LATVIJAS BANKA

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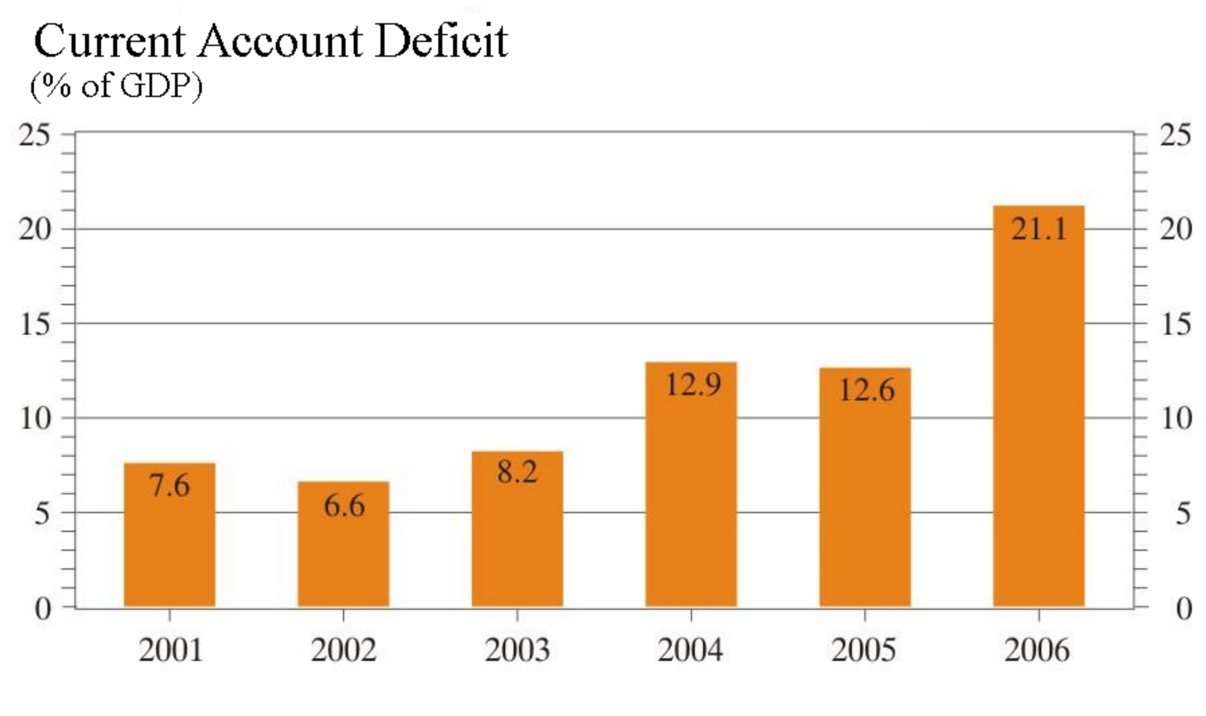
Latvia's Balance of Payments in the Fourth Quarter of 2006 and in the year 2006

In the fourth quarter of 2006, the current account deficit of Latvia's balance of payments amounted to 26.3% of GDP (15.2% in the corresponding period of the previous year); **in 2006** it reached 21.1% of GDP (12.6% in 2005). The overall current account deficit in 2006 widened due to a significant rise in the ratios of deficit of goods to GDP (from 18.9% in 2005 to 24.4% in 2006) and the income deficit to GDP (predominantly on account of higher reinvested earnings), while that of the services and current transfers surplus to GDP decreased. **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

Last year and particularly in the fourth quarter, the signals of overheating in Latvia's economy strengthened. The record-high GDP growth was mostly fuelled by an increase in domestic demand rather than that in the sectors producing export goods. It resulted in a situation where the annual increase in the exports of goods was fairly moderate at 13.3% whereas imports expanded at a twice higher rate (29.4%), partly driven by the implementation of several significant investment projects. Consequently, the current account deficit of Latvia's balance of payments widened, contributing to higher risks due to the imbalanced development. In the fourth quarter, the current account deficit of the balance of payments peaked to a record-high 26.3%, reaching 21.1% of GDP overall in 2006.

Last year foreign direct investment in Latvia posted an accelerated rise of 2.5 times, its inflow accounting for 8.1% of GDP (compared to a mere 4.5% of GDP a year ago). It covered more than one third of the current account deficit. The rest of the current account deficit was offset by other investment, the latter increasing Latvia's external debt though, mostly in the form of long-term loans from parent banks of Latvian commercial banks abroad. We should be aware that without the above record-high borrowing peak Latvia's current account deficit would be closer to the 12% of GDP mark at present. Therefore attention should be paid to the way the availability of funds from abroad will be affected by the awareness of Latvia's macroeconomic risks, increasingly observed among the foreign financial experts. In view of the above it is essential to point out that the Scandinavian parent banks of Latvia's major commercial banks – some already earlier and others relatively recently – have expressed their readiness to reduce the lending growth: that would be a positive impetus towards the narrowing of the current account deficit, as well as decreasing the demand side pressure on inflation.

However, a crucial role in reducing the macroeconomic imbalances in the future will be played by the action plan for curbing inflation and stabilizing the macroeconomic situation in this country, adopted by Latvian Government in March this year, in line with its declaration developed after the election in autumn last year.

The slowdown of the increase in the domestic demand and reduction of inflation expectations as a result of the plan could hinder the widening of the current account deficit. Hence, an accurate and coordinated implementation of the plan is of utmost importance, demonstrating both the understanding of macroeconomic processes and the ability to control them: its consistent implementation may reduce the overly strong economic growth as well as the accompanying high inflation.

Notes to the Balance of Payments in the Fourth Quarter of 2006 and in the Year 2006

In the fourth quarter of 2006, the current account deficit of the balance of payments amounted to 26.3% of GDP (15.2% in the corresponding period of the previous year). The goods and income deficit ratio to GDP increased considerably while the services and current transfers surplus ratios to GDP declined.

In the fourth quarter, Latvia's foreign trade growth moderated in comparison with the previous quarters of 2006. The expansion of exports and imports by 9.1% and 24.5% respectively was driven by the persistently strengthening domestic demand. Exports of wood and articles of wood, base metals and articles of base metals and transport vehicles posted the highest rise while those of mineral products decreased significantly. Overall, exports grew mostly on account of price rises since the volume of exports shrank. Exports to EU 10 countries (Lithuania and Estonia) and CIS countries (Russia and the Ukraine) recorded a higher rise whereas to EU 15 countries (Ireland, Germany, France and the UK) it contracted. The increase in imports of goods was dominated by transport vehicles, machinery and mechanical appliances, electrical equipment, agricultural and food products and base metals and articles of base metals. The volume growth was a stronger driving factor for the expanding imports as compared to the price rise. In the fourth quarter, the services surplus decreased by 31.3 million lats year-on-year, as the increase in imports of services exceeded that of exports in all service groups.

Exports of services continued to be dominated by transport services (half of the overall exports of services). The surplus of transportation services shrank mostly as a result of declining exports and increasing imports of other transportation-related services by sea. A minor rise was recorded in the deficit of travel services. The other services surplus narrowed considerably on the account of an increase in imports of other business activities and insurance services.

Income deficit grew by 86.2 million lats year-on-year, as the increase in non-resident income in Latvia along with the significant direct investment growth four times exceeded that of resident income from investment. Non-resident income from direct investment and other investment posted the highest gains.

The surplus of the capital and financial account was 872.2 million lats in the fourth quarter. Financial intermediation attracted the bulk of direct investment in Latvia, totalling 293.4 million lats or 8.9% of GDP, covering 34.0% of the current account deficit.

In the fourth quarter, the largest part of the current account deficit was financed by loans from foreign banks. Other investment recorded a surplus of 700.1 million lats, most of them (83.7%) in the form of long-term liabilities. Apart from persistently expanding their long-term foreign liabilities (mostly in the form of long-term loans), resident companies also contracted the amount of short-term trade credit considerably.

In the fourth quarter, with banks converting foreign currencies to meet the demand for lats, reserve assets increased by 237.3 million lats.

In 2006, the current account deficit of the balance of payments rose to 21.1% of GDP (12.6% in 2005). The current account deficit widened due to a significant rise in the ratios of the deficit of goods to GDP (from 18.9% in 2005 to 24.4% in 2006) and the income deficit to GDP (predominantly on account of higher reinvested earnings). At the same time, the ratio of surplus of services and current transfers to GDP decreased.

Following the accelerated growth in the previous year, the expansion of exports of goods (13.3%) moderated notably whereas the boost in imports (29.4%) was driven by the persistently strengthening domestic demand, inter alia the implementation of several large investment projects. The overall export structure remaining almost the same, exports of base metals and articles of base metals, transport vehicles, agricultural and food products, products of the chemical industry, machinery and mechanical appliances, electrical equipment recorded the highest growth. Export growth decreased largely on account of the minor growth in exports of wood and articles of wood, and a drop in exports of mineral products.

Three fourths of overall exports went to EU countries. The largest share of exports of goods was delivered to EU10 countries (Lithuania and Estonia) whereas exports to Poland decreased twice. Exports to CIS countries expanded by one third, and by a small amount also to other countries. Latvia's major export partners were Lithuania, Estonia, Germany, Russia, the UK and Sweden.

In 2006, the substantial rise in imports was on account of Latvia's major import goods: machinery and mechanical appliances, electrical equipment, mineral products, transport vehicles, agricultural and food products, base metals and articles of base metals, as well as products of the chemical and allied industries. Latvia's major trade partners in imports of goods were Germany, Lithuania, Russia, Estonia and Poland.

In 2006, the services surplus increased by 41.4 million lats due to a higher rise in exports of services. The transportation services surplus went up notably, with the travel services deficit narrowing to a lesser extent. The surplus of other services shrank somewhat. Exports of services were dominated by transportation services (53.4% of total services rendered), other services (28.0%) and travel services. In imports of services, the contribution of all services groups was similar.

The surplus of transportation services increased by 38.0 million lats, primarily on account of expanding exports of freight transportation services by road. Exports of passenger transportation services rendered by air also posted a solid increase, widening the surplus of this group of transportation services. The surplus of transportation services by sea shrank as a result of imports of freight transportation and other transportation-related services by sea expanding to a larger extent than exports. The travel services deficit decreased. According to the data provided by the CSB, in 2006 the spending of Latvia's travellers abroad was 138.4 million lats higher than that of non-resident spending in Latvia, despite a 4 times larger increase in the number of foreign visitors to Latvia than Latvian travellers abroad.

Income deficit grew by 176.4 million lats as the increase in the growth of non-resident income from investment in Latvia (mostly in the form of income from direct investment and other investment) three times exceeded that of resident income from investment abroad. The current transfers surplus shrank by 66.2 million lats, mostly on account of larger amounts of debit transactions in other sectors.

In 2006, net inflow of the capital and financial account amounted to 2 414.0 million lats. Current account deficit was fully covered by long-term capital in the form of foreign direct investment and other long-term investment.

Direct investment in Latvia increased by 2.2 times year-on-year, amounting to 8.1% of GDP. Investment from Estonia, Cyprus and Sweden (in financial intermediation and real estate) posted the highest growth.

Portfolio investment assets slightly exceeded liabilities resulting in a net negative position of 6.9 million lats.

The current account deficit was predominantly financed by bank loans from their parent banks. The surplus of other investment amounted to 2 522.3 million lats, mostly contributed by transactions in the banking sector. The share of long-term loans in the net lending profile of the banking sector (59.0%) recorded a significant decrease. The corporate sector foreign liabilities posted a slightly higher growth than its claims, hence the surplus of other investment of the corporate sector stood at 1.3 million lats.

In 2006, reserve assets increased by 1 103.0 million lats as a result of higher demand for lats, inter alia in relation to the compliance with the banks' minimum reserve requirement.

Mārtiņš Grāvītis
Press Secretary of the Bank of Latvia

Phone: +371 670 22 349
Mobile: +371 265 10 385
E-mail: Martins.Gravitis@bank.lv
http://www.bank.lv