LATVIJAS BANKA

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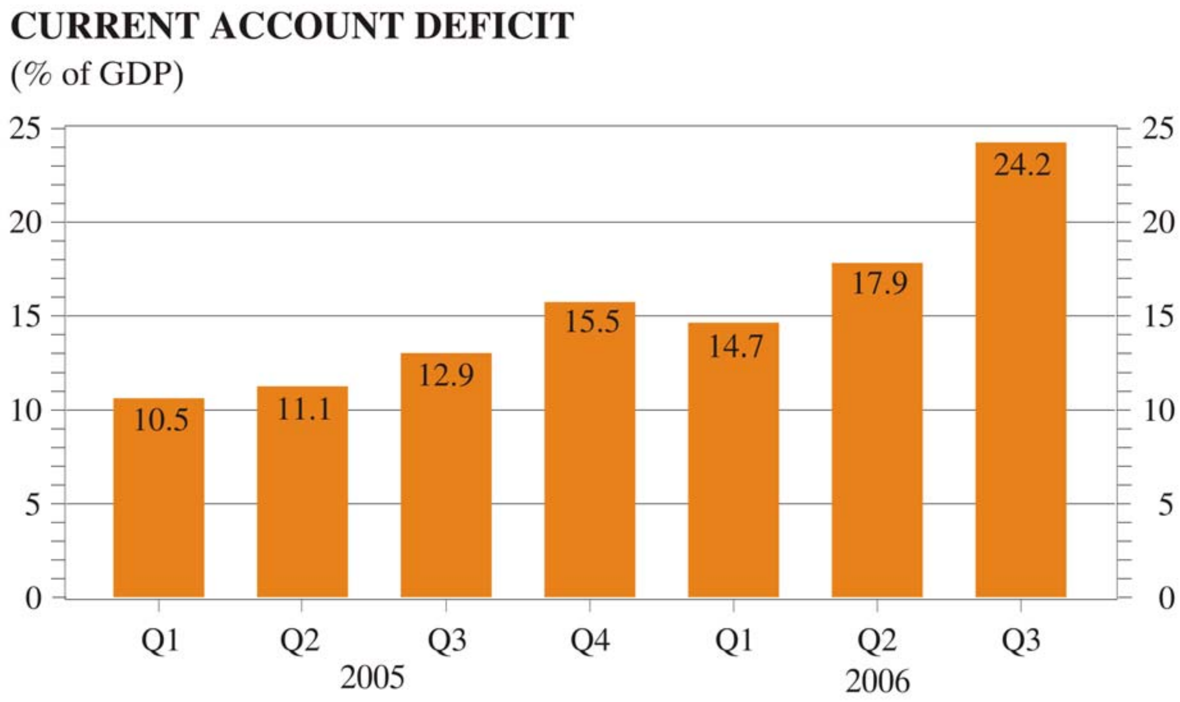
Latvia's Balance of Payments in the Third Quarter of 2006

In the third quarter of 2006, the current account deficit of Latvia's balance of payments reached 24.2% of GDP (12.9% in the corresponding period of 2005), the rise driven by the increasing goods deficit against the backdrop of imports notably outpacing exports. The income deficit to GDP also inched up, reflecting non-residents' growing income from investment. At the same time, the surplus of services and current transfers to GDP decreased.



Evaluation and outlook

The economy of Latvia continues on a strong upward trend. The domestic demand, driven by expanding employment and real income, inflows of foreign capital and the buoyant increase in lending, remains robust, boosting imports and ensuring sustainable inflation levels. A number of significant investment projects have also facilitated the expansion of imports. At the same time, the ability of Latvian exporters to compete in the global markets and the contribution of exports to the economic growth have deteriorated somewhat, pushing up the current account deficit and increasing the risks associated with imbalanced development. In the third quarter, the current account deficit of the balance of payments rose to a record high 24.2% of GDP (19.3% of GDP in the first nine months of 2006).

Stronger inflows of foreign direct investment (a twofold increase in the first nine months of the year), covering slightly over two thirds of the current account deficit, are a positive trend. Long-term borrowing, mainly from foreign banks, also figured prominent in covering the deficit.
The same factors triggering strong growth will also prevail in the future. A significant current account deficit caused by the high domestic demand and the related import growth together with large investment projects in transport and energy sectors at the close of the current and in the next year will determine a sustained high deficit also in 2007. Despite a continuous strong inflow of foreign direct

investment and the decisive role of long-term capital in financing the economy, a more balanced growth requires a policy that would reduce the domestic demand. In the situation of a record fast economic development, however, the approved state budget plan for 2007 with a projected deficit of 1.4% of GDP will add to the strengthening of already robust domestic demand, facilitate the expansion of imports and constrain the inflation easing measures.

Notes to Latvia's Balance of Payments for the Third Quarter of 2006 and the first nine months of 2006

The developments characterising Latvia's foreign trade **in the third quarter** were much like those in the first half of 2006, with export growth decelerating (to 13.1%) but the high domestic demand and several large investment projects fuelling import expansion (31.2%). The share of exports to the EU countries in total exports shrank somewhat (exports to the EU15 countries narrowed, those to the EU10 expanded), whereas exports to the CIS countries grew.

In the third quarter, Latvia's exports of goods were dominated by wood and articles of wood, base metals and articles of base metals, agricultural and food products, and machinery and mechanical appliances, electrical equipment. Year-on-year, exports of base metals and articles of base metals, agricultural and food products, and transport vehicles recorded the highest growth. Behind the observed overall deceleration of export growth was a fall in exports of mineral products and (to a lesser extent) wood and articles of wood.

As for Latvia's imports of goods, machinery and mechanical appliances, electrical equipment, mineral products, transport vehicles, agricultural and food products, and base metals and articles of base metals dominated and boosted imports.

In the third quarter, the services surplus fell somewhat (by 11.0 million lats year-on-year). The growth in transportation services surplus did not counterbalance the growing travel services deficit and the declining other services surplus. The growth in transportation services surplus was on account of expanding freight transportation services rendered by road and passenger transportation services rendered by air. With the volume of services received expanding at a faster pace, the travel services deficit increased. Other services surplus declined somewhat.

The income deficit grew year-on-year (by 21.7 million lats) along with a significant pickup in non-resident income from investment, which was not offset by the growing resident income from the compensation of employees. Behind the shrinking current transfers surplus were transactions in the government and other sectors.

The surplus of the capital and financial account was 656.4 million lats in the third quarter. Net inflow of foreign direct investment increased most in financial intermediation; overall, it amounted to 115.3 million lats or 4.0% of GDP, covering 16.5% of the current account deficit.

The largest part of the current account deficit in the third quarter was financed using borrowings from foreign banks. The other investment surplus was 879.3 million lats. Compared with previous quarters, short-term liabilities increased at a faster pace. Non-residents notably (by 319.1 million lats) augmented their demand deposits with the Latvian banks. Likewise, resident enterprises substantially increased their foreign liabilities, primarily long-term borrowings and trade credits.

With banks converting foreign currencies to meet the demand for lats, the reserve assets increased by 334.8 million lats in the third quarter.

In the first nine months of 2006, the current account deficit of the balance of payments amounted to 19.3% of GDP (11.6% in the corresponding period of 2005). To GDP, the goods deficit grew significantly (from 17.9% to 24.0%), whereas the increase in income deficit was less pronounced; the services surplus recorded a moderate pickup but the current transfers surplus shrank somewhat.

The growth in exports of goods over the period from January to September was dominated by base metals and articles of base metals, agricultural and food products, transport vehicles, products of the chemical and allied industries, and machinery and mechanical appliances, electrical equipment. Exports of mineral products recorded a substantial contraction.

The services surplus increased from 3.9% of GDP to 4.1% year-on-year. With the travel services rendered growing at a faster pace than those received, the deficit of the respective services to GDP shrank.

Year-on-year, the income deficit went up from 1.5% of GDP to 2.3% because the non-resident income from investment in Latvia grew significantly as foreign direct investment inflows expanded.

In the first nine months of 2006, the surplus of the capital and financial account was 1 541.9 million lats. The current account deficit was covered by long-term capital (foreign direct investment and long-term borrowing).

Net inflow of foreign direct investment grew twofold year-on-year, covering 36.5% of the current account deficit and reaching 7.0% of GDP. Investment from Estonia, Denmark and Germany posted the largest pickup, boosting financial intermediation and real estate activities.

The current account deficit was predominantly financed by borrowings from parent banks. The other investment surplus stood at 1 822.2 million lats, primarily in the banking sector. Banks' short-term liabilities to non-residents grew almost equally with their long-term liabilities. The corporate sector's other investment surplus reached 51.8 million lats (mainly short-term trade credits and long-term loans).

In the first nine months of 2006, the reserve assets increased by 865.7 million lats on account of the growing demand for lats due to, inter alia, meeting the banks' minimum reserve requirement.

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