LATVIJAS BANKA

BANK OF LATVIA
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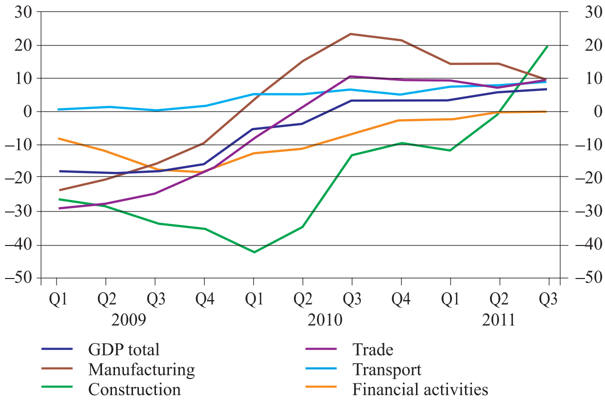
1. Highlights

Revised GDP figures show better-than-expected growth

GDP growth, production side
(y-o-y; %)

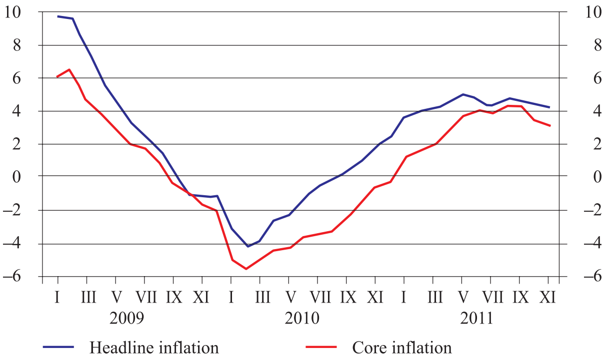


Recent releases show that in the third quarter the GDP growth reached 1.7% quarter-on-quarter (instead of the previously estimated 1.3%), and 6.6% year-on-year (instead of the estimated 5.7%). Thus the growth figures have been adjusted upwards as predicted by economists.

Looking by sector, it is obvious that the main contributors to the GDP growth were the following four sectors: trade (1.8 percentage points), construction (1.4 percentage points) manufacturing (1.2 percentage points), and transport (1.1 percentage points). What is new compared to the previous quarter is that construction has become one of the drivers of growth.

Inflation continued to moderate in November

Annual inflation
(%)

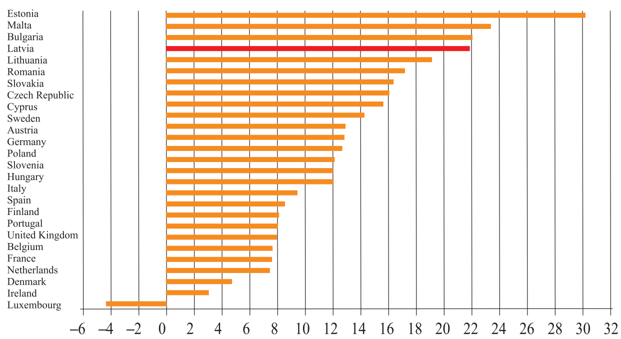


The annual inflation dropped to 4.2% in November, with the average consumer prices remaining unchanged month-on-month. Thus, the trend of declining annual inflation that was observed in previous months, continued in November.

We expect this trend to persist. The most significant contributor to the moderation of inflation in 2012 will be the deceleration of the economic growth or even economic downslide in Latvia's main trading partners. Furthermore, declining economic growth in Latvia itself will also mitigate the pressure of demand on inflation. Nevertheless, there is some potential for changes in the domestic prices in the immediate future due to a certain degree of uncertainty prevailing in the area of administered prices (primarily those of natural gas and the related heating tariffs).

Exports resilient despite external weakening

Export volume growth
(January–August 2011; y-o-y; %)



The global economic developments of the last months have had no significant influence on the external trade in goods yet. In October, the annual increase in exports and imports reached 21.4% and 26.5% respectively.

This year, Latvia's exports posted one of the highest growth rates in the European Union. In the first 10 months of 2011, year-on-year export growth was reported in all commodity groups. The largest year-on-year contribution to the 10-month export growth was made by mineral products as well as base metals and articles of base metals.

A positive sign is that Latvia's global export market shares continued to grow in the third quarter. However, with the rise in import prices outpacing that of export prices the overall terms of trade have slightly worsened. Moreover, the confidence indicators for the fourth quarter have also deteriorated with regard to both export orders and competitiveness outlook.

2. Macroeconomic Data

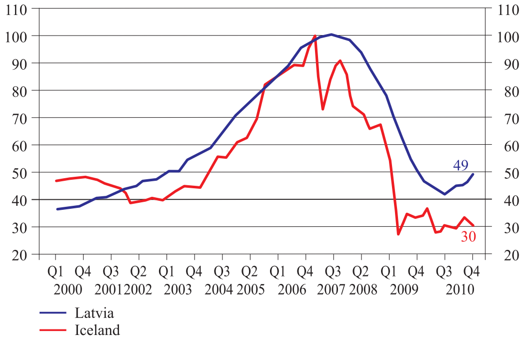
	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 09.12.2011 Adjusted indicator points to a faster GDP growth in the third quarter	2011 Q3	**1.7**
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year; year-on-year growth)	2011 XI 2011 XI	**20.4** **3.9**
Consumer price changes Consumer Price Index (CPI; month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.12.2011 Annual inflation continues to drop in November	2011 XI 2011 XI	**0.0** **4.1**
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 12.12.2011 Foreign trade still positive	2011 X 2011 X	**21.4** **26.5**
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 13.12.2011 In October, a small deficit in the balance of payments	2011 Q3 2011 Q3	**–3.8** **6.7**
Industrial output Working day-adjusted industrial output index (year-on-year growth) 05.12.2011 Industrial development uncertain; impact of global recession becoming pronounced	2011 X	**5.9**
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 30.11.2011 Retail down substantially in October; future prospects grim	2011 X	**4.9**
Employment and unemployment Registered unemployment (share of working age population) 24.11.2011 Latvia steps down as "champion" in EU unemployment	2011 XI	**11.5**
Monetary indicators Broad money M3 (year-on-year) 20.12.2011 The role of more liquid instruments increasing in money supply	2011 XI	**2.3**

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

3. In Focus

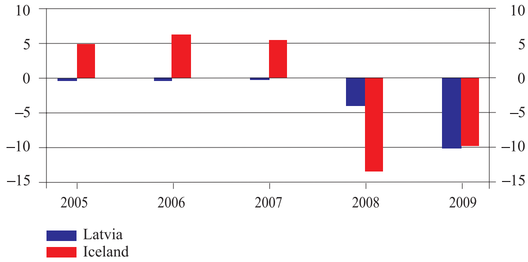
Latvia vs Iceland: some insight into adjustment under different exchange rate regimes

Real gross fixed capital formation
(pre-recession peak = 100)



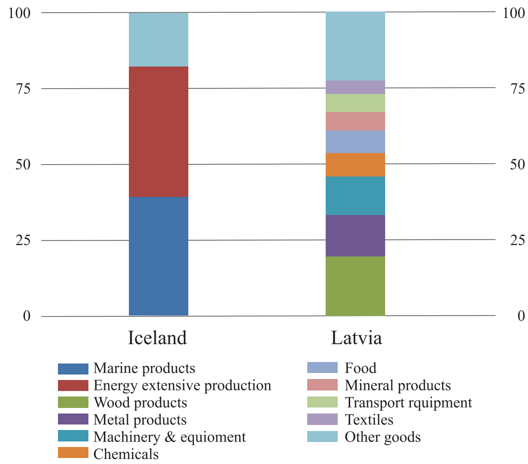
Data source: Eurostat, seasonally adjusted data.

General government budget balance
(% of GDP)



Data source: Eurostat.

Breakdown of merchandise exports
(%)



Data source: CSB Latvia, Statistics Iceland.

Latvia and Iceland occasionally are used as recent examples of economic adjustment under two different exchange rate regimes, namely fixed vs floating. Some economists claim that Iceland, allowing for a nominal depreciation, has fared the recent crisis much better than Latvia, as suggested by a less severe drop in GDP and employment. In this short note, we will try to shed some light on the actual developments to see whether the answer is as simple as that.

First of all, although the overall GDP drop was steeper in Latvia compared to Iceland, this masks diverse developments in its sub-components across both countries. In particular, consumption decline was very similar in both countries. At the beginning of this year, private consumption reached 76% and 74% of the pre-recession peak in Iceland and Latvia respectively. While Latvia experienced a nominal wage decline, in Iceland the real income was compressed by depreciation-related inflation. A similar pattern was observed also in import developments of both countries. Investment, another component of GDP, showed an even stronger decline in Iceland. At the beginning of this year, investment stood at 49% of the pre-recession peak in Latvia, while in Iceland it reached only 30%. However, Iceland performed much better in terms of public consumption and exports resulting in a less severe decline of the Icelandic GDP. While the former was largely related to a much stronger fiscal performance during the run-up to recession (Iceland refrained from building up an unsustainable level of public expenditure during the boom years and ran 5–6% of GDP budget surpluses), the latter, indeed, relied on exchange rate depreciation. However, Iceland was rather an exception to this end, as all other European countries that experienced large depreciations recorded rather strong export declines. For example, real exports of goods and services expanded by nearly 7% in Iceland in 2009, but they contracted by more than 13% in Sweden (on par with Latvia) and by some 10% in the Czech Republic, Hungary and the UK. This could be at least partly explained by the Icelandic export structure that is dominated by natural resources, namely, marine products and energy intensive production building on the use of geothermal energy. For this reason, the Icelandic exports presumably rely more on domestic and less on imported inputs; therefore, depreciation has a much stronger positive effect on exports.

To conclude, both countries have suffered significantly during the recent crisis; however, conclusions regarding the factors affecting performance differences cannot be made based only on aggregate data. The Icelandic GDP (and employment) has dropped less compared to Latvia, but this was due to Iceland-specific factors. Moreover, there are considerable differences looking forward. The Latvian economy and particularly investment have started to recover; our exporters have regained competitiveness in external markets and Latvia currently ranks among top performers in Europe in terms of export and manufacturing expansion. In Iceland, however, investment remains at an extremely low level hinging on future growth prospects, whereas the recent export performance is not encouraging. In addition, Iceland has still to unwind capital controls and restructure its private sector balance sheets (significantly impaired by depreciation), which is associated with capital outflow risks and a potential new wave of bankruptcies.