Latvian Macro Monitor

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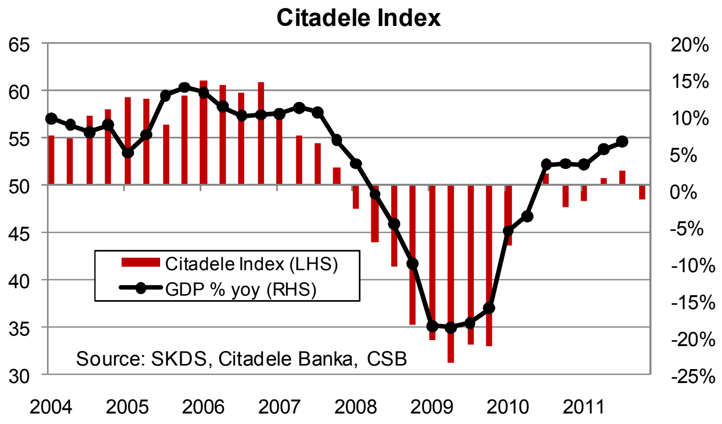
According to the Citadele Index, entrepreneurs are becoming slightly pessimistic about the Latvian economic prospects, as the deceleration of growth in Europe weighs heavily on the Latvian economic development going forward into 2012. The high-frequency data is still pointing to a more robust growth, albeit the dynamics have become more volatile lately. Retail trade turnover (excluding fuels) declined by 1.5% m-o-m in December after an increase in the previous month, with an annual growth reaching 7.5% y-o-y in 2011. Annual average inflation stood at 4.4% y-o-y in 2011. It is still expected to edge lower in the coming months, sliding below 2% by the year-end.

Citadele Index

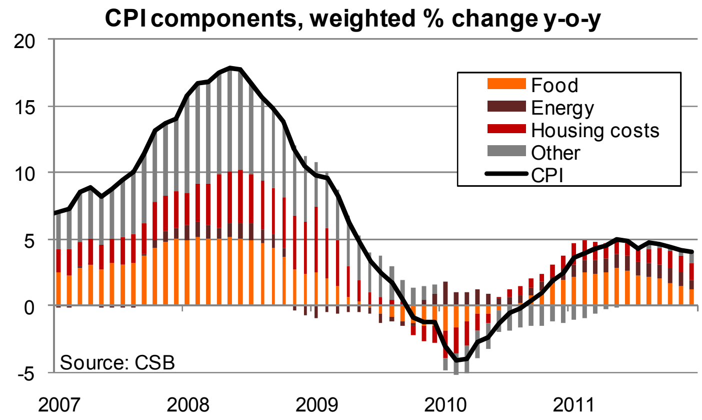


According to the Citadele Index, entrepreneurs' confidence has started to deteriorate, with the Citadele Index dropping below the 50 point threshold in the fourth quarter of 2011. An assessment of both current and future economic situations has noticeably worsened, indicating a turn-around in the entrepreneurs' perceptions. Still the evaluation of the current economic situation could not be fully justified yet, as entrepreneurs might be biased towards more pessimism in their assessment due to the events in the Latvian banking sector in the last months of 2011. The assessment of the future economic development has dropped for the second straight quarter, influenced mainly by the deteriorating external environment. Moreover, smaller enterprises with lower turnover are feeling themselves more vulnerable in the face of possible deceleration in the economic growth both in Europe and Latvia. As compared to the previous quarter, economic sectors oriented towards domestic demand have seen the largest declines in their assessment, while entrepreneurs representing industrial production sector still have remained cautiously optimistic in their judgments.

Inflation

The development of the inflation dynamics was well predictable during the whole 2011. Inflation pressures mounted in the first half of the year, fueled by an increase in energy and food prices, as well as changes in the VAT and excise taxes. As commodity price rally in the global markets halted in the second half of the year and base effects started to kick in, inflation pressures eased noticeably, with an inflation curve starting to lean downward. According to the CSB, annual average inflation reached 4.4% in 2011, being in line with our earlier projections.

Apart from the performance of more volatile product categories, core inflation has also deliberately continued to strengthen. The contribution of core components to the price increase picked up in the last months of 2011. According to our estimates, core inflation increased from approximately -2.2% y-o-y, registered in the last months of 2010, to an average level of 0.8% y-o-y in the last several months of 2011. An increase in core inflation is one of the fundamental issues in the process of economic recovery, as it is thought to signal a rebound in the private consumption.

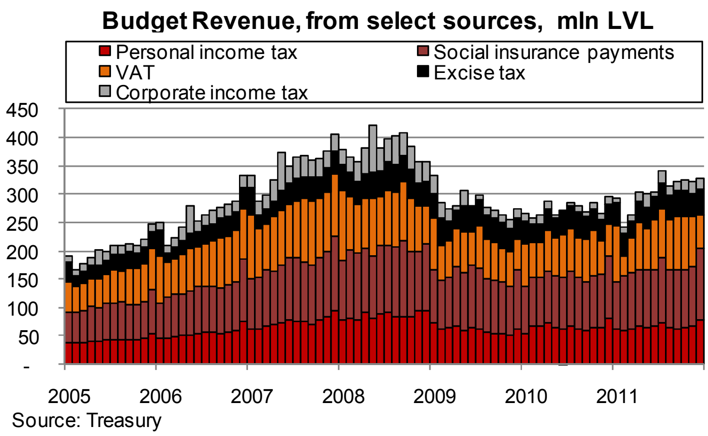


This year has started with an increase in energy prices – housing costs, fueled by an increase in heating and natural gas tariffs, as well as prices of fuels rose dramatically in January. This inevitably will translate into higher monthly inflation number in January, with the total effect accounting for around 0.7- 0.8 percentage points.

Moreover specific external factors could also drive the price level up in the months ahead – for example geopolitical tensions in the Middle East, depreciation of euro, etc. Still according to our baseline scenario, resource prices are about to remain flat or even decline in the subsequent months. An increase in core inflation in Latvia is also likely to weaken if the growth of domestic demand starts to decelerate. According to our projections, inflation could even slide to 1.5% in spring and average annual inflation is expected to edge below 2% by the end-2012.

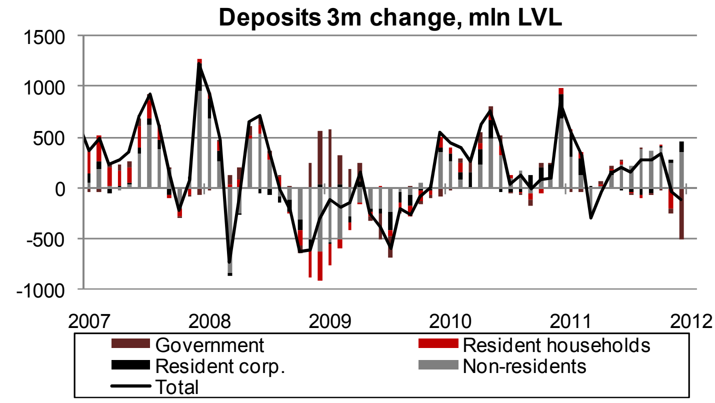
Treasury

According to the Treasury Department, the cumulative general government budget deficit reached 444.9 million LVL in 2011 or approximately 3.2% of GDP, if calculated using the cash flow method (the number is about to be higher due to the necessity to correspond to the ESA95 methodology). The budget deficit was almost halved in 2011 compared to the preceding year, as an increase in revenue amounted to 10.4% y-o-y compared to the previous year, while expenditure increased by 2.4% y-o-y in 2011. Nevertheless, although budget revenue picked up in 2011, it was still about 1.3% below the proposed plan, as collections of certain taxes lagged behind the projections. While collections of direct taxes overfulfilled the annual plan in 2011 with collections of corporate and personal income taxes exceeding the annual plan by 61.9 and 6.2 percentage points respectively, collections of VAT have been weaker than previously projected, reaching only 98.6% of an annual plan. As expenditure was also about 6 percentage points below the annual plan, it somewhat cushioned the underperformance of certain tax categories, with the consolidated budget deficit most likely being below the target level of -4.5% of GDP in 2011.



Banking sector

According to the Financial and Capital Market Commission, the banking sector profit reached 75.5 million LVL in the first eleven months of the year, as loan loss provisions have continued to trend downward, reaching 11.0% of loan portfolio by the end-November.



Source: Bank of Latvia

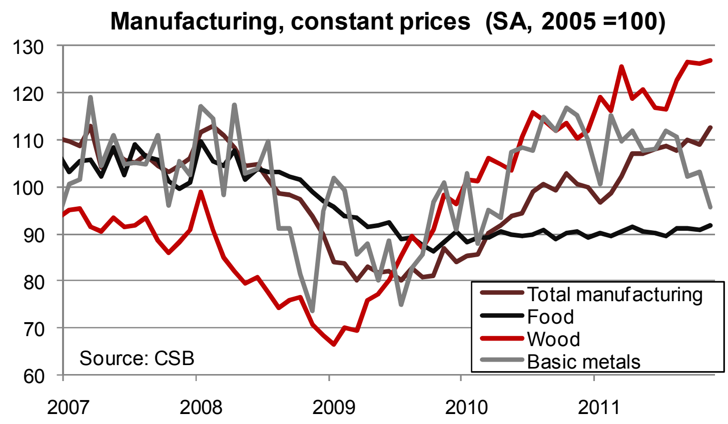
Recent events haven't had a major impact on the Latvian banking sector with the amount of households' deposits bouncing back in December after a dramatic decline in the previous month, related to the bust of Latvijas Krājbanka. The amount of deposits of non-resident has been still on the uptrend and that of resident entities has also risen for the third straight month after a more subdued performance in the first nine months of the year. The amount of government deposits in the Latvian banks, in turn, shrank in December, as part of the resources was lent to the FCMC in order to ensure the timely payments of the State-guaranteed deposit reimbursements, according to the Latvian legislation, and government's financing needs increased in December as well.

The loan portfolio shrank sharply in December, as the pace of deleveraging of non-financial resident entities increased by the year-end on the back of larger amount of repaid loans compared to the previous months. According to the Bank of Latvia, resident loan portfolio declined by 2.3% m-o-m in December with an annual decline totaling 8.3% y-o-y by the year-end. Loan portfolio of the banking sector has shrunk by 23% from its peak since the onset of recession, with the pace of deleveraging of entities outpacing that of households. The quality of loans has slightly deteriorated in November, mainly owing to an increase in the amount of loans less than 30 days overdue. The share of loans more than 90 days overdue has continued to decline, reaching 17.7% of the total loan portfolio in November compared to 19.0% registered by the end-2010.

In order to free additional resources for commercial banks to foster lending, the Central Bank of Latvia has cut the reserve ratio for banks by one percentage point – from 3% to 2% for bank liabilities above 2 years and from 5% to 4% for other liabilities. This move was thought to increase the availability of lending resources for economy to sustain the economic growth.

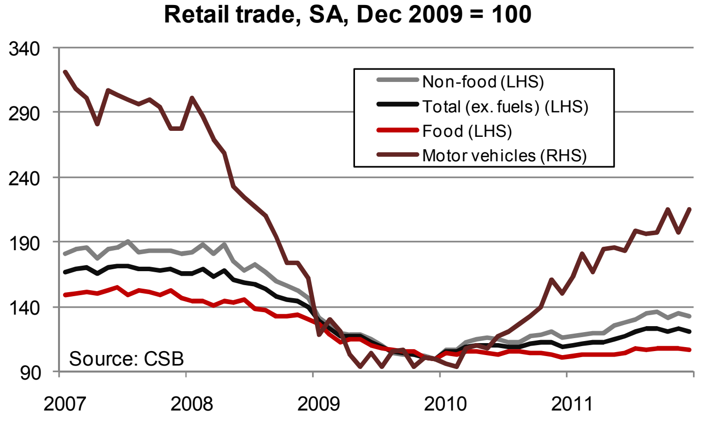
Manufacturing

According to the CSB, the seasonally adjusted manufacturing output soared by 3.2% in November over the previous month, with the growth accounting for 11.7% y-o-y in the first eleven months of the year. Similarly to the previous month, an increase was mainly driven by minor manufacturing categories, while the dynamics of major manufacturing sectors remained rather mixed with the manufacturing output of basic metals losing another 7.5% m-o-m, while remaining almost flat on the annual basis from January to November (+1.2% y-o-y in November) and manufacturing of wood increasing by a minor 0.6% m-o-m, with an annual growth edging lower to 12.0% y-o-y in the first 11 months of the year. An increase in the seasonally adjusted manufacturing turnover (at current prices) in the domestic market



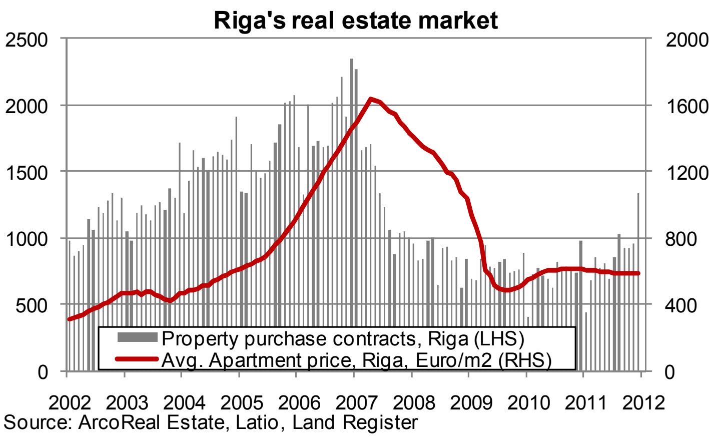
has continued to outpace that in the exports markets with the turnover growing by 3.0% m-o-m and 0.9% m-o-m respectively in November.

Retail trade



According to the CSB, the seasonally adjusted retail trade turnover (excluding fuels) has dropped by 1.5% m-o-m in December. Albeit the dynamics of the retail trade turnover was quiet volatile in the last months of the year, it increased by 7.5% in 2011 compared to the preceding year. During the whole 2011, the retail trade turnover was mainly driven by the retail trade with non-food products (excluding fuels), which added 12% y-o-y in 2011. The retail trade growth with food products remained subdued in 2011, increasing by a minor 1.3% y-o-y. The growth of retail trade with motor vehicles has remained robust during the whole year, increasing by 55.7% y-o-y in 2011, while still being around 30% below its peak, reached in the early-2007.

Real estate



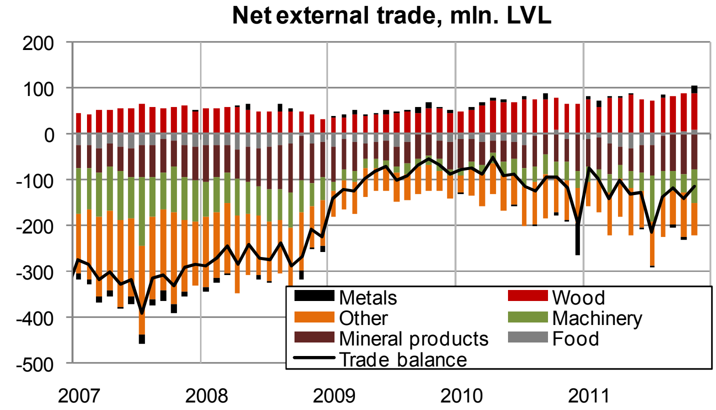
Source: ArcoReal Estate, Latio, Land Register

The number of deals in the real estate market in Riga started to perk up in 2011 mainly owing to the non-resident interest in the purchases of the real estate in Latvia, with the number of property purchase contracts in Riga advancing by 16.9% y-o-y in 2011. Still, as only several sectors of the real estate market gained a heightened buyers' interest, in general, the activity remained rather subdued. According to Arco real estate the price of the standard type apartments increased for the first time in more than a year in December, adding 0.2% m-o-m. On an annual basis, prices declined by 4.3% y-o-y in 2011, following an increase of almost 17% y-o-y in the preceding year. The supply of standard type apartments declined in December, while still being more than 20% higher compared to the respective period of the previous year.

External trade and current account

According to the Bank of Latvia, the current account was almost balanced in November, posting just a minor surplus. The current account standing slightly improved in November, mainly owing to the decline in imports of goods, as well as to a pickup in exports of services. Net income was little changed in November, with the deficit of the net direct investment income totaling 30.2 million LVL in November. The cumulative current account deficit stood at 101.5 million LVL in the first 11 months of the year down from a surplus of 436 million LVL in the respective period of the previous year, as the balance of goods has deteriorated dramatically, owing to the rising imports of goods, and increasing profitability of the foreign-owned enterprises resulted in the negative net direct investment income.

The deficit of external trade with goods narrowed in November as imports declined at a faster pace compared to exports, with imports of mineral fuels mainly contributing to the decline. According to the CSB, the pace of growth of both exports and imports remained robust in the first 11 months of 2011 compared to the respective period of the previous year, with exports adding 29.6% y-o-y and imports rising by 31.1% y-o-y. Nevertheless major categories of exports, namely wood and basic metals, have started to lose their growth momentum since the mid-year, while still sticking close to their record high levels. One of the major threats for further exports growth is the deceleration of growth in the main trading partner economies, which have already seen cuts in their GDP growth projections for 2012.



Source: CSB

The Baltics

Although the actual high-frequency macro data in Europe is not as poor as most of the confidence surveys' suggested, the proposed fiscal consolidation and the lack of comprehensive debt crisis resolution are about to weigh on the Eurozone growth perspectives in the subsequent quarters. This in turn is likely to translate into more subdued growth both in Eurozone, and in its neighboring countries. For the time being, exports of the Baltic countries have managed to retain the growth momentum with exports of goods advancing by 42.1% in Estonia and by 30.9% in Lithuania from January to November compared to the respective period of the previous year. Moreover, the growth of imports was broadly in line with exports in Lithuania and slightly lower in Estonia (+39.7% y-o-y) during the same period. Similarly to the previous months, the growth of exports in Estonia was mainly driven by exports of mineral products and metals and articles thereof. In Lithuania, in turn, the growth was mainly owing to exports of petroleum products, vehicles and fertilizers.