

LATVIJAS BANKA

BANK OF LATVIA

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1 Highlights

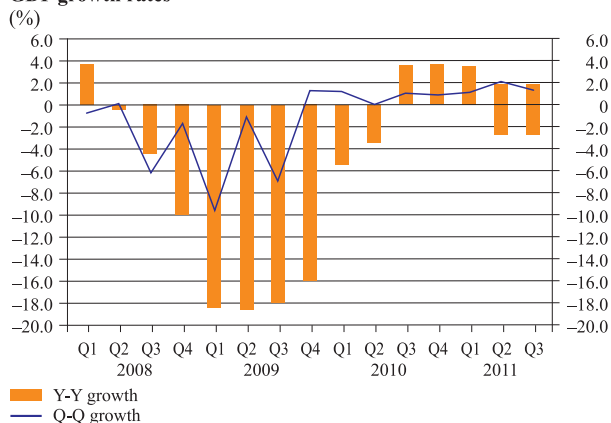
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1. Highlights

Growth continues, slowdown likely ahead

GDP growth rates

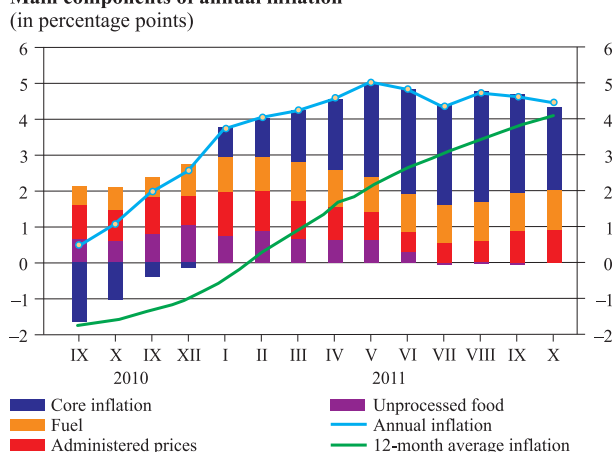


According to the flash estimate, the annual GDP growth reached 5.7% at constant prices in the third quarter of 2011, with the quarterly growth amounting to 1.3%.

Such GDP growth can be considered as a success, particularly against the deteriorating external economic background. Yet there is no guarantee that this trend will persist in the coming quarters, since the growth in most EU economies is gradually beginning to slow down. The Latvian economy, however, has rebounded after the downside and has lately been growing fast; therefore, it is now much better prepared for the second wave of the crisis than before. Nevertheless, any adverse developments in the EU are likely to affect also the growth of the Latvian economy. Consequently, we expect it to moderate next year.

Inflation still on a downward trend

Main components of annual inflation

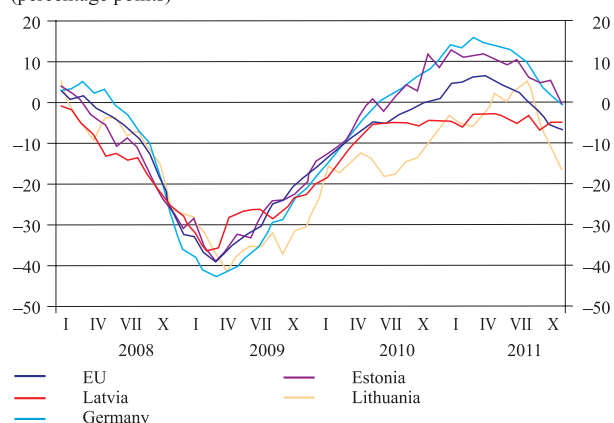


The annual inflation continued to decline in October reaching 4.4%. The price rise was smaller than last year because of the gradual strengthening of the downward pressure of global prices. As the fall of the global food prices has accelerated, we expect that the food prices in Latvia will also go down accordingly.

Next year, inflation can be expected to ease considerably, largely as a result of the economic developments in Europe and in the rest of the world. With concerns regarding growth in Europe and elsewhere continuing to mount, the upward pressure of demand on global prices will be negligible. Nevertheless, no substantial drop that could cause a decline in consumer prices in Latvia can be anticipated as the supply, especially that of the oil products remains limited.

Manufacturing growth lower, but still respectable

Industrial confidence index
(percentage points)









In September 2011, manufacturing output grew 2.1% month-on-month at constant prices, with the quarterly growth amounting to 1.1% in the third quarter and that of the first nine months of 2011 totalling 12.4% year-on-year.

Industrial confidence has only declined by 0.3 point in Latvia over the year, whereas elsewhere in the European Union the drop has been much larger. In terms of the manufacturing output growth reported over the year, Latvia is among the leaders and is likely to conclude the year in the same group.

There is no reason for euphoria, however. The Purchasing Managers Index of recent months suggests that most countries can expect a drop in industrial volumes in the coming months. Despite quite remarkable manufacturing results recently achieved by Latvia, any global turmoil and demand shocks would inevitably result in deceleration of its economic activity.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 09.11.2011 Latvian economy growing but second wave of crisis approaching 	2011 Q3 (flash estimate)	1.3
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year; year-on-year growth)	2011 X 2011 X	15.2 3.6
Consumer price changes Consumer Price Index (CPI; month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.11.2011 Drop in global demand drives down food prices 	2011 X 2011 X	0.2 3.9
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 09.11.2011 Latvian exports continue to grow notably, yet global uncertainty also on the rise 	2011 IX 2011 IX	16.1 17.7
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 11.11.2011 In September 2011, the current account remained close to balanced 	2011 Q2 2011 Q2	0.9 5.3
Industrial output Working day-adjusted industrial output index (year-on-year growth) 04.11.2011 Manufacturing continues to grow but at a slower pace 	2011 IX	11.0
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 31.10.2011 Retail trade turnover continues on an upward trend, while consumer sentiment deteriorates sharply 	2011 IX	8.1
Employment and unemployment Registered unemployment (share of working age population)	2011 X	11.5
Monetary indicators Broad money M3 (year-on-year) 21.11.2011 Business lending stabilizing yet overall money supply stagnating 	2011 X	3.4

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

3. In Focus

On progress made in drafting the 2012 budget

In the past three difficult years much has been achieved. While overcoming the crisis, it has become clear that, in terms of the budget, less means more:

- lower deficit means higher growth and it rebounds faster,
- lower deficit means higher competitiveness and more production,
- lower deficit means more jobs and higher export growth.

Latvia has already become one of the fastest growing and export-capable economies in the EU. This should be reinforced by completing the consolidation and achieving a balanced budget in 2013. Moreover, the lesson learned during the crisis, i.e. the rule to save when the economy is growing should be incorporated in the Constitution and the Law of Fiscal Discipline as well as real three-year budgeting should be introduced.

Given the short time that the new government has had at its disposal for drafting the budget, what has been accomplished is commendable. The government has been aware that it is not just a regular budget but one with far-reaching consequences: it will determine how we live for the next ten years and not just next year. It will likewise determine whether we live with the euro or without it.

We appreciate the fact that there is no longer any disagreement between the international donors and the government and that the consolidation amount is close to 150 million lats, a figure proposed by the central bank. Unfortunately, this contains no safety margin! We should take into account the fact that we are witnessing an exacerbation of the sovereign debt crisis in the world and particularly in Europe. The second wave of the crisis has already begun to roll, resulting in substantial downward revisions of the growth forecasts. New important developments are taking place every day, not just every week or month.

In November, the Vice-President of the European Commission for Economic and Monetary Affairs and the Euro, Olli Rehn, warned of a possibility of a "new recession", i.e. a renewed contraction in production and services output. The EC autumn forecasts also point to an expected growth deceleration. The latest statistics indicate a drop in industrial production already in the remaining months of this year. The recent ECB Survey of Professional Forecasters also suggests that the short-term euro area GDP growth will be low (0.8% in 2012). Moreover, it predicts slow growth for the next five years. The economies of many European countries, including the core economies, are stagnating.

Recent experience shows that under such circumstances it is the countries with sound public finances that are the most successful. There is still much to be done in improving Latvia's public finances: next year the state will continue to spend a million of borrowed lats a day and public expenditure remains at the level of 2007. Should the downturn risks in Europe materialise, Latvia may have to implement additional consolidation measures in the middle of next year.