LATVIJAS BANKA

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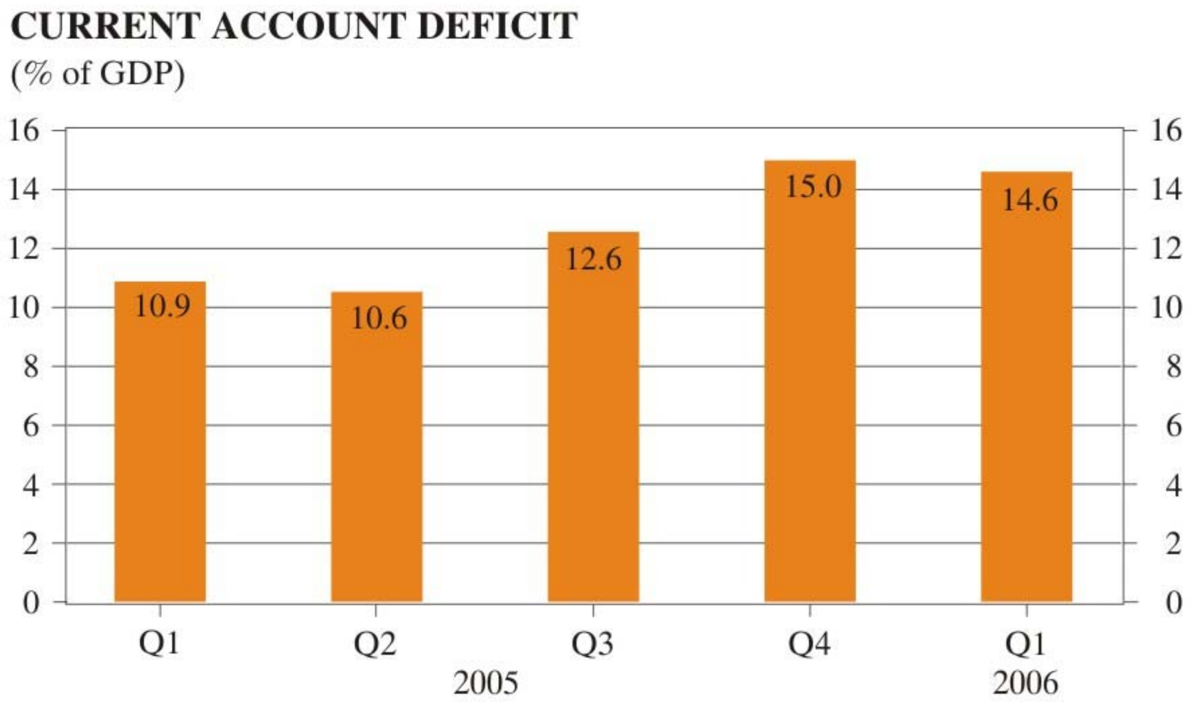
Latvia's Balance of Payments in the First Quarter of 2006

In the first quarter, the current account deficit of the balance of payments reached 334.3 million lats or 14.6% of gross domestic product (GDP; 200.6 million lats or 10.9% in the first quarter of 2005). The growth of the current account deficit was caused by an increase of the deficit of goods and income to GDP, which could not be offset by the growing surplus of services and current transfers to GDP.



Evaluation and Outlook

In the first quarter of 2006, the increase in the current account deficit of the balance of payments to 14.6% of GDP was primarily driven by deceleration of the growth rate of exports of goods. The import growth, fuelled by the persistently growing domestic demand and the high global oil prices, remained close to the level of the corresponding period of 2005. The terms of trade deteriorated, and Latvia's market share in the EU Member States also contracted, causing concerns about sustainability of competitiveness.

Although the services and current transfers surplus expanded, it could not offset the growing goods and income deficit. With income in the form of reinvested earnings gained by businesses owned by foreign investors in Latvia increasing rapidly, the current account deficit rose notably. Foreign investors' income in Latvia was higher than income from foreign investment by Latvian businesses. Such trend also prevails in other EU10 countries.

Nevertheless, a significant pick-up in direct investment improved the financing of the current account deficit: 61.3% of the deficit was covered by direct investment, the rest by other long-term capital, mainly borrowing from foreign banks.

It is obvious that the current account deficit will not shrink this year and will continue to act as one of the macroeconomic imbalance factors, as the economic growth will continue and the high domestic demand will push up the need for imports. An additional contributor to the rise of imports will be the continuing drawdown from the EU funds.

Alongside with measures aimed at diminishing the domestic demand, raising the competitiveness in terms of productivity is seen as another challenge in the coming years. This involves creation of links between the system of education and the labour market and between research and businesses, as well as acquisition and adaptation or development of technologies, resulting in better competitiveness on the external market due to higher value added products and improving the situation in the area of the balance of payments.

Notes to Latvia's Balance of Payments for the First Quarter of 2006

At the beginning of the year, the economic activity in several EU15 countries was still moderate, whereas domestic demand followed an upward trend; it resulted in decelerating export growth and continued expansion of imports. In the first quarter, Latvia's exports and imports of goods increased by 13.8% and 27.2% year-on-year, respectively.

Uneven export market development was reflected in its structure. Latvia's exports to the CIS countries (mostly Russia) and other countries (Algeria) expanded considerably, and the share of these groups of countries in total exports also increased. The share of the EU Member States shrank in the first quarter (to 74.5%; 78.3% in the first quarter of 2005) on account of decreasing share of the EU15 countries. In the group of EU10 countries, exports to Lithuania and Estonia continued to grow, whereas that to Poland (mineral products) declined considerably. Latvia's major export partners were Lithuania, Estonia, Germany, Russia, the United Kingdom and Sweden.

The highest growth of exports (on account of an increase in the volume of exports) was reported for agricultural and food products, transport vehicles, products of the chemical industry, machinery and mechanical appliances, electrical equipment. Exports of mineral products shrank.

With domestic demand growing, imports of all goods expanded. Growth was particularly notable for transport vehicles, machinery and mechanical appliances, electrical equipment, mineral products, agricultural and food products, and products of the chemical industry. The volume of imports grew more rapidly than the prices.

In the first quarter, the services surplus increased by 32.0 million lats year-on-year, as the increase in exports of services exceeded that of imports almost twice. The surplus of travel and other services improved slightly, whereas that of transportation services rose significantly, with exports of transportation services (mainly freight transportation by road) as well as other transportation-related services by sea expanding notably.

Income deficit grew by 41.8 million lats, as non-resident income in Latvia grew twice as much as resident income abroad. Resident income abroad grew on account of both investment income and compensation of employees, whereas non-resident income in Latvia was dominated by direct investment income in the form of reinvested earnings (121.3 million lats).

The changes in the surplus of current transfers were also considerable in the first quarter. With transfers received by the Government and other sectors growing, it increased by 56.7 million lats. The increase in the Government sector was underpinned by farmer subsidies received from the EU, whereas that in other sectors by transfers made by private persons.

The surplus of the capital and financial account expanded twofold year-on-year in the first quarter (376.3 million lats). Current account deficit was covered by long-term capital (foreign direct investment and other long-term investment).

The surplus of foreign direct investment covered 61.2% of the current account deficit and amounted to 8.9% of GDP. Foreign direct investment in Latvia was made primarily in the form of reinvested earnings and equity capital. An increase in resident (bank) investment in foreign debt securities resulted in net outflows of portfolio investment.

The surplus of other investment amounted to 450.3 million lats, and its growth was underpinned by rising liabilities of residents (mainly banks). Banks continued to increase their borrowing (primarily from parent banks). The maturity profile of liabilities was dominated by long-term loans. At the same time, non-residents slightly reduced demand deposits with Latvian banks. Businesses increased their foreign assets (in the form of demand deposits and trade credit) more than borrowing.

Reserve assets increased by 178.1 million lats, mainly as a result of the Bank of Latvia's interventions on the foreign exchange market.

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