



# Latvia ECONOMIC Outlook

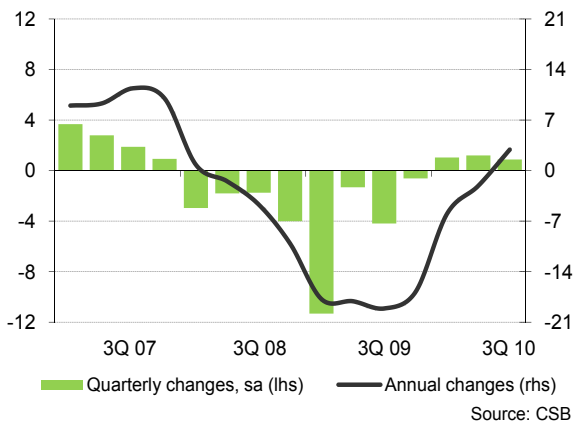
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In 2010 Latvia's economic growth exceeded the most optimistic forecasts. The ability of the Latvian businesses to cut their expenses (unit labour costs almost one quarter down

**Latvia's economic growth in 2010 exceeded the most optimistic forecasts**

compared with the beginning of 2009!) and faster than expected recovery in foreign markets encouraged growth of exports

Real GDP changes, %



and promoted industry as the main driving force of the Latvian economy. The domestic market started a gradual process of recovery as well. Consequently, in the 3rd quarter of 2010 the GDP growth was observed also in year-on-year terms – for the first time after a decline lasting more than two years. The

## RECOVERY EXPANDING, STRUCTURE OF ECONOMY GAINING BALANCE

In 2010 the changes in Latvia's economic structure became more and more conspicuous. The role of exports and manufacturing industry is gradually increasing, which is a sign of a more balanced structure of the economy. In the first 11 months of the year exports of goods rose by 28%, compared with the corresponding period of 2009, and by the end of the year reached an unprecedented record. At the same time, the development in exports of services was a lot weaker – in 2010 exports of services practically stood at the level of 2009. Export growth has greatly helped boost the share of manufacturing industry in Latvia's economy: from 8.9% at the beginning of 2009 to 12.6% in Q3 last year. In January – November 2010 the fastest year-on-year growth of output was seen in machine building (67.2%), timber industry (29%), manufacture of fabricated metal products and basic metals (by 24% and 18% respectively). A small one-digit drop was registered in a few sectors only: manufacturing of pharmaceuticals, furniture and some food products.

government established after Saeima elections continues to implement the agreement reached with the international creditors and to reduce the budget deficit with the aim to introduce the Euro in 2014.

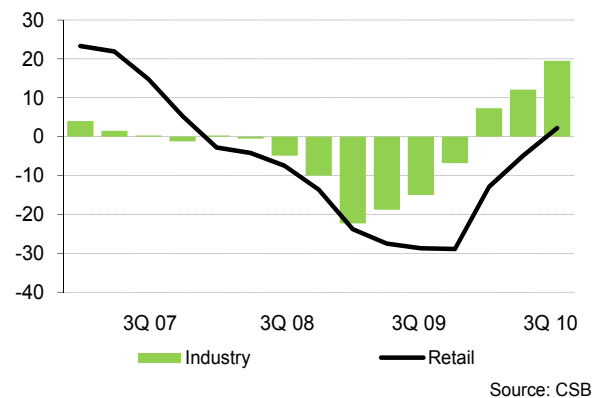
Despite the rapid improvement of economic indicators so far and a very gradual change of the economic structure towards sustainability, there are growing concerns about the lack of a clear long-term vision in the currently pursued economic policy. Undeniably, the government and Saeima have been able to accomplish substantial consolidation and to maintain the country's financial stability, yet the decisions adopted so far lack a clear structural policy. The state budget is mostly seen as an end in itself rather than an instrument for achieving long-term sustainable development. The fiscal consolidation plan for 2011 was developed in a big hurry and reforms reflected therein are not only weak, but in some positions even counter-productive. The ALCB is of the opinion that implementation of structural reforms – particularly in education, health care

**Budget as an end in itself rather than an instrument for achieving sustainable development**

and employment – remain high on the government's agenda.

Unless negative shocks happen to the global economy, in 2011 and 2012 GDP growth in Latvia will be good. Unfortunately, the lack of strong structural improvements means weak development in the long term when the current strong „rebounding” effects, e.g. improvement in export and labour markets from the very low recession levels, will have exhausted its potential.

Industry and retail (changes year on year), %



Many exporting companies are already working close to their full capacity therefore the increase of the export volumes

greatly depends on investments. Quite logically, after the decline that lasted almost three years, in Q3 of 2010 investments increased compared with the previous quarter, and so did the hope for renewal of stable growth of investments and imports this year as well. In 2011 exports will continue to be the driving force of the economy albeit its pace will be slower. Fiscal problems in the peripheral Eurozone countries are clearly hampering Europe's development, yet those markets that are very important to Latvia – the other two Baltic states, Germany and Sweden – are going to show strong growth. Hence the main factor working against the rise of export volumes will be the shortage of capacities and qualified workforce.

It is not surprising that the increasing demand for intermediate consumption and capital goods, following the rise of exports and investments, has also pulled imports up: In Ja-

**Most important markets for Latvia - the other Baltic states, Germany and Sweden – will show strong growth**

nuary-November 2010 imports rose 21% year on year. Foreign trade balance for a year already has been fluctuating around zero and in the nearest future will be slipping into minuses: the rise of imports will be driven by the need for raw materials for the export industries, increase of investments (by diminishing the capacity problems in manufacturing and more active drawing of the EU funds) and gradually also by a modest rise in household consumption. Still, the domestic demand is going to be too weak to have a drastically negative impact on trade balance. The expected levels of current account deficit in the nearest future do not pose a threat of instability.

## STRUCTURAL PROBLEMS IN LABOUR MARKET

The recovery of the labour market, though anticipated, was stronger than predicted. The percentage of jobseekers reached its peak in Q1 of 2010 (20.4%) and in Q3 it dropped to 18%. The registered unemployment rate indicates that by the end of last year unemployment was not significantly decreasing any more – probably due to seasonality. Although over the year unemployment was most likely reduced by emigration, creation of new jobs had its impact as well – after the decline lasting for almost two years, in the 2nd and 3rd quarter of 2010 37 thousand new jobs were created (excluded those involved in the activities of the State Employment Agency). The improvement of household sentiment (particularly the diminishing unemployment expectancy at the beginning of 2010) and the rise of employment over the year stimulated growth of retail turnover (in November 2010 +8.1% year on year). Nevertheless, consumption is still rather feeble and will stay so this year too – unemployment will remain high and income will rise very slowly, besides, purchasing power will be weakened by inflation. Most probably, the jobs created last year were partly the result of a rebound from the exaggerated job loss in 2009. Such a rise in employment has a one-off effect and indicates that in 2011 new jobs will appear at a slower rate than last year. Moreover, the tax changes included in the state budget for 2011 do not promote employment. The seemingly good indicators of labour market improvement hide growing

structural imbalances – rising long-term unemployment where despite the very high jobless figures there is an increasing lack of specific professional skills as the employers cannot find the workers with necessary qualification. Due to lack of skills and experience it is particularly hard for the youngsters to find work and they are forced to emigrate thus undermining the growth potential of Latvia's economy in the long term. The current employment policy is unable to address these problems effectively.

**The current employment policy is unable to address the problem of structural unemployment**

At the same time, the gap between the productivity and wage levels has narrowed. The ALCB forecasts the rise of wages and salaries this year, which will be slow and diverse in different industries. Exporting industries are in a better situation as the productivity is rising faster there and the growth prospects are brighter. Still, the pay per hour is not likely to improve significantly on a mass scale and the remuneration will most probably be improved by renewing the incentive schemes that were suspended during the recession. The overall rise of incomes and hence spending will ascend very moderately and the sectors oriented to the domestic market will recover slowly.

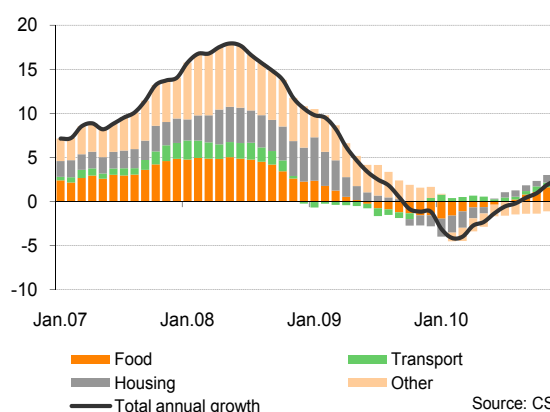
## INFLATION GOES UP

The deflation period in Latvia ended quickly and in December of 2010 the consumer price index was already 2.5% above the previous year's level. The fastest growth was observed in prices of essential goods, which seriously aggravates the income inequality and thus disrupts and fragments economic growth. The ALCB forecasts that annual

**Inflation may become a major challenge for introduction of Euro in 2014**

average consumer price inflation in 2011 will reach 2.9%. Approximately one percentage point will be added by the raised VAT and other taxes. Though slower than last year,

Contribution to CPI in annual inflation, percentage points



the global prices will rise as well. In 2011 inflation will be driven by the supply factors and demand factors could be noticeable only in 2012. Inflation may become a major challenge for introduction of Euro in 2014, particularly if the structural imbalance in the labour market grows and the current rise of profit margins in certain industries in-

dicates weakness of competition. The calculation method of the inflation criterion also should be taken into account – if weak economic growth in the peripheral EU countries keeps inflation down, the inflation criterion can be very low.

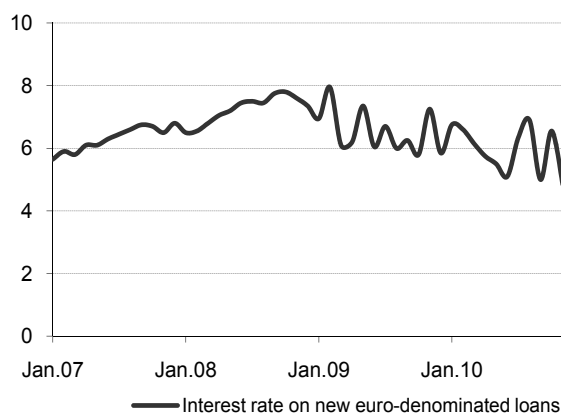
## LENDING ACTIVITY INCREASES

Due to big uncertainty and difficulty to distinguish between the clients' liquidity and insolvency problems during the recession, the lending activity of the banks had slumped. As the economy rebounded, the situation in lending improved. The supply has become wider and more accessible which is indicated by the decrease of average interest rates for new loans. The banks have accumulated approximately a billion lats that cannot be effectively distributed in credits due to the clients' inadequate risk profile and weak demand. Demand for loans is low because: (i) part of the companies and households still must reduce their credit liabilities in order to balance them with their assets and cash flows; (ii) part of the companies cannot invest an appropriate portion of their funds into project implementation, and do not wish to dilute their stock by attracting new investors (iii) another part of the companies hesitate to make investments due to uncertainty, or (iv) have accumulated resources and have no need for credits.

The demand for credit resources is high outside of the banks' traditional sphere of activity, e.g. in the new business segment where the high risk profile lenders usually operates as venture capital funds. Sadly, there are few players in this market and the market is inactive. If these alternative market segments are not developed, the access to financial resources

will remain limited. Of course, as the economy gains strength, the banks will lend more actively. Nevertheless, due to amortisation of the huge amount of loans outstanding, in 2011 the total loan portfolio, particularly in the household segment, will keep shrinking.

Interest rate on new loans



Source: CSB

## CONSOLIDATION ≠ STRUCTURAL REFORMS

As GDP grows faster, the budget revenues are much better than estimated by the Ministry of Finance. Even bearing in mind that last year the state consolidated combined budget was almost doubled, we forecast that in 2010 the consolidated combined budget will be below the maximum level agreed by the international creditors – 8.5% of GDP. The fast economic growth in 2010 allowed minimising the scope of consolidation for 2011 (from approx. LVL 400m to LVL 292m).

Unfortunately, consolidation has been mostly achieved by conserving the existing budget structure with minor adjustments and missing the opportunity to make rapid, deep and vast structural reforms. A similar opinion has been expressed by the international creditors who have insisted on additional consolidation of LVL 50 million.

Although in 2010 the seasonally adjusted GDP grew rapidly (on average by one percent) quarter by quarter due to







the negative base effect of 2009 when Latvia's economy fell by 18%, in 2010 GDP stayed at the average level of 2009. As the growth in 2010 expanded and the „rebounding” effects extended into 2011, Latvia's economy is expected to grow steadily this year, even despite some instability in Europe due to fiscal problems of some European countries and price pressure of energy resources and agricultural goods globally. The ALCB forecasts the growth of GDP by 3.6%. Nevertheless,

it should be stressed that the economic development is still very uneven, the business environment is unstable due to the leaps and bounds in taxation, and the inequality in purchasing power of the population increases. Clearly, if the scenario of weak structural reforms is realized Latvia will not sustain rapid economic growth in long-run. Short-lived success must not create euphoria and interfere with implementation of reforms.

***If the structural reforms are weak Latvia will not sustain rapid economic growth***

## WHAT SHOULD BE DONE?

The ALCB insists and urges the government to do the following:

-  Immediately develop detailed plans of structural reforms (in higher education, health care, Employment Facilitation etc.), to make appropriate amendments to the budget for 2011 and continue/commence their implementation already this year.
-  By introducing a medium-term budget planning, draft specific plans of structural reforms and consolidation scope in a three-year perspective. Already in the course of this year the public must be clearly informed of the essence and time scale of changes (incl. the planned changes in tax policy).
-  In order to minimize distortions in the economy, immediately start implementing the measures against the shadow economy and inform the public both of motivation and punishment instruments.
-  Improve the efficiency of the state/local government property management and to assess the need of retaining such property under the state/local government ownership. When the option of privatisation is considered, to assess its benefit for the public instead of attempting to raise funds quickly for stopping the holes in the budget.
-  Elaborate and promptly implement the employment policy that properly addresses the problem of structural unemployment.
-  View recovery of business and crediting activity jointly with the sovereign rating, effective insolvency process, trade insurance, state guarantees and other attendant factors.

## ALCB FORECAST

	2008	2009	2010(p)	2011(p)	2012(p)
GDP, %	-4.2	-18.0	0.0	3.6	3.8
Inflation (CPI), %	15.4	3.5	-1.1*	2.9	2.5
Harmonised unemployment level, %	7.5	16.9	18.8	16.5	14.7
Net wage changes, %	22.6	-2.6	-5.5	2.3	3.9
Current account, % of GDP	-13.1	9.6	4.5	0.9	-1.1
Fiscal balance, % of GDP (ESA 95)	-4.1	-10.2	-8.3	-5.5	-3.1

\* actual data



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