



Latvia's Road to Recovery

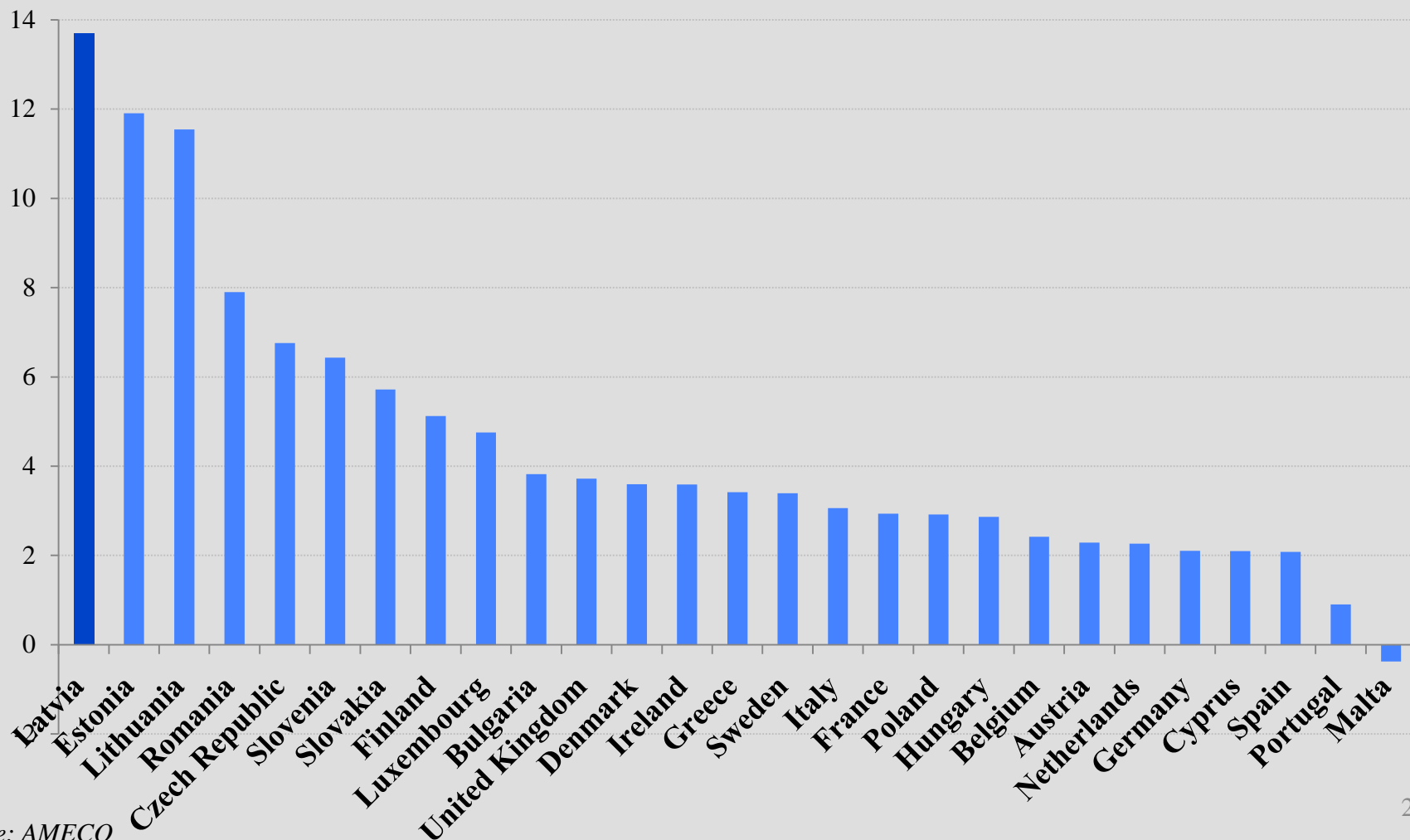
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Vienna, February 18, 2013

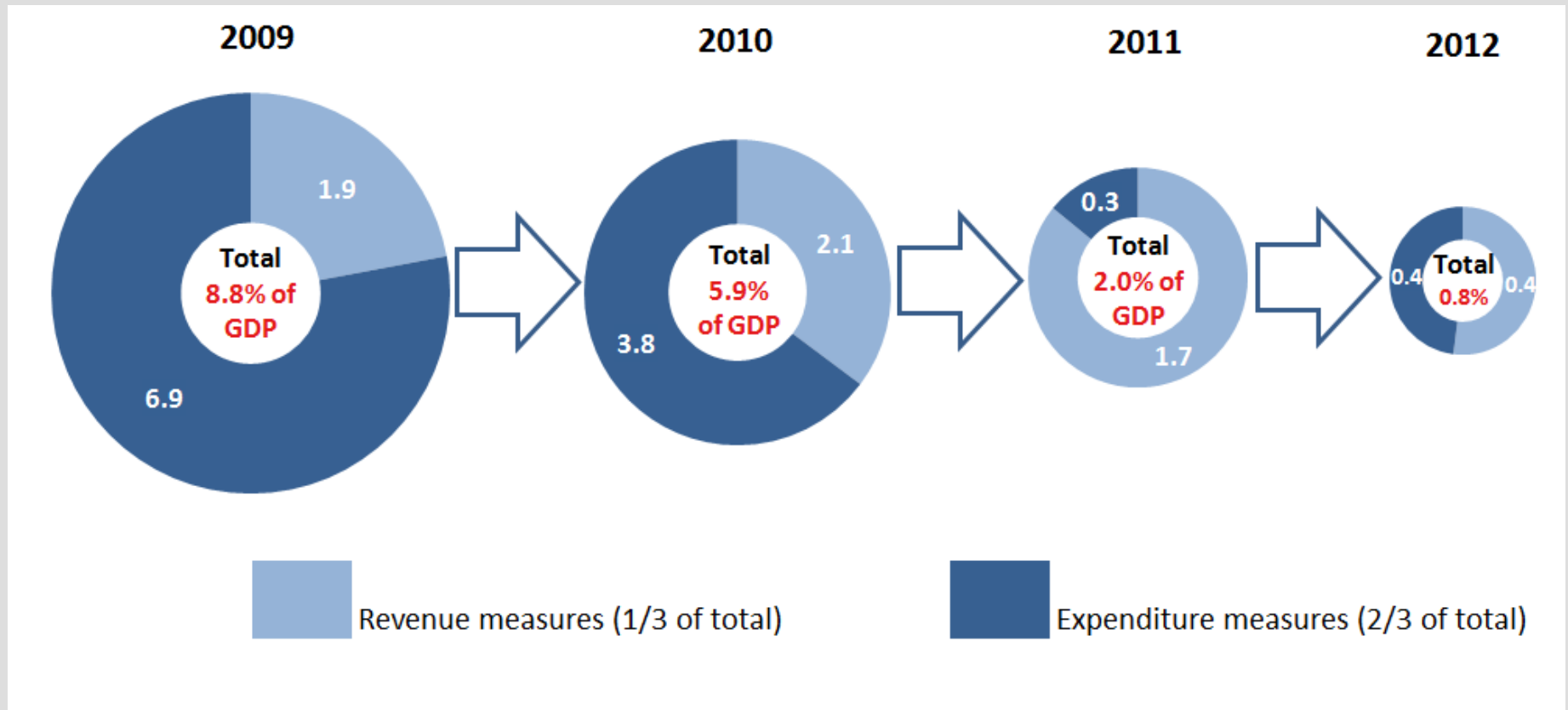
Starting point: Latvia entered past crisis as EU's most overheated economy

Output gap in 2007, %



Policy choice: frontloaded fiscal consolidation underpinned by structural reforms

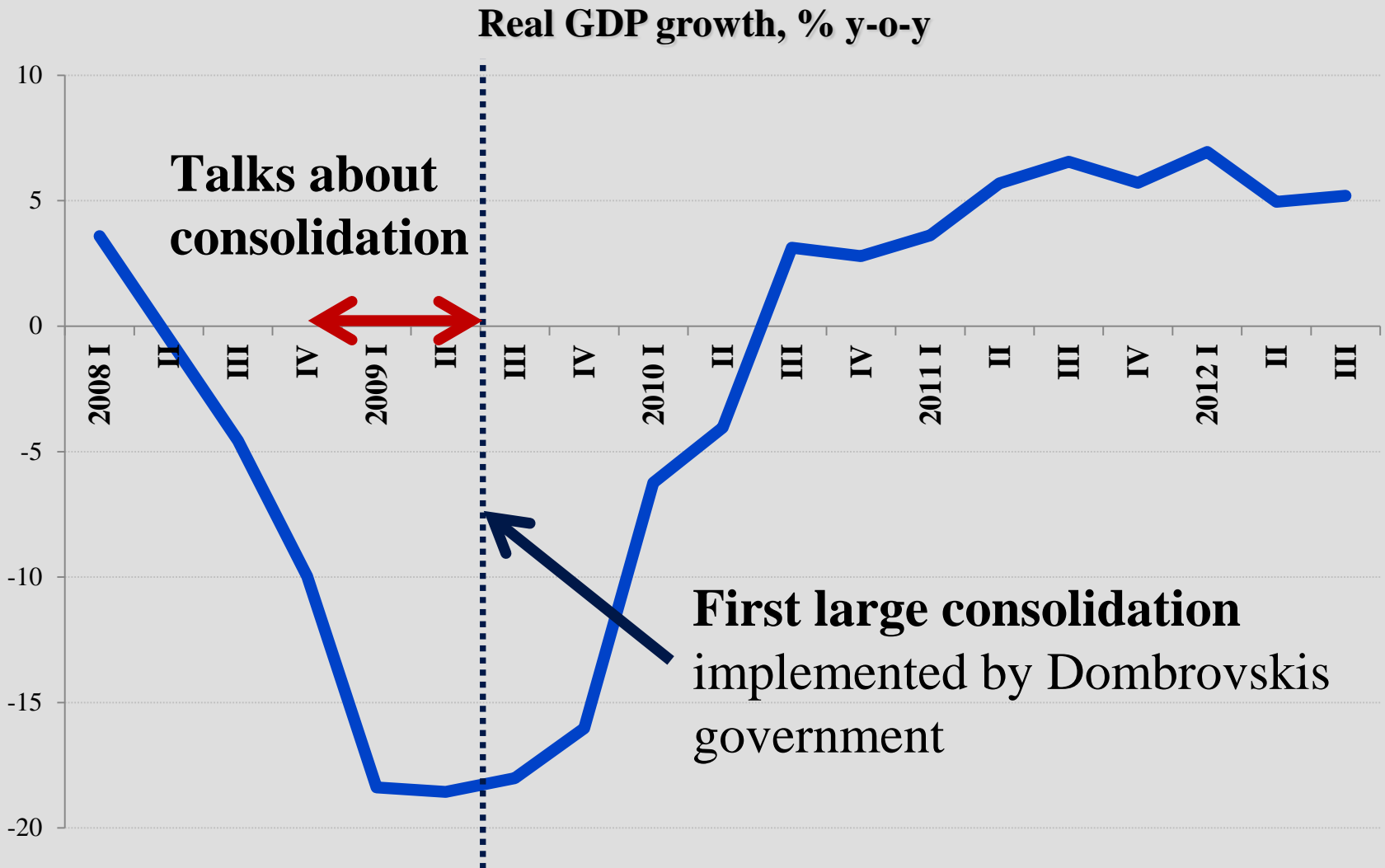
Breakdown of budget consolidation measures, % of GDP



Key reform areas

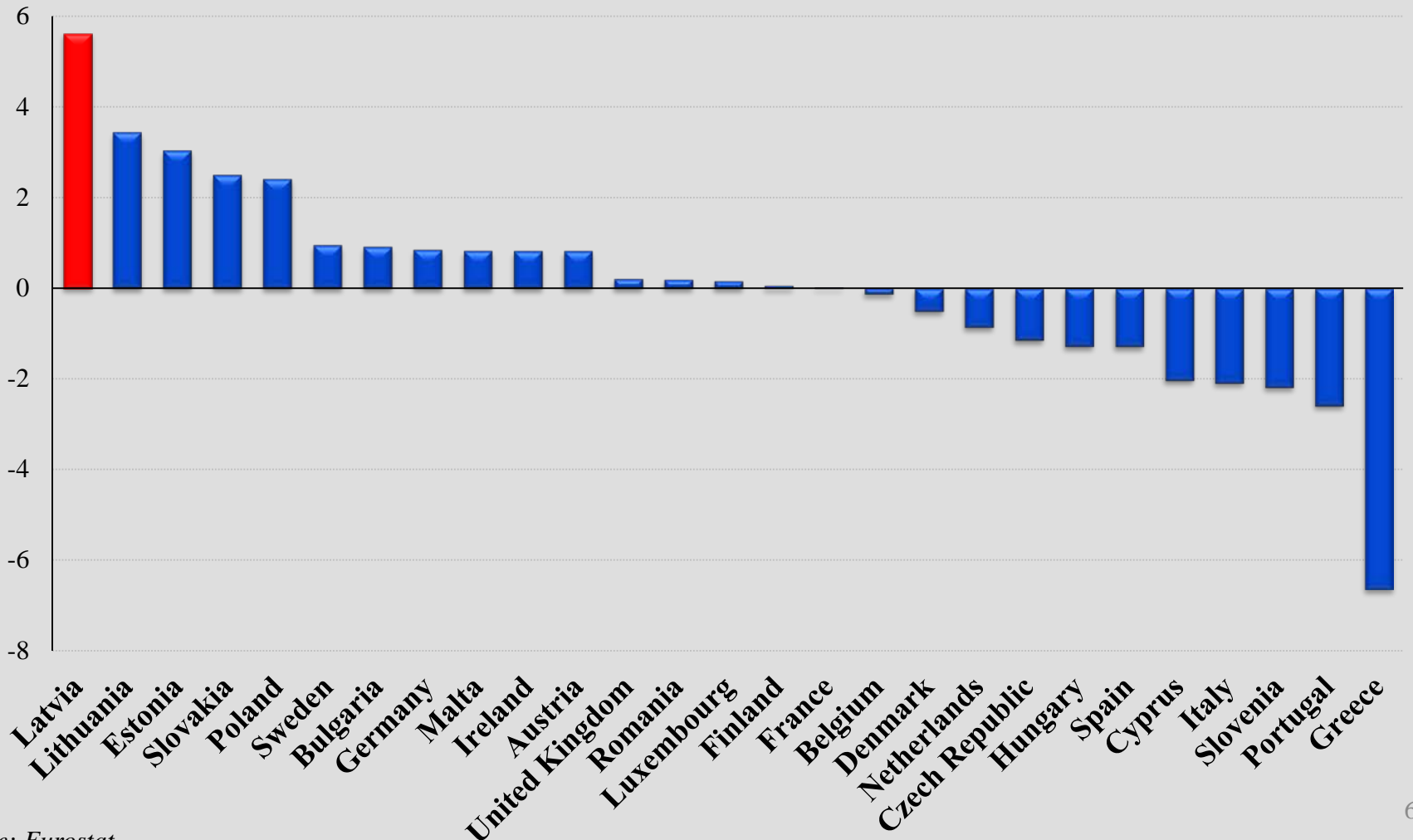
- Increased efficiency of public administration, education and health sectors
- Decreased red tape to encourage private entrepreneurship, improved allocation of EU funds
- Product and labour market reforms
- Strengthened financial sector regulation
- Improved fiscal governance
- Tax reform
- Pension reform
- Strengthened social safety nets

GDP growth resumed with the adoption and implementation of the first large consolidation package



Today Latvia is again the fastest growing EU economy, but this time with sound fundamentals

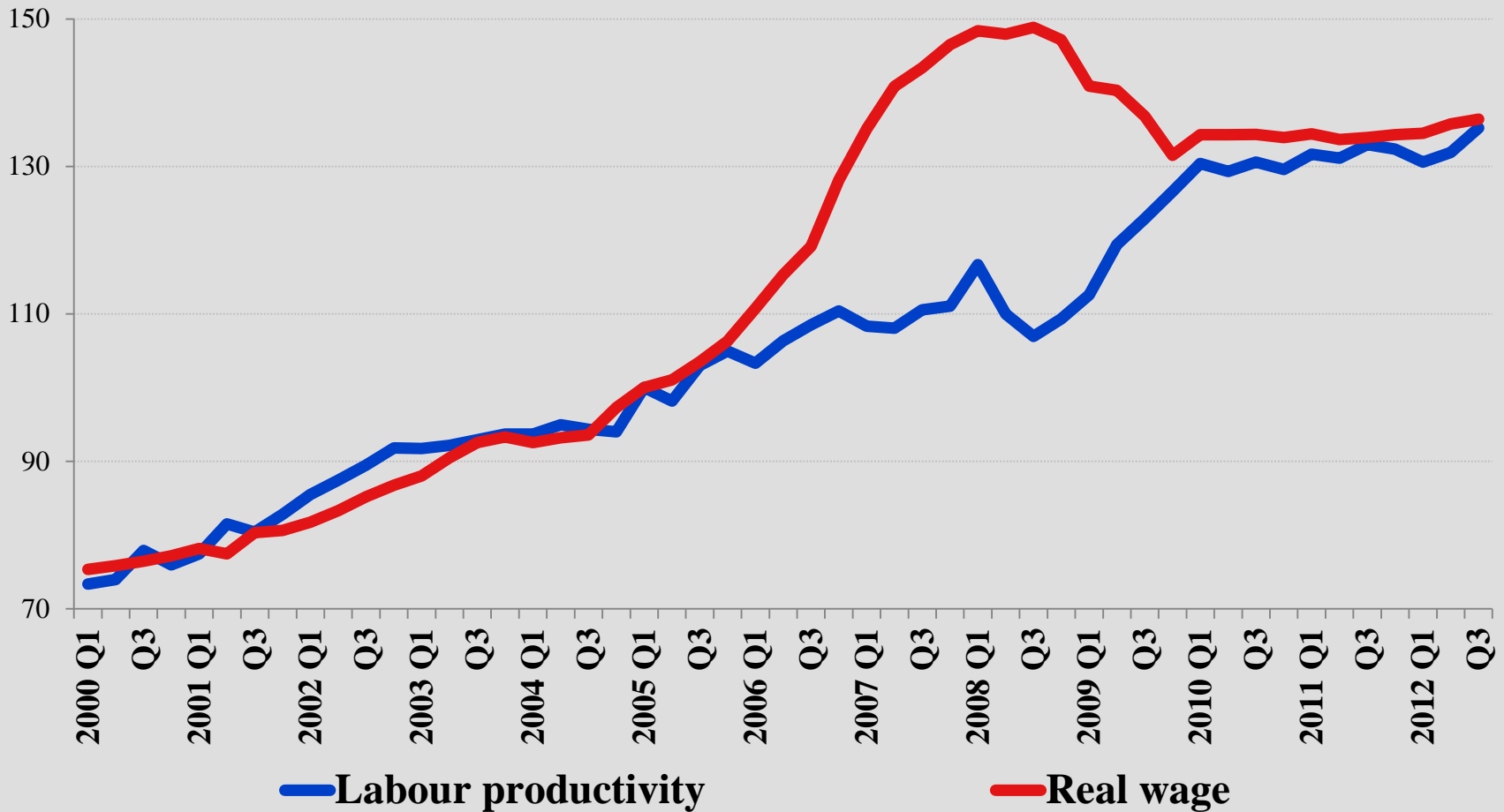
GDP growth in the first three quarters of 2012 (% y-o-y)



Source: Eurostat

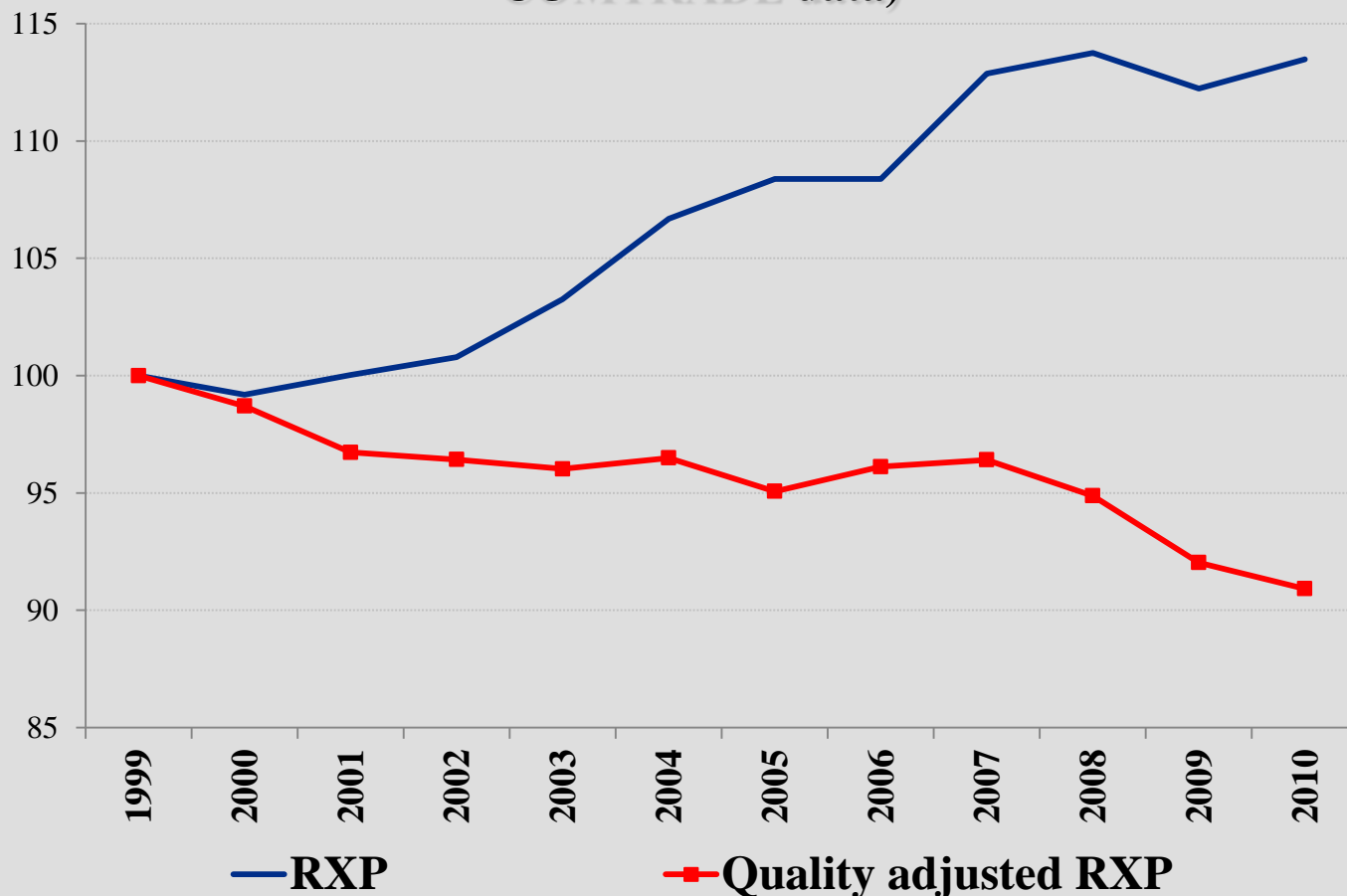
Growth has been supported by regained competitiveness: wage-productivity gap has been closed

Wage and productivity (2005 Q1 = 100, seasonally adjusted)



Latvia's quality adjusted relative export price has decreased notably over past years

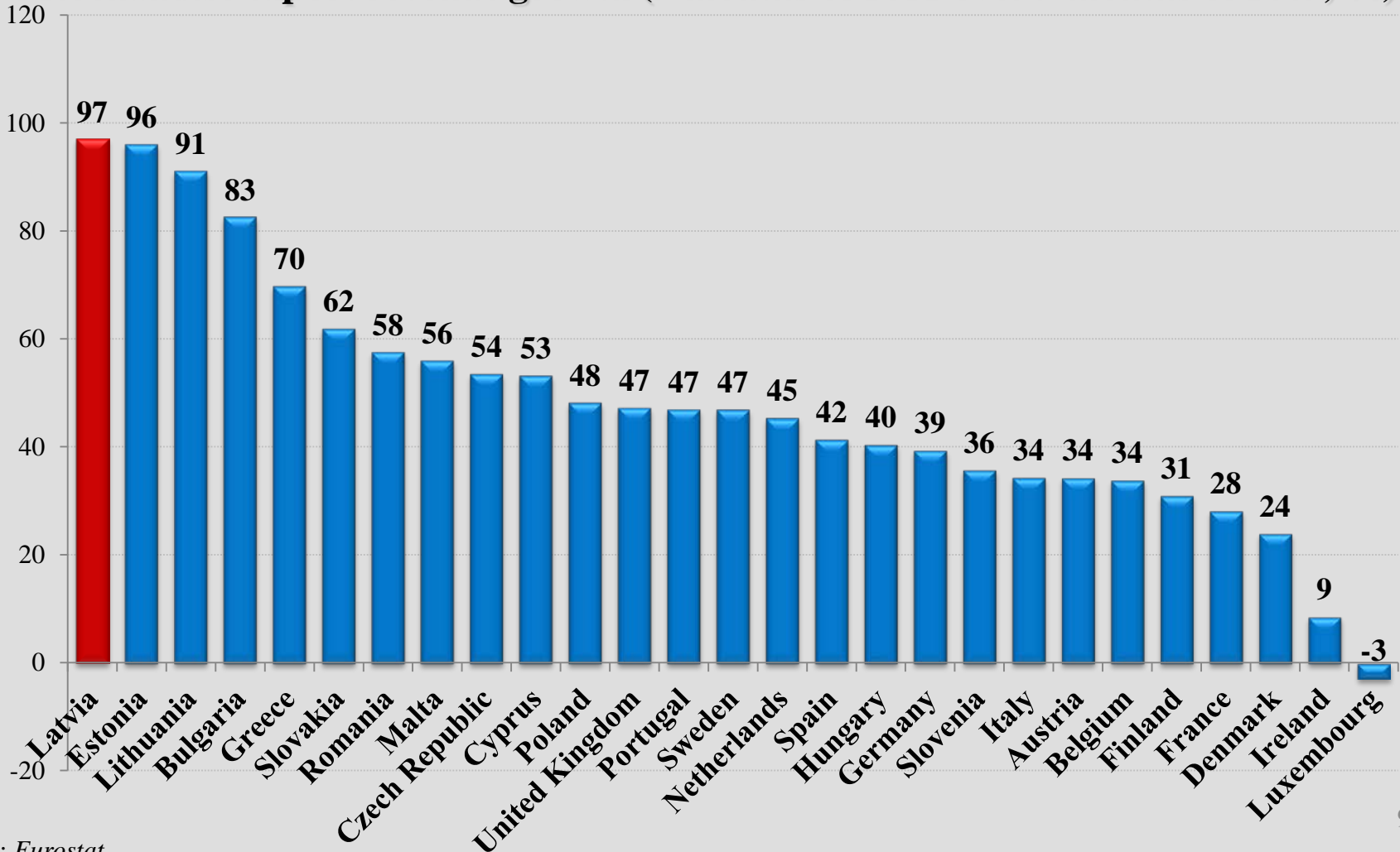
Conventional and quality adjusted relative export price indices, 1999=100 (world market, COMTRADE data)



Source: Source: Beļkovskis, K. (2012). *Competitiveness of Latvia's Exporters*. *Baltic Journal of Economics*, Vol 12 (2), pp 17-45. See also Wörz, J., Beļkovskis, K. *Non-Price Competitiveness Gains of Central, Eastern and Southeastern European Countries in the EU Market. Focus on European Economic Integration*, 2012, No.3, pp.27-47

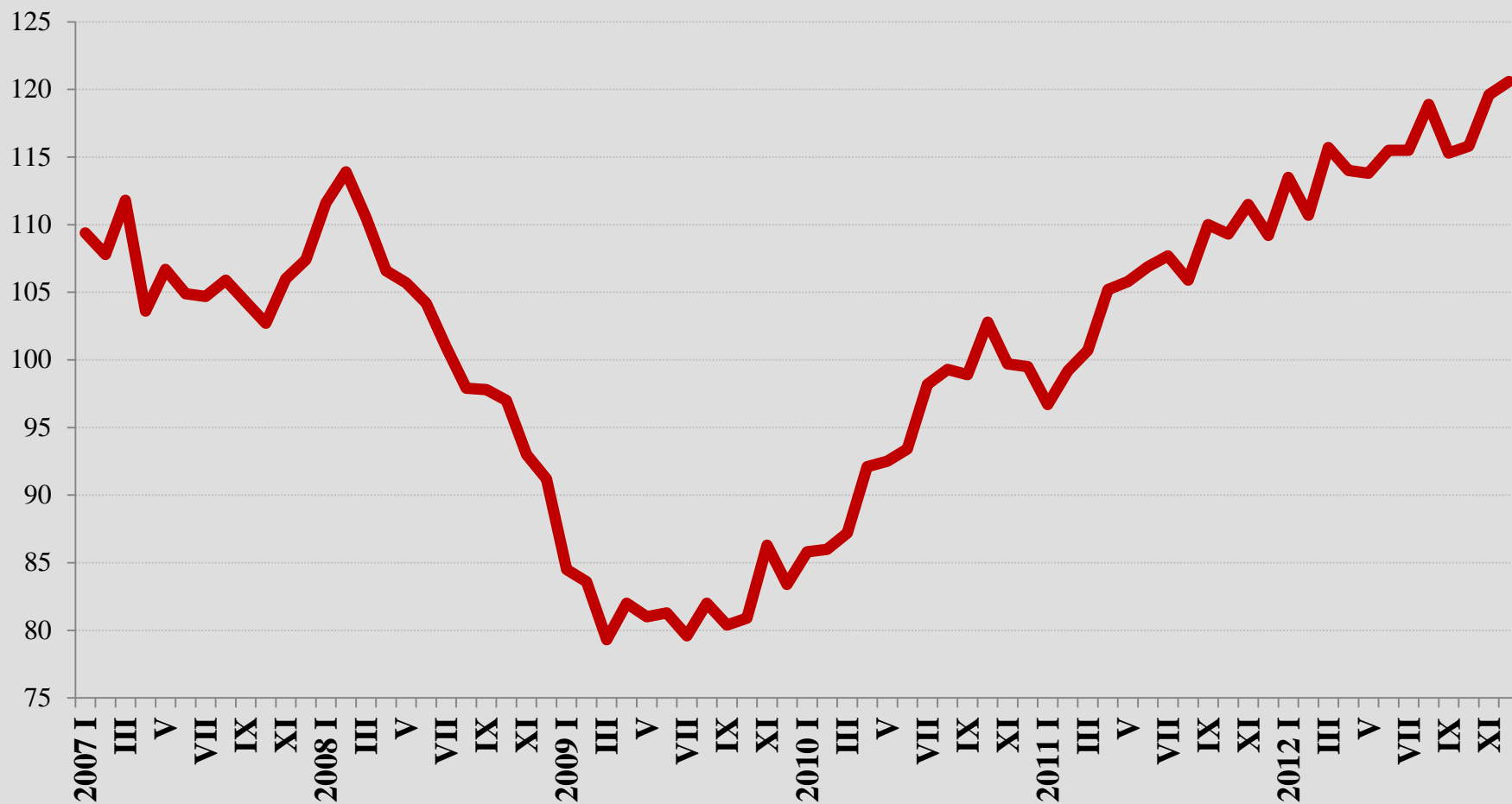
Favorable competitive position shapes export trends: Latvia ranges among the export leaders in Europe

Merchandise export revenue growth (9 months of 2012 over 9 months of 2009, %)



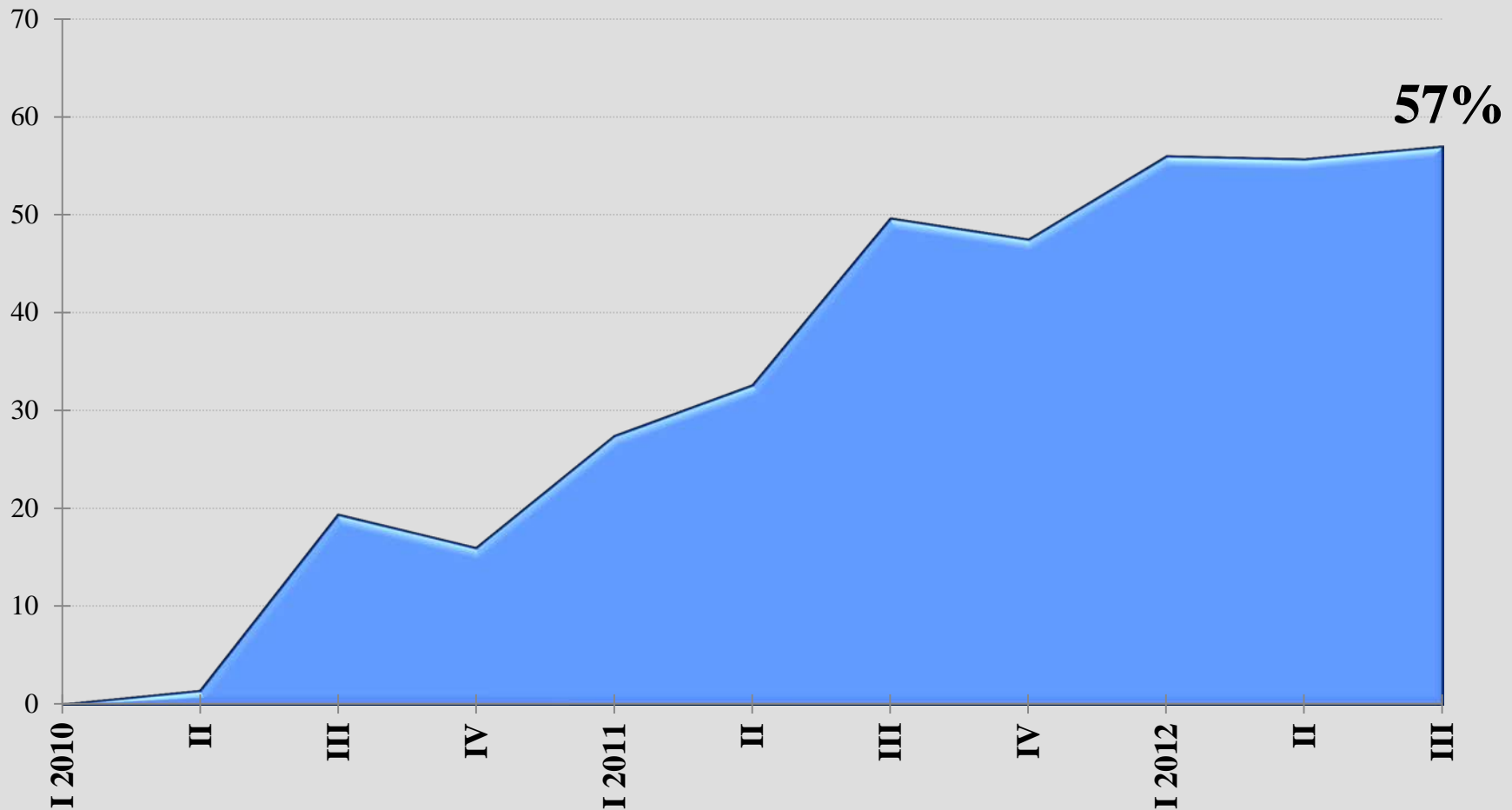
Manufacturing output already above the pre-recession peak level

Manufacturing volume index (2005 = 100, seasonally adjusted)



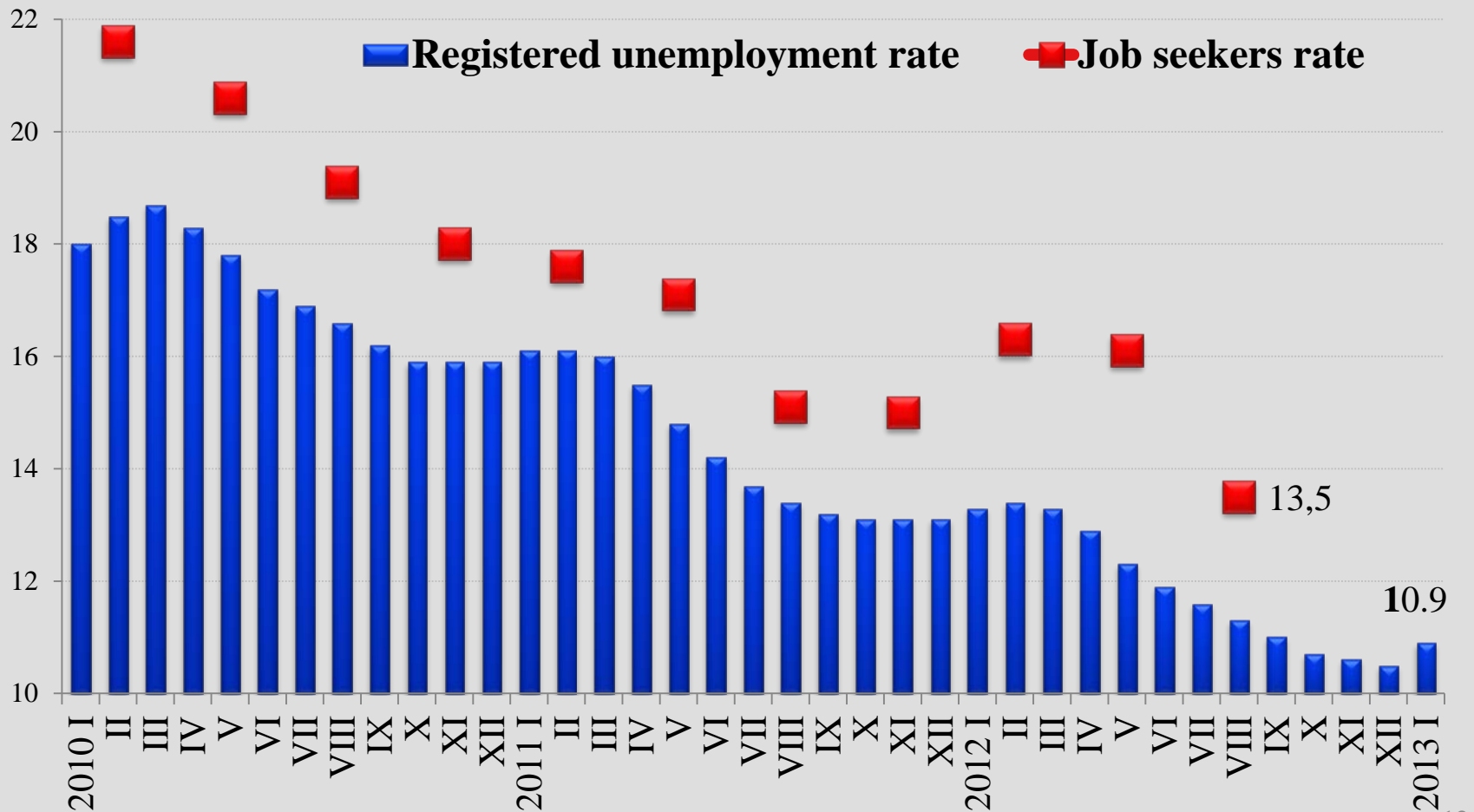
Domestic demand has also recovered: regained competitiveness and corporate profitability have pushed up productive investment

Gross fixed capital formation (1Q 2010 = 100)



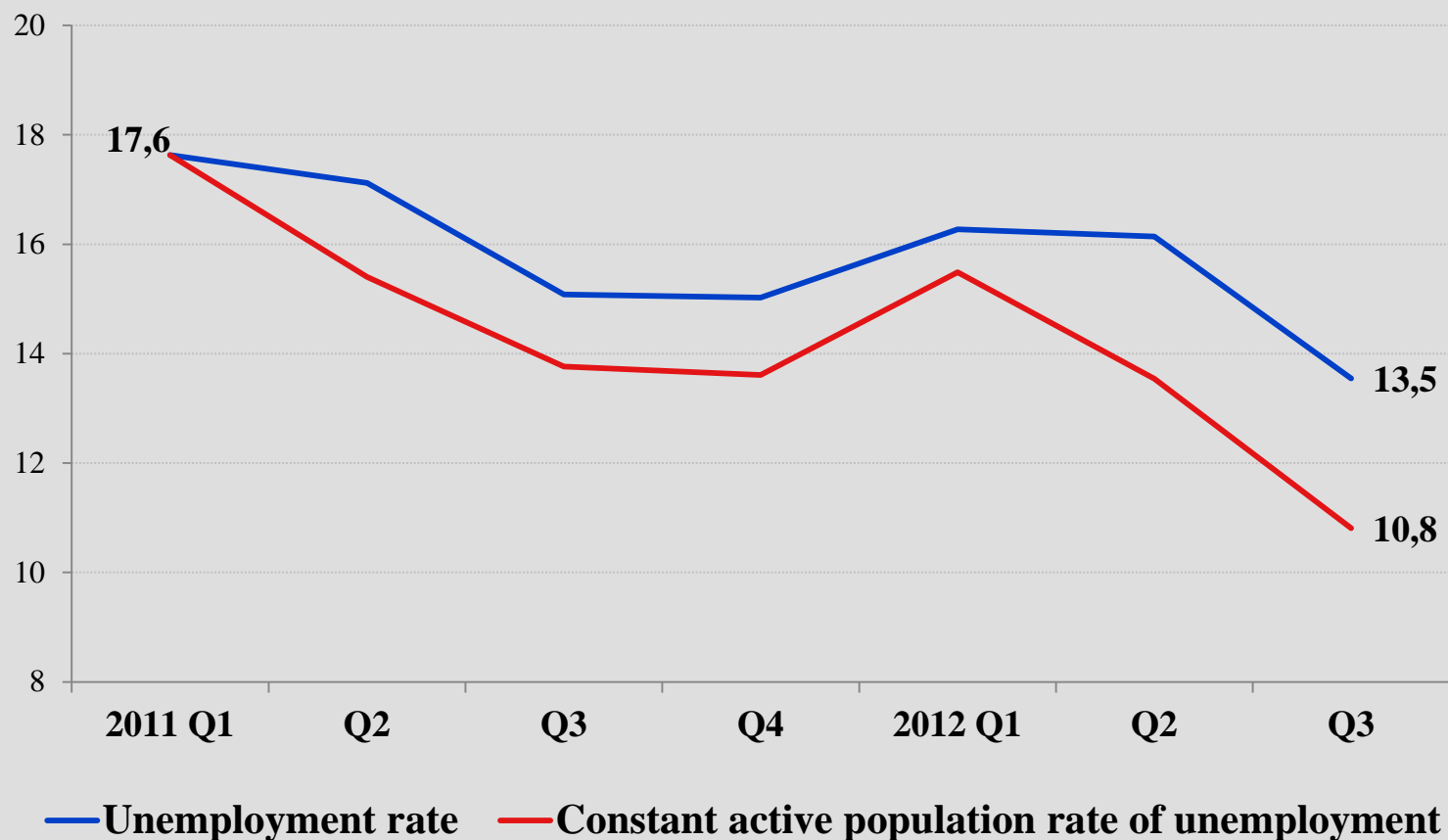
Unemployment rate going down with growing employment opportunities

Unemployment rate (% of economically active population)



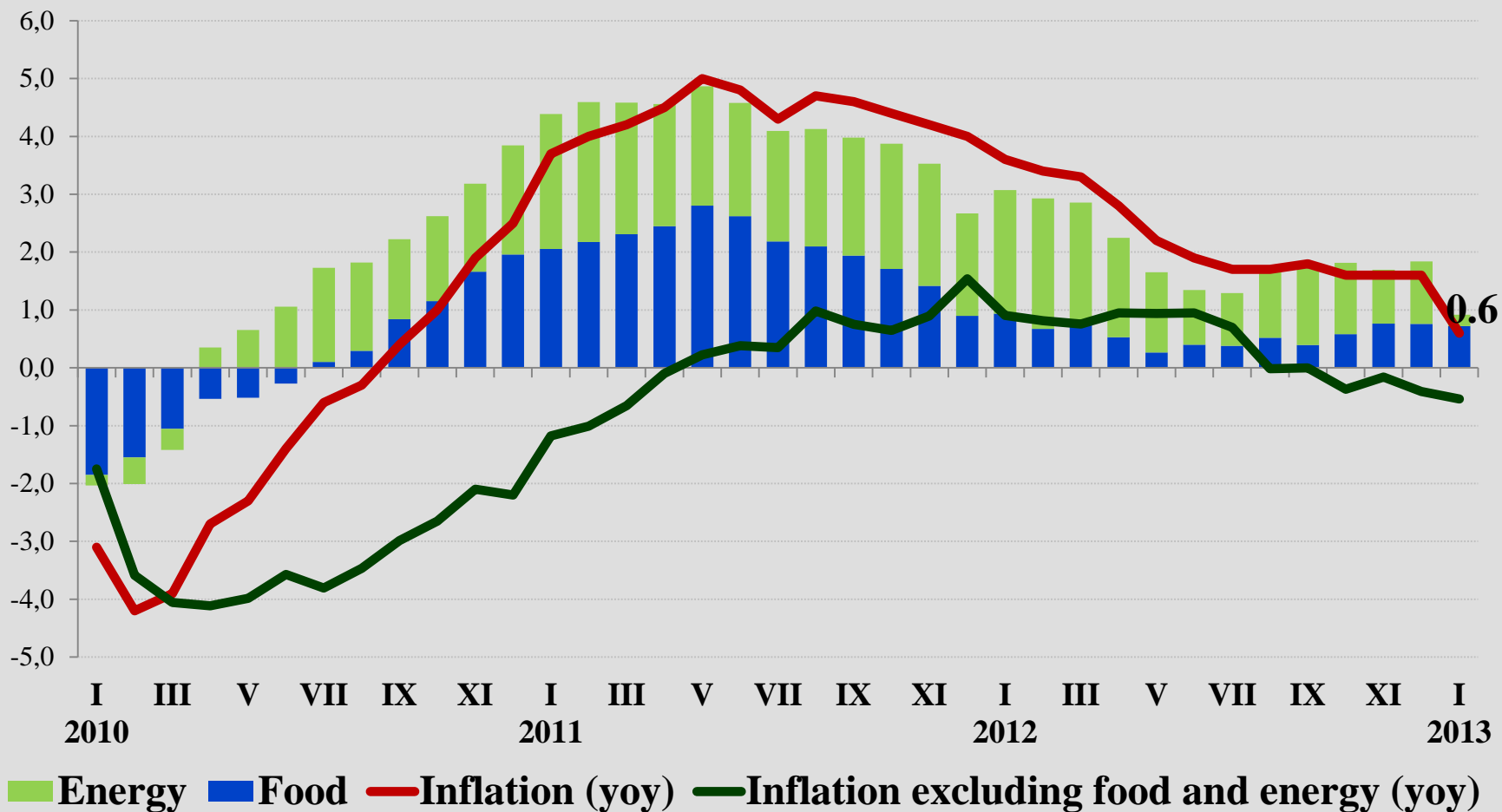
Unemployment pushed up by increasing participation rate

Unemployment rate (% , age 15-64)



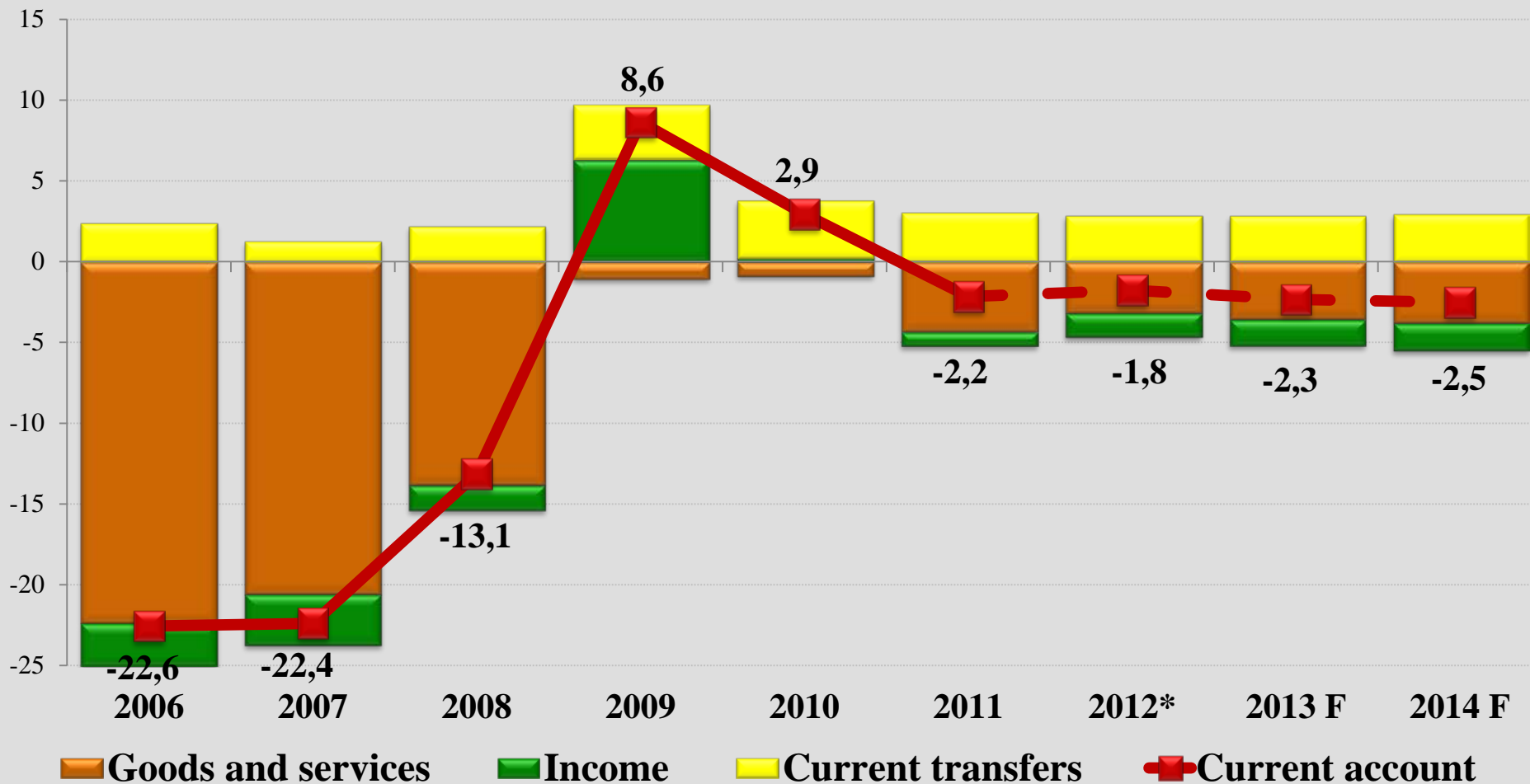
Internal balance has been restored: inflation is low and sustainable

Impact of food and energy prices on total inflation (pp) and the y-o-y inflation rate (%)



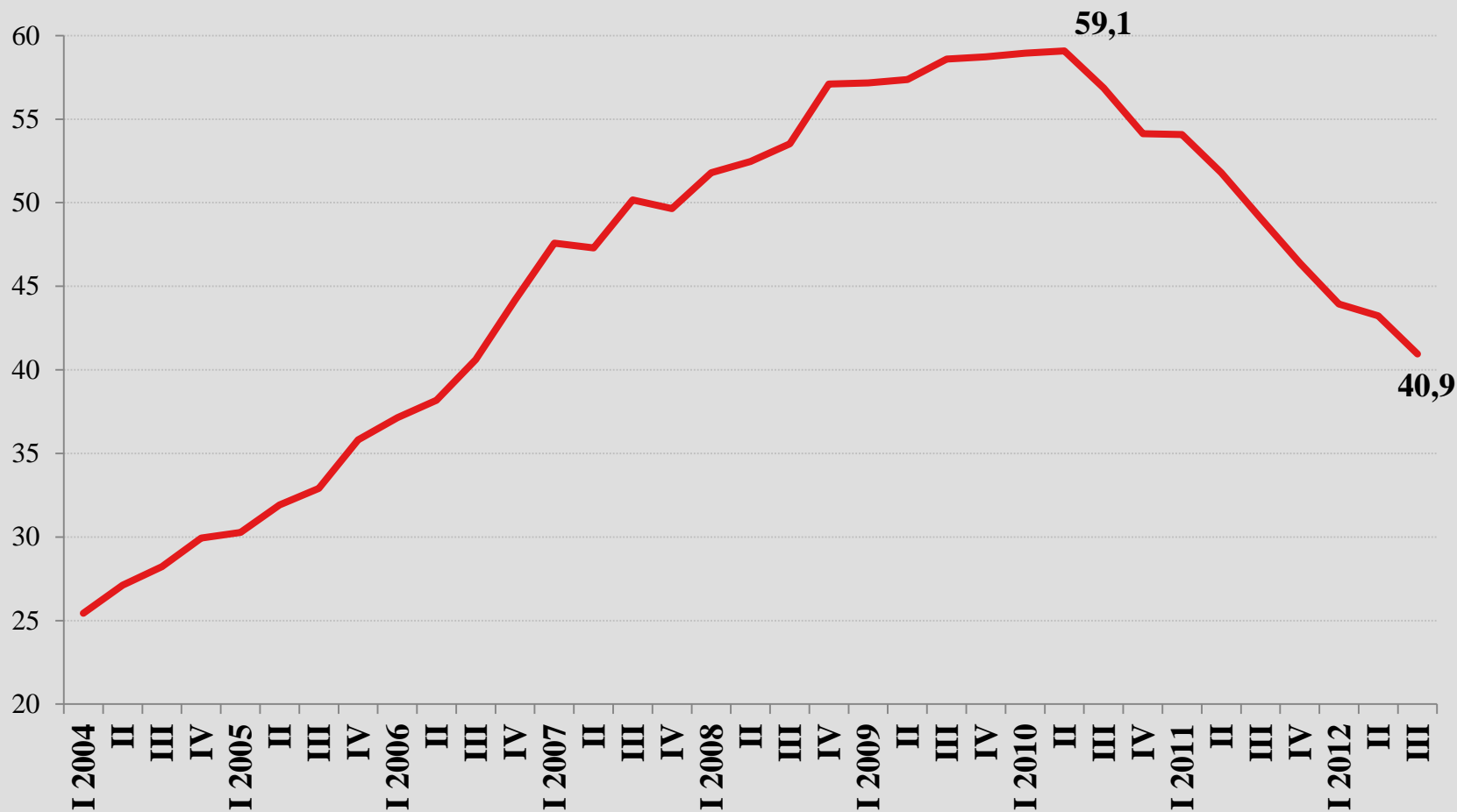
External sustainability has also been regained: current account remains close to balance

Current account (% of GDP)



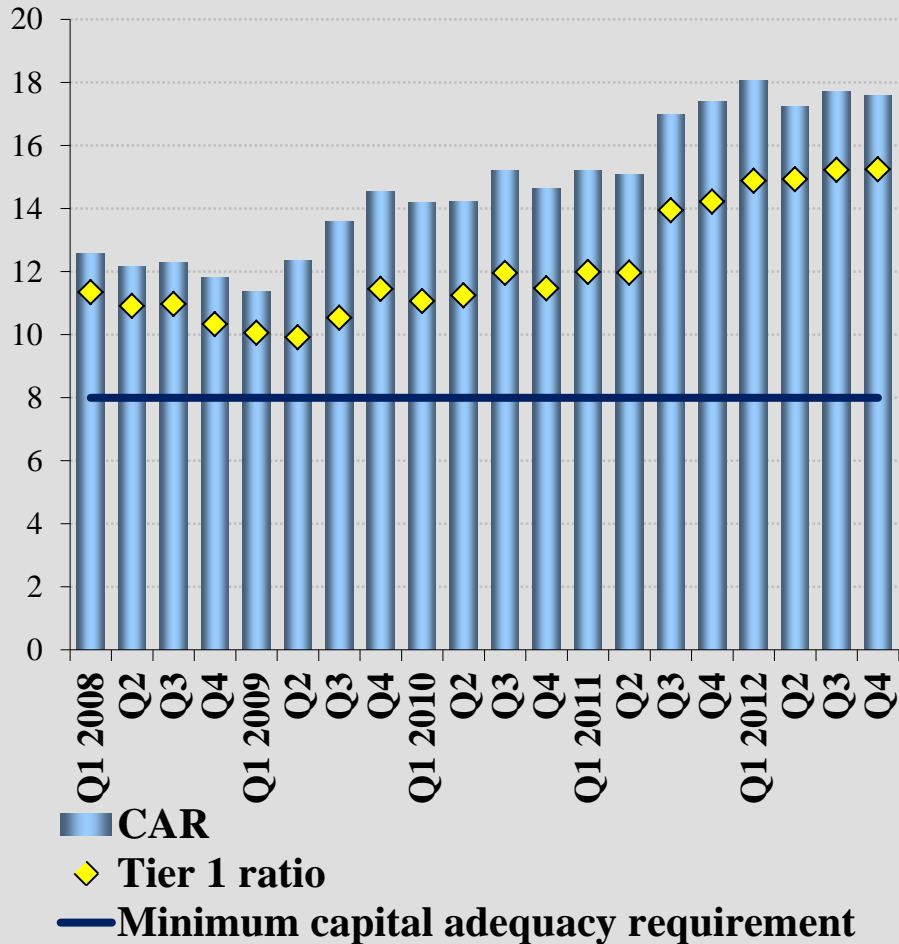
Ongoing deleveraging: external debt continues to decline

Net external debt (% of GDP)

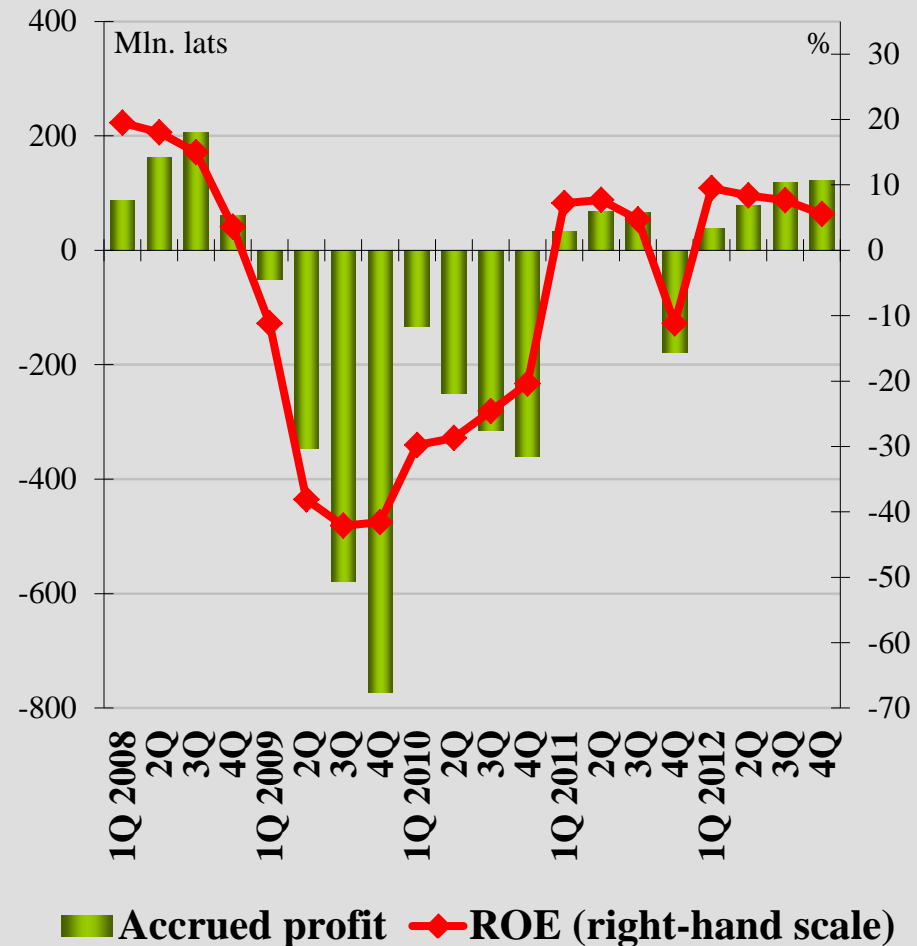


Banking sector has returned to profitability, capital adequacy has strengthened to record-high levels

Capital adequacy ratio, %



Banking sector profitability indicators



Latvia maintains its aim of Euro introduction in 2014 and the target is well within reach

Maastricht criterion	Reference value	Latvia's respective indicator
Inflation (December 2012)	2.8%*	2.3%
Budget deficit (% of GDP, in 2012)	-3%	-1.7%*
Public debt (% of GDP, 2012)	60%	44.1%*
Long-term interest rate (December 2012)	5.9%*	4.6%
ERM II membership	At least 2 years	Since 2005

Determination to further reforms remains intact

- Support strengthening of EU policy framework
- Implementation of fiscal prudence framework
- Continuation of reforms in education and healthcare
- Further improvement of governance and institutions (judiciary, management of public enterprises, etc.)
- Further reforms to improve business environment and investment climate
- Strengthening of tradable sector (Industrial policy V2.0)
- Further enhancement of financial sector regulation

Key lessons learned

- Devaluation is neither inevitable nor necessary to regain competitiveness and ensure V-shaped recovery
- Fiscal consolidation may be efficient tool to regain competitiveness, credibility and growth
- Adjustment should be significant and frontloaded to ensure credibility gains
- Expenditure reduction is more efficient than tax increase
- Structural reforms are essential to make consolidation permanent and shift growth momentum towards private sector