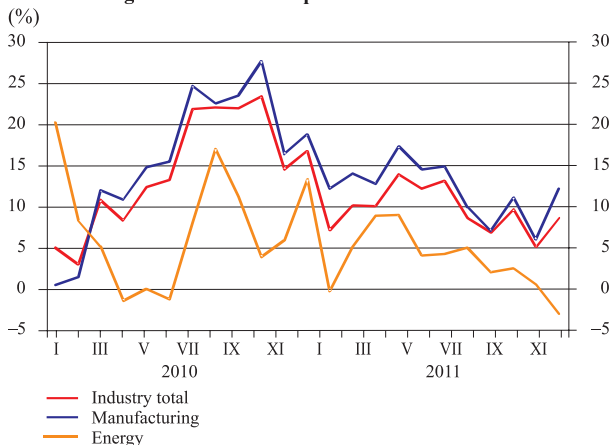


## 1. Highlights

### Manufacturing continues to surprise

Annual changes of industrial output (%)



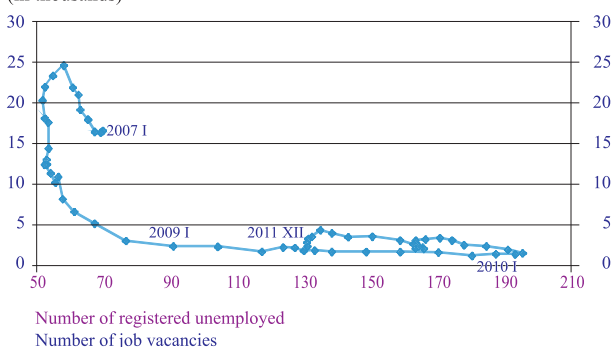
Manufacturing followed a prominent upward trend throughout 2011 determined by both the hitherto persistent external demand and the regained competitiveness of the sector.

Despite global developments, surprisingly high growth rates were continuously reported for manufacturing output: 3.2% month-on-month and 12.1% year-on-year in November 2011.

The performance of manufacturing has been quite impressive in the recent months, yet the future prospects of the industry will depend mainly on the depth of the recession prevailing in Europe. Thus it can be expected that the development will be fairly uneven in the coming months, and the possibility of a slightly downward trend cannot be fully ruled out.

### Unemployment to continue on a downward trend, albeit at a slower pace

Beveridge curve: number of unemployed registered with the SEA and job vacancies (in thousands)

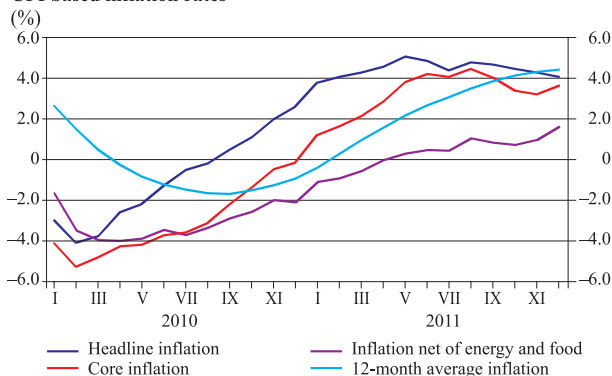


Registered unemployment stabilised since mid-October and stood at 11.5% of the economically active population at the end of 2011.

It is expected that during the remaining winter months it could rise again slightly by 0.1–0.2 percentage point per month. Yet with the appearance of seasonal vacancies in spring (particularly in construction, agriculture and catering), the downward trend in unemployment would resume. With the economy decelerating, the overall drop in registered unemployment in 2012 will be about half of what it was in 2011 when it amounted to 2.8 percentage points. In the second half of the year, registered unemployment may approach 10%.

### Inflation declines, still affected by taxes and global developments

CPI based inflation rates (%)



The average consumer prices remained unchanged in December 2011, whereas the annual inflation dropped to 4.0%. The main contributor was the diminished impact of the prices on fuel and unprocessed food. The average rise in consumer prices by 4.4% observed in 2011 was mostly related to the impact of indirect taxes as well as the global energy and food prices.

Deceleration of the global and Latvian economic growth as compared to the rates in 2011 eases the pressure on prices both in Latvia and Latvia's main trading partners. At the same time, higher natural gas prices and heating tariffs will be an inflation-supporting factor. Overall, we expect that the average annual inflation this year will drop to 2.4%.

## 2. Macroeconomic Data

	Reporting period	Data (%)
<b>Gross Domestic Product (GDP)</b> (quarter-on-quarter growth; seasonally adjusted)	2011 Q3	1.7
<b>State budget</b>		
Tax revenue (current month; year-on-year growth)	2011 XII	13.5
General government expenditure (since the beginning of the year; year-on-year growth)	2011 XII	2.3
<b>Consumer price changes</b>		
Consumer Price Index (CPI; month-on-month growth)	2011 XII	0.0
12-month average annual inflation (to comply with the Maastricht Criteria)	2011 XII	4.2
09.01.2012 <a href="#">Inflation in 2011 in Latvia: result of taxes and global prices</a> 		
<b>Foreign trade</b>		
Exports (year-on-year growth)	2011 XI	22.3
Imports (year-on-year growth)	2011 XI	17.0
09.01.2012 <a href="#">European problems affect Latvia's foreign trade</a> 		
<b>Balance of payments</b>		
Current account balance (ratio to GDP)	2011 Q3	-3.8
Foreign direct investment in Latvia (net flows; % of GDP)	2011 Q3	6.7
12.01.2012 <a href="#">In November 2011, current account close to balanced</a> 		
<b>Industrial output</b>		
Working day-adjusted industrial output index (year-on-year growth)	2011 XI	12.1
04.01.2012 <a href="#">Manufacturing continues to surprise with its resistance to external turmoil</a> 		
<b>Retail trade turnover</b>		
Retail trade turnover at constant prices (year-on-year growth)	2011 XI	7.6
30.12.2011 <a href="#">Retail slightly up in November; likely due to short-term factors</a> 		
<b>Employment and unemployment</b>		
Registered unemployment (share of working age population)	2011 XII	11.5
11.01.2012 <a href="#">Unemployment drop to halve this year</a> 		
<b>Monetary indicators</b>		
Broad money M3 (year-on-year)	2011 XII	1.7
19.01.2012 <a href="#">Money supply indicators recover after turmoil in the banking sector</a> 		

Sources: Treasury, Central Statistical Bureau of Latvia, and Bank of Latvia data.

### 3. In Focus

#### **Impressive consolidation gives no reason for complacency**

As a result of focused work during the last two months of 2011, the Budget 2012 was prepared in due time for its adoption and before the completion of the European Commission and IMF review mission. In a concerted effort of the Ministry of Finance, the Bank of Latvia, the international lenders and other stakeholders, differences were resolved and a budget aiming to contain the budget deficit under the Maastricht threshold of 3% of GDP was agreed.

The sizeable adjustments in the Budget 2012 amounting to nearly 1% of GDP are even more impressive as they top the 17% of GDP consolidation measures implemented since November 2008. The commitment of the government to go through with a series of austerity measures in order to bring the public finances on a sustainable path has been truly remarkable and the success achieved has earned praise from economic observers, international financial institutions and heads of state.

This last effort concludes a period of close guidance in fiscal matters by our international partners. It also provides the opportunity for Latvia to stand on its own feet as the international assistance programme conditions have been satisfied and the budget deficit is now under the threshold provided by the euro area accession criterion. However, the opportunity to implement a completely independent budget policy does not mean an opportunity to return to the "old ways", i.e. to spending increases. Quite the contrary, even a low deficit does not help to run down the debt accumulated in the recent crisis mitigation efforts. The fulfilment of the above-mentioned minimum criteria may also be at risk taking into account the fairly low safety margin and adverse external economic developments.

In the near future, the downside risks to meeting the budgetary targets are related to the deterioration of the economic situation in Europe. The macroeconomic forecasts on which the Budget 2012 – including the revenue targets – was based projected a 2.5% GDP growth. However, the intensification of the debt crisis in Europe has translated into downward revisions to growth projections in many trade partner countries that will have a bearing on growth in Latvia. At this point, it seems very likely that the economic growth will turn out to be lower than projected at the time of the budget preparation: current forecasts indicate that the GDP growth could be closer to 1%. Consequently, revenue underperformance and hence a higher than projected deficit can be expected. This would mean that to remain on the undertaken path and, more formally, to fulfil the Maastricht criterion for the budget deficit in 2012 corresponding measures on the expenditure side will be required. Should the unfavourable growth projections materialise to a full extent the current expenditure plans might need to be reviewed as early as in spring. For that reason, a list of areas and expenditure items where additional cuts could potentially be carried out should be prepared to avoid hurried last minute decisions.

In a slightly longer-term view, prudent management of public finances and adherence to publicly declared commitments is crucial to tangibly demonstrate fiscal sustainability, considering the need to refinance the sizeable public debt maturing in a 3–4 years time. Sound public finances and Latvia confidently remaining on the path towards sustainability will provide benefits in the form of easier access to credit on better terms.

Having prepared the Budget 2012 that complies with the Maastricht criterion is not the end but just the beginning of a journey that Latvia has undertaken towards sustainable public finances of our own design and in our own interest. To minimise the imminent and longer-term risks to the implementation of the sound budget plans the government has to stand ready to mitigate any adverse impact of unfavourable economic developments on the budget balance.