# Atradius Country Report

## Latvia – February 2009


## Overview

**General information**

Capital: Riga
Government type: Parliamentary democracy
Currency: Lat (LVF)
Population: 2.4 million
Status: Upper middle income country (GDP/capita: US-$ 14,833 in 2008)

**Most important sectors (% of GDP, 2007)**

Services: 75 %
Industry/mining: 22 %
Agriculture: 3 %

**Main import sources (2007)**

Germany: 15 %
Lithuania: 14 %
Russia: 9 %
Poland: 7 %

**Main export markets (2007)**

Lithuania: 15 %
Estonia: 14 %
Russia: 13 %
Germany: 8 %

**Main expenses of foreign exchange**

Services (trade, transports, finance etc.), capital goods

**Main sources of foreign exchange**

Timber products (40%), textiles, food, (financial) services

## Key indicators

| | 2005 | 2006 | 2007 | 2008* | 2009** |
|---|---|---|---|---|---|
| GDP (US-$ million) | 16,034 | 19,950 | 27,154 | 33,986 | 31.623 |
| Real GDP growth (%) | 10.6 | 12.2 | 10.3 | -2.0 | -5.5 |
| GDP per capita (US-$) | 6,971 | 8,712 | 11,910 | 14,833 | 13,809 |
| Inflation p.a. (%) | 6.7 | 6.6 | 10.1 | 15.8 | 6.0 |
| Fiscal balance (% of GDP) | -1.0 | -0.3 | 0.7 | -1.5 | -4.5 |
| Total foreign debt (US-$ million) | 14,505 | 22,795 | 33,531 | 38,597 | 36,557 |
| Foreign debt/GDP (%) | 90 | 114 | 123 | 114 | 116 |
| Foreign debt/XGS (%) | 175 | 231 | 250 | 278 | 259 |
| Short-term debt/inter. reserves (%) | 323 | 245 | 227 | 267 | 250 |
| Debt service ratio (%) | 39 | 33 | 32 | 38 | 41 |
| Current account balance (US-$ m.) | -1,991 | -4,552 | -6,485 | -5,084 | -2,832 |
| Current account/GDP (%) | -12.4 | -22.7 | -23.9 | -15.0 | -9.0 |
| Nom. exchange rate to US-$ (average) | 0.59 | 0.54 | 0.48 | 0.51 | 0.52 |
| International reserves (US-$ million) | 2,319 | 4,270 | 5,393 | 4,200 | 3,800 |
| In months of merchandise imports | 3.2 | 4.5 | 4.3 | 3.2 | 3.2 |

* estimated    ** forecast    Source: Economist Intelligence Unit (EIU)

## Political situation: Unstable coalition

| | |
|---|---|
| **Head of state:** | President Valsdis Zatlers (since July 2007) |
| **Head of government:** | Prime Minister Ivars Godmanis (since December 2007) |
| **Form of government:** | Centre-right coalition of the People's Party, First Party/Latvia's Way, Union of Greens and Farmers and For the Fatherland and Freedom party |

### Internal political situation

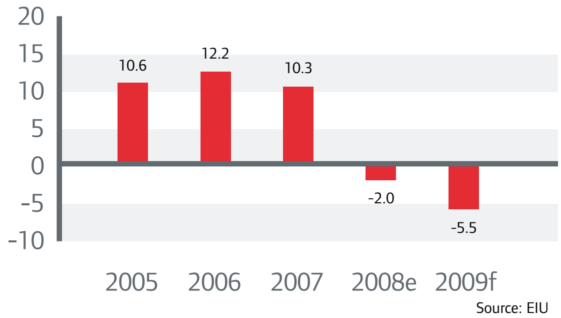
Since its independence in 1991 Latvia has been governed by frequently changing coalitions. Despite many personal rivalries in Latvia's politics, the country's broad political consensus aimed at market-oriented economic policies and close alignment to the West has not been at risk. But this may change now that Latvia has been severely hit by the credit crisis. In January 2009 popular dissatisfaction with the government, especially with its economic policy, caused the worst riots since the struggle for independence.

### External political situation

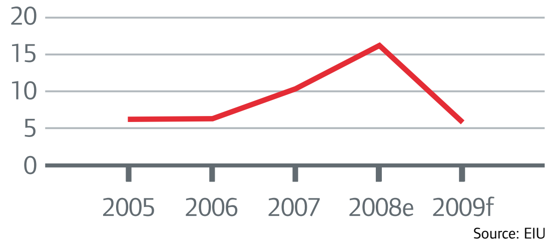
A large Russian speaking minority (approx. 35 % of the population) is a constant source of tension with Moscow. Relations have also been strained by Latvia's strong condemnation of the Russian invasion of Georgia.

## Internal economic situation: Hard landing and deep recession

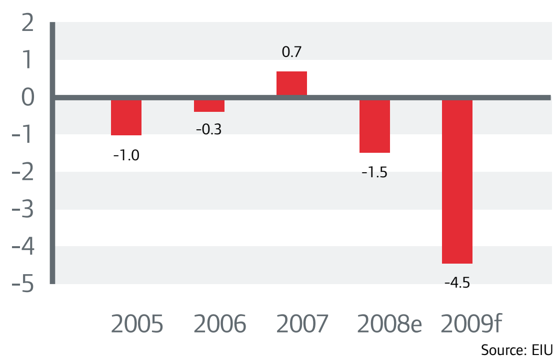
**Real GDP growth (%)**




**Inflation p.a. (%)**




**Fiscal balance (% of GDP)**



**General situation**

After years of record high GDP-growth (more than 10% p.a.), the Latvian economy is experiencing a hard landing and a deep recession. In 2008 real GDP-growth contracted by 2 %. This year real GDP-growth will contract even more: probably by 5 %. Domestic demand has collapsed due to tighter credit conditions, falling real estate prices and high inflation. Retail trade and construction are worst hit. Exports are adversely affected too, by the economic crisis in Latvia's main export markets. Rising wages, food/ energy prices and excise duties stoked inflation to 17.9 % in May 2008, only gradually levelling off (13.8 % in October 2009). Serious labour shortages have led to high unit labour costs, thereby eroding the competitive position of industrial exports and impeding new foreign direct investment. This has also led to the relocation of some production capacity to the Commonwealth of independent stats and Asia.

This hard landing is aggravating the credit risk as the private sector is heavily indebted (mainly in Euros). The banking sector was faced with a run on deposits in the last months of 2008. This has forced the government to finally nationalise Parex, a major locally-owned bank, to prevent it from failure. Except for Parex, the financial sector is mainly Nordic-owned and expected to be strong enough to withstand a drain on reserves.

**Economic policy**

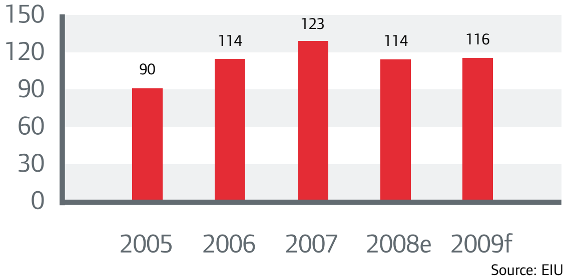
The intervention to save Parex and other measures will strongly weaken Latvia's budgetary position, as public sector debt is expected to rise from less than 10 % of GDP to about 34 % of GDP this year. Higher public sector tariffs have cancelled out the positive impact of global drop of oil- and food prices on inflation.

End of 2008 Latvia received a massive international standby package totalling € 7.5 billion to stabilise the economy, with contributions from the International Monetary Fund (IMF), the European Union and some Nordic countries. This aid had become urgent in order to tackle Latvia's structural weaknesses and to consolidate its eroded level of international reserves: since mid-October the central bank had already spent 20% of its foreign currency reserves to defend the lat, which is pegged to the euro in the European Exchange Rate Mechanism (ERM) II.

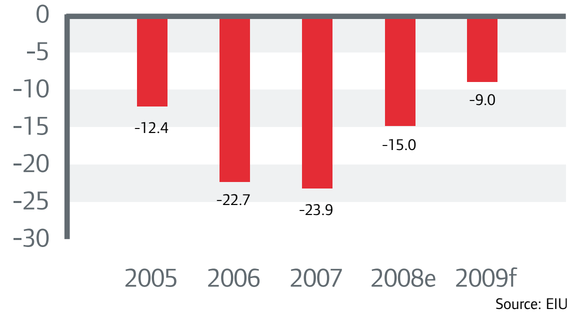
The international standby agreement imposed tough demands on Latvia for fiscal measures to trim both the current account deficit and inflation. The government has already launched tax rises as well as wage and spending cuts, which led to the earlier mentioned public protests.

## External economic situation: Precarious

**Foreign debt/GDP (%)**




**Current account/GDP (%)**




### Foreign debt

| | |
|---|---|
| Level: | Very high: US-$ 38 billion by the end of 2008 (114 % of GDP, 278 % of exports of goods and services) |
| Structure: | Unfavourable: approx. 30 % short-term |
| Debt service ratio: | High: 38 %, very high 45 % including short-term deposits |

Remarks:
Foreign debt has more than trebled since 2004: more than 90 % of it held by the private sector. The debt largely comprises funds from foreign (parent) banks and from Russians. In December 2008 the IMF approved a 27-months € 1.68 billion standby loan, to be disbursed in nine instalments. This is part of a package of international support totalling € 7.5 billion, of which the EU contributes € 3.1 billion and Nordic countries € 1.8 billion.

### Balance of payments

| | |
|---|---|
| Trade balance: | Very large deficits – declining because of lower imports |
| Current account: | Decreasing, but still high deficits (9 % of GDP in 2009) |
| Capital account: | Surpluses |
| Total Account: | Negative in 2008 |

Remarks:
The huge trade and current account deficits are only partly covered by FDI; the remainder coming from EU funds and borrowing by Latvian banks from their foreign parents to facilitate domestic lending to the private sector. The lat is pegged to the euro within a 30 %-margin, but the central bank aims to keep it within a +/- 1 %-band. The currency is constantly under pressure as worries mount over Latvia's ability to finance its external gaps. Due to the high short-term deposits, the short term debt/reserves ratio is very unfavourable.

### International reserves

| | |
|---|---|
| In months of imports (cif): | Declined by 20 % to less than 3 months of import cover in the last quarter of 2008 after central bank interventions to prop up the lat. Net foreign assets have become strongly negative. |

## Prospects: Alarming for the time being

### Political situation

In view of growing tensions within the government and corruption allegations against some members of the ruling parties, the coalition is unlikely to survive until the next general election - due in October 2010. Therefore an early election this summer looks likely. More social unrest over the austerity measures is expected, adding to the instability of the domestic political situation.

### Economic situation

Latvia will face a deep recession in 2009 (a real GDP-decline of at least 5.5 %) and the outlook for a recovery in 2010 remains very uncertain. The conditional multilateral aid has to pave the way for the preservation of the monetary policy and the pegging of the Lat to the euro. Despite this massive external support, it remains uncertain whether, in the end, a devaluation of the Lat can be staved off. The high indebtedness (mainly in euro) and falling property prices have already led to a high credit risk for many private debtors. Any devaluation would therefore severely hit unhedged Latvian private debtors and also further weaken the loan portfolio of banks. Furthermore, it could also trigger a currency crisis in the two other Baltic States (Estonia, Lithuania) whose currency is also pegged to the euro.

Latvia will not enter the eurozone before 2013 at the earliest. Before that can happen, the country will experience more years of austerity, social hardship and serious finance imbalances.