Unique case of Latvia: internal adjustment

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After sharp economic adjustment in terms of GDP, Latvian economy is back on export-based growth track.

Source: Central Statistical Bureau of Latvia; F – Bank of Latvia forecast
A mix of fiscal, income and structural policy as key adjustment mechanisms in Latvia

- The fixed narrow band exchange rate of the lats as the anchor for monetary policy until the euro adoption.

- Policy mix as tools for restoration of competitiveness and a precondition for an export-based economic recovery in Latvia:
  - Sizeable fiscal consolidation;
  - Fiscal consolidation measures designed with the focus on structural reforms and wage/employment cuts in the public sector;
  - Cost optimisation and productivity enhancement in private sector.
Sizeable fiscal consolidation in Latvia has taken place already in 2009

<table>
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<tr>
<th>Country</th>
<th>Year</th>
<th>Total consolidation</th>
<th>Revenue measures</th>
<th>Current expenditure measures</th>
<th>Capital expenditure measures</th>
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</table>

Source: Convergence programmes; Bank of Greece; Bank of Latvia
Institutional fundamentals ensure smooth economic adjustment through wage flexibility in Latvia

Collective bargaining coverage (%)

Source: ETUI-REHS
Wage elasticity allows to restrain wages in both public and private sector

Gross nominal hourly wage y-o-y growth (%)
Cost optimisation and productivity enhancement contributed to narrowing the wage-productivity gap.

Wages and productivity
(whole economy, seasonally adjusted, expressed per hours worked, Q1 2005=100)

Source: Eurostat, Bank of Latvia's calculations
Gains in competitiveness are reflected by increase in market shares in major trading partner countries

Export market shares
(\% of major trading partners' imports in Q4 2008 – Q2 2010; 3-months moving average)

Source: Bank of Latvia's calculations
Improvement in competitiveness boosted export growth since mid-2009

Nominal export growth (I 2005=100)

Source: Central Statistical Bureau of Latvia
Current account in surplus; goods and services balance is expected to improve further.
In manufacturing, structural changes towards re-orientation to export markets are taking place.

Share of export (% of total turnover in particular sectors)

- Manufacturing
- Furniture
- Electronics
- Chemicals
- Printing
- Wood production
- Textiles
- Food production

Source: Central Statistical Bureau of Latvia
With improvements in employment prospects in export-oriented sectors, unemployment started to decline.

Unemployment rate (% of economically active population)

Source: Central Statistical Bureau of Latvia; State Employment Agency
Improvement in business and consumer sentiment supports ongoing economic recovery

Economic sentiment and confidence indicators (balance, %)

Source: European Commission
Central bank has replenished its foreign currency reserves which were drained in the market turmoil following Lehman's collapse in 2008.
Money market rates have reached their historical lows reflecting inter alia the significant improvement in financial market sentiment.

Money Market Index RIGIBOR (%)

Source: Bank of Latvia
Capacity to confront changes in market sentiment has improved significantly.

Selected indicators (at the end of VIII 2010)

**NFA* / monetary base**

- **2.5**

**NFA / cash and non-bank deposits in lats**

- **1.1**

**NFA in the months of imports of goods**

- **9.4**

**Short-term external debt/NFA**

- **1.5**

Source: Bank of Latvia

*Net foreign assets of the Bank of Latvia; ** at the end of 2nd Q 2010