



The following is a brief summary of Latvian economic developments based on an IMF Staff report and includes excerpts from the © 2009 International Monetary Fund January 2009, IMF Country Report No. 09/3

BACKGROUND ON ECONOMIC DEVELOPMENTS IN LATVIA: IMF STAFF REPORT

Since 2000, Latvia's economy has grown extremely rapidly. From 2000 to 2007, GDP expanded at an average annual rate of 9 percent, the fastest in the EU. Per capita income rose from 37 percent to just under 60 percent of the EU27 average. Rapid growth initially reflected utilization of excess capacity (after the Russian crisis) and productivity gains from successful reforms. Growth further accelerated after EU accession in 2004, driven by private sector capital inflows and EU funds, although sizable outward migration dampened potential growth.

BUT BY MID-2006 THE ECONOMY WAS OVERHEATING:

- **Credit grew at an annualized rate of more than 50 percent** even though the stock of credit (70 percent of GDP at end-2005) had risen to close to the EU average. Real estate prices jumped more than 60 percent in both 2005 and 2006.
- **Domestic demand grew excessively**, especially private consumption and real estate investment, so that the current account deficit peaked in late 2006 at more than 25 percent of GDP.
- **Wage and price inflation accelerated in early 2007**, with core inflation rising to almost 10 percent year on year by mid-2007. The CPI-based real effective exchange rate appreciated by 15 percent from EU accession to end-2007. Substantial wage increases and low productivity growth meant the ULC-based real exchange rate appreciated even more rapidly.
- **Pro-cyclical fiscal policy contributed to the boom.** Real expenditure grew by 80 percent between 2003 and 2007 as the authorities spent cyclically strong tax revenues and began receiving substantial inflows of net EU grants. Staff estimates a cumulative fiscal stimulus of more than 6 percent of GDP through end-2007, while output exceeded potential by 9 percent.

RECENT DEVELOPMENTS

The economy is now slowing rapidly. GDP started to level off from the fourth quarter of 2007, and this year is projected to fall by 2 percent. The main cause is a slowdown in lending that started in early 2007, driven by concerns among foreign banks about their overexposure to the Baltics. As a consequence, consumption and investment fell. While the overheated non-tradable sector needed to slow down, manufacturing output also dropped sharply due to weaker export demand and the lagged effects of the past deterioration in competitiveness. Wage growth has started to decelerate and employment to decline.

Tax revenues have slowed with economic activity, putting this year's budget targets out of reach. The government's original objective of a 1 percent surplus was abandoned this summer in favour of budget balance, but even this revised target will not be attained following weak end-year tax revenues, particularly VAT and other revenues linked to domestic demand. Despite attempts to cut appropriations at the end of the year, the deficit is expected to increase to around 3 percent of GDP.

The current account deficit is declining quickly, narrowing by more than 10 percentage points in the last year, to 13 percent of GDP in the third quarter of 2008. As the economy slows,

the contraction in the current account deficit has been driven by: (i) a rise in the trade balance of 7.8 percentage points, due to falling imports; and (ii) an increase in the income balance of 1.2 percentage points—due to falling profits and reduced earnings of direct investment by foreign investors.

DESPITE THE CURRENT ACCOUNT ADJUSTMENT, EXTERNAL VULNERABILITIES REMAIN SUBSTANTIAL:

- **Gross external debt has risen above 130 percent of GDP**, the highest among EU new member states.
- **External debt with original maturity below one year (including non-resident deposits at call) exceeds 50 percent of GDP.** An additional 12 percent of GDP in medium- and long-term external liabilities matures in the next year. Latvia is thus very exposed to the risk of a sudden capital stop.
- **Solvency concerns relate primarily to the private sector**, which has net external debt of 70 percent of GDP. The public sector is currently a net external creditor, though there is a risk that it will have to assume some private sector liabilities.
- **Banks' reported short-term liquid external assets are substantial (45 percent of GDP)** and provide some buffer against external outflows. However, the market value of these assets and the ability to realize these quickly in the current international financial environment has come into question.

Financial-sector risks accumulated during the boom are materializing rapidly, calling into question the value of bank assets. Two-thirds of bank loans are backed by real estate. Since most of these mortgages were issued at the peak of the real estate boom (since when real estate prices have fallen by a third), many of these will now have negative equity. The proportion of overdue loans has picked up; many of these will probably turn non-performing.

THE BANKING SYSTEM'S RELIANCE ON FOREIGN FUNDING - AND THE DIFFERENT FINANCING MODELS FOR DOMESTIC VERSUS FOREIGN OWNED-BANKS - CREATES ADDITIONAL COMPLEXITIES:

- **Almost 60 percent of the banking system is owned by banks from Sweden and other Nordic countries.** Loans from their parent institutions are these banks' main source of financing. Though parent bank share prices have come under severe pressure, these credit lines have been maintained, and 80 percent of these loans have maturity greater than one year. The introduction of financial support schemes by the home governments of these banks has boosted confidence and helped stabilize their deposits in Latvia. However, foreign bank ownership in Latvia is much lower than in Estonia and Lithuania (97 and 85 percent foreign bank shares).
- **The remaining banks are mainly domestically owned (though with a few small banks owned by investors from CIS countries).** These banks rely on more fragile forms of foreign financing, mainly short-term syndicated loans and non-resident deposits, which now face considerable redemption pressures given worsened global liquidity conditions. On the surface, reported liquidity and capital adequacy ratios suggest that these banks should be able to withstand a gradual deterioration of loan quality or a mild decline in deposits. However, solvency indicators for all banks were (somewhat artificially) boosted in October as banks reclassified parts of their securities portfolio as "held to maturity" in line with a new IFRS regulation, which allowed them to revalue their assets.

The Current Crisis The current international financial market turmoil has brought these vulnerabilities to a head. Markets have grown increasingly concerned over the sustainability of the peg, and the likelihood that contingent financial sector liabilities will have to be absorbed by the government. All three ratings agencies have recently downgraded Latvia, with Fitch and S&P currently assigning it their lowest investment grade ratings, both with negative outlook. Latvia's Eurobond spread has increased to around 600 basis points, while its CDS spread has flirted with

the 1,000 basis point level (Figure 9). Liquidity demands from non-resident depositors have aggravated these developments.

The banking system faces growing liquidity strains as deposit growth falters, which spill over into balance of payments problems (Tables 6 and 7): • **From end-August to end-November, system-wide deposits fell by 10 percent**, excluding valuation effects (the appreciation of the dollar artificially increases foreign currency deposits when measured in Lats). Non-resident deposits (almost half total deposits, and overwhelmingly in Latvian-owned banks) have fallen the most (13 percent since end-August). Parex Bank has faced the greatest problems, losing one quarter of its deposits since end-August.

- **The BoL has increased liquidity to meet these deposit withdrawals.** Since end-August the BoL has provided LVL 555m (€780 million, 3½ percent of GDP) in additional banking system liquidity. Out of this, LVL 195 million (€279 million) can be attributed to operations backed by the Treasury bills issued specifically for liquidity support of Parex Bank. In addition, earlier in the year the BoL released LVL 200 million in liquidity by lowering reserve requirements; further cuts in November and December release an additional LVL 380 million.
- **Increased liquidity has reduced central bank foreign exchange reserves.** Since end-August the BoL has sold around €900m in foreign currency: just under a quarter of official reserves.
- **An additional (prospective) balance of payments risk comes from Latvian banks' need to rollover €1.4 billion of syndicated loans** (roughly 5 percent of their liabilities) in the coming year.
- **Initial responses to Parex Bank's growing illiquidity failed to stem the deposit run.** At first the government reached a voluntary agreement with the former shareholders to take over only 51 percent of the bank. This agreement would have allowed the former owners to remain on the management board and retain significant influence over the bank's operations, and also granted them the right to buy back their shares one year later. This approach, which the authorities believed would persuade non-residents to keep their deposits, failed to stem the outflows. As a result, the authorities had to increase liquidity support— LVL 350 million (€ 500 million or more than 2 percent of GDP) from the Treasury and a net LVL 200 million (1¼ percent of GDP) from the BoL—to meet the deposit outflow. On December 1, the authorities also imposed a partial freeze limiting withdrawal amounts from large non-commercial private deposits, to conserve liquidity in Parex.

Left unresolved, Parex's problems could worsen the balance of payments crisis. Parex has €775 million (3½ percent of GDP) of syndicated loans maturing in February and June 2009, in addition to its €200 million Eurobond which is potentially callable. Thus risks in Parex could lead to a €1 billion capital outflow.

THE LATVIAN INSTITUTE

The Latvian Institute (Latvijas institūts) was established by the Latvian state to provide a wide range of information about Latvia, its society, culture and history.

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