LATVIJAS BANKA

BANK OF LATVIA
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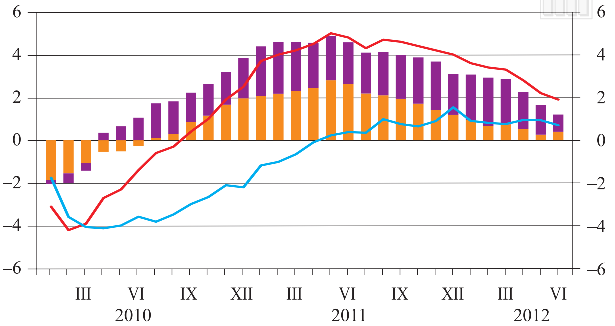
1. Highlights

Inflation declines further, already below 2%

Impact of energy and food prices, inflation



Contribution of food prices (in percentage points)
Contribution of energy prices (in percentage points)
Total inflation (%)
Inflation (excluding food and energy price changes; %)

Sources: CSB, MPD calculations

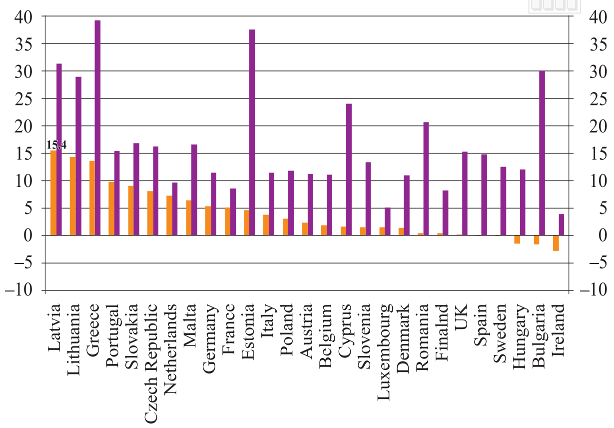
The annual inflation in June continued on its downward trend reaching 1.9%. Within a month consumer prices fell by 0.1%. The annual inflation decreased as a result of domestic factors on account of the so-called base effect – in June of last year the excise tax was raised for several products affecting the annual inflation rate for 12 months.

Inflation in June was also positively affected by the global price dynamics: global food prices moved down by 1.8%, whereas the month-on-month decline in oil prices reached 13.6%. The impact of these price changes was partially observed in Latvian consumer prices as well: fuel prices fell by 3.6%.

A rather small demand-side pressure on the consumer price dynamics was evidenced by the annual core inflation edging down to 0.7%. In July the annual inflation rate might see a further slight decline on account of the reduced VAT, and the average fuel prices may still remain under the June average.

Exports keeping up, amidst global slowdown

Annual changes in exports of goods
(%)



Jan-Apr 2012 / Jan-Apr 2011 2011

Source: Eurostat

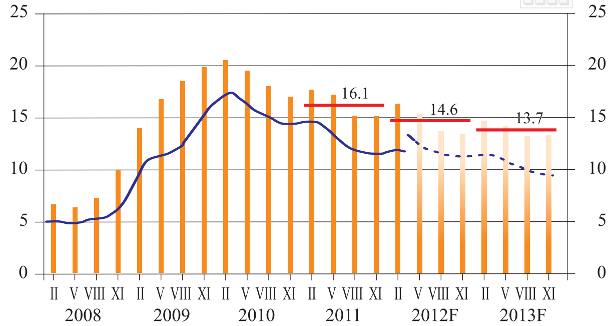
In May 2012, the external trade turnover grew 5.3% month-on-month.

The export value of goods increased by 9.0% month-on-month. The fastest growth was observed in exports of base metals and articles of base metals, mineral products, wood pulp and wood as well as prepared foodstuffs.

The Business Climate Indicator *(BCI)*, dropping slightly both in May and June, is evidence to the deterioration of the economic environment in the euro area. However, in the countries closest to Latvia which are its main trade partners the situation continued to be stable. Thus, Latvia continues to exhibit export growth rates that are among the highest in the EU.

Unemployment drops to lowest level since spring 2000

Registered unemployment and rate of jobseekers
(% of economically active population)



Rate of jobseekers Registered unemployment rate

Source: CSB labour survey and SEA data, MPD forecasts

Under the influence of seasonal factors, the unemployment rate continued to decline in June by 0.4 percentage points to 11.9% of the economically active population. The number of the unemployed was the lowest since spring 2009, reflecting the sustained rise in GDP.

The unemployment rate is expected to continue to fall, since the economic growth, inflows of investment and a rise in private consumption will require additional labour. Business forecasts regarding employment remain broadly positive and are more convincing than last year, suggesting a future rise in employment.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted)	 2012 Q1	 **1.1**
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year; year-on-year growth)	 2012 VI 2012 VI	 **13.5** **1.8**
Consumer price changes Consumer Price Index (CPI; month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 09.07.2012 Inflation down to 1.9% in June	 2012 VI 2012 VI	 **–0.1** **3.5**
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 10.07.2012 External trade grew in May	 2012 V 2012 V	 **5.7** **7.2**
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 12.07.2012 Latvian current account in May in the pluses	 2012 Q1 2012 Q1	 **–2.9** **3.8**
Industrial output Working day-adjusted industrial output index (year-on-year growth) 04.07.2012 Manufacturing in May: not much change	 2012 V	 **7.3**
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 29.06.2012 In May, retail turnover picked up again	 2012 V	 **7.4**
Employment and unemployment Registered unemployment (share of working age population) 13.07.2012 Seasonal drop in the registered unemployment level	 2012 VI	 **11.9**
Monetary indicators Broad money M3 (year-on-year) 19.07.2012 Domestic loan balance slightly up in June	 2012 VI	 **2.0**

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

3. In Focus

Six Conclusions from the Conference "Against the Odds: Lessons from the Recovery in the Baltics"

The international conference which took place in Riga on 5 June analysed Latvia's experience with internal devaluation. The overwhelming conclusion was that the adjustment strategy chosen by the Latvian authorities has worked, namely significant and frontloaded fiscal consolidation, while at the same time keeping the nominal exchange rate against the euro fixed and unchanged. After the initial and notable drop, the country's GDP is growing again. In fact, Latvia is currently the fastest growing EU economy. How has Latvia managed to achieve this? Can this experience be copied elsewhere? The Latvian success seems to be based on six underlying factors.

There are **outside factors** that certainly affect the chances of success of any stabilization policy.

• Latvia is a small and open economy, with the goods and services exports reaching more than 44% of GDP (in Greece, for instance, the share of exports in GDP is below 20%). The more open the economy, the easier it is to shift the economic activity towards producing tradables and thus generate an export-led recovery.

• In Latvia, as in the other Baltic countries, the economic overheating was almost unprecedented, yet it did not last long. When it came to a stop, almost everyone here understood that the correction was due. Moreover, even after a 25% drop in economic activity, Latvia's average incomes are currently at the 2005 levels. In other countries, the economic expansion may have lasted so long that it has become the new "normal", and thus the inevitable correction is perceived as an unreasonable dent in living standards rather than the reversal of previous excesses. This makes the implementation of any reforms more complicated.

• Latvia entered the crisis with a much better fiscal position. In 2007 the total government debt in Latvia was 9% of GDP. The relatively low level of debt allowed the Latvian government to implement counter-cyclical fiscal policies (in 2009, the budget deficit in Latvia was close to 10% of GDP), thus avoiding an immediate fiscal drag on the already contracting economy. Countries that have entered the crisis with much higher public debt levels do not have this luxury, as any attempt to boost the economy by fiscal stimulus is overshadowed by the concerns about the sustainability of the country's fiscal position.

Moreover, there are three additional factors that help to explain Latvia's success story. These are **related to the way in which the economic stabilization programme was implemented**.

• The fiscal stabilization in Latvia was carried out at a rapid enough pace. Within three years (from 2009 to 2011) the budget deficit was cut from almost 10% of GDP to 3.5% of GDP. Textbook economics tells that larger budget deficits in times of economic crisis help to boost demand and thus support economic recovery. However, if there is not only lack of demand but also problems on the supply side, boosting demand by fiscal stimulus may not work, as this would only lead to a worsening of the balance of payments. In this case, fiscal adjustment should be swift and frontloaded.

• Policymakers had a strong sense of ownership in the economic adjustment programme. It definitely helped that both the gains from sticking with the programme (keeping the peg, ultimately paving the way for the euro area entry) and the costs of not doing so (possible default) were clearly spelled out. It was the right mix of incentives that motivated the right policy choices.

• Finally, the sequence of economic adjustments is also important. In the process of fiscal consolidation it is relatively easier to take measures that involve raising taxes and more difficult to reduce the budget expenditures. This is exactly why adjustment should start with the most difficult and least popular measures: cutting expenditure. This is exactly how Latvia did it, as budget consolidation was initially carried out primarily by cutting expenditure and the importance of tax changes grew only gradually over time.

To sum up, the Latvian success combines bold and frontloaded policy action (which can be replicated elsewhere) with rather favourable initial conditions (which, unfortunately, cannot). Nevertheless, the Latvian way out of the crisis deserves merit, if only to prove that sometimes things which everyone "knows" are impossible can be done after all. Thus all the academics and economic experts who predicted that Latvia would become Argentina No. 2 were proven wrong. And when these experts now "know" that Europe is doomed, maybe they will be proven wrong yet again.