

LATVIJAS BANKA

BANK OF LATVIA

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1 Highlights

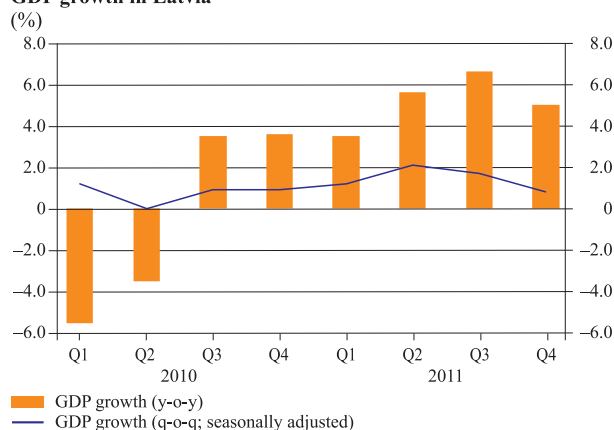
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1. Highlights

GDP growth robust amid global concerns

GDP growth in Latvia



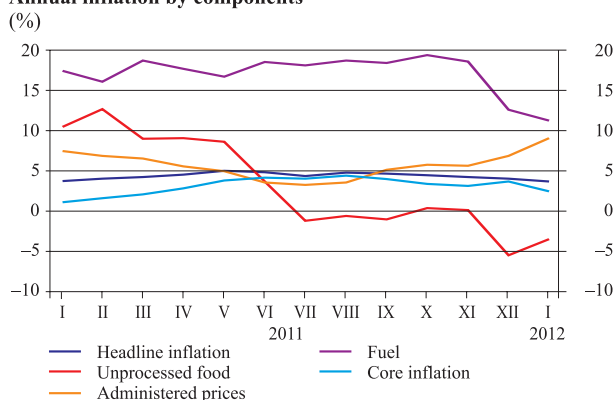
According to the flash estimate, real GDP in Latvia grew 5.0% year-on-year, and 0.8% quarter-on-quarter. Thus in 2011 overall, Latvian GDP grew by approximately 5.3%, making Latvia one of the most rapidly growing economies in the European Union.

Nevertheless, the last quarter of the year produced a slowdown of GDP growth. Successful performance in manufacturing and transportation was offset by disappointing growth in retail trade. This shows that weaker growth in Europe is affecting our economy.

It is possible that the full impact of the European problems on our economy will be somewhat delayed because historical evidence suggests that the Latvian economy lags slightly behind the European cycle of economic activity. On the other hand, economic confidence remains robust: according to EC data, the Latvian economic sentiment indicator (ESI) lags behind only that of Germany.

Annual inflation continues to shrink despite soaring energy prices

Annual inflation by components



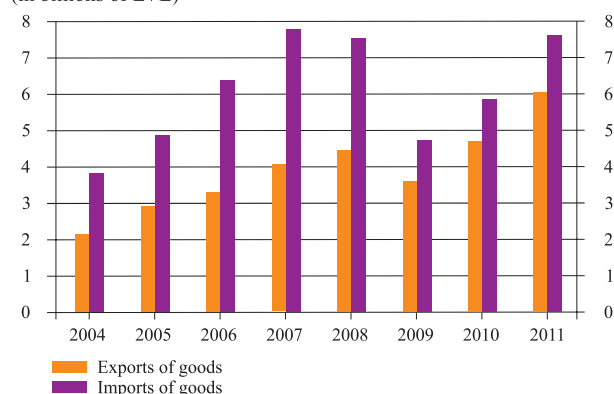
In January 2012, the annual inflation dropped to 3.6%, yet consumer prices rose 0.8% month-on-month.

As was already expected, the global price hikes resulted in a month-on-month rise in energy prices: gas (8.6%), thermal energy (9.4%) and fuel (4.0%). Global food prices have become less volatile year-on-year and, compared to 2011, the proportion of food in the consumer basket has shrunk, thereby easing the upward pressure of food prices on inflation. Overall the prices of food and non-alcoholic beverages rose 1.1% month-on-month.

Despite the high degree of uncertainty surrounding the future development of oil prices, considering the deceleration observed in the global economy it is quite likely that this year demand will have a much smaller effect on the prices of oil products and other energy resources than in 2011. Therefore, it is likely that the domestic prices will remain on a downward trend throughout the year.

Foreign trade results good for 2011, a tougher year ahead

Latvia's foreign trade turnover
(in billions of LVL)




Latvia's foreign trade activity grew substantially in 2011, with exports and imports of goods rising by 28.1% and 28.3% year-on-year respectively. In December, however, a month-on-month decline for both was reported (8.2 % and 1.8% respectively). The slackening of the trade activity in goods in the last months of 2011 was determined by the weakening external demand.

In 2011, nominal exports of goods exceeded the pre-crisis level substantially reaching new peaks for several consecutive months. Similar to 2010, Latvia was among the European leaders in terms of export growth in 2011. One of the main reasons behind it was improved competitiveness.

In 2012, Latvia's economic growth will remain largely dependent on export opportunities; therefore, the primary risk on the downside is related to the global economic development. Especially the quality of export goods will play an increasingly more important role in Latvian exports.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 09.02.2012 Gross domestic product grows in the last quarter of last year as well 	2011 Q4 (flash estimate)	0.8
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year; year-on-year growth)	2012 I 2012 I	16.0 -0.3
Consumer price changes Consumer Price Index (CPI; month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.02.2012 Annual inflation continues to shrink despite growing energy resource prices 	2012 I 2012 I	0.8 4.2
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 09.02.2012 Foreign trade results for 2011 good; a tougher year ahead 	2011 XII 2011 XII	13.5 1.4
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 10.01.2012 Services granted to foreigners in end-2011 balance the current account 	2011 Q3 2011 Q3	-3.8 6.7
Industrial output Working day-adjusted industrial output index (year-on-year growth) 04.02.2012 Manufacturing ends the year on a positive note 	2011 XII	9.6
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 30.01.2012 Population's spending more cautious at the end of the year 	2011 XII	7.1
Employment and unemployment Registered unemployment (share of working age population)	2012 I	11.7
Monetary indicators Broad money M3 (year-on-year) 20.02.2012 Money supply posts a seasonal drop 	2012 I	1.4

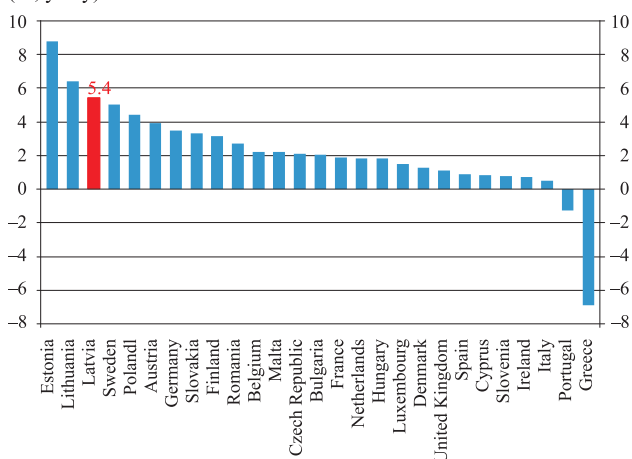
Sources: Treasury, Central Statistical Bureau of Latvia, and Bank of Latvia data.

3. In Focus

Internal adjustment strategy proved to be successful

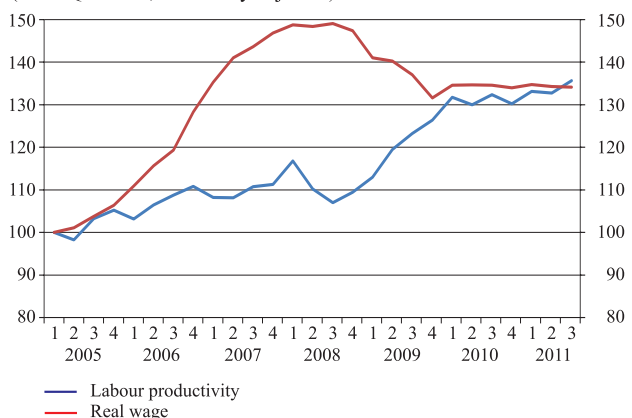
Over the recent years, Latvia experienced a severe recession; the recovery, however, proved to be fast and strong, quite in contrast to the expectations of a long and painful adjustment initially voiced by many economists. The internal adjustment strategy chosen by the Latvian authorities has proved successful. The EU/IMF-lead international financial assistance programme has helped to restore confidence and get the economy back on track. In 2008, only a few believed that the internal adjustment strategy would succeed and the adjustment mechanism under the fixed exchange rate regime was not understood by many; therefore, a long-lasting output decline was predicted. Although the implementation of budget austerity measures and structural reforms required an enormous effort on the part of the nation (fiscal retrenchment in the amount of 17.6% of GDP over the period of 2009–2011), the economy turned out to be sufficiently flexible to regain competitiveness through internal adjustment. With the improved cost competitiveness, the Latvian economy is expanding at a solid pace now; the GDP growth rate of 5.4% y-o-y achieved in the first three quarters of 2011 ranks Latvia among Europe's top performers.

Real GDP growth in the first three quarters of 2011
(%; y-o-y)



Source: Eurostat.

Real hourly wage and labour productivity per hour
(2005 Q1 = 100; seasonally adjusted)



Source: Central Statistical Bureau of Latvia.

Many imbalances were corrected in a timely manner and the economy re-adjusted towards a more export-oriented model. Owing to the high degree of labour market flexibility nominal wages have declined significantly and, in combination with productivity improvements, have ensured gains in price competitiveness. Cost optimisation and enhanced productivity contributed to the closing of the wage-productivity gap. External imbalances have been corrected rapidly. Latvia's market shares in major trading partner countries have increased over the last two years owing to competitiveness gains boosting the exports since 2009.

The international financial assistance programme was successfully completed at the end of 2011, with the IMF acknowledging that Latvia has achieved better shock resistance for the economy as compared to the period before the 2008 global economic crisis. Latvia did not draw on the residual funds in 2011 and overall has used only about 60% of the allocated programme funding. Instead, Latvia has re-established its name in capital markets by releasing already two successful and oversubscribed bond issues on the international capital markets.

As a sign of returning confidence, Latvia was able to tap the international financial markets in June 2011 with a 500 million USD worth 10-year bond issue and just recently with a one billion USD worth 5-year bond issue. The former was Latvia's first international bond issue since early 2008 with investors' aggregate bids exceeding the supply seven-fold, whereas the bid-cover ratio stayed close to 6

for the most recent issue. These deals were important milestones for Latvia. Taking into account the breadth and depth of investor interest, it could be interpreted as a sign of recognition of Latvia's accomplishments in stabilising its economy.