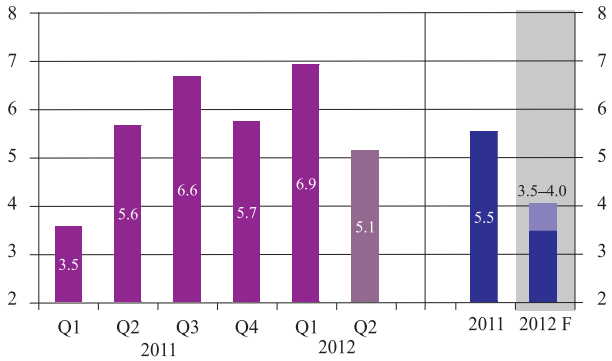
3. In Focus

Latvian macroeconomic developments and forecasts for 2012

In the first half of 2012, the pace of the Latvian economic development remained buoyant, with investment and exports being the key drivers of growth. Moreover, private consumption also picked up as it was supported by employment growth and a moderate increase in wages. Competitiveness that was regained in the recent years allowed the Latvian producers to increase their export market shares, which, to some extent, compensated the slower growth in the external demand.

Real GDP growth

(%: y-o-y)



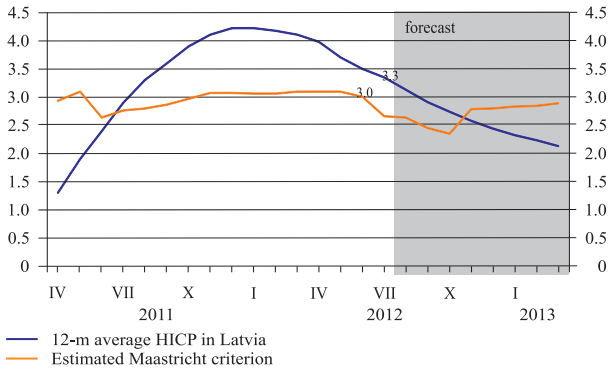
Source: CSB; F – BoL forecast; * – CSB flash estimate.

With capacity utilisation returning to its pre-crisis levels, investment started growing substantially as early as in the second half of 2011. In the first quarter of 2012, its share in GDP rose to 30% in real terms. In contrast to the end of 2011, private investment growth was very rapid. Compared to the boom years the structure of investment also has improved substantially: now investment tends to concentrate in export sectors and an increasing share of investment is made in technological equipment and infrastructure.

Economic growth this year will be more rapid than estimated previously. GDP growth is expected to range between 3.5 and 4.0% in 2012. The risks to the forecast are broadly balanced and they are largely related to external factors, mainly the developments in Europe associated with the debt crisis and their effect on Latvia's external demand.

12-m average HICP and the estimated level of Maastricht inflation criterion

(%)



Source: Eurostat, EC and BoL estimates.

As expected, the year-on-year inflation rate decreased over the first seven months of 2012 and was 1.7% in July. A number of factors could be mentioned behind these favourable inflation developments: for instance, the loose labour market and absence of domestic pressures on inflation, a weaker impact of world commodity prices (mainly food and energy), gradually fading base effects of the administered prices and indirect taxes raised in 2011 and others.

With the year-on-year inflation rate decreasing, the 12-month average HICP inflation also dropped notably, reaching 3.3% in June and thus nearly approaching the level of the Maastricht criterion.

In the nearest months, the inflation rate is expected to remain low, with no distinct downward trend, however, as there are some risks on the upside. The world oil prices have resumed growth as a result of political unrest in the Middle East and tensions between this region and the Western countries regarding nuclear armament as well as changing news about the levels of oil reserves. Moreover, the prices of agricultural products and food (mainly sugar and cereals) have picked up as a result of either persistent drought in some areas or rains impeding the harvesting. Nevertheless, the average annual inflation is expected to be 2.4% in 2012, which is almost twice as low as in 2011. As no upward pressure on inflation is expected from the demand side factors over the forecasting horizon, the key drivers of the price level in the near-term are likely to be the developments in the global food and energy prices.