LATVIJAS BANKA

PRESS RELEASE

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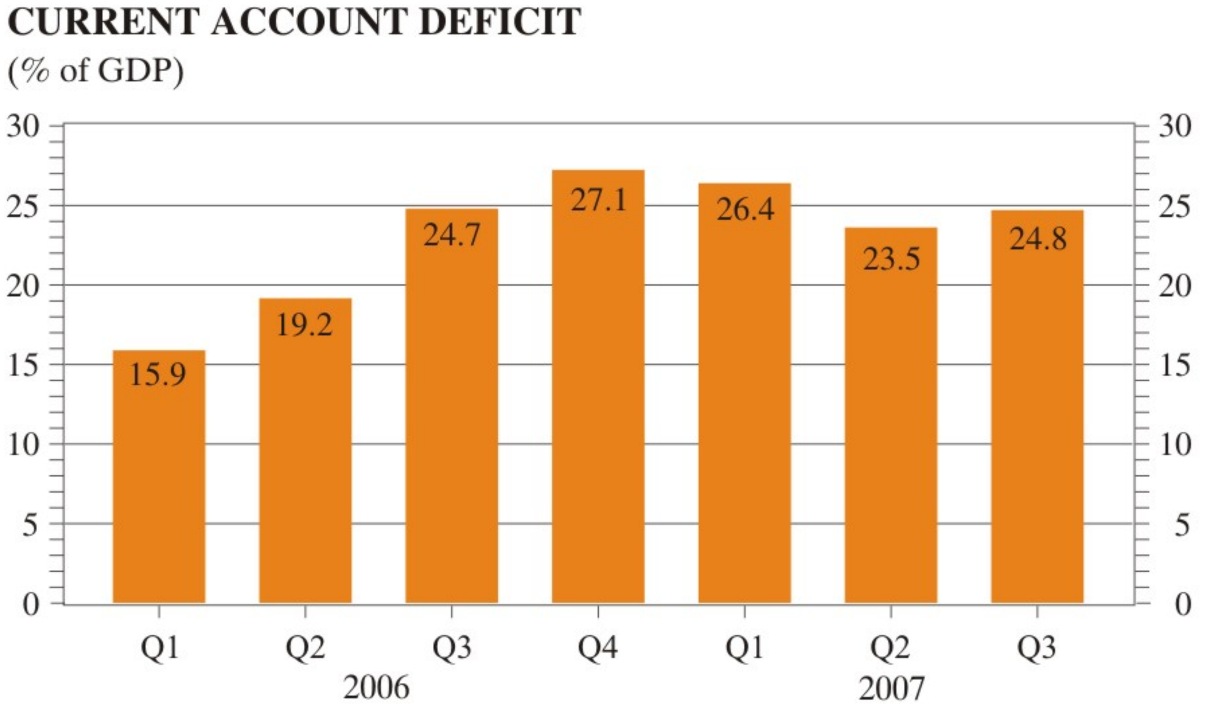
Latvia's Balance of Payments in the Third Quarter of 2007

In the third quarter of 2007, the current account deficit of Latvia's balance of payments was 930.8 million lats or **24.8% of GDP** (733.4 million lats or 24.7% of GDP year-on-year). As the growth of imports decelerated and its pace was coming close to that of exports, the ratio of goods deficit to GDP decreased. The ratio of services surplus to GDP increased due to dynamically growing volume of services rendered. At the same time, the ratio of income deficit to GDP rose, with the non-residents' income from investment on a continuous upward trend. The current transfers surplus to GDP declined, with the current transfers debit transactions expanding steeply.



Although the current account deficit showed no marked year-on-year changes in the third quarter, its high level in the first half of the year determined the **nine-month cumulated outcome**, with the deficit accounting for **24.8% of GDP** (20.3% a year earlier). All current account positions to GDP deteriorated, with the goods deficit recording a steeper rise and the current transfers surplus declining more.

In the third quarter, the current account deficit was fully covered by long-term capital. Net inflow of long-term other investment was particularly strong and even exceeded the current account deficit. The increase in asset and liability positions of currency and deposits was notable (606.8 million lats and 767.2 million lats respectively) and can be explained by intermediation activities of the Latvian banks in placing the funds. Direct investment in Latvia (240.4 million lats) went mainly to financial intermediation. Reserve assets increased by 189.2 million lats.

In the first nine months of 2007 overall, the current account deficit was covered by long-term capital. The structure of net direct investment inflows (8.2% of GDP) was dominated by investment in equity (71.5%). Long-term other investment amounted to 22.3% of GDP.

Evaluation and outlook

In the third quarter in line with the forecasts, Latvia's economy was passing through a contradictory phase of development in terms of external stability, typical for times of shifting economic trends when an excessively buoyant growth is replaced by a more moderate pace sustainable in the long run. In response to the signs of economic overheating, a set of measures for balancing the economic development of the country was adopted in the spring of 2007, and its implementation since summer has yielded the first results, with the extremely strong economic growth subsiding over the year. However, a number of indicators, e.g. the current account deficit and inflation rate, so far have been under the impact of inertia.

According to foreign trade data, the annual growth rate of imports is decelerating on a quarterly basis (from 35.8% in the first quarter to 19.8% in the third quarter), whereas the growth in exports has remained stable since the beginning of the year at around 20%. However in the third quarter, the ratio of the current account deficit to GDP increased quarter-on-quarter, amounting to 24.8% of GDP. A sharp drop in the growth of Estonian imports gives rise to concerns, as it may have an adverse effect on Latvia's exports to Estonia. In the situation of a moderating domestic demand and, consequently, also decelerating import growth in both Lithuania and Estonia, Latvia's major export partners (accounting for almost one third of Latvia's total exports in the third quarter), the Latvian exporters should more proactively penetrate into new export markets.

Long-term other investment became more important in financing the current account deficit, whereas net inflow of direct investment amounted to 5.3% of GDP. The relatively low level of net direct investment inflow can be attributed to decreasing investment in financial intermediation, as the Latvian banks had substantially raised equity in the previous periods. Such net inflow level of direct investment allowed the current account deficit to be fully covered by long-term capital, primarily long-term bank lending, in the third quarter. Deceleration in the growth of lending, which in absolute terms was dramatic in the first half of the year, moderated in the third quarter, suggesting that the parent banks of major Latvian banks implement a gradual slowdown of lending, thus supporting the efforts of macroeconomic risk mitigation in the country. In the third quarter, the lats strengthened, and the Bank of Latvia reserve assets continued on an upward trend.

Looking ahead, an important challenge for the Latvian Government will be to further enhance exports and production, the main drivers of Latvia's sustainable economic development. Although the export market of Latvia is sufficiently diversified, the exporting enterprises of Latvia will also face a challenging task of accessing new markets and supplying higher value added goods in a situation of changing demand patterns in the major export partner countries. Such export encouraging measures in combination with moderating domestic demand should spur exporters' activity and break the pace of import expansion, thus gradually making a positive contribution to minimising the current account deficit of Latvia's balance of payment.

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