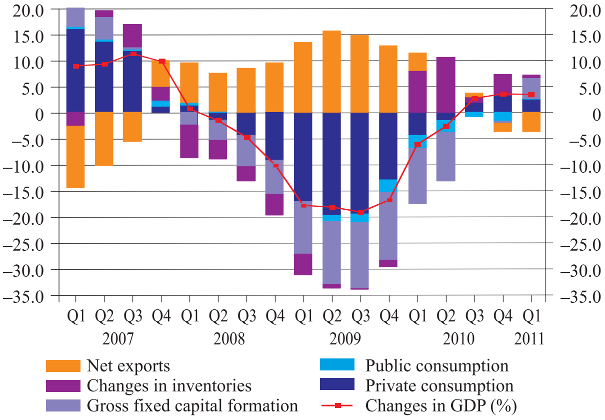
LATVIJAS BANKA

BANK OF LATVIA MONTHLY NEWSLETTER • JUNE 2011

1. Highlights

GDP growth revised upwards, yet risks remain

Contribution to real GDP growth
(precentage points)



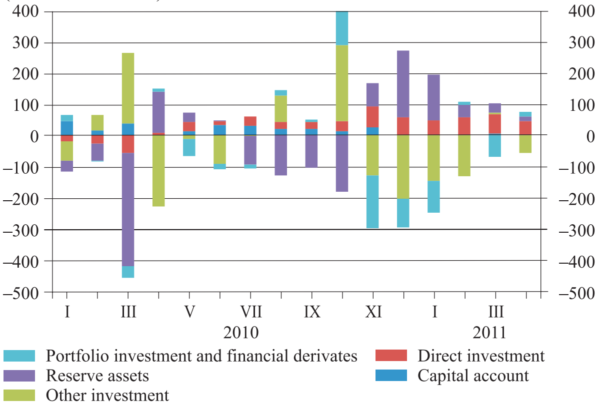
Revised data reveal that in the first quarter of 2011 the real GDP expanded by 0.3% quarter-on-quarter and by 3.5% year-on-year. Both the quarterly and the annual growth figures have been adjusted upwards by 0.1 point in comparison with the flash estimate of the CSB.

With the wage-bill gradually increasing, private consumption continued on the upward trend observed in the previous two quarters, albeit the rate of growth remained low. Gross fixed capital formation increased by 28.4% year-on-year, yet it has to be noted that the level of investment still remains very low from a historical perspective.

The GDP growth is expected to pick up in the second quarter. However, in the second half of the year downward risks to further growth are related to further price shocks on the world commodity exchanges and lingering uncertainties with respect to Latvia's 2012 budget.

Current and financial account dynamics positive

Net positions of financial and capital accounts
(in millions of lats)



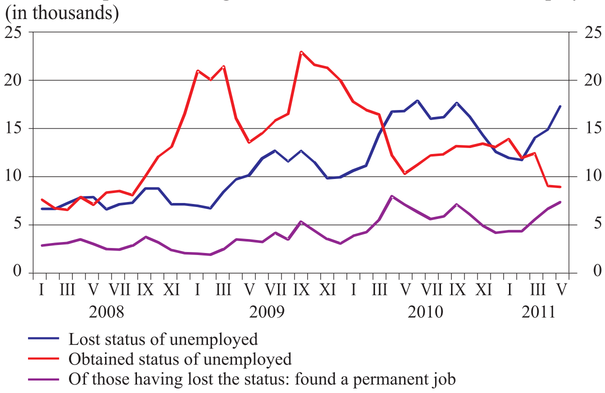
In April, the current account surplus increased, fostered primarily by the improved trade balance. With the imports of goods contracting at a notably faster pace than exports, the goods trade deficit reversed into surplus, while a small increase in the surplus of the services sector was determined by successful development of freight transportation services by rail.

The financial account also ran a surplus in April. The largest inflows were formed by the non-resident deposits made with the banking sector and foreign direct investment.

Gradual spending of the received international loan funding, with the government abstaining from further borrowing from these sources in the first four months, resulted in a progressive contraction of reserve assets, yet it is important to note that the rate of the coverage of the monetary base by reserve assets remains record-high at over 200%. Reserve assets also equalled the imports of 6.8 months, which is substantially higher than during the boom years when this ratio fluctuated between 3.5 and 4.5 months.

Labour market recovering

Number of persons having obtained and lost the status of unemployed
(in thousands)



A steep decline in registered unemployment has been observed for the second consecutive month: to 13.2% of the economically active population in May. Unemployment is thus contracting faster than last year and also during other post-crisis periods after the restoration of national independence.

Compared to its historic high in March of 2010, registered unemployment has dropped by 4.1 percentage points, with the number of unemployed contracting by almost one fourth. In April and May, the number of people with newly-granted unemployed status hovered around the average level of 2004–2005. Thus the period of 2.5 years when the labour market was characterised by layoffs can be considered to have come to an end, and the staff turnover currently corresponds to the historical average.

The contraction in registered unemployment is taking place alongside a decline in actual unemployment. The number of employed is growing according to all available sources of statistics. This eases the concerns that the recovery of the labour market is taking place merely on paper and the number of unemployed is decreasing in the State Employment Agency (SEA) registers only because jobseekers have ceased registering with the SEA.

2. Macroeconomic Data

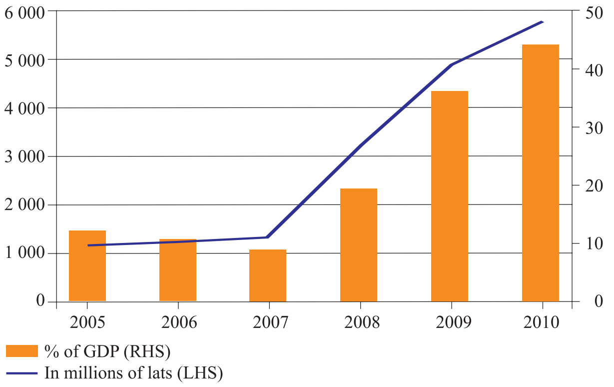
	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth, seasonally adjusted) 09.06.2011 Higher GDP growth expected in the forthcoming quarters, yet external risks and domestic obstacles exist	2011 Q1	**0.3**
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	2011 V 2011 V	**17.0** **0.8**
Consumer price changes Consumer Price Index CPI (month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.06.2011 Global prices stabilized yet in Latvia their effect still reflected in price rises	2011 V 2011 V	**0.4** **1.9**
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 10.06.2011 Foreign trade affected by price volatility, domestic and global political developments	2011 IV 2011 IV	**27.6** **29.9**
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 13.06.2011 Current account positive dynamics in April 2011 determined by trade balance	2011 Q1 2011 Q1	**1.7** **6.0**
Industrial output Working day-adjusted industrial output index (year-on-year growth) 03.06.2011 Rapid growth continues in manufacturing; global trends point to slower development in future	2011 IV	**17.1**
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 30.05.2011 Retail in April under the influence of caution and dropping purchasing power	2011 IV	**–1.1**
Employment and unemployment Registered unemployment (share of working age population) 14.06.2011 Labour market recovery not on paper alone	2011 V	**13.2**
Monetary indicators Broad money M3 (year-on-year) 20.06.2011 Money Supply Resumes Growth	2011 V	**6.2**

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

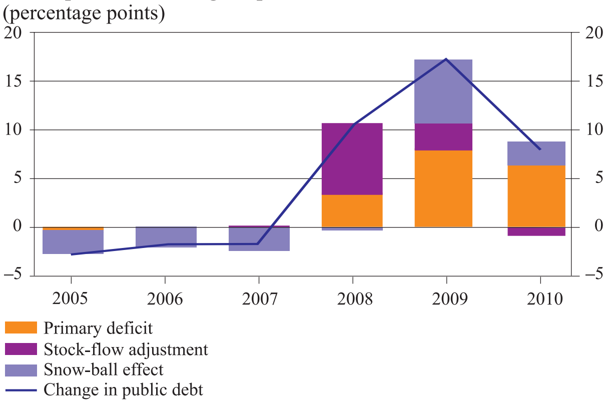
3. In Focus

Maastricht criterion for public debt expected to be complied with

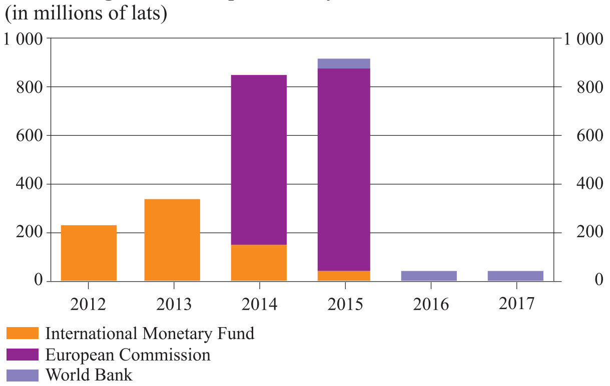
Latvia's public debt



Decomposition of change in public debt ratio
(percentage points)



Refinancing of the loans provided by international creditors
(in millions of lats)



Public debt in Latvia has grown from the exceptionally low level of 9% of GDP in 2007 to 44.7% of GDP in 2010: in nominal terms, it has quadrupled over three years. The increase in the public debt ratio was driven by high levels of primary deficit (as budget revenue fell dramatically), negative economic growth/interest rate differential ("snow-ball" effect) and a debt-increasing stock-flow adjustment (on the background of financial assistance to Parex Banka). Due to wide-ranging austerity measures amounting to 16% of GDP, broadly equally distributed between revenue and expenditure sides, Latvia's Government succeeded in preventing the public debt ratio from growing even further and managed to stabilise it at the level of 40–50% of GDP. Additional consolidation efforts in 2012 and prudent fiscal policy onwards are crucial to ensure the sustainability of public debt (bearing also in mind the forthcoming effect stemming from ageing population). Continuation of structural reforms, inter alia the recently announced old-age pension system reform, would contribute to bringing Latvia's public finances back on a sustainable path.

70% of the increase in public debt was determined by funds provided by international creditors as Latvia turned to international institutions for financial assistance at the end 2008. Due to a revival in economic activity and the implemented austerity measures, the Latvian authorities are not expected to draw the loan in full. Looking forward, Latvia will have to refinance quite substantial amounts in the medium-term. Financing needs will be especially significant in 2013–2015. In light of this, the Government has already made the decision to start negotiations with potential investors in order to return to international capital markets. Latvia's economic recovery, credit rating upgrade, wide-ranging austerity measures and progress toward Latvia's goal of euro adoption are projected to bring about favourable borrowing conditions.

In the medium term, the Latvian public debt ratio is expected to increase slightly (with the debt-increasing effect stemming from primary deficits partly offset by debt-decreasing "snow-ball" effect), remaining comfortably below the Maastricht threshold of 60% of GDP. Therefore, the Maastricht criterion for public debt is expected to be complied with when assessing Latvia's readiness for euro adoption in 2014.