



Ministry of Foreign Affairs of the Republic of Latvia

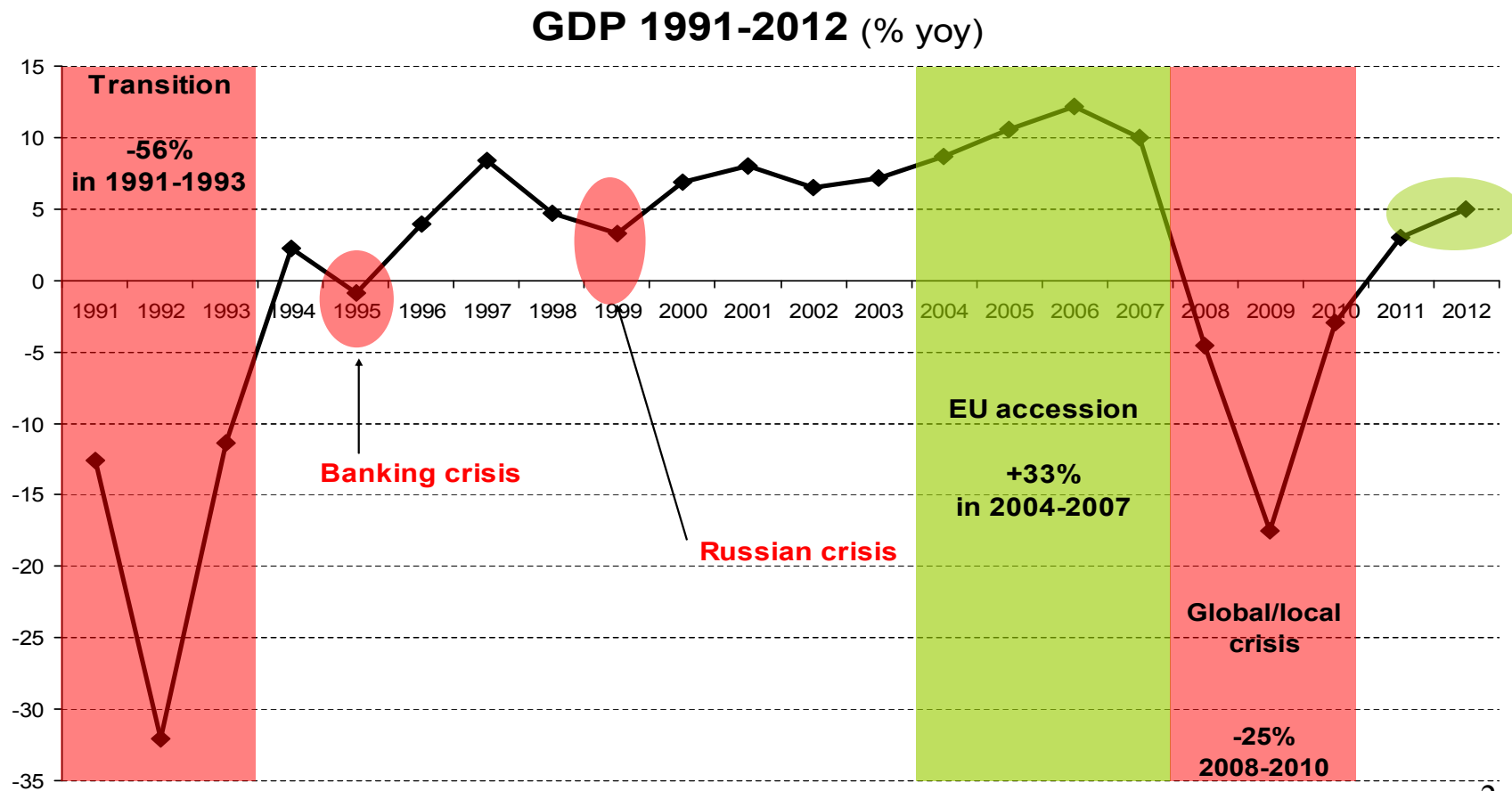
Latvia during the global economic and financial crisis

Second Japan – Baltic Seminar

1 December 2009, Tokyo

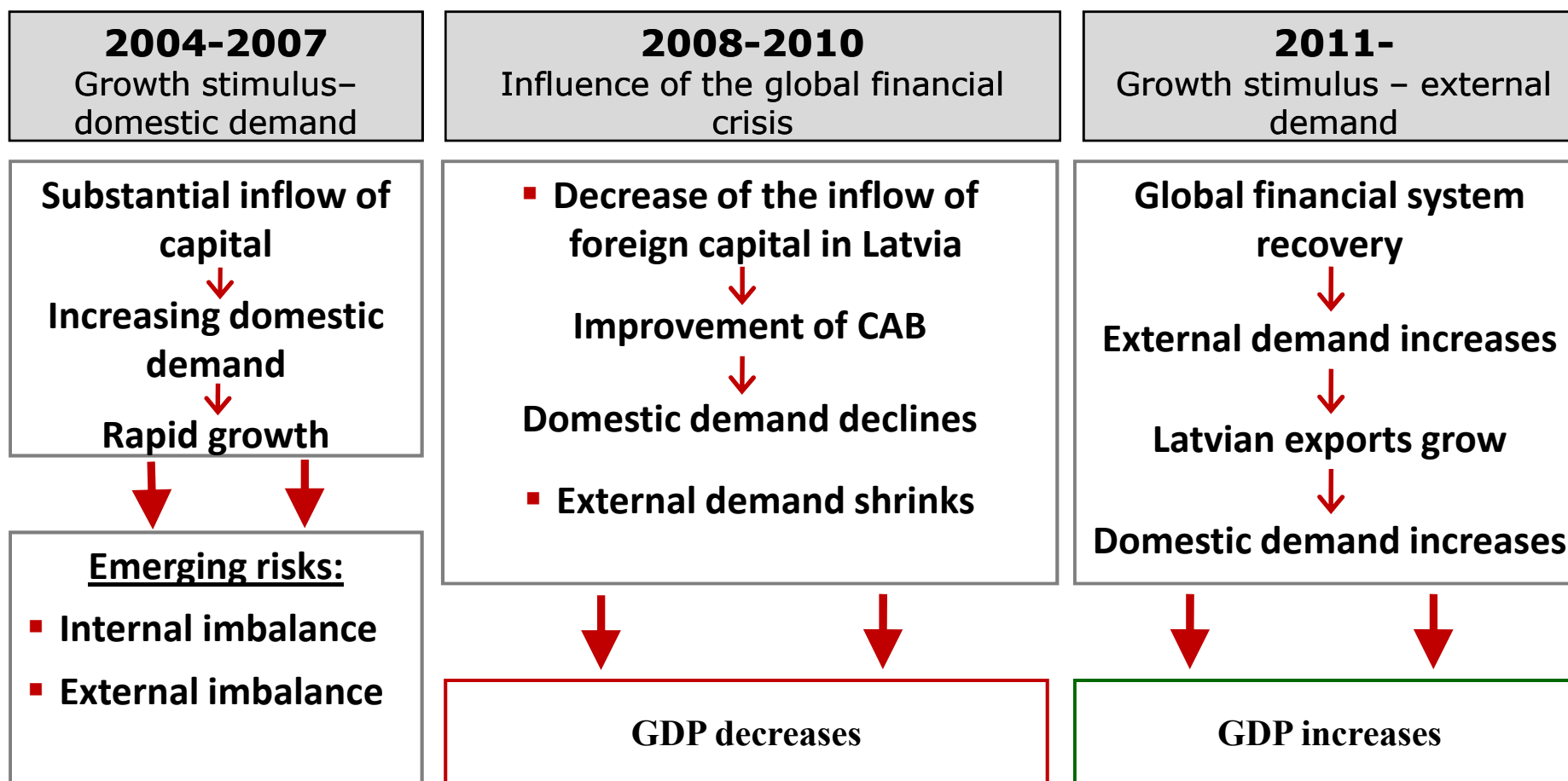


Different experience behind, challenges ahead





Development trends of economy





Main reasons behind the severe crisis in Latvia

Expansionary fiscal policy in the booming times - no reserves for tougher times

The real estate bubble:

- real estate prices increased 6.5 times
- the increase in wages – only 2.5 times (June 2001- December 2006)
- partially financed by credit (50% per year growth in 2003-2007);

Inflation without corresponding productivity growth eroded Latvia's competitiveness
(in 2008 inflation was 15.4%)

Large current account deficit (>25% of GDP in 2006)

Global financial crisis at the end of 2008 hit also Latvia's banking system (bail-out of the largest domestically-owned commercial bank worth 1.9% of GDP directly and 5% indirectly)



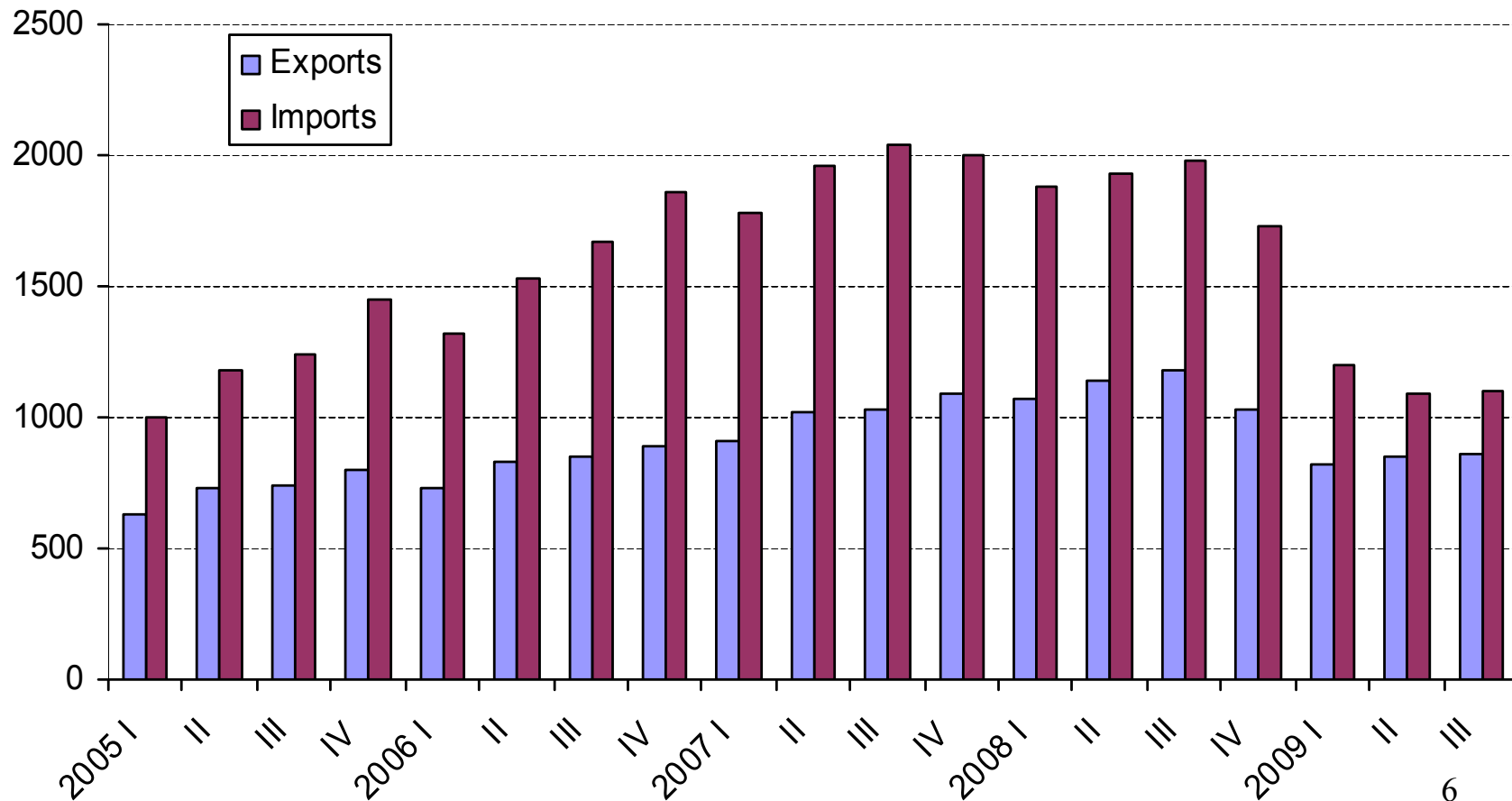
Macroeconomic indicators of Latvia in 2009

- **The economy of Latvia is still in the correction phase from the huge imbalances accumulated during the years of overheating, but stabilisation signs start to appear:**
 - In Q3 2009 GDP dropped by 18.4% (seasonally non-adjusted, year-on-year), while on quarter-to-quarter basis there was an increase by 3.9% (positive already for 2 periods);
 - The overall industrial production output has slightly increased (in Q3 2009 increased by 0.5% compared to Q2 2009);
 - Several industries display growth on a yearly basis (wood and chemical up by 17% and 8% respectively);
- **The enormous contraction of the economy induces changes in the labour market and the job market is returning under the control of the employers:**
 - Registered unemployment level has grown to 14.1% in October 2009;
 - In Q2 2009 the average real wage compared to the previous year's value was lower by 3%, while in the state budget sector the nominal wage cut was approximately 22%;
- **There are clear signs for increased Latvia's competitiveness:**
 - Year-on-year inflation in October 2009 was negative with deflation of 0.9%, while on a monthly basis prices have been decreasing already for 7 months, averaging to 0.5% per month;
 - Current account deficit has turned into a surplus (from -13% in 2008 to +1.3% in Q1 2009, and approximately +14.2% of GDP in Q2 2009).



Foreign trade is renewing

Exports and imports of goods by quarters (LVL mln)

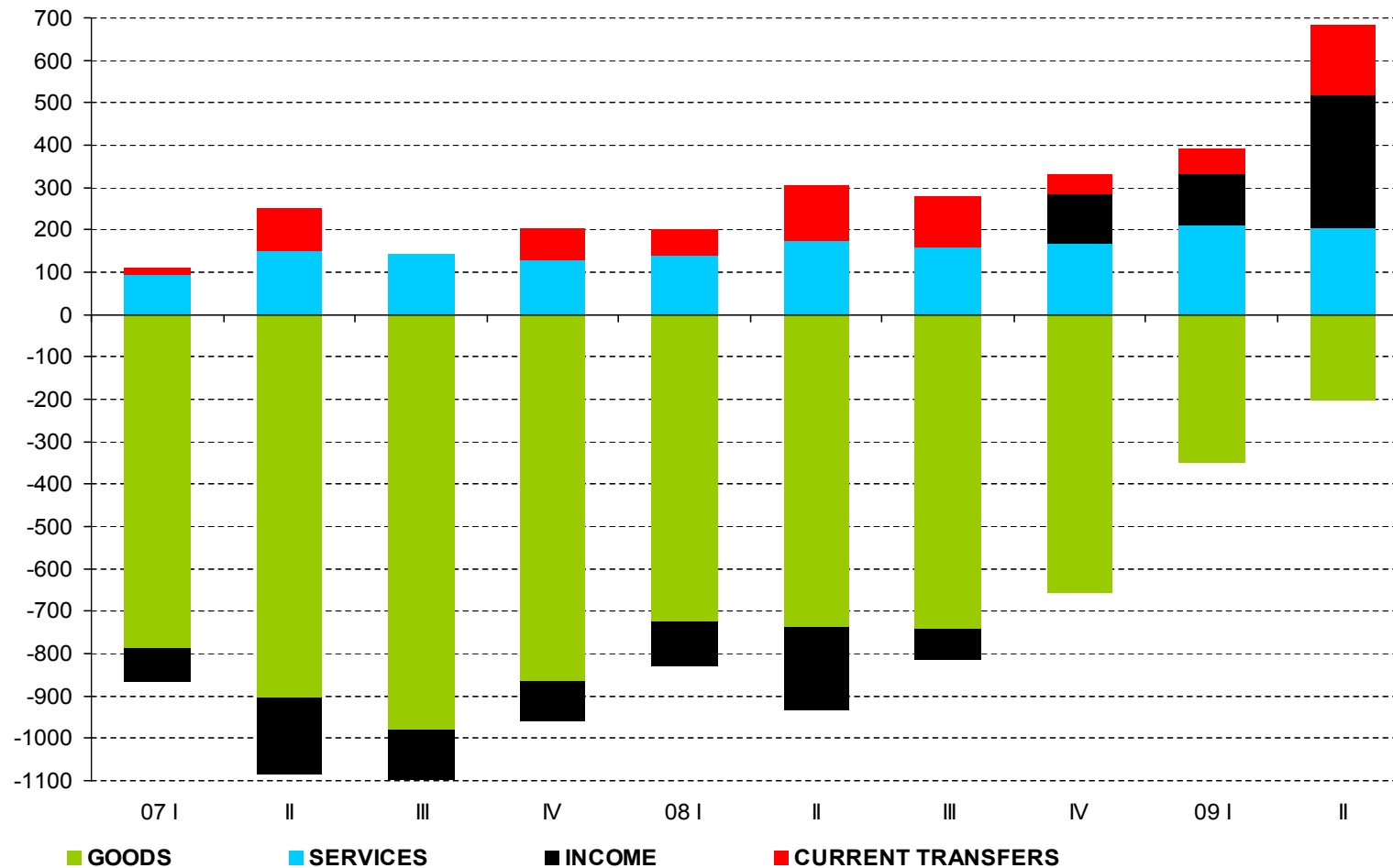


Source: CSB



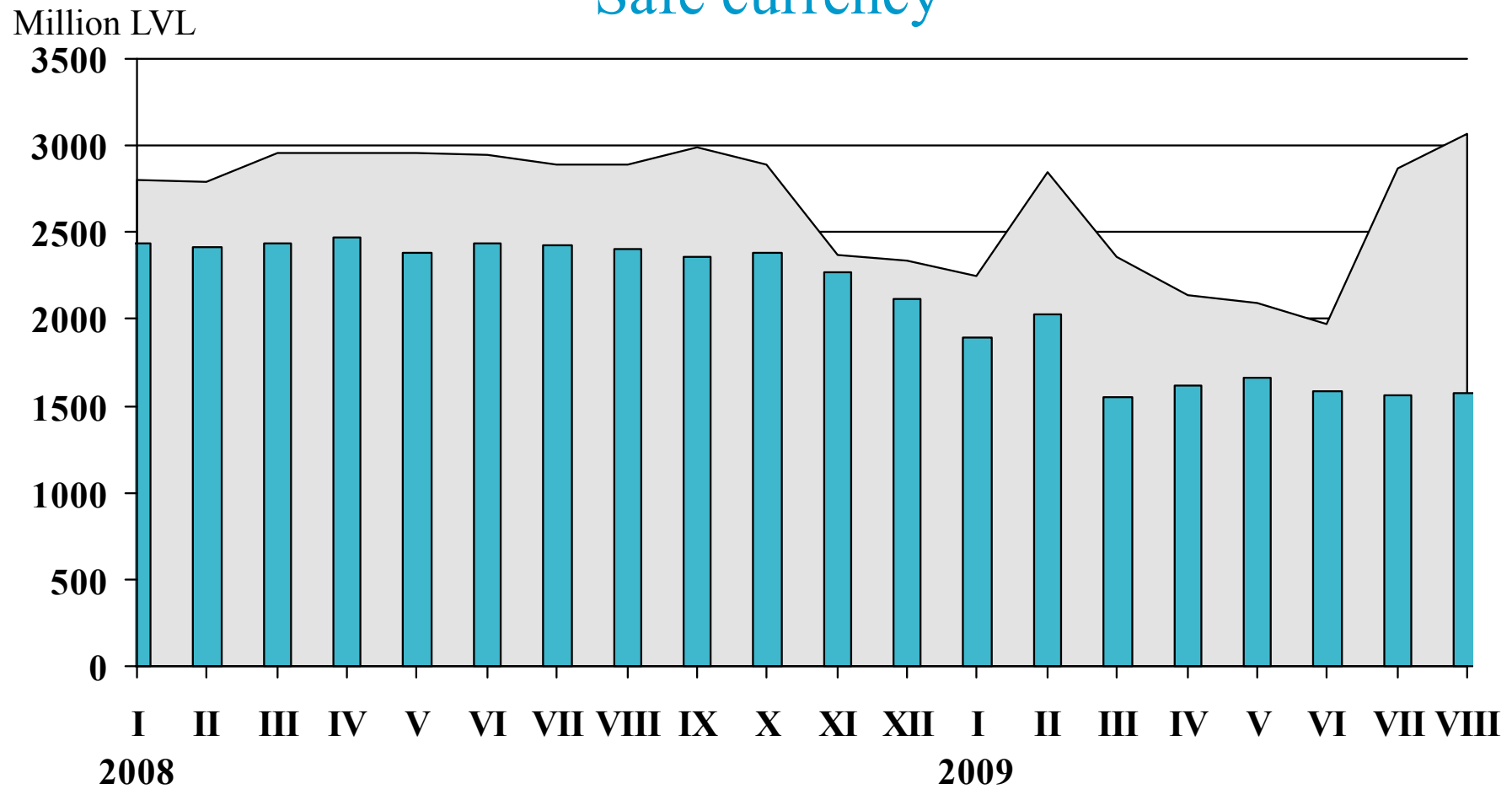
Astonishing surplus in current account

Current account (LVL m)





Safe currency



Net foreign assets

Monetary base



International Financial support

- **EUR 7.5 billion available**

- 40% of GDP 2009

- 40% taken by now

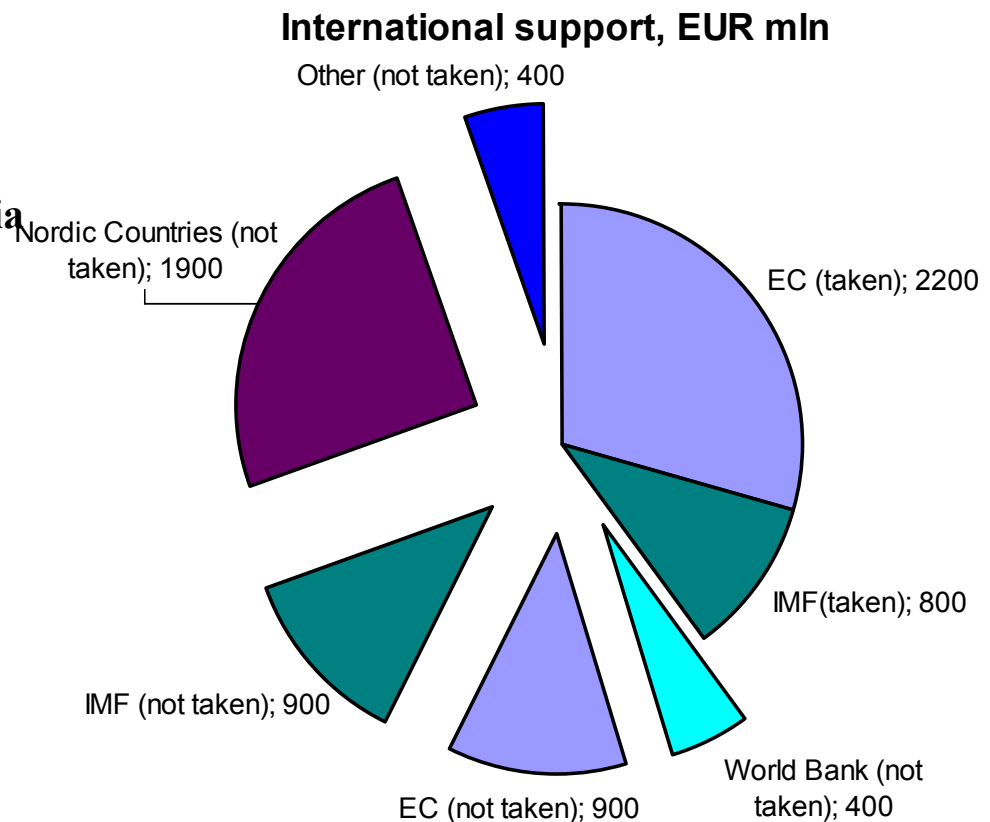
- **The financial support has allowed Latvia to, i.a.:**

- Cover budget deficits

- Refinance the government liabilities

- Support the banking system

- NB - close to 50% of the received funds were held in the Treasury to ensure the stability of financial sector**





Program for stabilization and growth revival of the national economy (I)

Goals:

- to stabilise the economy;
- to evade possible liquidity problems;
- to renew long-term stability – by strengthening the banking sector, preventing fiscal imbalances, and preserving stable monetary policy;
- to improve the competitiveness of the national economy to reach sustainable GDP growth and balanced state budget as soon as possible.



Program for stabilization and growth revival of the national economy (II)

- **Strict and stable monetary policy, which is based in fixed exchange rate of the national currency to the euro.** The do all the necessary steps to fulfill the Maastricht criteria that would ensure introduction of the euro as soon as possible – by 2014;
- **Strict fiscal policy.** Consolidation measures to decrease the budget deficit in 2012 by up to 3% of GDP;
- **Decreasing of remuneration.** Reductions of wages and the employed in the public sector and to encourage understanding and agreement with the private sector to promote the moderation of wages in all sectors;



Program for stabilization and growth revival of the national economy (III)

- **Continuation of making state administration more effective and efficient, carrying out of education, health, and other public services reforms** by decreasing and restructuring of human resources in these sectors and optimise ministries and their subordinate agencies in terms of activity and number of institutions;
- **Increasing the flexibility of labour market** by fostering requalification and returning to work of the unemployed;
- **Stabilisation of financial sector.** Provision of state aid for strengthening of credibility and work ability of credit institutions hand in hand with intensified supervision of credit institutions;



Program for stabilization and growth revival of the national economy (IV)

- **Maintaining of social protection activities to lower social tension;**
- **Decreasing the administrative burden:**
 - simplifying the processes of tax administration, real estate registration, receiving construction permits, as well as by promoting a wider usage of the state integrated information systems among institutions and enterprises;
 - The state and the municipal governments implement the measures to foster the development of entrepreneurship and to facilitate business registration and licensing procedures;
 - In order to improve the processes of business insolvency and liquidation, the government has drafted amendments to the Insolvency Law;
 - Legal framework for PPP projects is improved;



Program for stabilization and growth revival of the national economy (V)

- **Improving economic competitiveness by concentrating the financing of the EU structural funds.**
 - EUR 4.53 billion (20% of GDP 2009) available by year 2013. Almost 20% of the funds or close to EUR 1 billion for stimulating entrepreneurship;
 - Loan instruments, guarantees by the Latvian Guarantee agency and the State Treasury, risk capital instruments, advance payments for projects financed from the EU funds to be implemented;
 - Several programmes have been launched aimed at promotion of knowledge-based economy;
 - The export credit guarantee system that has been introduced as of 1 June 2009;
 - The programme on the improvement of energy efficiency of apartment buildings has been launched.



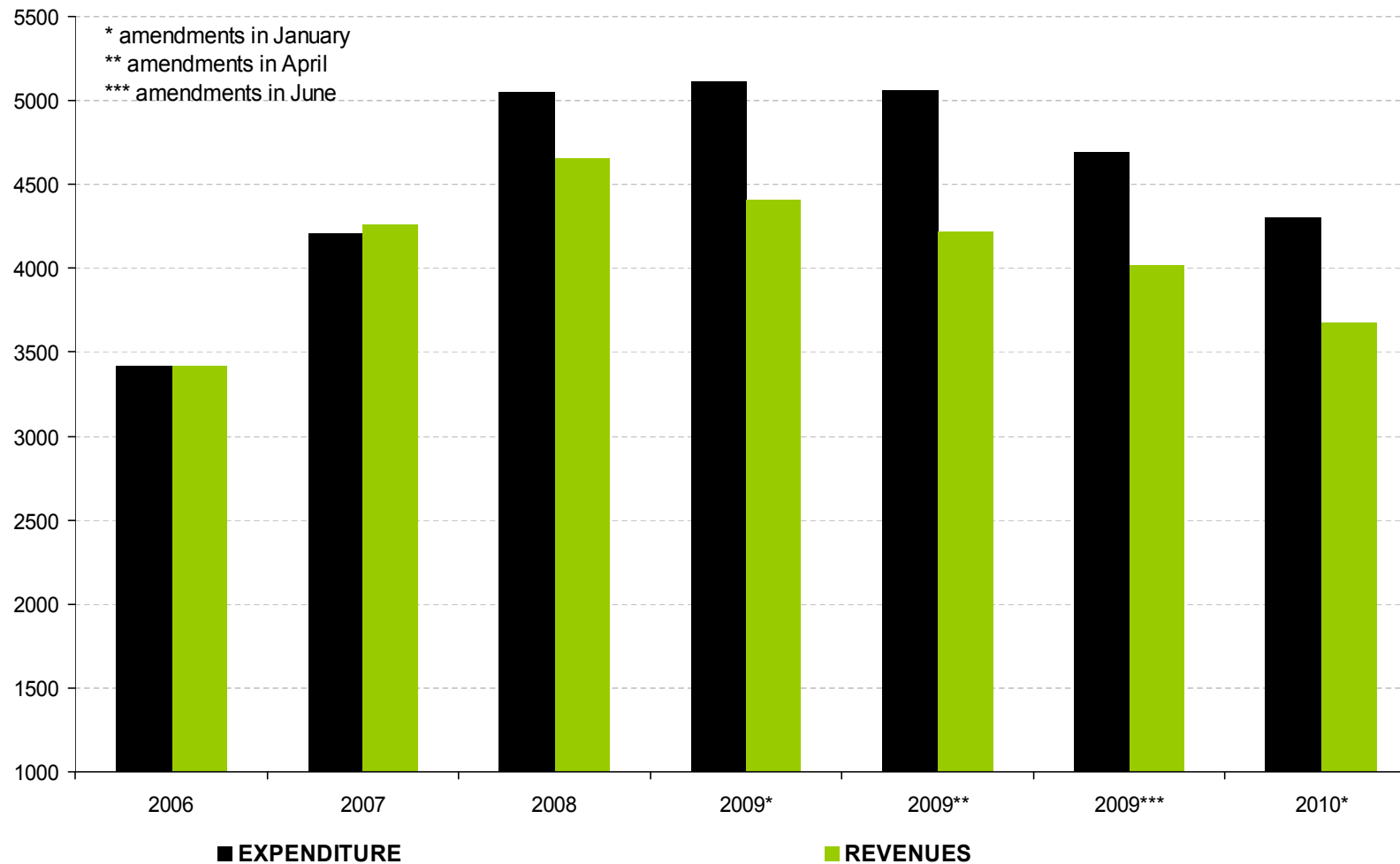
Budget 2010

- **Screening of the state budget expenditures according to functions;**
- **Domestic and external experts, social partners involved;**
- **Takes into account the agreements reached with international donors;**
- **Budget deficit of 6.5% of GDP 2010:**
 - Consolidation by 4.2% of GDP 2010;
 - Well below the 8.5% agreed with the IMF and the EC;
- **Budget 2010 to be passed in Parliament today (1 December 2009).**



Fiscal consolidation will continue

Central government budget deficit (mln. lats)





Consolidation measures/ structural reforms (I)

- Structural reforms/ optimizations:

- # of employees in ministries ↓ (-30%)
- # of state agencies ↓ (76→25)
- Nominal wages in public sector ↓ (-22%) (Q2 2009 (y-o-y))
- Unified salary system in public sector
- # of hospitals ↓ (59→24)
- # of schools ↓ (# closed ~100)
- Administrative burden ↓ (e.g. easing the VAT related procedures)



Consolidation measures/ structural reforms (II)

•Revenues:

- Excise tax ↑
- Real estate tax base ↑
- Capital gains tax for deposits, dividends – introduced
- Gambling tax ↑
- VAT ↑ (18→21%)
- Non-taxable minimum ↓
- Dividends from state owned companies ↑
- No changes planned in Corporate Income tax

•State guarantees for loans:

- To improve competitiveness
- For exports to risky destinations
- For self-employed and micro companies



Outlook for 2010

The GDP decline has bottomed out in 2009. In 2010 the GDP contraction is expected to be around 4% with positive GDP growth in the second half of 2010.

At the end of 2010 the registered unemployment level is expected to be close to the value today.

The internal devaluation process will keep its momentum – the wages are expected to further adjust so to reach the real level of Latvia's productivity.

The negative wage growth will also be reflected in the inflation – the overall yearly average inflation will be negative in 2010.

The latter two factors will have a positive impact on Latvia's competitiveness, notably it will be displayed in Latvia's export dynamics. In 2010 Latvia's exports are expected to resume growth on a yearly basis.

In 2010 the internal market is still expected to shrink, therefore we expect also continuation of the decrease in imports.