



Latvia ECONOMIC Outlook

No. 5 • July 2009

The condition of the Latvian economy has significantly deteriorated since the beginning of 2009 as manifested by the free fall of the economy, external signals alarming exporters and ambiguous situation in the global

The plummeting of the economy was caused by the prolonged double shock inflicted both by internal and external factors in the situation of immense confusion and uncertainty about the future

economy and financial markets as well as the failure of the Latvian government to make substantial corrections in the budgetary expenditure and achieve stable mutual cooperation with the international lenders. The last months have passed in the atmosphere of speculations and rumours regarding Latvia's ability to cooperate with the lenders within the framework of the previously accepted programme, the currency peg and structural reforms in the public administration and economy resulting in confusion and lack of faith in the chosen course both at home and abroad. In order to

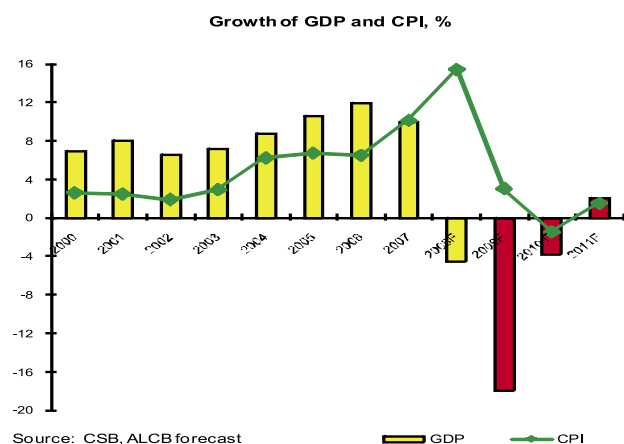
qualify for the current tranche of the international loan, the government had to make substantial cuts in the expenditure of the combined budget which may seriously affect bu-

business activity due to shrinking em-

ployment, wages and salaries, fall of purchasing power and increasing deflation.

Nevertheless, Latvia is firm in its resolution to follow its chosen effective though rocky road of restructuring of the public sector and the economy. The speed and efficiency of the results on this road will greatly depend on the understanding and commitment of the entire nation. The second half-year's economic indicators will be essentially affected by the use of the available funds and enhancement of the country's business activity.

THE 1ST HALF YEAR TO SHOW THE STEEPEST FALL IN THE ECONOMY



The free fall of the Latvian economy observed since the beginning of 2008 continued in the first quarter of this year as GDP dropped alarmingly by 18%. Thus the economy has been contracting for four consecutive quarters in the biggest recession since the beginning of the 90ies when it underwent the huge transformation process from the crumbling centralised economy to the beginnings of a free market economy. Sadly, our warning of a deeper GDP fall expressed in the previous survey has come true as the global economy and financial markets have suffered the biggest decline and change since the Great Depression in the USA.

The plummeting of the Latvian economy was caused by the prolonged twofold shock that had lasted for some time as the economy was undermined both internally and externally and enormous confusion and perplexity were prevailing sentiments. Besides, quite noticeably, the businesses are sliding back into the shadow economy. Consumption is shrinking and so do investments and various business pro-

jects. Thus, in the 1st quarter the heaviest fall was observed in investments (-34%) and household consumption (-17%). Exports, and especially imports, fell substantially while government spending changed only slightly due to postponement of crucial structural decisions. Industry-wise a shocking fall was reported by the tourism industry (-39%), followed by all the major branches of the Latvian economy. Construction volumes over the year have dropped by 28.2%, both domestic trade and manufacturing – by 25.8%, transport and communications – by 15.4%. The trade is pushed deeper down by the weak purchasing power, vague future prospects further curbing consumption. Construction is frozen with new administrative, residential and industrial projects almost at a standstill. At the same time, the measures of reviving the economy by means of the EU structural funding for house insulation and infrastructure objects have been delayed by several months already. The drop in the transport sector is bigger than expected while commercial and financial services have suffered less than predicted. The public sector has shown a comparatively small decline, yet the reforms are gaining momentum and the fall will become faster over the coming quarters of the year.

Such a sharp and deep fall has obviously brought the economy to the greatest decrease of GDP in the first six months of 2009. Considering that in the 2nd half of 2008 GDP had already shrunken substantially, that Latvia will continue to implement structural reforms and receive the international loan avoiding further downgrading of its credit rating and anticipating recovery of the external markets in the a few months' time, we can predict that from Q3 the economic fall will slow down (yoy terms). Nevertheless, recession will hardly be stopped over some 4 – 5 more quar-

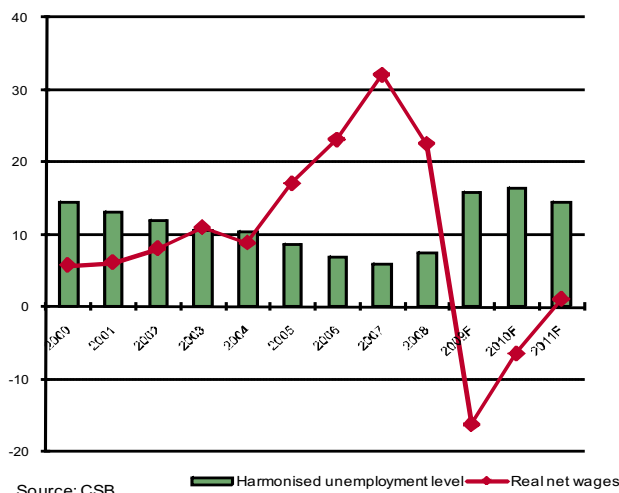
ters when the economy is expected to bottom out in terms of GDP volume. Indeed, the fast fall so far, a greater state support in implementation of the reforms and the utilisation

LCBA forecasts an 18.0% decrease of GDP this year and a 3.8% decrease next year.

tion of the EU structural funds can substantially accelerate economic recovery of Latvia. The forecast of the Latvian Commercial Banks' Association for GDP is: -18% for 2009, -3.8% for 2010 and +2% for 2011.

The labour market has been going through major changes for quite some time already as employment and wages shrink and the shadow economy expands in this segment. While the private sector has been exposed to this change already for at least a year, the main events in the public sector are still to come. Registered unemployment over half a year has grown from 7% in December to 11.5% in June while the ratio of jobseekers in Q1 reached 13.9%. By the end of the year these indicators will grow by a few percentage points. Employment is rapidly falling back to the level of 2002-2003. With the employment, wages and salaries are decreasing too. In Q1 salaries in the public sector lost 16%, in the private sector - 1%, compared with Q4 of 2008. Already in Q2 salaries will have dropped compared with 2008. The growth of real wages and salaries is negative already (-2.7% in Q1) and a major fall in the households' purchasing power is anticipated in the coming quarters although it may

Unemployment and wages (%)



be slightly curbed by increasing deflation. The fact that the salaries are more substantially corrected in the public sector is not surprising considering that over the last years the pay rise in the public sector overtook that in the private sector. Besides, in the private sector restructuring, including salary cuts, has been underway already since 2008. Wages and salaries this year will shrink considerably and this trend will continue next year too.

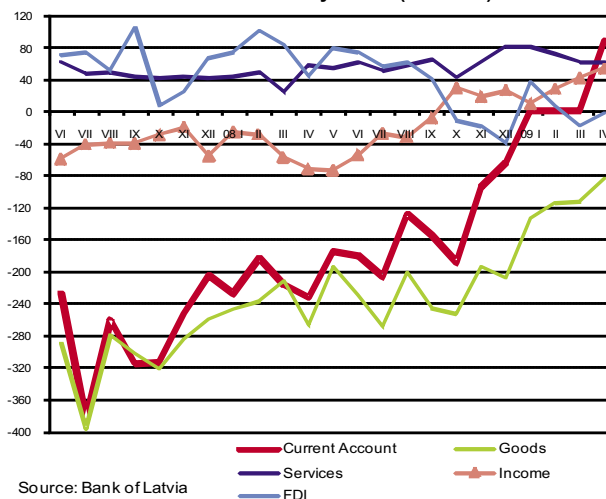
Another factor of imbalance in the economy has crum-

A TURN TOWARDS DEFLATION

With domestic demand considerably decreasing Latvia is rapidly moving towards the deflation zone. As mentioned before, increase in taxes was rapidly absorbed by the

bled: in a very short period of time the current account in the balance of payments from long-lasting minuses (more than 20% of GDP), for the fourth months has stayed positive. The changes have taken place in surprisingly short time and the reason behind them is a substantial drop in consumption and its financing. Of course, such a situation will not last long, because it is a reflection of the great confusion

Balance of Payments (mln. lats)



Source: Bank of Latvia

caused by the free fall of the economy. The foreign trade balance is improving month by month with the fall in imports overtaking the decrease in exports. Imports of goods in Q1 fell by 36.5%, while exports dropped by 26%. In Q1 negative balance amounted to 396 million lats or almost by half down from every quarterly result in 2008. As the economy recovers, we will not avoid a moderate deficit in the current account. However, thanks to structural reforms, it should not become a stumbling block for the economy. Lack of clarity in the economic outlook had a serious negative effect on the influx of foreign direct investment which this year will be considerably smaller than in the previous year.

Although the economic deterioration has been very painful indeed, the banking system has sustained the blow quite well. Even though the provisions have increased from 2.1% in December to 4.4% in May, and the share of overdue loans has grown substantially, the situation is better than in many western countries where the recession has been milder. The banks are issuing new loans although their volumes have shrunk considerably due to the great uncertainty in the economy. Without active participation of the commercial banks rapid recovery of the economy will not be possible, yet crediting could be best improved by a better sovereign credit rating of Latvia and a stable and comprehensible movement upwards from the bottom of recession. A serious stabilising factor for the banking sector and the entire Latvian economy is the consistent support of the foreign parent banks declaring their long-term strategies in the Latvian and Baltic market.

plummeting purchasing power and lack of clarity in the economy. If at the beginning of the year we still observed inflation determined mostly by the raised tax rates, since

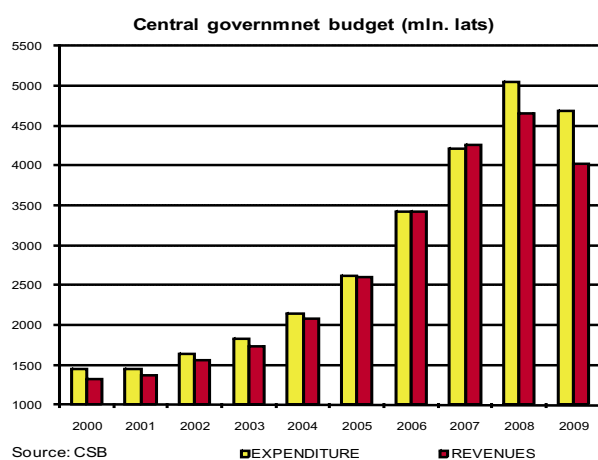
April the prices have started to decline. In April consumer prices were down by 0.4%, in May – by 0.5%, and afterwards are likely to fall even more month by month. Unless the signals of global economic recovery, disappearing deflation in the EU and the rise of resource prices are strong enough, consumer prices in Latvia will keep falling at least for a year. Latvia is most likely to enter the deflation zone already this autumn and reach its lowest point at the end of this and the beginning of the next year. This process could be considerably delayed by the rise of some taxes, the forecasts of prices of energy and other resources going up, stabilisation and recovery of the economy in Latvia and worldwide. On the other hand, it will be intensified by the fall of salaries and wages, further decline of the economy, decreasing purcha-

Latvia has no experience of deflation and it can pose a great challenge to the businesses.

sing power, particularly in the heating season.

Latvia has not yet experienced deflation which can become a major challenge for the government and businesses. Short-term deflation is definitely positive as it will push the prices of goods and services in the direction of the real purchasing capacity and thus improve the state competitiveness. It is the disproportionate price level that has been and still remains one of the major factors creating imbalance in the economy. LCBA is expecting annual average inflation to reach 3% this year and moving into deflation (-1.5%) next year.

ON THE RIGHT ROAD AT LAST?



For six months already Latvia has been in the focus of global attention as a country that has got itself into dire straits. Its economy has taken the deepest plunge in the European Union, its international loan is huge in proportion to its GDP, its steady resolution to maintain the currency peg is in contrast with the common world practice (devaluation), the government's procrastination in introduction structural reforms and substantial revision of public spending are perceived as negative signals at home and abroad. The road chosen by Latvia, the so-called internal devaluation by reducing costs and reforming public sector, has caused perplexity and flood of accusations as strongly-worded declarations have been feebly supported by actions. However, at the beginning of June the processes were triggered by the government's decision to make a slash of costs unprecedented in Latvia's recent history. It will make a significant impact on the society, and yet there is no other way to continue the thorough restructuring of the economy and public sector. It is a pity that because of lack of political will these processes could not be accelerated already at the beginning of 2009 when cutting of budgetary expenditure would have been less painful to the people and the economic rescue measures would be made available to the businesses at an earlier stage. Undoubtedly, the IMF, the EC

and other lenders will appreciate our resolution and Latvia should not have any problems with receiving the next tranches of the loan which will eventually give more confidence to foreign experts and investors. Latvia must not let its credit rating slide down below its present quite meagre level that is a signal for future business projects and credits.

The necessity to cut at least 500 million lats this year and at least the same amount next year will increase the social tension and reduce the government spending. Although it is the fact that the total budgetary expenditure has not been decreased even to the level of 2007, a number of indicators have dropped below that level. The measures that must be implemented in the public sector have for some time already been introduced in the private sector where restructuring is already starting to bring fruits. Now that we have successfully responded to the first challenge, i.e. a real revision of public spending, it is the time to address another important issue – the rescue of the economy – that has been anticipated by the business community for almost a year. The sooner we introduce a comprehensive economic rescue package, the sooner we will be able to relieve social tension and avoid its growing pressure in the autumn of this year. As

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we already mentioned in the previous issue, the shock therapy will not bring the desired result without all-embracing support to businesses. After all, Latvia has access to almost 1 billion euros for 2009 in various programs both from the EU structural funds and other sources, numerous instructions and procedures have been written to make it all work. Not least important is the awareness of the EU and west-European countries of the economic problems that have overwhelmed the new EU member states and first of all – Latvia. We certainly expect greater understanding on the part of the EU and additional influx of funds into our economy provided that we resolutely pursue the road of reforms.

WHAT HAPPENS NEXT?

The economy will keep falling for a few more quarters of a year, yet this process will slow down considerably until reaching the bottom of recession in the 2nd -3rd quarter

of 2010. The recovery will start with the demand rising in the foreign markets (exports, transit, and logistics). Certain signals will be sent by the real estate market where prices

will have fallen quite substantially. By receiving regular portions of international loan and positive evaluation of our progress, in a few months' time we shall diminish tension in the financial markets and among investors. Falling costs and more prudent public spending in combination with faster and more effective utilisation of available funds in the economy will encourage the flow of foreign investment into Latvia. All these processes can be further enhanced by the recovery of the global economy when the search of poten-

tial investment regions and industries will begin.

The road chosen by Latvia is difficult and thorny yet it is clearly the most effective if correctly pursued, and understood and accepted by the public. If we succeed in laying strong foundation to the structural reforms and revival of the economy, many cost cuttings and tax increases planned for the coming years could be laid aside as the economy by the year 2010 will have gained new strength.

WHAT SHOULD BE DONE?

Work must be started immediately on the framework for raising productivity and competitiveness of the national economy in concerted effort of all the stakeholders. The framework should define the tasks of the public and private sector in short, medium and long-term perspective.

LCBA deems it necessary and urges to do the following:

- ✂ To continue to implement the programme of crisis management and improvement of competitiveness accepted by Latvia and the international donors:
 - o to accelerate state functional audit and cutting of inappropriate costs;
 - o in the functional audit to focus on the usefulness of specific functions;
 - o to continue improving efficiency of public administration in the coming years, even if the economic cycle is reversed;
 - o to seek support of the social partners and experts in order to achieve better results in optimisation of state expenditure and administrative functions;
 - o to permit no deliberate procrastination and blocking of the decisions and procedures in the state apparatus.
- ✂ To establish objective, carefully weighed and farsighted communication with the public with regard to tackling of the crisis on the basis of the social contract.
- ✂ To accelerate significantly all the available economy rescue programmes in order to utilise maximum available funds for this year thus enhancing recovery of the economy.
- ✂ To urgently adopt the decisions crucial for stabilisation and enhancement of the economy on the insolvency process, government procurement, support to struggling borrowers of housing loans.
- ✂ To promote the initiatives of the public sector employees, to increase the individual accountability of the civil servants at the junior and medium level, to make closer assessment of individual performance and the possibilities of rotation in the system establishing links between the levels horizontally and vertically.
- ✂ To loose no time in defining priority directions and industries so that the state and commercial banks could focus their efforts in supporting of the economy.
- ✂ Not to permit ill-considered and hasty changes in the taxation system without an in-depth analysis, frustrating the businesses and the employees and pushing the economy into the gray zone.

ALCB FORECASTS

	2008	2009(f)	2010(f)	2011(f)
GDP, %	-4.6	-18.0	-3.8	2.0
Inflation (CPI), %	15.4	3.0	-1.5	1.5
Harmonised unemployment level, %	7.5	15.8	16.5	14.5
Real net wages, %	22.5	-16.3	-6.5	1.0
CAD, % of GDP	-12.6	-0.5	-2.5	-2.5
Fiscal balance, % of GDP	-4.0	-8.3	-5.5	-3.0



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