

LATVIJAS BANKA

# BANK OF LATVIA

## MONTHLY NEWSLETTER • MARCH 2012

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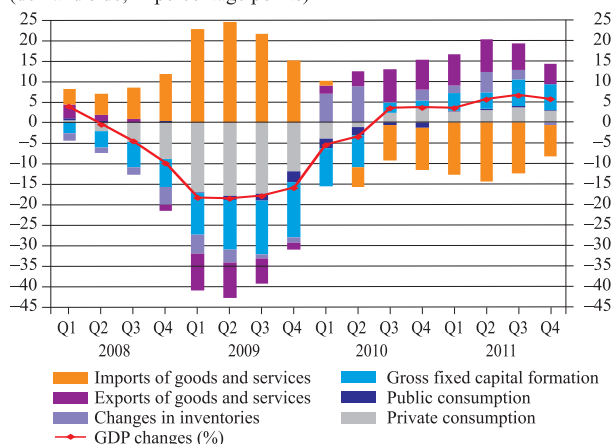
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# 1. Highlights

## GDP growth revised upwards

**Breakdown of annual changes in GDP**  
(demand side; in percentage points)



GDP growth reached 5.5% in 2011 (instead of 5.3% estimated previously), including an increase of 5.7% in the fourth quarter. Consequently, Latvia was one of the fastest growing European economies in 2011 alongside with the other Baltic States.

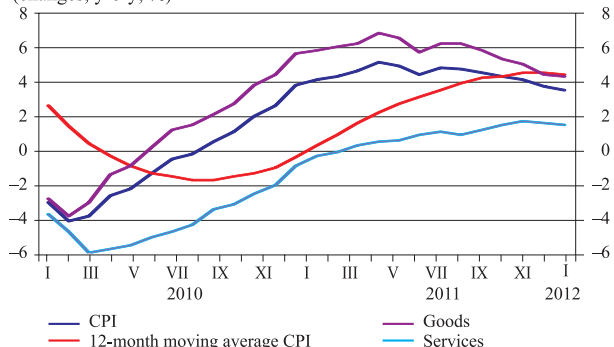
Real exports of goods and services retained its position as the main driver of the economy in 2011. Despite the negative global developments, particularly those observed in Europe, Latvia's export growth was impressive at 12.6%. This was supported by the regained competitiveness in manufacturing and the surge in investment inflows.

Although the rise in external demand was more vigorous, domestic demand also developed dynamically as a result of the very sharp increase in investment. Gross fixed capital formation grew by 24.6% in 2011.

Private consumption (the largest component of domestic demand) increased by 4.4% in 2011. In Latvia's case, this rise should be considered as moderate. The recovery of the private consumption is slow because of the weak purchasing power and the high level of household indebtedness.

## Annual inflation down again

**Inflation in Latvia by components**  
(changes; y-o-y; %)



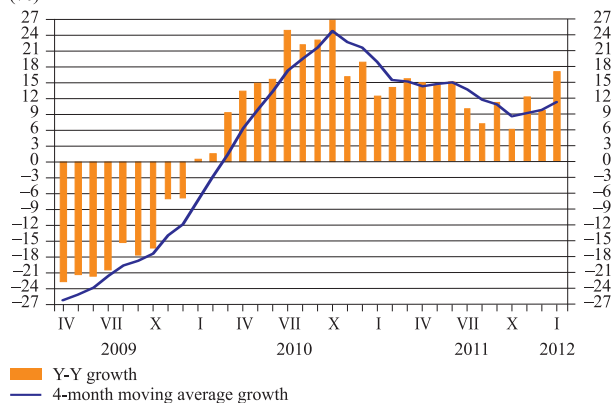
Inflation increased by 0.1% month-on-month in February 2012, which is a much lower rise than in January when the prices of natural gas and heating tariffs were raised. Annual inflation dropped to 3.4% in February (down from 3.6% in January).

External developments, such as changes in global food prices and global oil price trends, remain the main factors determining the inflation dynamics in Latvia. That being said, the contribution of fuel prices to the annual inflation declined slightly in February compared to a year ago and amounted to 0.7 percentage point.

With the upside risks associated with the oil price developments remaining broadly unchanged, the downward inflation trend could gain momentum starting from April, as some of the one-off effects from the last year (such as higher electricity tariffs as well as excise tax on fuel and tobacco etc.) start to fade.

## Manufacturing starts the year on a strong note

**Manufacturing growth in Latvia**  
(%)



In January, manufacturing output grew by 3.0% month-on-month, with the year-on-year rise amounting to 16.8% (calendar-adjusted data).

The main contributors to this growth were the manufacture of wearing apparel, pharmaceutical products, basic metals, fabricated metal products as well as other transport equipment, their respective outputs expanding by 9.4%, 15.8%, 10.2%, 10.2% and 46.6% month-on-month.

In 2011 overall, manufacturing sales rose by 16.8%, including an increase of 20.6% in exports and 13.3% in the domestic market respectively. This is another indication that in 2011 manufacturing growth was based on a substantial rise of turnover in the external markets.

## 2. Macroeconomic Data

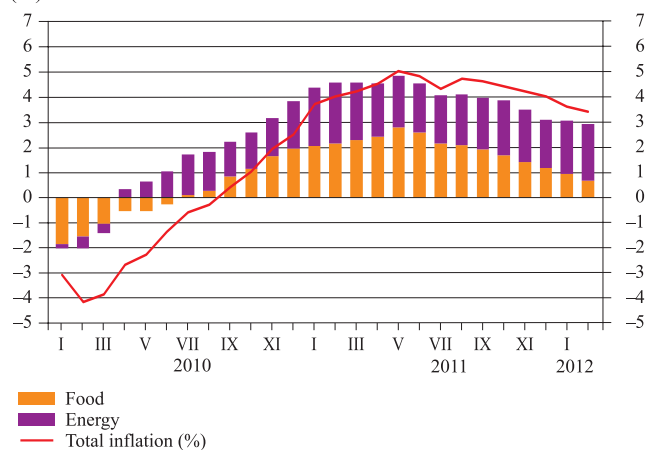
	Reporting period	Data (%)
<b>Gross Domestic Product (GDP)</b> (quarter-on-quarter growth; seasonally adjusted) 09.03.2012 GDP growth in 2011 faster than estimated 	2011 Q4	1.1
<b>State budget</b> Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year; year-on-year growth)	2012 II 2012 II	20.9 3.4
<b>Consumer price changes</b> Consumer Price Index (CPI; month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.03.2012 In February inflation affected by oil prices, end of seasonal sales 	2012 II 2012 II	0.1 4.2
<b>Foreign trade</b> Exports (year-on-year growth) Imports (year-on-year growth) 13.03.2012 The Year Begins with Current Account Deficit 	2012 I 2012 I	12.5 25.7
<b>Balance of payments</b> Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 05.03.2012 Latvia's Balance of Payments in the Fourth Quarter of 2011 and Year 2011 	2011 Q4 2011 Q4	1.2 3.8
<b>Industrial output</b> Working day-adjusted industrial output index (year-on-year growth) 05.03.2012 Manufacturing begins year with growth, yet no reason for great optimism 	2012 I	16.8
<b>Retail trade turnover</b> Retail trade turnover at constant prices (year-on-year growth) 29.02.2012 Year begins with substantial pluses in retail 	2012 I	16.6
<b>Employment and unemployment</b> Registered unemployment (share of working age population) 22.02.2012 Unemployment drop slows due to seasonality and changes in "100-lats" temporary jobs programme 	2012 II	11.8
<b>Monetary indicators</b> Broad money M3 (year-on-year) 20.03.2012 A moderate rise in money supply resumes 	2012 II	1.5

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

### 3. In Focus

#### Inflation rate remains on a downward trend

Contribution of food and energy prices to inflation (pp) and the y-o-y inflation rate (%)



Sources: FAO, Reuters.

World food and oil price developments

(%; Jan 2010 = 100%)



Sources: FAO, Reuters.

The annual inflation rate has been declining since August 2011 and was 3.4% in February 2012. Both external and domestic factors contributed to the deceleration of consumer prices. Firstly, this year the domestic tax policy is more favourable: no new tax measures affecting consumer prices have been introduced as was the case in 2011. Thus the impact of the increases in VAT and excise tax on fuel, tobacco and alcoholic beverages implemented over 2011 is gradually fading out (the so-called base effect). Secondly, a relatively smaller rise in global food prices in the beginning of 2012 (as compared to January-February 2011) also contributes to the slowdown of the headline inflation (see Chart 1 and Chart 2). Even though the so-called administered prices still contribute around 1.5 percentage points to the headline inflation, they contain the impact of electricity tariffs raised in April 2011; therefore, the impact of administered prices on inflation is about to decrease as early as in Q2 2012.

Domestic factors other than indirect taxes and administered prices (highly dependent on world energy prices) seem to have a relatively small impact on the average annual inflation in 2012 as the economic growth is about slow down both domestically and in Latvia's major trading partner countries. This is reflected by the decreasing core inflation. Looking at the external factors, the political unrest in oil-producing countries seems to have taken on a more permanent character and is unlikely to be solved in the nearest months, thus adding to the uncertainty about the precise impact on the average annual inflation. Persistently high energy costs may affect

the total costs of other industries, including food production. The uncertainty surrounding the food prices is aggravated also by the weather conditions such as the drought in South America affecting crops as well as the harsh winter influencing the expected grain harvest in the CIS countries. In recent months, however, the food prices levelled out as a result of the good harvest of the previous season and hence sufficient stocks. Despite some uncertainty regarding the impact of external factors, the actual 2012 inflation rate is expected to remain on a downward trend and reach 2.4% in 2012 on average.