

THE NATIONAL ECONOMY OF LATVIA: A MACROECONOMIC REVIEW

Key indicators of economic development

Economic policy

Macroeconomic development

Gross domestic product

Manufacturing

Investments

Foreign trade

Balance of payments

Inflation

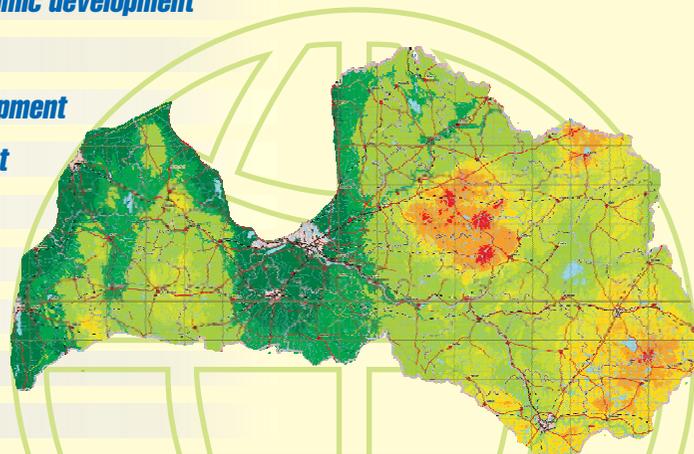
Monetary indicators

Budget and central government debt

Personal income

Employment and unemployment

*Main socio-economic indicators
of the Baltic countries*



Latvia: 2005

Territory, thsd km ²	64.6
Population (as of 01.01.2005, thsds)*	2307
of which:	
Urban area	1564
of which Riga, the capital city	731
Rural area	743
National currency: lats (LVL)	

* Estimate of the Central Statistical Bureau

Key Indicators of Economic Development

	2001	2002	2003	2004	2005 f
(increase over the previous year, in per cent)					
Gross domestic product	8.0	6.4	7.5	8.5 e	7.5
Consumer prices	2.5	1.9	2.9	6.2	5.0
(% of GDP)					
General government budget fiscal balance	-2.0	-2.3	-1.6	-1.1 e	-1.7
Central government debt	13.8	13.3	13.4	13.2 e	13.6
Current account balance	-7.6	-6.7	-8.2	-12.0 e	-9.8
Exchange rate, LVL per US dollar	0.628	0.618	0.571	0.541	0.52
Exchange rate, LVL per euro	0.563	0.583	0.645	0.67	0.7028
Unemployment rate (rate of job seekers as % of economically active population, aged 15-64 years)	13.3	12.1	10.7	10.0 e	9.5

	2003				2004		
	I	II	III	IV	I	II	III
(increase over the corresponding period of the previous year, in per cent)							
Gross domestic product	8.8	6.2	7.3	7.5	8.8	7.7	9.1
Consumer prices	1.9	2.9	3.5	3.5	4.3	5.8	7.4
(% of GDP)							
General government budget fiscal balance	1.0	-0.9	0.6	-6.4	2.4	-1.5	4.3
Current account balance	-5.0	-8.8	-9.3	-9.3	-9.4	-17.4	-12.2
Exchange rate, LVL per US dollar	0.585	0.573	0.574	0.554	0.538	0.548	0.545
Exchange rate, LVL per euro	0.627	0.649	0.646	0.658	0.673	0.660	0.666
Unemployment rate (rate of job seekers as % of economically active population, aged 15-64 years)	10.8	10.8	11.0	10.4	11.7	10.1	10.2

f - forecast of the Ministry of Economics; e - estimation of the Ministry of Economics.

Economic policy

After more than ten years of relentless pursuit, the desired goals of many governments are now achieved: in 2004 Latvia became a member of NATO and the EU. Accession to the EU gives Latvia new opportunities for economic development. By joining the EU single market, Latvia can use the advantages provided by a broad and stable market, free movement of goods and services, labour and capital, i.e., the most advantageous conditions on the EU market.

The aim of the government's economic policy is to achieve within 20 to 30 years a welfare level of the population that would align with the medium standard accepted in the EU, by means of ensuring stable, balanced and sustainable growth and implementing the transition from a labour-intensive economy to a knowledge-based one.

To achieve this goal, a stable macroeconomic environment is maintained and structural reforms implemented to raise productivity and economic activity and to improve the business environment, infrastructure and the manpower potential, etc.

Latvia's aim is to become a full-fledged member of the European Economic and Monetary Union (EMU) in the nearest future. The re-pegging of the lats from SDR to euro from the 1st of January this year marks the first stage on the road to EMU. Latvia intends to enter the European Exchange Rate Mechanism (ERM II). The Bank of Latvia and the government have scheduled the beginning of 2007 as the target date when all necessary criteria for the adoption of the euro should be met.

Private initiative and capital are now the main driving forces for growth. The privatisation of state property is basically completed. In recent years the business environment in Latvia has been substantially improved by introducing the requirements of the EU body of legislative acts (*acquis communautaire*) and implementing the *Action Plan for Improvement of Business Environment*. Latvia is consistent in its efforts to liberalise the monopoly markets in telecommunications, electricity and gas supply as well as in post and railway to stimulate competition. The Commercial Law testifying to a fundamental reform of the business environment became effective in 2002. Currently the corporate income tax rate in Latvia is among the lowest (15%) in the EU. Legislation provides special corporate income tax relief for large-scale investment projects as well as to enterprises operating within the special economic zones.

The government continues to upgrade the infrastructure, with special attention paid to the development of the energy sector, building of the electronic communications and information systems, improvement of the quality of transport infrastructure and creation of an effective network. The utilisation of the EU funds offers broader opportunities to improve infrastructure. The aim of the government is to guarantee full utilisation of the funds allocated by the EU.

Successful implementation of structural reforms in Latvia will ensure the stability of economic growth, promote the catch-up process and deeper integration into the European and world economy.

Macroeconomic development

The reforms carried out in the country and integration into the EU have made a positive impact on economic development. Growth rates in Latvia are among the highest in the EU. In the period between 2001 and 2003 the average GDP growth rate was 7.3% per year. Estimates put the average growth of GDP in 2004 at 8.5%. The high growth rates are based on stable domestic demand and the ability of Latvian enterprises to expand the export market.

Growth can be observed in all main sectors of the economy. The rise in domestic demand promotes the development of services especially trade and construction. High growth rates are also observed in the transport and communications sectors, most notably in 2004. Since 2001 manufacturing output has been rising by 9-10% annually (6.2% in 2004). The competitiveness of Latvian manufacturers is based on productivity growth, which was spurred by the investments made in previous years. Export dynamism attests to the competitiveness of several industries on the external markets where conjuncture conditions are not quite favourable.

Economic growth in Latvia was achieved in a stable macroeconomic environment. For several years inflation has been around 2-3%. Inflation in 2004 mounted to a higher level primarily owing to a combination of several one-off effects (an increase in the administratively regulated prices, harmonisation of the indirect tax rates, inflation expectations due to joining the EU and the high oil prices on the global scale). According to a forecast, due to the diminishing influence of the aforementioned factors, inflation in the next years will gradually return to its previous level.

The general government budget deficit is lower than allowed by the Maastricht Treaty. In 2004 it was 1.1% of GDP. The parliament has confirmed the general government budget deficit for 2005 at 1.68% of GDP. Although the current account deficit is comparatively large it should not be considered today as critical as it is covered by foreign direct investment and long-term loans. Net foreign reserves of the Bank of Latvia fully cover the reserve money.

The employment and unemployment indicators are gradually improving. The rate of job seekers aged 15-64 years has decreased notably (from 20.5% in 1996 to 10.7% in 2003). In 2004 this rate continued to decline and in the 3rd quarter was 10.2%.

The reforms carried out in the previous decade have strengthened the private sector and created favourable macroeconomic conditions; the business environment is also improving. Investments continue to grow rapidly promoting the modernisation of production and transition to new and more productive technologies. Accession to the EU has a particularly positive impact on the development of the economy. This strengthens confidence that growth in the coming years will also be sustainable. If there are no external shocks GDP can be expected to grow by 6-8% in the medium term. A forecast of the Ministry of Economics puts the increase in GDP in 2005 at 7.5%.

Gross domestic product

2003

GDP, at current prices	
mln lats	6322
mln US dollars	11073
mln euro	9802
GDP per capita	
lats	2719
US dollars	4762
euro	4215
GDP by sector, %:	
Agriculture ¹	4.3
Industry	17.2
Construction	5.6
Trade ²	19.4
Transport and communications	15.4
Public services ³	15.5
Other services	22.6

¹ Including forestry and fishing

² Including hotels and restaurants

³ Public administration including healthcare and education

Rapid economic growth is observed from 2000. The current statistical data also allow assessing growth in 2004 at a high level and the Ministry of Economics forecasts it at 8.5%.

Compared with the three quarters of the previous year, GDP growth in the three quarters of 2004 was 8.5%. Growth accelerated in particular in the third quarter (by 9.1%), straight after Latvia's joining the EU.

Similarly as in the previous year, stable domestic demand and increasing commodity exports were the main reasons for growth.

The favourable financial situation (low interest rates on loans and expanding mortgage lending) encourages investing. Compared with the same period of the previous year, gross fixed capital formation in the three quarters of 2004 rose by nearly one fifth. The expansion of crediting had a favourable impact on private consumption.

The development of the services sector accounted for almost three quarters of the overall growth. High growth rates persist in all economic sectors, especially in construction, transport and communications. Growth in manufacturing has somewhat slowed down in comparison with the preceding year and this can be partly explained by the adjustment to the new conditions following EU accession.

High growth rates in the third quarter were accounted for mainly by the strong acceleration in the transport and communications sector, which was mainly due to the increasing freight transportation, passenger conveyance and the development of the communications sector.

Gross domestic product

GDP by Sector

(growth over the corresponding period of the previous year, %)

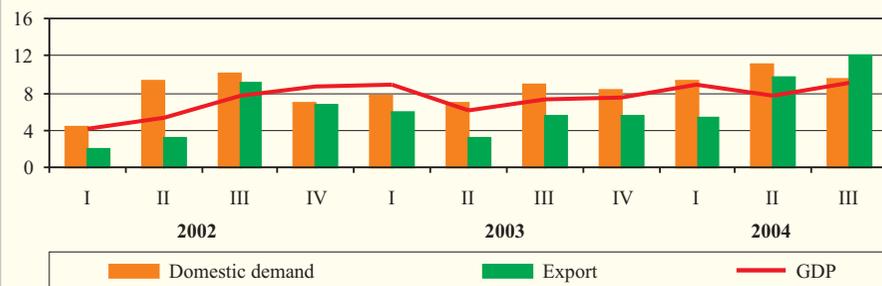
	2003				2004			2001	2002	2003
	I	II	III	IV	I	II	III			
GDP	8.8	6.2	7.3	7.5	8.8	7.7	9.1	8.0	6.4	7.5
Agriculture ¹	4.5	0.7	-1.8	2.5	5.6	4.1	2.0	6.4	4.4	1.0
Industry	9.6	7.3	8.6	6.1	9.7	6.5	5.1	9.7	8.1	7.8
Construction	17.5	10.3	20.4	7.4	13.0	12.0	11.4	6.1	10.8	13.7
Trade ²	16.9	9.8	8.5	11.1	11.2	8.2	10.4	10.8	11.9	11.6
Transport and communications	7.8	7.6	10.1	10.3	8.3	10.9	17.0	9.5	3.4	8.9
Public services ³	2.5	2.7	2.8	3.5	4.5	4.1	3.5	1.7	2.3	2.9
Other services	4.5	3.2	3.4	6.2	8.3	7.9	10.4	10.6	5.4	4.4

¹ Including forestry and fishing

² Including hotels and restaurants

³ Public administration including healthcare and education

Quarterly Changes in Real GDP and Major Expenditure Items (% of the corresponding quarter of the previous year)



Manufacturing

2003

Growth rate: 9.1%

Share in GDP: 14.0%

The period from 2001 to 2003 witnessed a steady increase in manufacturing, with the annual average growth rate of 9.4% considerably exceeding the average growth rates in the economy. Growth was largely accounted for by export expansion.

Manufacturing output in 2004 exceeded the level of the previous year by 6.2%. The sharpest acceleration was in the growth of the chemical industry (by 22.2%) and the manufacture of construction materials (12.4%). Growth in other industries was less conspicuous.

Sales volume of the food industry, the biggest manufacturing sector in Latvia (a quarter of the average value added in manufacturing) increased in 2004 both on the domestic and external markets, however, exports rose at a faster pace, especially to the EU countries.

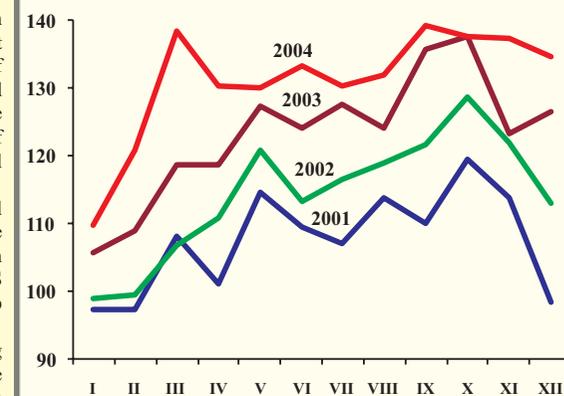
Wood processing is one of the most dynamic sectors of Latvia's industry. It is the second largest industrial sector in Latvia (approximately one fifth of the total value added in manufacturing). The expanding export volume accounted for growth as approximately 70% of the products are exported, with the main trade outlets located in the EU countries. It is worth noting that recent years have also witnessed rapid expansion of the market to other countries including Lithuania, Estonia and Russia.

The manufacture of metals and metalworking industries together with machinery accounted for approximately 1/4 of the total value added in manufacturing. The share of these sectors in industry is rising year by year. Export accounts for 70% of the total output of these sectors. Lately a discernible trend of increasing domestic market can be observed. Along with the development of construction the demand for metal products is also growing.

In Latvia, the share of the chemical industry in manufacturing is not large (slightly below 5%). Export growth, in particular to Russia and other CIS countries, accounted for the sharp acceleration in this industry in 2004.

As opposed to other manufacturing industries, the main stimulus for the development of the construction materials industry is domestic demand.

Manufacturing Output (average monthly output in 2000 = 100)



Investments

2003

Foreign direct investment stock per capita, at the end of the year:

1415 US dollars

Gross fixed capital formation (% of GDP):

24.4

The share of fixed investments in GDP in the last three years (2001-2003) was on average 24%. This indicator is one of the highest among the EU countries.

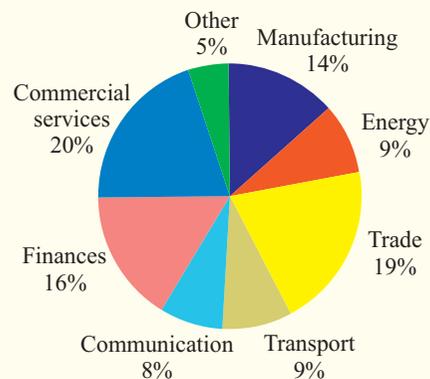
In 2004 the investment level in the economy stayed high. Compared with the corresponding period of the previous year, gross fixed capital formation in the three quarters of 2004 rose by 18%. The investment process was favourably influenced by better accessibility to financial resources, reduction of interest rates on long-term credits and the high growth rates.

At the end of September 2004 foreign direct investment stock totalled 2188.4 mln lats or approximately 30% of the annual GDP.

In the three quarters of 2004, the inflow of foreign direct investment exceeded the total for 2003 one and a half times and was 257.8 mln lats (4.9% of GDP). The incoming foreign direct investments covered one fifth of the fixed capital formation. The largest investments were made in energy, intermediate trade and financial services.

In comparison with the previous year, the interest of EU investors in Latvia has increased. In January-September 2004, investors from the EU countries accounted for 85% of the incoming foreign direct investment. In this period the most noteworthy foreign direct investments came from Germany, the Netherlands and Russia.

Accrued foreign direct investment by industry
(at end of September 2004, per cent)



Foreign trade

2003

Structure of export, %:

Wood and products of wood -	35.2
Metalworking, machine building and transport equipment -	21.7
Light industry goods -	13.7
Chemical goods and articles of plastics -	7.7
Agricultural and food products -	9.0
Other goods -	12.7

The value of commodity exports from Latvia in January-November 2004 was much higher (by 26.6% at current prices) than in January-November a year ago.

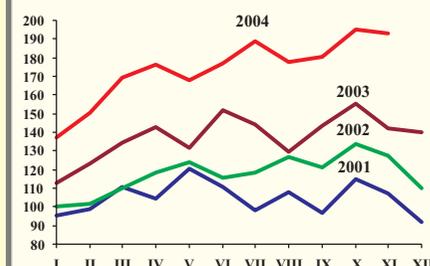
The sharp increase in the export unit value in 2004 reaching 14.5% in the third quarter made a favourable impact on commodity exports in comparison with the third quarter of the previous year. The price increase was accounted for by the advantageous changes in the exchange rate as well as by the increase in global prices for several commodity groups, especially for base metals and articles of base metals.

Exports increased considerably on all the markets trading Latvian goods both in the direction of the EU and CIS countries as well as in other countries worldwide. The sharpest increases were in the exports of base metals and articles of base metals, machinery products and articles of wood.

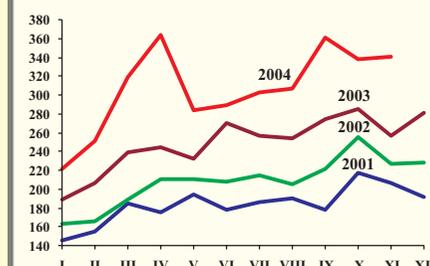
Exports to the EU countries increased mainly due to the export of wood and of articles of wood (19% of the total export growth to EU-25) and of base metals and articles of base metals as well as of agricultural and food products (by 21% and 16%, respectively).

Imports in this period considerably exceeded the level of the previous year (by 24.8%). The most substantial increase in imports, observed in March-April 2004, was due to the entrepreneurs' desire to import in the last months before EU accession as many as possible intermediate and consumer goods in compliance with the old terms of trade. An increase in imports was observed in all commodity groups; the steepest being in the mineral products group (20% of the total import growth) and in the group of machinery products (19%).

Commodity Exports by Month
(mln lats)



Commodity Imports by Month
(mln lats)



Balance of payments

2003

Current account balance

mln LVL: -520.6

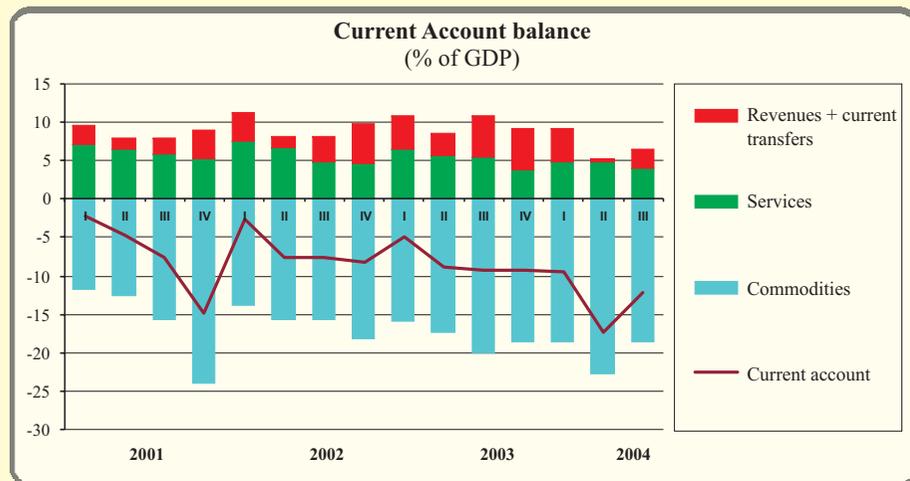
mln US dollars: -916.7

There is a relatively large current account deficit in Latvia. In 2003 it constituted 8.2% of GDP. The main source of the deficit is the markedly negative trade balance (18% of GDP). Slightly less than one third of the deficit is covered by the positive balance on services, as there is a large share of transit services in the economy.

Due to the worsening of the trade balance, current account deficit in the three quarters of 2004 reached 13.1% of GDP exceeding the level of the three quarters of the previous year by 5.3 percentage points. It should be noted, however, that the sharp

rise in imports had occurred at the beginning of the year prior to EU accession but in the second half of the year the situation improved and the current account deficit declined.

Foreign direct investment and long-term flows cover the largest part of the current account deficit. In January-September 2004 foreign direct investment in Latvia constituted 37% of the current account deficit. Net flows from the capital and financial account exceeded the current account deficit, and reserve assets have increased.



Inflation

December 2004

(12-month inflation)

CPI: 7.3%

PPI: 11.4%

In 2004, the rates of inflation accelerated sharply in Latvia: in December the 12-month inflation reached 7.3% and the annual average inflation in 2004 was 6.2%. The price growth in 2004 was more than 2 times faster than in 2003.

The relatively high inflationary pressure in 2004 was caused by a coincidence of several factors determining the price increase.

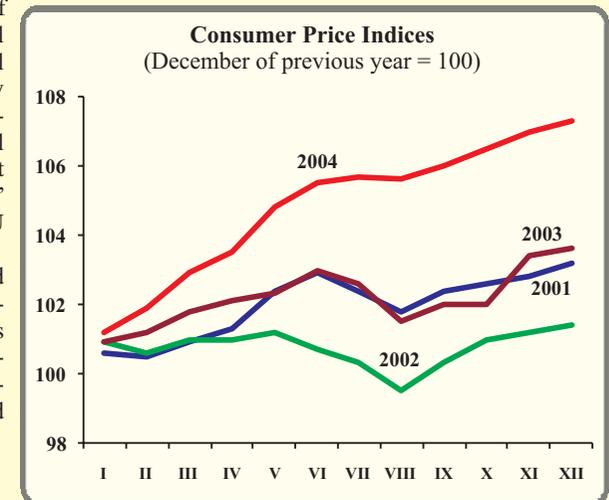
Firstly, the nearly simultaneous increases in the administratively regulated prices of gas, electricity and other

public utilities.

Secondly, the price increase related to Latvia's joining the European Union. The coming into force of several EU legislative acts caused a price rise in various commodity groups, for example, a rise in the excise tax on fuel, the introduction of a reduced value added tax (5%) and its imposition on the goods and services, which until now had been exempt from the VAT.

Thirdly, at the beginning of 2004 there was a substantial increase in the prices of several commodity groups caused by the so-called inflation expectations based on a psychological factor and speculations about the anticipated "enormous" price rise in the run-up to EU accession.

The high domestic demand that was stimulated by a susceptible wage rise in previous years and the brisk growth of crediting intensified the second-phase effect of inflation caused by the aforementioned factors.



Monetary indicators

2003

Domestic enterprises and private persons

Loans:	40.2% of GDP
Deposits:	26.2% of GDP

The stability of the banking sector, growing welfare of population and the rising economic activity are the reasons stimulating steady growth of the basic monetary indicators of the banking system of Latvia.

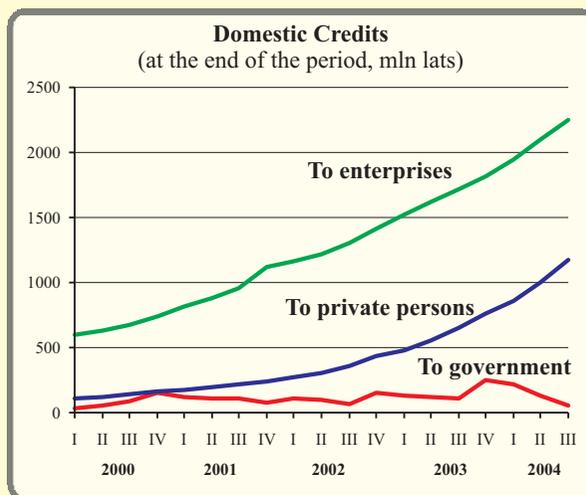
Compared with December 2003, the amount of broad money M2X in December 2004 rose by 27.0%, currency in circulation increased by 6.6% and deposits rose by 34.1%. In the same period credits to enterprises and private persons continued to increase (by 47.0%). The share of short-term loans in the overall credit structure is decreasing while that of long-term loans is increasing. Although the amount of crediting is rising, the quality of loans has not

deteriorated. At the end of September 2004 the share of loans generating no income in the total number of loans was only 1.2%.

Reacting to the increasing domestic demand and in order to slacken the growth of crediting, the Bank of Latvia in March and November 2004 raised its re-financing rate by 0.5 percentage points to 4% and increased in July its reserve requirement from 3% to 4%. However, the effectiveness of these measures in Latvia has been limited by the fixed exchange rate regime and several other specific factors, such as the low share of loans granted to resident borrowers in GDP, the relatively easy access by the banks to foreign resources and the relatively large share of loans issued in foreign currencies in the total structure of loans.

In December 2004 the average weighted interest rate on short-term credits was 17.6% but on long-term credits 10.2%; for credits in the currencies of foreign countries these rates were 15.2% and 6.3%, respectively.

¹ Short-term and with a changing interest rate.



Budget and central government debt

2003

General government budget (% of GDP):

Revenues:	33.3
of which taxes:	28.2
Expenditures:	35.0
of which capital investment:	3.5

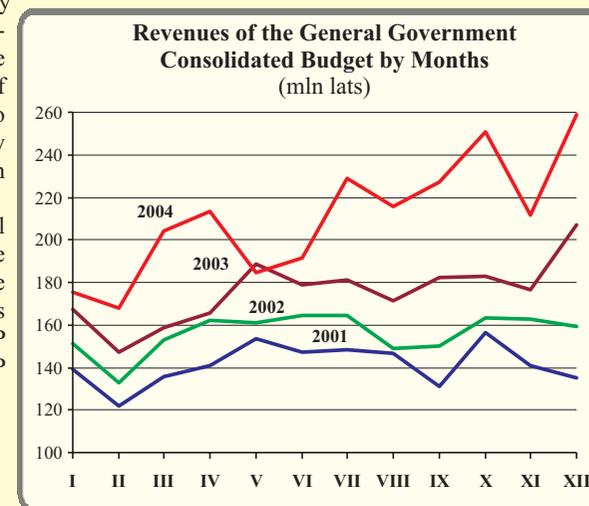
The budget deficit in 2004 was lower than planned, 79 mln lats or approximately 1.1% of GDP (102.4 mln lats or 1.6% of GDP in 2003). The revenues of the general government budget in 2004 were 20% higher than in 2003 and, accordingly, expenditures were 19.3% higher.

The Parliament has confirmed the general government budget for 2005 with a deficit of 1.68% of GDP. In 2005, the priorities of the budget are: restructuring of the healthcare system, integration into the EU and NATO fully utilising the opportunities provided by these organisations and protecting national interests, extensive use of the EU political instruments allotted to Latvia with an aim to effectively

ensure the country's development and prosperity and the development of its scientific potential.

In pursuance of a socially responsible policy, the minimum untaxable income of the population has been raised as of 1 January 2005 from 21 lats to 26 lats and the monthly allowance for a dependent from 10.5 lats to 18 lats.

The level of the central government debt in Latvia is one of the lowest in the EU. At the end of 2004 it was 975 mln lats or approximately 13.2% of GDP (846.3 mln lats or 13.4% of GDP at the end of 2003).



Personal income

2003

Average monthly net wage:

lats 138
US dollars 242

Average monthly old-age pension (paid):

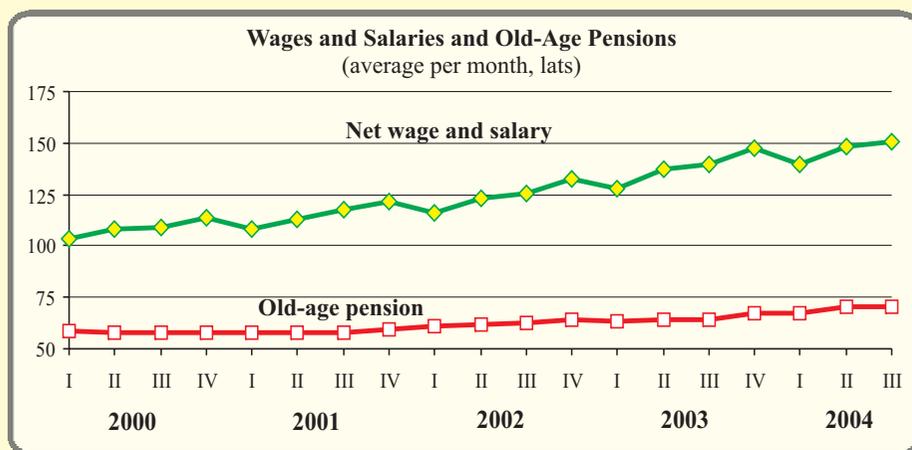
lats 64
US dollars 113

Compared with the previous year, the average net monthly wage in 2003 increased by 14 lats or 10.9%. With inflation taken into account, the real income of employees has increased by 7.8%.

The average monthly net wage in the third quarter of 2004 was 151 lats, an increase of 11 lats compared with the third quarter of the previous year. One of the reasons for the increase in the average wage is the raising of the minimum wage by 10 lats. The minimum wage in 2003 was 70 lats but since 1 January 2004 the minimum wage has been fixed at 80 lats. However, taking into account the steep upward movement of the prices, real wage in 2004 increased only marginally. In the third quarter the real wage exceeded the

level of the third quarter of the previous year by 0.5%.

Compared with the previous year, the average size of the monthly pension paid in 2003 to old-age pensioners registered with the social security institutions increased by 2.2 lats or 3.5%. The minimum pensions were raised from 1 December 2003. The average size of pensions in the 3rd quarter of 2004 was 71 lats.



Employment and unemployment¹

2003

Unemployment rate (rate of job seekers aged 15-64): 10.7%

Registered unemployment rate (at end of year): 8.6%

Economic development in recent years has made a positive impact on the labour market and the number of employed has increased (by 2% aged 15-64 years in 2003). The employment rate in the country in 2003 reached 61.8%. The female employment rate is comparatively high (57.8%) exceeding the average female employment rate in the EU. Women accounted for 48.7% of the total number of employed.

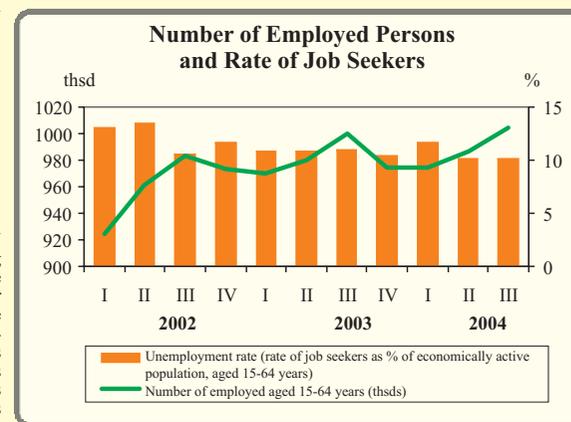
The majority of employed persons work in manufacturing, representing 17.4% of the total number of employees followed by trade (15.3%) and agriculture, hunting and forestry (13%).

Compared with the corresponding period of the previous year, the number of employed rose in the third quarter of 2004 by 4.3 thsd aged

15-64 years mainly due to the increase in the number of employed in financial intermediation and construction. There is a trend persistent in nearly all sectors of the economy whereby growth in the sector has little influence on employment increase within this sector. Along with the increasing number of the employed, the unemployment rate has declined. Compared with the third quarter of the previous year, the unemployment rate in the 3rd quarter of 2004 decreased by 0.7 percentage points and was 10% (aged 15-74 years).

According to the State Employment Agency, there were 90.8 thsd registered unemployed persons at the end of December 2004 (90.6 thsd at the end of 2003). During the year the number of unemployed has increased slightly owing to the ever-increasing number of unemployed persons legalising their status of unemployed. The highest unemployment rate is in Latgale where in several districts (those of Ludza, Rēzekne, Balvi, Daugavpils and Krāslava) it exceeds 20%. The lowest unemployment rate could be observed in Riga and the districts of Ogre, Riga, Saldus, Tukums and Jelgava.

¹ To achieve compliance with EU requirements, various changes including those in the age of respondents were made in the organisation of the CSB Labour Force Survey beginning from 2002. The age of the respondents was set at 15-74 years; previously the age of respondents had been 15 years and over. The analysis of employment and market trends deals with people aged 15-64 years and this corresponds to the EU practice.



Baltic countries

Main socio-economic indicators of the Baltic countries

	Estonia	Latvia	Lithuania
Territory, thsd km ²	45.2	64.6	65.3
Population as of January 1, 2004, thsd	1351	2319	3446
Gross domestic product, % of corresponding period of the previous year			
2003	105.1	107.5	109.7
2003: 1 st quarter	105.8	108.8	109.9
2 nd quarter	103.5	106.2	108.0
3 rd quarter	105.2	107.3	109.3
4 th quarter	106.2	107.5	111.5
2004: 1 st quarter	106.8	108.8	107.1
2 nd quarter	105.9	107.7	107.3
3 rd quarter	106.1	109.1	105.8
Industrial output index, %			
2003 against 2002	109.8**	106.5**	116.1
January - November 2004 against January - November 2003	107.0**	106.0**	110.0
Unemployment rate, %*			
2003	10.0	10.6	12.4
2004 1 st quarter	10.1	11.5	13.0
2 nd quarter	10.0	9.9	11.3
3 rd quarter	10.0	10.0	10.6
Consumer price changes, % against previous year			
2003	1.3	2.9	-1.3
2004	3.0	6.2	2.9
Producer price changes in industry, %			
2003 against 2002	0.2	3.2	-0.5
December 2004 against December 2003	3.9	11.4	6.8

* Persons aged 15-74 years.

** Short-term statistics for 2003 and 2004.