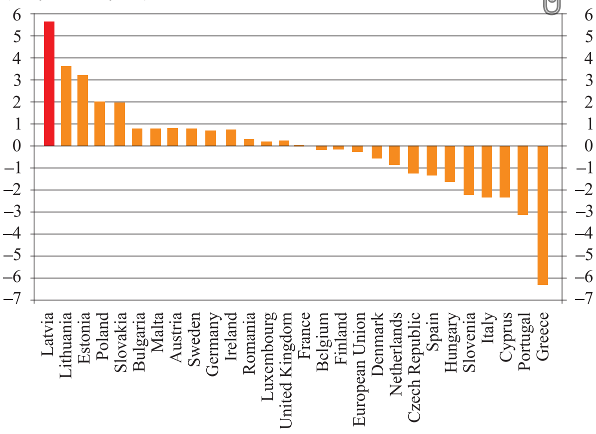
LATVIJAS BANKA

BANK OF LATVIA
MONTHLY NEWSLETTER • MARCH 2013

1. Highlights

Economic growth in Latvia fastest among EU countries again

GDP growth in 2012
(%; year-on-year)



Source: Eurostat

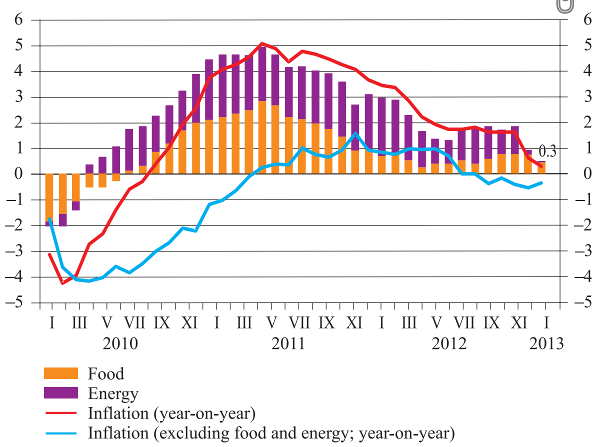
The revised GDP figures show that in the last quarter of 2012 GDP grew 1.4% quarter-on-quarter (adjusted upwards by 0.1 percentage point relative to the flash estimate). Hence, the Latvian economy continued to grow rapidly in 2012, reaching the highest rate of growth in Europe at 5.6%.

At the beginning of 2012, investment played a crucial role as the main GDP driver, later yielding to private consumption, whereas in the last six months the GDP growth was significantly supported by net exports.

We do not expect the GDP growth to remain on the level of the last two years in 2013, yet it should still be among the highest in Europe.

Inflation continues on a downward trend

Impact of food and energy price on headline inflation and the year-on-year inflation rate
(in percentage points; %)



Sources: CBS, Bank of Latvia staff calculations

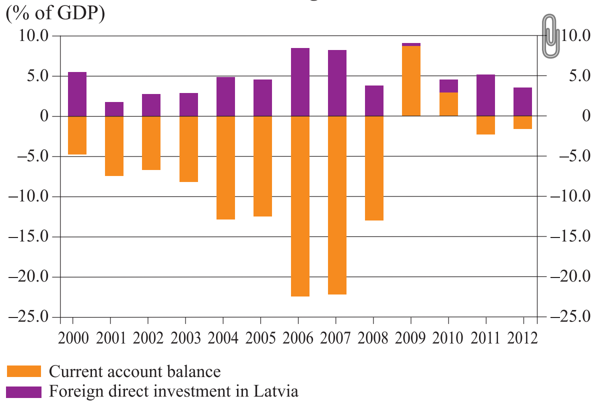
In February 2013, the annual inflation continued to decline and was at 0.3%, with prices going down 0.1% month-on-month. Downward pressure on inflation was exerted by a decrease in administered prices: the reduced sales prices of natural gas caused a decline in the heating tariffs, as expected.

Furthermore, it is evident that the demand-side pressure has not increased and for the time-being the prices of many goods and services do not tend to revert to their previous levels.

As a result, the average annual inflation this year could be lower than the forecasted 2.0%, even considering the potential rises in the electricity prices.

Current account close to balance, the deficit more than covered by FDI

Current account balance and foreign direct investment in Latvia
(% of GDP)



Sources: CSB, Bank of Latvia

With exports of goods continuing on an upward trend, the current account of Latvia's balance of payments actually recorded a surplus of 0.5% of the GDP in the fourth quarter of 2012. Overall in 2012 the current account deficit in Latvia contracted to 1.7% of the GDP.

Most of this improvement was achieved on account of the booming export sector. The annual growth in exports of goods and services stood at 15.2% in the fourth quarter, while the respective imports increased by 8.6%. The weak external demand notwithstanding, the market shares of Latvian exporters expanded in the European Union countries in general and in such major trade partners as Denmark and Finland in particular.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 11.03.2013 GDP growth in Latvia, at 5.6%, the fastest in Europe; growth to moderate this year	2012 Q4	**1.4**
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	2013 II 2013 II	**4.8** **9.0**
Consumer price changes Consumer Price Index CPI (month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.03.2013 The annual inflation continues to drop	2013 II 2013 II	**–0.1** **1.8**
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 12.03.2013 A drop in Latvian external trade activity in January	2013 I 2013 I	**11.7** **3.2**
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 06.03.2013 Latvia's Balance of Payments in the Fourth Quarter of 2012	2012 Q4 2012 Q4	**0.5** **3.4**
Industrial output Working day-adjusted industrial output index (year-on-year growth) 06.03.2013 Although manufacturing begins the year with a drop, future prospects have not deteriorated	2013 I	**0**
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 01.03.2013 Retail trade grows in January, a drop expected in February	2013 I	**5.2**
Employment and unemployment Registered unemployment (share in working age population) 01.03.2013 Purchasing power of salaries keeps growing at a pace, yet poses no inflation risks	2013 II	**10.9**
Monetary indicators Broad money M3 (year-on-year) 20.03.2013 As Latvia moves toward participation in the euro zone, the amount of cash currency in circulation shrinks	2013 II	**3.4**

Source: Treasury, Central Statistical Bureau of the Republic of Latvia, and Bank of Latvia data.

3. In Focus

Latvia joins the reference group for the Maastricht inflation criterion in February

At the beginning of March, the Latvian government formally requested the European Commission and the European Central Bank to measure its economic performance and compliance with the criteria for joining the euro as laid out in the Treaty of Maastricht. Results are due in early June and a decision by EU finance ministers is expected in July. A positive evaluation and an invitation would see Latvia joining the euro next year.

"We have no worries that Latvia could fail to meet any of the criteria at the last moment," Ilmars Rimševičs, Governor of the Bank of Latvia said on 14 March, addressing the media after the bi-monthly Council meeting of the central bank.

For several months running, Latvia's inflation has been among the lowest in the European Union. **In February, Latvia joined the reference group for the inflation criterion** consisting of the three best-performing EU Member States in terms of the lowest 12-month average annual inflation. Latvia's inflation has consistently followed a downward trend: in January and in February, the inflation rose by 0.6% and 0.3% respectively in annual terms. The average annual inflation stood at 1.8% in February.

The persistently low inflation observed in the first months of the year was a result of both the drop in administrated prices (primarily those of thermal energy and natural gas) and the stable global energy prices. The February inflation in Latvia was largely determined by the drop in the sales price of natural gas triggering a change in heating tariffs as well as further discount sales of clothing and footwear. The primary reason for the decrease of the annual inflation in February was the fact that the rises in the prices on fuel and unprocessed food were lower than the ones registered in the previous year.

At the moment, we can confirm that no upward inflationary risks are posed either by changes in **producer prices** or by the **labour market**. The monthly rise in producer prices in January was a mere 0.1% for the production sold domestically. Over this year, a number of domestic factors will also exert a downward effect on **energy prices**: in the coming months, a positive impact could be *inter alia* expected from the sales price of natural gas. A decline in other costs could also have a compressing effect on thermal energy prices in, e.g. Rēzekne and Riga.

Nor are there any substantial inflation risks imminent from the perspective of the labour market. Labour shortages as estimated by businesses have stabilised and the number of vacancies is gradually returning to the level observed before the steep economic growth period. Even though a minor rise in salaries can be expected in the future, it will be overall consistent with the productivity gains. Consequently, it will not result in higher production costs that would push up the prices.

An upward pressure on inflation could be potentially caused this year by the liberalisation of the electricity market expected in autumn in combination with a rise in the mandatory procurement component. The impact on inflation is currently estimated as rather insignificant: assuming that the market liberalisation takes place in September, the potential rise in electricity prices could add approximately 0.2 percentage point to this year’s annual inflation.

In view of the low inflation recorded in January and February, **the central bank has also revised downwards its estimate of the average annual inflation for 2013** from 2% to 1%, nevertheless, keeping in mind the uncertainties surrounding the indirect impact of the electricity prices and the food prices in the new harvest season.