ASSOCIATION OF LATVIAN COMMERCIAL BANKS

Latvia ECONOMIC Outlook

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In spring the macroeconomic indicators started to improve one after another gaining stability and testifying to certain trends in the economy. Positive growth is observed in industry and exports, consumption is falling at a lesser rate, budget revenues exceed the targets and unemployment is gradually decreasing. It can be said now that Latvia's economy climbing out of the pit of recession, which is confirmed by the GDP figure for the 1st quarter of 2010. Although in annual terms the economy is still in minuses, the trends show that its recovery may be faster than expected.

Latvia's reputation has greatly improved as the country is honouring its obligations toward the creditors, fulfilment of which was greatly doubted. The performance of Latvia in particular and the Baltic states in general stands out in a positive contrast to a few other EU member states hesitating to implement the necessary fiscal consolidation measures. Chances are that Latvia's credit rating will be upgraded already this year, which is crucial for the country's further growth. However, the Latvia's price for the changes in the economy is the highest unemployment rate in the EU, the biggest number of emigrants and the heavy fall of consumption that can be reversed only by much greater economic activity, investment flow and newly created jobs.

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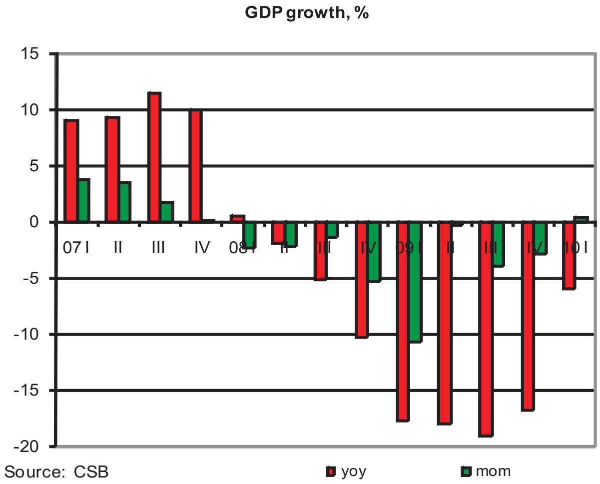
RECESSION IS CURBED

The economy bottomed out at the end of 2009 and already Q1 of 2010 saw a tiny 0.3% growth of GDP compared with Q4 of 2009. No matter how frail, it is the first positive sign of stabilisation and rising economic activity. It should be noted that last time a quarterly growth was registered at the end of 2007 (+0,1%). There is still a 6% decrease year-on-year, yet it is considerably smaller than in the previous quarters (on average -18%). Given the prevailing trends, the rate of fall will further slow down toward the middle of 2010 and by the end of the year the economy should attain at least a slight positive result. The quicker changes than expected are determined mostly by two factors: the positive export results and the base effect of plummeting economic performance last year.



Source: CSB

The economy is observed to become less and less homogenous and is expected to remain so for a long time. The export-oriented industries have survived and boosted their competitiveness persuading of their future potential. Regretfully, the share of the manufacturing industry, although growing, is not big enough to give a decisive kick-start to the economy. It is crucial now to focus on the industry of Latvia, boosting of its export figures and its potential to replace imports, as industry this year and the next ones will be pulling the country's economy. Q1 in annual terms saw the growth of 6.8% in manufacturing industry and even greater increase in March and April. For example, the output in wood-processing has already exceeded the pre-crisis levels. Notably, that several branches are showing positive results: transport and communications (2.3%), agriculture (5.9%), energy (17.5%). At the same time, domestic consumption – both private and public – is still shrinking compared with the same period last year. The domestic trade volumes in Q1 of 2010 fell 8.1%, and there was bigger or smaller decline in other services too. It was especially conspicuous in construction (-43.1%). Investments in economy were scanty due to prevailing apathy and lack of faith as the outlook for the economy is still unclear.

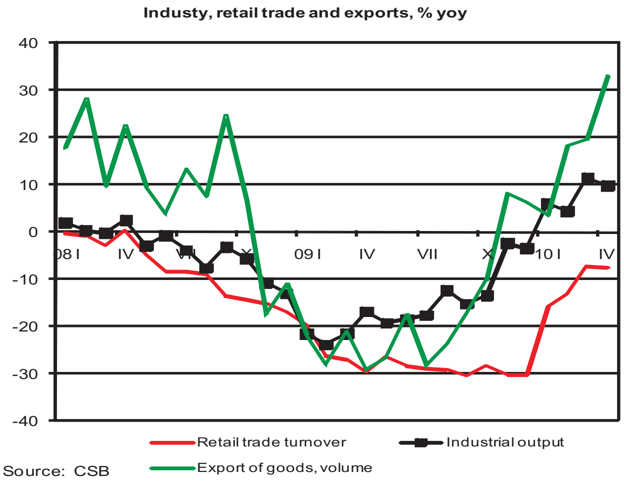
For 2010 the ALCB forecasts a GDP decrease of 2.2%, and for 2011 – the rise of 3.7%.

In view of the signs of some improvement in the economy, the ALCB slightly raises its GDP forecast for this and the next year: in 2010 GDP will decrease by 2.2% (formerly -3%), and in 2011 it will grow by 3.7% (3.2%).

POSITIVE CHANGES IN SOME DATA

Along with the above mentioned GDP and industry data, the improving trends in exports, budget revenues, property market, and financial markets and to some extent in employment also deserve to be mentioned. They are supported by the Confidence Indicator that is getting better month by month signalling positive expectations of the business community already for the coming months.

The breakthrough in exports over the last months has been spectacular. In Q1 it rose by 14.3%, and in April – even by 33%! Imports, too, are out of the deeply negative last year's results and beginning to grow. It is the sign not only of the growing producer prices, but of the general recovery of the economy. In real volumes expressed in lati exports have not yet fully rebounded and now stand at the level reached at the end of 2008. At the same time, imports have dropped to the level of 2005.



Source: CSB

It is vividly reflected in the current account surplus of the balance of payments, which in Q1 accounted for 9.2% of GDP. Significantly, for the fourth consecutive quarter the positive balance of services has been exceeding the negative balance of goods. The situation over the last couple of months has not changed a lot, not only in the above mentioned goods and services, but also in the income and current transfers positions. The trends, nevertheless, indicate gradual shrinking of the current account surplus caused by decreasing losses of banks. Still, at least for the nearest two years the account balance is sure to be positive. Another good news was the tax revenues that in April and May considerably exceeded the target in several groups of taxes, in some cases even reaching a two-digit figure. It confirms certain activity in the economy as well as the fact that the budget forecast has been very conservative. This trend will most probably continue bringing more revenues into the budget.

It is important to monitor the stability of this trend in order to fine-tune the fiscal consolidation measures for the coming two years. Task number one in this direction is effective programme to fight against the shadow economy. It is more and more persistently insisted upon by the international creditors as an income source of great potential.

Slowly, yet resolutely, unemployment, too, is decreasing. Registered unemployment over a few months has shrunk from 17.3% in March to 16.2% at the end of May. The overall situation is still worrying as the number of employees in the course of Q1 has dropped by 15 thousand, raising the share of jobseekers to 20.4%. On the other hand, the number of vacancies is slowly picking up.

Yet another positive sign is confidence in the financial markets reflected by the record low interest rates for local currency loans in the inter-bank market that is approaching 2% (compared to last year's occasional 30%). We should also mention the slow but steady rise of property prices continuing for almost half a year.

IS DEFLATION ENDING?

One of the indicators that have changed their course radically in the last months is the Consumer Price Index (CPI). The monthly deflation that had started last spring stopped on the eve of the New Year and in the following months the prices started to climb up again. In the first four months of 2010 the CPI kept rising month by month gaining 1.5% over the period and only in May a tiny decrease of the index (-0.1%) was registered. The consumer price dynamics is quite unclear: on the one hand it will be affected by the global price trends, on the other hand – by the weak purchasing power in Latvia. However, many signals suggest that the deflation period will be shorter and less deep that predicted earlier. The ALCB is lowering its CPI deflation forecast to 1.9% this year; whereas next year will already see a slight rise in prices by 0.8%.

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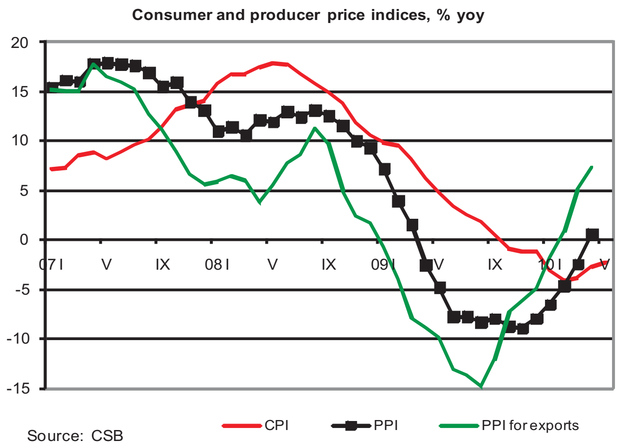
Nevertheless, it is too early to expect the end of the deflation story. The price rise registered so far has been mostly dictated by the global increase of prices and the weak euro. In the nearest perspective the main reason for the rise of the CPI will still be external factors. The prices originating locally will remain under the pressure of deflation, although milder than before, as the labour market will be weak and incomes will keep shrinking. The difference in the trends of sales and non-sales prices (i.e. internal and external) is clearly seen in service prices that have been decreasing month by month for more than a year now and in May their rate of fall reached 5.6% while the prices for goods have dropped by a mere 1%.

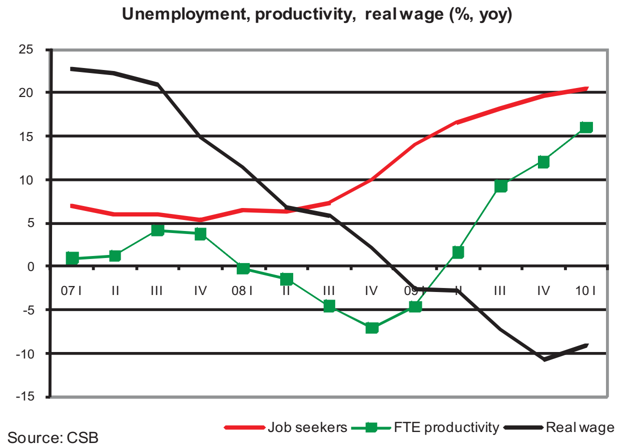


Source: CSB

Similar trends are observed in the Producer Price Index (PPI). Thus, for exported goods in April the prices have risen by 7.3%, year on year, while the prices for products sold in local market are 3.6% down from last year's level. In monthly terms the prices have been climbing up for some time both for local and export products. In the domestic market this process is slower because of the weaker purchasing power.

REGAINING COMPETITIVENESS

The plummeting labour costs and lately also the weakness of euro have helped boost Latvia's competitiveness. The cost of a labour unit keep falling and in Q1 they had dropped by 24% from the peak reached in Q3 of 2008. The real effective exchange rate of the lats over the year has lost 10%, i.e. approximately one third of the rise in the boom times has been regained. Average productivity



Source: CSB

per one full-time worker in Q1 was almost 16% above the last year's level. The Bank of Latvia's calculations show that the market shares of Latvian businesses in the export markets are growing.

Nevertheless, the growth potential of competitiveness by decreasing labour costs to a great extent has been exhausted already. Further progress can be only achieved by improving the quality and range of goods and services, upgrading of production processes, acquiring new markets and optimisation of the business environment. As we have already stressed in the earlier ALCB Macroeconomic surveys, the support of the government is crucial in implementation of structural reforms. Without achieving a visible progress in the reforms the economy may begin to

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stagnate, with new jobs appearing too slowly, which will drive the people into emigration, raise social tension and a number of long-term problems, such as the sustainability of the pension system. The vivid example of badly needed reforms is the slow acquisition of the EU funds, lack of perspective in the reform of academic education. There is an urgent need for diversification of financial markets – the bank activities do not directly cover a range of market segments that are important for new companies, e.g. the risk capital that should be attracted with greater effort. If creation of such segments is not encouraged, the economic development will be held back by the lack of money.

TAXATION POLICY

The data of the CSB and the Bank of Latvia show that the income of the population in Q1 continued to decrease while retail turnover and household savings increased. It clearly shows the growth of the shadow economy: people are spending the money that is not paid to the government in taxes, at the same time raising great objections to the state for its not being able to function in the same scope and qualify as a couple of years before. These trends not only distort competition, scare away foreign investments, make cash flows less transparent, increasing risks and raising interest rates, but also endanger the prospects of balancing the state budget. Improvements of the budgetary situation will not succeed, if the shadow economy is not kept under control.

The ALCB is considering it expedient to increase the untaxed minimum of the personal income tax (PIT), decrease the rate of the PIT and raise the property tax (PT) on housing.

The plans of the Ministry of Finance targeting the shadow economy and basic tax guidelines is a step in the right direction. Nevertheless, the ALCB is of the opinion that these documents need to be more clearly linked. The intended tax changes should reverse the growing trend of the shadow economy. In order to achieve this, the tax burden should not only be shifted to the base where tax evasion is not so easy, but the honest taxpayers must be persuaded that it will not be done at their expense. It must be achieved at last that taxes are paid by those who until now had managed to avoid them. The ALCB is considering it expedient to increase the untaxed minimum of the personal income tax (PIT), decrease the rate of the PIT and raise the property tax (PT) on housing. To simplify disclosure of illegal income, a zero income declaration should be introduced with a special provision – amnesty for the previous tax evasion. For the population to accept such changes, they have to be simultaneous and sufficiently fast.

MOVE TOWARD BETTER CREDIT RATING AND INTRODUCTION OF THE EURO

Although there are many home-grown sceptics who doubt Latvia's chances of successful movement from the crisis to sustainable development based on competitiveness and strong fiscal policy, Latvia's progress is increasingly noticed by foreign experts and institutions. It was recently confirmed by the international creditors who urged to continue the work, not to lose the tempo at the sight of first positive signs, and not to give in to political populism. The road pursued for some time already by Latvia and the other two Baltic states is set as an example to other EU states to put them on stable tracks.

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It was further confirmed by Estonia's achievements in fiscal discipline and regaining of competitiveness recently commended by the credit rating agency Standard & Poor's, who upgraded the country's credit rating. Estonia's move to introduction of the euro already in 2011 is very confident indeed. It is a good sign for Latvia that we can achieve the same as our neighbours unless we wander away from the chosen course. The move to the euro must be set as the country's priority because it has a much wider connotation than mere introduction of a new currency: a stable fiscal situation, healthy business environment and public administration that should be reflected in a growing competitiveness of the state.

WHAT SHOULD BE DONE?

The ALCB considers it expedient and urges:

- The government to draft detailed plans of structural reforms (in higher education, fiscal discipline etc.), so that the new Saeima can immediately make a choice from various options and introduce them already into the budget for 2011.
- To continue fiscal consolidation based on well-substantiated and good-quality structural reforms already in drafting of the budget for 2011, rather than blind and linear cutting of expenses.
- To increase the untaxed minimum of the personal income tax (PIT), decrease the rate of the PIT and raise the property tax (PT) on housing. Such changes must be simultaneous and sufficiently fast so as to maximize the gains from income legalisation.
- To grant substantial state social contributions relief with a clearly defined timescale to the businesses who:
  - a) recruit the long-term unemployed,
  - b) provide youngsters with their first workplace (youth is the highest risk group with 39% jobseekers at the age of 15-24 years).
- In order to seriously minimise the distortions in the economy and motivate people to pay taxes, the government to grant a priority status to the combat plan against shadow economy and to communicate it to the public by stressing both the measures of motivation and punishment.
- To emphasize Latvia's move toward the euro in close connection with raising the country's competitiveness, fiscal stability and effective public administration reforms.
- Not to view revival of business activity and crediting in isolation of the country's credit rating and efficient insolvency process, trade insurance, state guarantees and other crucial factors.

ALCB FORECASTS

	2008	2009	2010(f)	2011(f)
GDP, %	-4.2	-18.0	-2.2	3.7
Inflation (CPI), %	15.4	3.5	-1.9	0.8
Harmonised unemployment level, %	7.5	16.9	20.4	17.3
Real net wages, %	22.5	-2.3	-8.2	2.4
Current account balance, % of GDP	-12.6	9.4	7.0	4.6
Fiscal balance, % of GDP	-4.1	-9.0	-7.9	-5.7

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