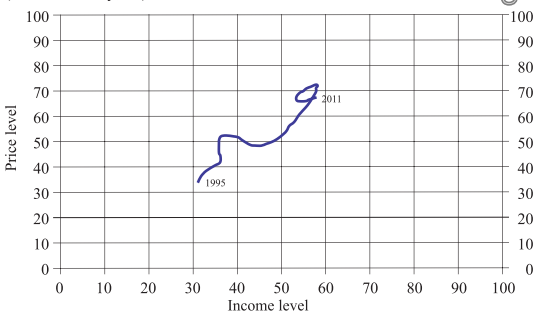
3. In Focus

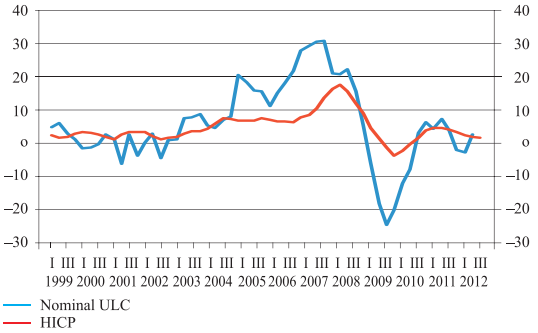
Inflation trends and its sustainability in Latvia

Relative income and price level in Latvia compared to EU27
(total economy; %)



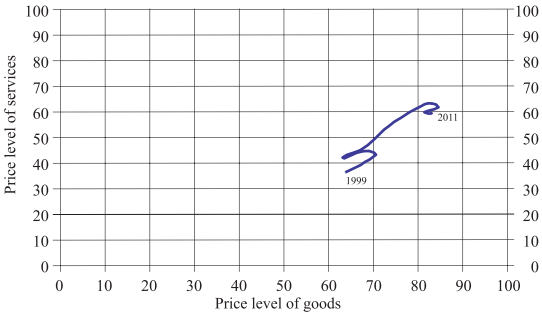
Source: Eurostat.

Growth of unit labour costs and HICP
(year-on-year; %)



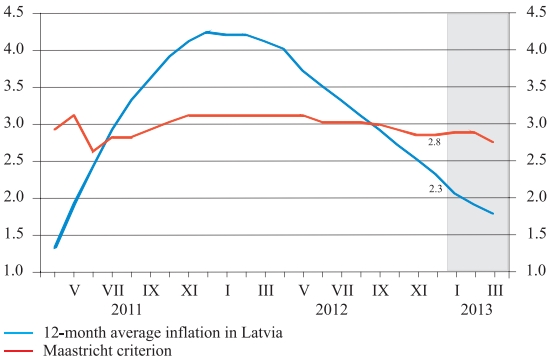
Sources: Eurostat, CSB and Bank of Latvia estimates.

Relative price levels of consumer goods and services in Latvia compared to EU27
(%)



Source: Eurostat.

12-month average HICP and the estimated level of Maastricht inflation criterion
(%)



Sources: Eurostat, EC and Bank of Latvia estimates.

Since the second half of 2011, the year-on-year inflation has been gradually declining and reached 1.6% in the fourth quarter of 2012 (both national inflation measure and HICP). The average annual inflation was 2.3% in 2012: well below the estimated value of the Maastricht criterion at 2.8%. This decline was influenced by both domestic and external factors such as sustainable wage–productivity developments, fading base effects of indirect taxes and stabilising global commodity prices.

In 2013, the average annual inflation could be even slightly lower. This will partly stem from a lower economic growth rate in comparison with the previous year, with the expected moderate global commodity price rises also contributing.

After a brief surge in grain prices in mid-2012, average global food prices have started to decrease in recent months, thereby easing the supply side pressure. The world energy price developments are contained by the persistently rather weak demand and moderate growth prospects in the EU, Russia and the USA. The recent slight decrease in the 9-month average price of heavy fuel oil has already resulted in lowering the natural gas and heating tariffs in Latvia as of January 2013.

As concerns the domestic supply side factors affecting the prices, there is no evidence of any upward inflationary pressure potentially caused by the unit labour costs in the nearest future, as producer prices mainly increase in the industries that do not quote labour shortage as an obstacle to their development. It is worth mentioning that, irrespective of the global energy price trends, a number of domestic thermal energy providers have already been able to reduce their tariffs as a result of production modernisation. Moreover, due to the improved fiscal stance, new indirect tax increases (which contributed notably to the average annual inflation in 2009–2011) are no longer required. On the demand side, both a flexible labour market and decentralised wage setting help keeping the wage–productivity developments sustainable.

The sustainability of inflation is, however, conditional on the real convergence. The average price level in Latvia has converged notably towards the EU average since the late 90-ties. The prices of consumer goods have reached around 80% of the EU average, while those of services (determined by the income level rather than tradability) constitute about 60% of the EU average. The high degree of convergence in the case of commodity prices and the gradual income convergence suggest a moderate increase in the price level: this may imply slightly higher inflation rates than the EU average, with the difference depending largely on the relative wage-productivity developments.