LATVIJAS BANKA

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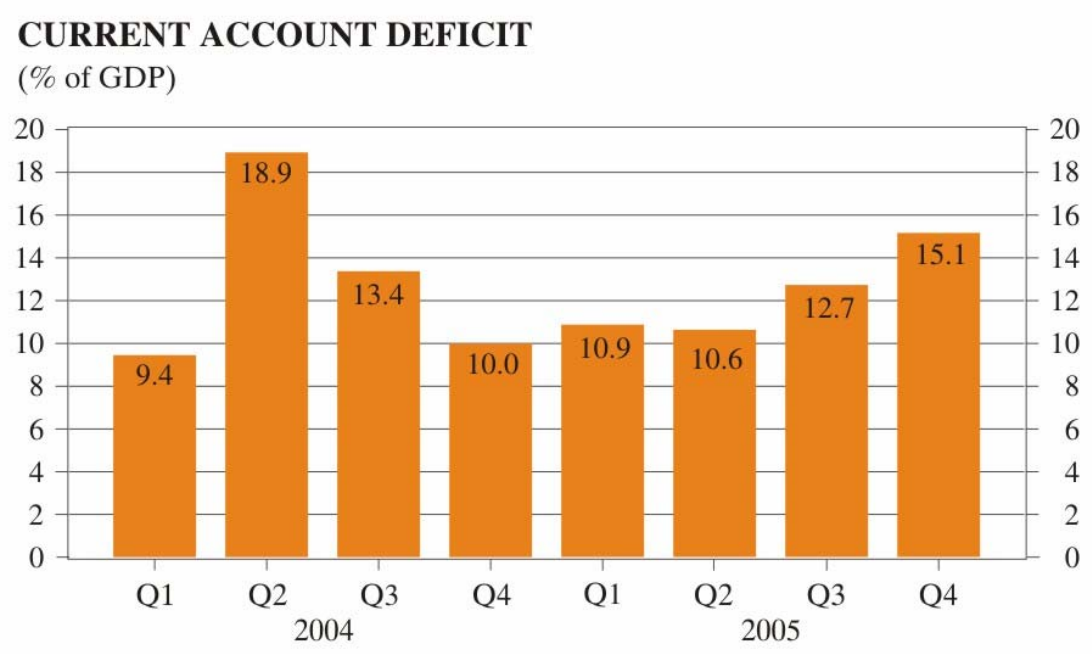
Latvia's Balance of Payments in the Fourth Quarter of 2005 and in the Year 2005



Evaluation and outlook

With capital inflows exceeding the current account deficit, Latvia's balance of payments was positive in 2005. Compared with the previous year, the current account deficit remained broadly unchanged (12.5% of GDP; 12.9% in the previous year), though foreign trade balance improved notably. It is important to note that the current account deficit is fully financed by long-term capital inflows, with foreign direct investment accounting for one fourth. Compared with the ample foreign direct investment inflow in the previous year, the level has declined slightly. Bank liabilities to foreign banks continued to rise and the role of borrowed resources in financing the economy and the current account deficit increased.

In 2005, the expansion of foreign trade was particularly rapid. The growth in exports of goods exceeded that in imports of goods, indicating the sustained ability of Latvian exporters to compete in external markets, primarily in the market of the new EU Member States and Russia, which was supported by a favourable trade situation in the first half of the year. Export growth decelerated somewhat in the second half of the year but imports kept on expanding. Volume growth accounted for two thirds of the annual increase in exports. Prices had a more pronounced effect on the import growth due to rising world prices (for oil products, metals, etc).

A substantial improvement of the current account balance is not likely in 2006. The growing foreign and domestic demand is going to sustain imports at a high level, which is unlikely to be offset by the anticipated export growth. The demand for imports will be significantly affected by projected reconstruction works in the energy sector and fleet rebuilding of the company *Latvijas Kugnieciba*. In the conditions of buoyant economic growth, it is important to ensure high lending standards and implementation of a restrictive fiscal policy. Positive growth of production and the services sector underpinned by the EU funding is a significant prerequisite for the improvement of Latvia's balance of payments.

Notes to Latvia's Balance of Payments for the Fourth Quarter and the Year 2005

In the fourth quarter of 2005, the current account deficit of the balance of payments amounted to 387.1 million lats or 15.1% of GDP (10.0% in the corresponding period of the previous year). Year-on-year, the goods deficit to GDP increased and the surplus of current transfers to GDP decreased. The surplus of services to GDP grew somewhat, whereas the income deficit to GDP contracted slightly.

In the fourth quarter, Latvia's foreign trade continued to grow buoyantly, recording a turnover of 2 214.0 million lats despite deceleration in the annual export growth (29.4%) and a sustained annual growth of imports (32.1%) compared with the previous quarters of the year.

Year-on-year, exports of agricultural and food products, machinery and mechanical appliances, electrical equipment, and transport vehicles recorded the largest growth. In the fourth quarter, a half of total exports went to Latvia's five major trade partner countries –Lithuania, Estonia, Germany, Russia and the United Kingdom. The largest increase was reported for exports to the EU countries.

Of imports, the most substantial year-on-year growth was recorded for machinery and mechanical appliances, electrical equipment, mineral products, transport vehicles, and agricultural and food products. Similar to exports, a half of total imports in the fourth quarter came from Latvia's five major trade partner countries – Lithuania, Germany, Russia, Estonia and Poland.

In the fourth quarter, the services surplus picked up year-on-year due to the expansion of the overall volume of services, of which transportation services rendered by road and rail recorded the strongest rise. Exports of services were dominated by transportation services (54.4% of total services exports). As to the volume of imported services, the share of travel services grew but that of transportation services (mainly by sea transport) fell. The travel services deficit increased because of a more substantial growth in imports of travel services.

Income deficit contracted slightly year-on-year, as compensation of employees received by residents abroad rose substantially (by 21.9 million lats), indicating that residents tend to leave Latvia to work abroad. The surplus of current transfers dropped 46.8 million lats mainly due to transactions in the government sector related to the decreasing amount of the EU funds and increasing contributions to the EU budget. The growth in outflows exceeded that in current transfer inflows in other sectors as well.

In the fourth quarter, the surplus of the capital and financial account was in the amount of 502.9 million lats.

Net inflow of foreign direct investment (46.3 million lats; 1.8% of GDP) covered 12.0% of the current account deficit. The inflow of investment in Latvia grew only by 54.1 million lats primarily in the form of reinvested earnings. Direct investment inflows mainly from Norway, Denmark and Finland (financial intermediation, wholesale and retail trade as well as electricity, gas and water supply) recorded the largest increase.

With Latvian banks cutting down their debt securities portfolio abroad, a net inflow of portfolio investment was recorded in the fourth quarter.

Net inflow of other investment (336.6 million lats) was the main source of financing the current account deficit. Mainly transactions within the banking sector pushed up foreign claims and liabilities. Both long-term and short-term bank liabilities to parent banks increased. Simultaneously with the growing volume of short-term loans to non-resident banks, Latvia's banks pushed up their demand deposits with foreign credit institutions.

In 2005, the current account deficit of the balance of payments rose to 12.5% of GDP (12.9% in 2004). Notwithstanding the contracting goods and income deficit to GDP and a simultaneously declining services and current transfers surplus to GDP, the current account deficit still soared high.

The economic growth in Europe was the driving force behind the growing demand for Latvian-made goods in the external market. Overall, Latvian products sustained the ability to compete, and the Latvian foreign trade boosted rapidly. Despite somewhat moderating annual export growth in the second half of 2005 due to the high base effect and deteriorating trade situation, growth in exports of goods (33.8%) exceeded that in imports of goods (27.3%), with imports sustaining their growth potential.

In 2005, exports of goods expanded on account of wood and articles of wood, base metals and articles of base metals, agricultural and food products, mineral products, machinery and mechanical appliances, electrical equipment, and also textiles and textile articles. In a number of commodity groups, the growth was driven by goods with a higher value added (further processed wood, miscellaneous machinery and electrical equipment, transport vehicles). In 2005, 76.3% of total exports went to the EU25 countries, recording an increase by one third as compared with the previous year.

Machinery and mechanical appliances, electrical equipment, mineral products, agricultural and food products, transport vehicles, base metals and articles of base metals were the most important goods imported by Latvia. Three fourths of total imports came from the EU25 countries.

Compared with the previous year, services surplus increased by mere 15.9 million lats in 2005, this pickup being underpinned by a larger growth in the volume of services rendered than services received. Transportation services accounted for more than a half of the overall growth in services rendered, whereas travel services contributed the same share to the growth in services received. This resulted in a growing transportation services surplus and travel services deficit.

Compared with the previous year, transportation services surplus rose by 93.5 million lats, mainly due to a rise in freight transportation services rendered by road and rail as well as the growing volume of other transportation related services delivered by sea. At the same time, the travel services deficit increased by 77.6 million lats as a result of substantially rising spending by Latvian travelers abroad.

Compared with 2004, the income deficit decreased by 48.3 million lats in 2005. It resulted from a more rapid growth of resident income abroad: compensation of employees increased by 91.4 million lats and income from investment went up 72.6 million lats. Non-resident income in Latvia (mainly in the form of direct investment and other investment) rose by 111.9 million lats.

With the government transfers to the EU budget expanding more than the financing from the EU funds recorded under the same caption, the current transfers surplus declined.

Net inflow of the capital and financial account amounted to 1 251.5 million lats in 2005. As the financing received from the EU funds exceeded the amount of the previous year, the surplus of the capital account posted a pickup of 31.0 million lats.

Current account deficit was covered by long-term capital, of which one fourth was foreign direct investment. Inflow of foreign direct investment was in the amount of 3.1% of GDP in 2005. Primarily in the form of reinvested earnings and equity capital, foreign direct investment inflows from Estonia, Denmark, Russia, Lithuania, Sweden and Norway (financial intermediation, wholesale and retail trade, electricity, gas and water supply as well as construction and manufacturing) posted the largest increase.

Portfolio investment recorded a net outflow. Latvian banks expanded their foreign debt securities portfolios more than non-residents increased their portfolios of securities issued by Latvian banks.

Net inflow of other investment reached 1 272.7 million lats. Foreign claims grew by 208.5 million lats but foreign liabilities by 1 481.2 million lats. With the volume of corporate demand deposits abroad and short-term trade credit growing, foreign assets expanded. However in the banking sector, foreign claims decreased due to banks scaling down their short-term loans to non-resident credit institutions to a greater extent than increasing long-term loans to non-residents. Transactions by the banking sector were the main contributor to an increase in foreign liabilities. Banks engaged in long-term borrowing mainly from the parent banks. Non-resident demand deposits with Latvian banks declined somewhat.

With the Bank of Latvia purchasing foreign currency, reserve assets grew by 294.1 million lats in 2005.