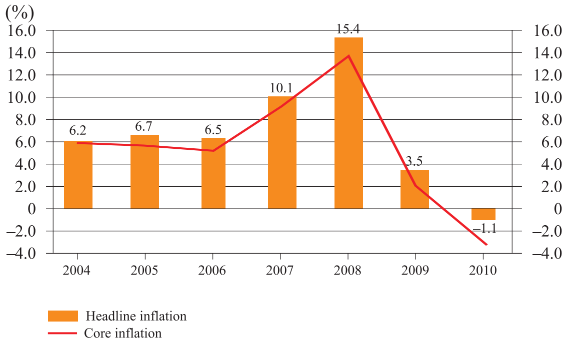
LATVIJAS BANKA

BANK OF LATVIA MONTHLY NEWSLETTER • JANUARY 2011

1. Highlights

Deflation in 2010 confirms the flexibility of the Latvian economy

Annual inflation



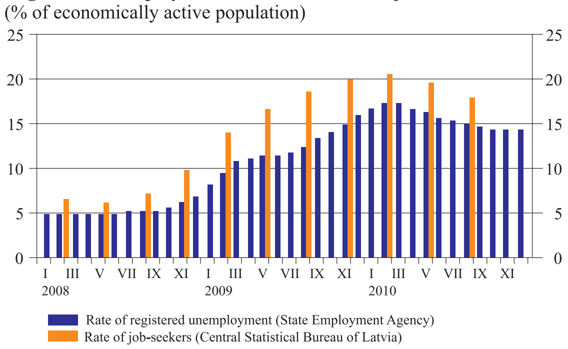
The average level of consumer prices in 2010 was overall 1.1% lower than in the year before. To a great extent, this resulted from the low domestic demand and the drop in production prices: with labour costs down and productivity on the rise, businesses had the opportunity to respond to the weakening demand with lower prices.

The rising global oil prices had a significant effect on fuel prices: in 2010, they exceeded the 2009 level by 14.6%. Moreover, the natural gas and heating tariffs also went up. Furthermore, global prices have pushed up the prices of unprocessed foods (particularly those of vegetables). By contrast, the prices have dropped persistently in those groups of goods and services that have been substantially affected by the fall in labour costs and demand in Latvia. The low domestic demand had the largest effect on prices of services, which continued to decline at the end of the year as well.

The changes in the value added tax rates in effect as of January this year are expected to have the most pronounced effect on inflation in 2011. The low demand, however, will continue to limit this increase and in the second half of the year inflation will resume a downward trend.

Drop in unemployment is stable: it is determined by renewed competitiveness

Registered unemployment rate and the rate of job-seekers
(% of economically active population)



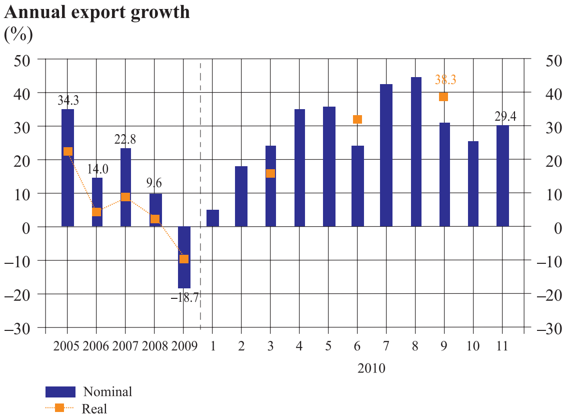
The rate of registered unemployment at the end of 2010 was at 14.3%. Compared to its historic peak in March 2010, it had dropped three percentage points by the end of the year.

According to Eurostat, in the second and third quarters of 2010 Latvia had the fastest growing employment among the members of the European Union. The explanation: renewed competitiveness in recent years not only on account of the drop in prices and costs but also increased productivity. The rise in productivity in Latvia has been the highest among the EU countries.

The largest contributor to the rise in employment was manufacturing which has also posted the biggest rise in productivity so far. During the crisis, the dry-up of investment precluded any rise in accumulated capital; moreover, the level of production capacity utilisation decreased. The current rise in productivity was thus achieved primarily by raising the organisational efficiency of businesses.

Exports continue to grow but the need for higher added value is also growing

Annual export growth



The annual export growth accelerated from 24.9% in October to 29.4% in November 2010. The highest annual rise in goods exports was posted by base metals, plastics, machinery and mechanical appliances as well as wood. In addition to the persistent foreign demand, the rise in exports of all the above industries was also stimulated by the improved competitiveness of Latvian producers, which was based on both competitive prices and higher productivity.

Taking into account the looming debt crisis risks in the euro area and the planned fiscal austerity measures in EU countries, the economic growth of Latvia's trading partners will moderate in 2010. Since the market capacity will grow slowly while the competition in the foreign markets will tighten substantially, the Latvian export producers will have to look increasingly for new niche products and develop products with a higher added value.

2. Macroeconomic data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth, seasonally adjusted)	 2010 Q3	 **0.9**
State budget Tax revenue of the consolidated general government budget (year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	 2010 XII 2010 XII	 **8.3** **–3.6**
Consumer price changes Consumer Price Index (CPI) (month-on-month growth) Average annual inflation rate of last 12 months (to comply with the Maastricht Criteria) 10.01.2011 Deflation in 2010 mostly determined by changes in prices for services	 2010 XII 2010 XII	 **0.1** **–1.2**
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 10.01.2011. Exports have a growing need for imports and a higher value added	 2010 XI 2010 XI	 **29.4** **38.3**
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 13.01.2011. Balance of payments in November 2010: current account surplus slightly on the rise	 2010 Q3 2010 Q3	 **1.1** **3.6**
Industrial output Working day-adjusted industrial output index (year-on-year growth) 03.01.2011. Manufacturing growth slows down; investment and qualifications of the labour force to play a crucial role in further development and competitiveness of businesses	 2010 XI	 **11.4**
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 29.12.2010. Retail turnover growth insignificant in November; further development depends on household sentiments regarding the economic situation	 2010 XI	 **8.1**
Employment and unemployment Registered unemployment (share of working age population) 11.01.2011. Restored competitiveness determined the stable drop in unemployment	 2010 XII	 **14.3**
Monetary indicators Broad money supply (year-on-year growth) 20.01.2011. Money supply posts seasonally fast growth in December	 2010 XII	 **11.5**

Sources: Treasury, Central Statistical Bureau of Latvia, and Bank of Latvia data.

3. In Focus

Progress with Fiscal Consolidation in Latvia

Curbing the budget deficit – from the planned 8.5% of GDP last year to below 6.0% and 3.0% of GDP in 2011 and 2012 respectively – is supposed to spell a gradual return to fiscal sustainability and restore the overall credibility of Latvian economy. The deficit adjustment measures already implemented in 2009–2010 amount to 14.0% of GDP: 10.0% of GDP come from cuts in the general government budget expenditure and 4.0% of GDP from revenue increasing measures. On the revenue side, both direct and indirect taxes have been raised. On the expenditure side, austerity measures have been largely backed by structural reforms in public administration, education and health care. At the same time, a social security net has been introduced to cope with the social consequences of the economic downturn and to protect the most vulnerable groups.

At the end of 2010, Latvia held general elections and the most urgent task of the new government was approving the budget for 2011 before the end of the year, thus under a very tough timetable. In order for the budget deficit to be in line with the target of 6% of GDP in 2011, a consolidation effort of 400 million lats was estimated to be needed, but due to improving macroeconomic conditions this estimate was revised downwards to 280 million lats (2.2% of GDP) of quality measures.

The structure of the consolidation plan adopted by the new government is not the same as the one promised by Latvian politicians before the elections (1/3 – tax increases, 2/3 – expenditure cuts), since there was not enough time for designing credible expenditure cuts. Instead, only 0.7% of GDP of deficit adjustment has resulted from spending cuts while the rest (1.5% of GDP) has been achieved by revenue measures, inter alia a VAT rate increase by 1 pp to 22%. Nevertheless, Latvia's government is expected to look for additional opportunities for spending cuts during the course of 2011 which would bring the deficit ratio from the projected 5.6% of GDP to even less, i.e. well below the target.

Furthermore, Latvia's government has established a working group to prepare a credible strategy for structural reforms underpinning 2012 budgetary consolidation. The working group is expected to focus on structural reform options in both the education and social security sectors as well as potential reforms concerning local governments, while not much could be saved at the expense of the health care sector. Latvia's government has already ruled out further tax raises, which would have a negative effect on the business environment and exert inflationary pressures.

In the meantime, Latvia's government has drafted a Fiscal Discipline Law to ensure counter-cyclical fiscal policy over medium-term and put public finance on a sustainable footing permanently. The law defines the basic principles of Latvia's fiscal policy, sets numerical budget balance and public debt rules and provides fiscal policy planning instruments. The medium-term budget framework law is required to contain binding expenditure ceilings for the following two years, based on the deficit target (as consistent with the balance rule) and budget revenue projections.

While some euro area countries are struggling to implement austerity measures on the background of stagnating economies, Latvia has accomplished the largest part of its homework and is currently well on track to reach the budgetary target necessary for the euro adoption already in 2014 as an exit from the current international support program.