the global financial markets triggered by the credit crunch and recession in the world's leading economies. The third quarter of 2008 saw negative annual growth rates in all

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the major industries including construction (-7.4) and financial mediation (-10.9%) where until recently the growth rate had been amazingly high. Sadly, recession is becoming deeper in manufacturing: its volumes shrunk by 8.9% year-on-year which is only marginally better than following the Russian default of 1998. In 3Q 2008 growth was observed only in fishing (19.5%), mining industry (9.1%), real estate and other commercial services (2.3%) as well as in state administration, defence and compulsory social insurance (0.4%).

An even sharper fall in real GDP was offset by the rise in exports of goods and services by 1.9% year-on-year and state expenditure by 0.6% while household expenses fell by 10.6%, investments by 10.1% and imports by 9.5%. Unfortunately, these trends will persist in 2009 and only in 2010 we can hope for stabilisation and at best slight positive quarter-on-quarter growth in the last quarters of the year. The Association of Latvian Commercial Banks (ALCB) decreases its forecast for GDP growth in 2008-2009 to -2.2% and -6.8% respectively and in 2010 to -2.3%. There is a risk of even greater fall of GDP if the global recession or stagnation in the leading economies turns out to be deeper and slips strongly into the year 2010. In order to minimize the negative consequences of the crisis and hasten recovery, the Latvian economy needs in-depth structural changes focussed on increasing of productivity (see below).

GDP Real Growth by NACE Sectors, YoY %



It was the slow restructuring in 2007 and at the beginning of 2008 that brought about the swift contraction of the Latvian economy over the past months. For example, hesitation to downsize employment despite significant drop in output has provoked a situation that is similar to pushing out a cork from a beer keg: with labour productivity and hence the company profits falling since early 2008 the pressure of unemployment grew until in autumn the companies, unable to withstand the high costs, actively started to sack their workforce. The delay of this operation has led to large numbers of people losing jobs in a short time span while other companies being unable to absorb that great number of jobseekers quickly. In the result the share of jobseekers in 2008 grew from 6.2% at the beginning to close to 8% at the end of the year whereas early in the year 2009 it will hit a two-digit figure. Although official data still show the annual increase of gross real wages and salaries by 3.9% in 3Q 2008, the real growth of wages and salaries (net of legalisation effect), early summer 2008 most probably has been negative.

Fast drop in spending and employment has taken its toll on the budget revenues, particularly in November. Revenues in the state consolidated combined budget fell 16.9% year on year. The biggest share in this drop directly is related to falling consumption: VAT revenues were 24.3% less than in the corresponding period of 2007. Things continued to worsen in December, and consolidated general budget deficit in 2008 most probably will be close to 3% of GDP.

By the end of 2008 the real estate prices from their highest peak of May 2007 tumbled by about a half with the market activity slowing down considerably. The recession, rising credit risk and interest rates have brought down the demand for loans, consequently the annual crediting growth rate in November had fallen to 14.6% (monthly growth rate -0.1%). The consumer and business confidence keeps falling, too, and in some businesses exaggerated optimism has been replaced with equally exaggerated pessimism.

On the positive side, weak domestic demand has

	General Budget, Annual Growth Rates %					Cumulative	
	2005	2006	2007	Nov 2008	Dec 2008	11M 2008	12M 2008
Net revenues	26.7	25.7	33.5	-16.9	...	10.3	...
Tax revenues	26.3	30.3	34.4	-2.6	-6.3	13.9	11.9
Personal income tax	16.9	29.1	35.1	3.0	-0.5	17.0	15.2
Social tax	17.1	28.1	37.7	8.3	6.4	22.7	21.1
Corporate income tax	41.3	40.5	57.5	14.1	17.2	26.6	25.9
VAT	39.1	37.4	29.3	-24.5	-39.0	-3.9	-7.1
Excises	31.2	16.6	22.3	-0.3	10.3	21.7	20.7
Customs	12.2	7.6	34.4	-25.7	-6.7	-5.1	-5.2
Non-tax revenues	19.3	13.1	21.7	-22.3	9.1	8.6	8.6
Net expenditures	25.7	24.4	28.0	14.9	...	23.1	...
Current expenditures	21.9	23.3	27.5	18.4	...	27.2	...
Capital expenditures	53.8	39.3	40.6	-8.6	...	6.7	...
Budget balance, % of GDP	-0.4	-0.2	0.1	-1.9	...

Source: State Treasury, State Revenue Service, ALCB calculations

helped reduce economic imbalances. In December annual inflation dropped to 10.5% (monthly inflation -0.5%). If so far the fall of inflation rate has been largely due to the falling energy prices worldwide, in the coming months we will see inflation rate retreating due to falling prices driven down by increasingly weaker demand. ALCB expects average inflation rate in 2009 to fall to 5.2%, yet even a faster drop is very likely resulting in a protracted deflation period in the second half of the year, if recession turns out to be deeper and longer than predicted. The VAT increase at the beginning of 2009 will only temporarily raise prices as the retailers will not be able to shift the burden of price rise to their clients. Current account deficit in 3Q 2008 decreased to 12.9% of GDP (25.8% in 2007) due to falling imports (-3.1%) and still quite strong exports (14.2%). Although export volumes in 2009 are likely to shrink, imports will fall more resulting in improved balance of payments and current account deficit over the year reaching approximately 8% of GDP.

LATVIA FORCED TO REQUEST INTERNATIONAL FINANCIAL SUPPORT

After the collapse of Lehman Brothers in September 2008 volatility in the global financial markets increased reducing access to financial resources and making them more expensive. Latvia was hit particularly hard due to its great dependence on external funding. Too little had been done to make public administration more effective and provide businesses with better mechanisms/ support to weather the global recession. Latvia had been complacent with its fast economic

ALCB considers the fast takeover of Parex Bank justified and crucial to maintain the stability of the financial system

growth for too long, procrastinating implementation of vital reforms. After the Parex Bank takeover it became clear that the country would not be able to overcome its problems alone and would have to seek help from international institutions. Parex Bank being of systemic importance, its takeover was justified and instrumental to maintain the stability of the entire banking sector and to minimize the adverse economic effects.

ECONOMIZING WITH DEVELOPMENT IN MIND

In just a few days Latvia did what had seemed impossible before: substantially revised its fiscal policy, choosing a more realistic GDP growth forecast. Dramatically dwindling budget revenues will be partly compensated by raising consumption taxes and at last cutting public administration expenses. However, these measures do not solve the problem completely. Latvia is going to receive a LVL 5.3 billion loan from the International Monetary fund, the European Union, the Nordic countries and other states and institutions for the term of 3 years. The facility is a credit line and may not necessarily be fully used by Latvia. What is the money meant for? Primarily, to bridge the budget deficit and refinance government debt. The second portion is intended for investments in Parex Bank and potentially to provide guarantees for refinancing of other banks' syndicated loans. Yet the activities related to restructuring and support of economic growth have

been less discussed. It is these measures that attract the most attention of the business community as they should help restructure and regenerate economic activity, yield budget revenues and finally permit to repay the newly incurred debt. If the long-discussed economic stimulus package is promptly implemented, Latvia still has a chance to overcome recession in about 2 years instead of the gloomy prospect of a 3-4 year contraction.

This rescue package must be taken as a bitter fact, unflattering for Latvia, yet it is a good opportunity to put the loan to good use to boost public sector efficiency and strengthen the country's competitiveness. The government must follow open communication with the public and the business community to eliminate rumours and distrust, and to cooperate for achievement of common goals.

SHOCK THERAPY WITHOUT STIMULUS TO BUSINESS WILL FAIL

And so, how is the business environment to react? Urgent changes in taxation that the businesses and public must face would have been useful some two or three years ago. Both ALCB and other business associations already in 2006 insisted on careful assessment of the tax system yet these proposals were declined

and stimulation of economic growth. Despite the continuous discussions with the government about the support measures only a few of those have actually been implemented. We still need mechanisms attract venture capital, instill export guarantees and a more reasonable tax collection policy (e.g. not to demand

ALCB urges the government to introduce effective support mechanisms for restructuring of the economy with the aim to raise productivity and export potential.

or discreetly discussed in narrow circles. The current changes will increase the tax burden on consumption and somewhat alleviate them on income – it is a step in the right direction yet the changes are not balanced and decrease of personal income tax too small. In our opinion, without a substantial revision of the tax system restructuring of the economy is difficult.

It has been publicly pronounced that over a billion lats are required for economic stabilisation including co-financing of EU structural fund projects, loans to businesses if the commercial banks deny their resources. Of course, the commercial banks continue to finance the economy, yet it is getting increasingly difficult in the situation of deteriorating economic situation in Latvia and in the majority of its export markets. Latvia still lags behind other EU countries in supporting its industries which is particularly evident in the situations of a crisis. In the absence of effective state support mechanisms neither businesses nor banks will be able to undertake all risks to provide the necessary financing for EU structural fund pro-

jects and stimulation of economic growth. Despite the continuous discussions with the government about the support measures only a few of those have actually been implemented. We still need mechanisms attract venture capital, instill export guarantees and a more reasonable tax collection policy (e.g. not to demand payment of VAT before settlement for goods and services are delivered - companies have been forced to credit the state budget this way and now the high cost of credit threatens the very existence of businesses), as well as reduction of bureaucracy and increasing the range of state investment programs within public-private-partnership framework. Flexible and efficient government apparatus with merged structures and functions delegated to the private sector which can be attained by means of a functional audit is in the interests of the general public and the business community.

The Ministry of Economics is about to submit to the government close to 70 proposals to support economic activity many of which have been carried over from the previous years when they were not timely or fully implemented. In order to implement these proposals as quickly as possible rather than leaving them on paper, the relevant government institutions must join forces with entrepreneurs so that the activities could yield results already in the first half of 2009. ALCB is actively communicating with the Mi-

nistry of Economics and other institutions in order to find the fastest and most efficient solution for support of businesses by commercial banks and the state.

WHAT SHOULD BE DONE?

ALCB sees as necessary and urges to take the following measures immediately:

- ✎ The government must draft and agree with the European Commission a detailed action plan to support economic growth and restructuring (e.g. to reduce liquidity problems).
- ✎ Provide complex support to exports, e.g. immediately introducing practicable export promotion mechanisms and assessment of all legislation initiatives in terms of their impact on promotion of exports.
- ✎ Urgent implementation of the frequently mentioned Economic Stabilisation Programme drafted by the Ministry of Economics and aimed at removal of various bureaucratic obstacles and reviving of economy.
- ✎ Improve public administration efficiency and cut the previous years' inflated expenditure:
 - o A functional audit conducted by an internationally recognized institution focussed on elimination of doubling of functions, merging of institutions, delegating part of functions to the private sector.
 - o Comprehensive review of the salary system in the public sector and its comparison with wages and salaries in the private sector. Cutting of salaries must be combined with reduction of employment in the public institutions to make the work of the remaining ones more efficient.
- ✎ The government should maintain objective and intelligent communication with the public regarding the solutions to the crisis. The experience of other countries shows that lack of social contract and mutual understanding regarding the methods to overcome a crisis makes recession longer and deeper.

ALCB FORECASTS

	2007	2008(e)	2009(e)	2010(e)
GDP, yoy %	10.3	-2.2	-6.8	-2.3
Inflation (CPI), yoy %	10.1	15.4*	5.2	2.1
Harmonised unemployment level, %	6.0	7.3	11.2	11.8
Real net wages, yoy %	21.9	4.7	-7.4	-1.0
CAD, % of GDP	-22.9	-14.1	-8.0	-6.3
Fiscal balance, % of GDP	0.1	-2.8	-5.4	-3.7

* - in fact



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