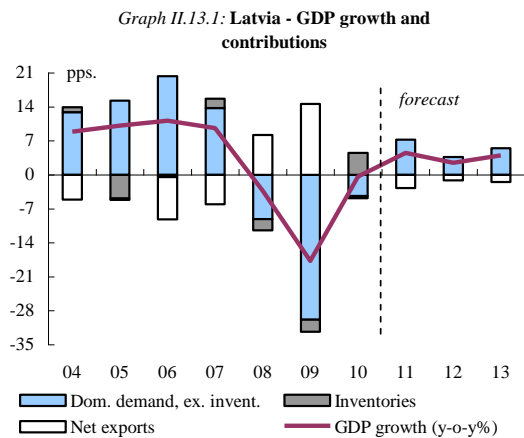


13. LATVIA

Growth exceeds expectations in 2011 but outlook for 2012 worsens

Corporate profits support investment and GDP growth in 2011

A strong rebound in corporate investment as well as sustained increases in private consumption and exports pushed up Latvia's economic growth to 5.6% y-o-y in the second quarter of 2011. Investment was mainly financed by corporate profits, with bank credit playing a decreasing role. On the supply side, manufacturing and tourism reported record rates of expansion of 14.7% and 25% in the first half of 2011. Both sectors benefited from the steep improvement in the country's price competitiveness in 2009-10 when unit labour costs (weighted according to trade patterns) dropped by around 20%. On the other hand, financial services and construction, which had been on a downward path for several quarters, eventually approached a turning point in the middle of the year.

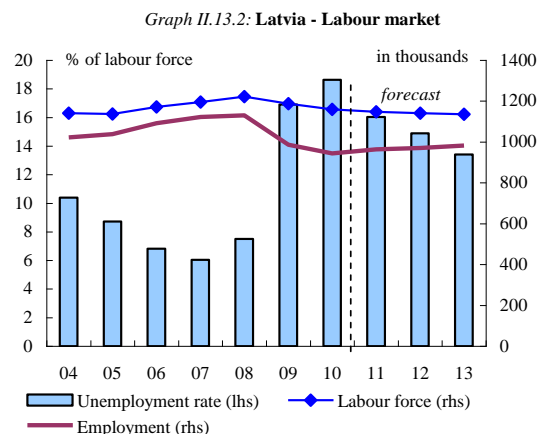


Despite global uncertainties, the latest monthly indicators suggest that retail sales, industrial production and exports grew at a fast pace also in the third quarter of 2011. These stronger developments support an upward revision of the GDP growth forecast to 4.5% in 2011 from 3.3% expected in spring. However, the expected slowdown in major EU economies and the steep fall in confidence in the euro area imply a significant downward revision of GDP growth to 2.5% in 2012 from previously projected 4%. Despite a relatively strong impact on the growth outlook, the new shock will not have such devastating effects on the economy as in 2008-09, when it compounded the burst of the property bubble, the collapse of the construction sector and

resulting huge financial outflows. Moreover, the export sector is now expected to take some advantages from the softer euro, leading to a depreciation of Latvia's nominal effective exchange rate, which will partly offset the weakening external demand. Overall, the Commission's economic sentiment indicator (ESI) for Latvia also paints a broadly positive picture, balancing the dynamic internal demand and a softening external environment. After a one-off decline in August, the indicator recovered in September to a four-year high of 3.6 pps. above the long-term average.

Unemployment drops substantially, helped by emigration flows

The unemployment rate, based on the Eurostat definition for the age group of 15-74, dropped by 3.2 pps. to 16.2% y-o-y in the second quarter of 2011. The overall improvement was supported by net job creation as well as by strong emigration flows that lowered the number of job seekers. The labour force contracted by 0.7% y-o-y in the second quarter of 2011 and the monthly statistics on the international mobility of the population showed that the change was largely driven by an increasing rate of emigration. The participation rate remained stable, however, as both the labour force and the working age population contracted at similar rates.

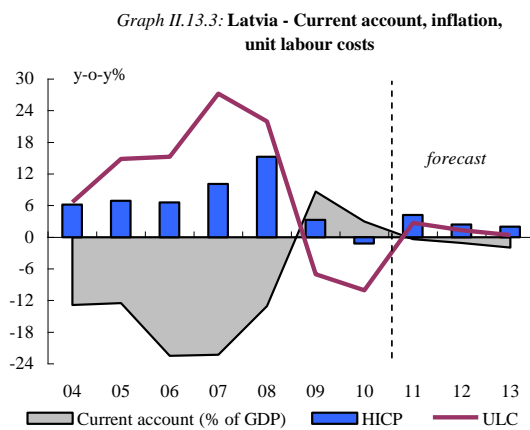


Thanks to improved economic conditions, wages increased at a relatively fast pace in the first half of the year but remained broadly in line with productivity gains. Employment and wages are

expected to rise only marginally in 2012 as the weakening economic outlook will contain labour demand. This is supported by the latest economic surveys where employment expectations for manufacturing and service sectors stayed positive but below the levels at the start of the year, while retail and construction firms reported negative employment expectations.

Inflation to fluctuate near EU average

Consumer price inflation expectedly accelerated in 2011 reflecting higher energy and food prices as well as two rounds of consumer tax hikes at the beginning of 2011 and in the summer. The harmonised index of consumer prices (HICP) surged to an annualised 4.2% in January-August compared to a deflation of 1.1% in 2010. However, inflation was mainly affected by taxes, food and energy prices, with core inflation remaining subdued. The constant-tax estimates of the national statistics office show much lower inflation of 2.8%, of which around 2 pps. can be attributed to changes in prices of energy and unprocessed food. As tax and commodity price effects will fade away in 2012-13, headline HICP inflation is expected to decelerate substantially towards the EU average rate. On the demand side, prices could face certain upward pressure from second-round effects linked to the steep wage and employment growth in the first half of 2011 but this is likely to be offset by the supply-side impact of the global slowdown.



Current account moves back to deficit

The current account moved to a small deficit in January-August 2011, following a two-year period of surpluses driven by internal adjustment and cyclical effects. In nominal terms, merchandise

exports and imports rose at similar annual rates of about 32% in January-August. The reversal in the primary income balance as well as the gradual recovery of private consumption and investment is set to expand the current-account deficit further in 2012-13. Nevertheless, as capital account inflows will offset the current-account gap, the net external lending is projected to remain positive. The country's external indebtedness is therefore expected to decline further in relation to GDP, continuing the positive trend of deleveraging in the private sector that brought the country's external debt to 149% of GDP as of end-June 2011, down from 165% as of end-2010.

The net inflow of FDI marked an eight-fold improvement in annualised terms to LVL 437 million in January-August 2011 (3.2% of the projected full-year GDP). The rebound is largely driven by the reversal in reinvested earnings of foreign-owned companies that moved to a positive balance of LVL 84 million from a negative value of LVL 226 million a year earlier.

Outlook for public finances reflects growth revival and past consolidation effort

In line with the revival of economic growth, tax revenue continued improving in the first three quarters of 2011. Income taxes in particular performed above expectations, while the improvement in the labour market led to lower unemployment costs. Together with restrained expenditure growth, this points to a notable improvement in the outlook for public finances in 2011. At the same time, as plans for restructuring of a state-owned bank are being implemented, a negative risk factor for public finances identified in the spring forecast is expected to materialise. Moreover, the government has also decided to provide stop-gap financing to the national airline company, which has incurred significant losses over the past two years. The estimated impact of these decisions is ¾% of GDP in 2011. Overall, these offsetting items lead to only a modest deficit improvement in 2011 compared to the spring forecast, with the general government deficit now expected at 4.2% of GDP, significantly down from 8.3% of GDP recorded in 2010, which was negatively affected by a number of one-off factors. The structural balance is set to improve in 2011 less than the change in the headline deficit, by a still impressive 1½% of GDP.

Due to early elections that took place in mid-September, the annual budgetary process has been delayed, with the draft budget law for 2012 expected by early December. The current forecast therefore does not include measures which the government intends to adopt to fulfil its aim of a deficit of 2.5% of GDP in 2012. A number of earlier decisions with effect in 2012 are nevertheless already included in the forecast, notably the suspension of the pension indexation until end-2013, as well as the full-year impact of some tax increases that took place in mid-2011. The forecast for 2012 includes some estimated further costs of restructuring of the national airline. Overall, not considering the forthcoming measures of the 2012 budget, the general government deficit is expected to decline to 3.3% of GDP in 2012 as revenue is projected to grow faster than expenditure, while the structural deficit remains broadly stable. Although the exact composition of measures to support the consolidation is not yet known, the new government has restated publicly its commitment to meeting the deficit target of 2.5% of GDP in 2012 set under the Balance of Payment assistance programme.

Albeit exceptional restructuring costs are assumed to be considerably lower in 2012 than in 2011, such measures remain a risk factor to the fiscal outlook. Further downside risks for 2012 are

related to uncertainties concerning the economic outlook discussed above and their impact on revenue. In 2013 the nominal general government deficit is projected to remain broadly unchanged as the planned increase in state contributions to the mandatory funded pension scheme, with a negative impact of 1.0% of GDP, offsets an improvement in tax revenue due to improving macroeconomic conditions.

In June 2011, Latvia returned successfully to the international financial market by issuing a USD 500 million Eurobond. Further borrowing from international financial markets is expected in both 2012 and 2013, including with the aim to pre-fund the repayment of loans under the international financial programme – these repayments will start in 2012 and peak in 2014-15. As a result, the gross general government debt is expected to continue increasing over the forecast horizon, reaching 47.1% of GDP by end-2013, though rapidly falling thereafter as large repayments are made.

Table II.13.1:

Main features of country forecast - LATVIA

	2010			92-07	Annual percentage change					
	mio LVL	Curr. prices	% GDP		2008	2009	2010	2011	2012	2013
GDP	12738.7		100.0	2.2	-3.3	-17.7	-0.3	4.5	2.5	4.0
Private consumption	8024.1	63.0		-	-5.8	-22.6	0.4	3.5	2.4	3.3
Public consumption	2230.6	17.5		-	1.6	-9.4	-9.7	1.0	0.0	0.5
Gross fixed capital formation	2487.2	19.5		-	-13.8	-37.4	-12.2	21.5	8.0	12.0
of which: equipment	860.4	6.8		-	-	-	-	-	-	-
Exports (goods and services)	6853.4	53.8		-	2.0	-14.1	11.5	11.0	5.8	6.2
Imports (goods and services)	7034.9	55.2		-	-10.8	-33.3	11.5	14.9	7.0	7.7
GNI (GDP deflator)	13006.5	102.1		1.9	-1.0	-10.6	-5.5	2.2	2.6	3.8
Contribution to GDP growth:		Domestic demand		-	-9.1	-29.8	-4.4	7.2	3.7	5.5
		Inventories		-	-2.4	-2.5	4.5	0.0	0.0	0.0
		Net exports		-	8.2	14.6	-0.5	-2.7	-1.1	-1.5
Employment				-1.4	0.9	-13.2	-4.8	2.2	0.7	1.3
Unemployment rate (a)				12.1	7.5	17.1	18.7	16.1	15.0	13.5
Compensation of employees/head				-	15.7	-12.7	-6.0	4.4	2.8	3.2
Unit labour costs whole economy				-	20.7	-7.9	-10.2	2.1	1.1	0.5
Real unit labour costs				-	6.9	-6.7	-8.2	-1.8	-0.6	-1.1
Saving rate of households (b)				1.3	4.9	10.3	4.2	2.2	3.1	2.8
GDP deflator				29.7	13.0	-1.2	-2.2	4.0	1.7	1.6
Harmonised index of consumer prices				-	15.3	3.3	-1.2	4.2	2.4	2.0
Terms of trade of goods				-	-1.8	-2.9	1.1	3.2	0.0	0.2
Merchandise trade balance (c)				-14.5	-17.8	-7.1	-7.1	-8.2	-9.1	-10.0
Current-account balance (c)				-5.7	-13.1	8.6	3.0	-0.4	-1.1	-2.0
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-3.4	-11.6	11.1	4.9	1.7	1.0	0.5
General government balance (c)				-	-4.2	-9.7	-8.3	-4.2	-3.3	-3.2
Cyclically-adjusted budget balance (c)				-	-6.4	-6.8	-5.7	-2.9	-2.5	-3.1
Structural budget balance (c)				-	-6.4	-6.3	-4.6	-3.2	-3.3	-3.1
General government gross debt (c)				-	19.8	36.7	44.7	44.8	45.1	47.1

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.