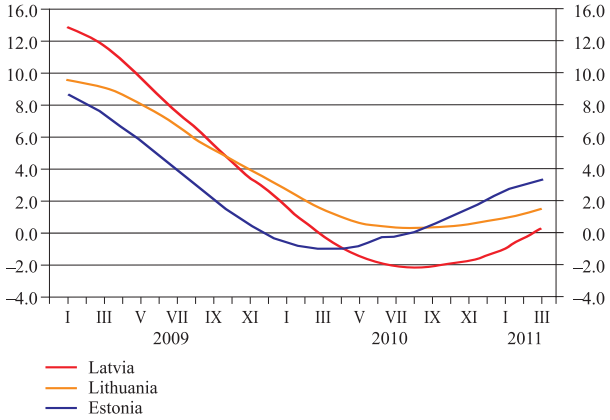
3. In Focus

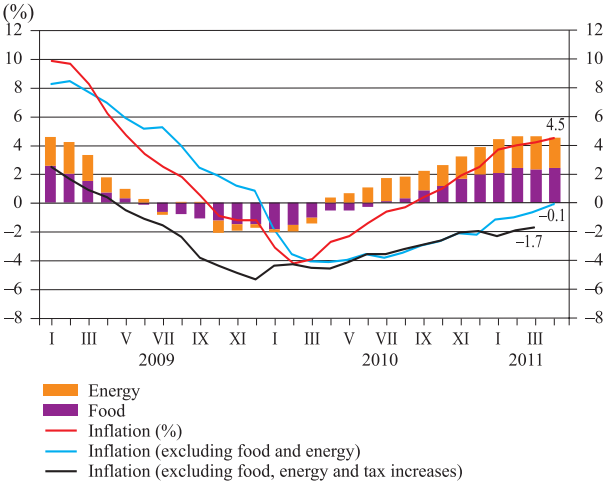
Inflation up temporarily on account of external supply shock

12-month average inflation
(%)



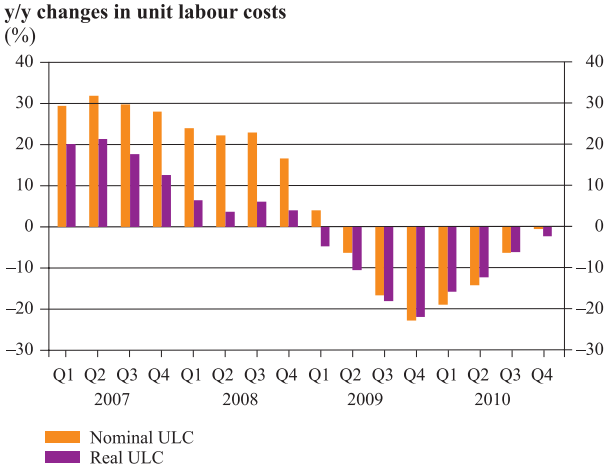
Source: Eurostat.

Food energy price contribution and indirect tax increase impact on inflation
(%)



Source: CBS, BoL calculations.

y/y changes in unit labour costs
(%)



Source: Eurostat, BoL calculations.

After a year's stay in deflationary territory, Latvia's inflation turned positive: in April 2011, the year-on-year inflation reached 4.5%, although the 12-month average consumer prices were only 1.3% above the level of the previous year.

Higher inflation was driven by supply-side factors. Prices increased mainly on the account of one external factor: the surge of the global food and energy prices. As the price setting in Latvia is highly flexible, the surge in raw materials was reflected promptly in the overall consumer price level. In addition, a larger share of food and energy items in consumer basket, if compared to the EU15 countries, contributed to a stronger transmission of global developments to the domestic price level in Latvia. However, the most significant domestic driver of inflation was the ongoing fiscal consolidation, which included a rise in indirect tax rates, thereby pushing up consumer prices as well. Headline inflation excluding the contribution of food and energy prices remained negative.

At the same time, weak labour market conditions and persistently sluggish credit growth exerted downward pressures on prices. Core inflation excluding unprocessed food, fuel and administered price increases indicated the absence of domestic demand pressures and demonstrated a significantly slower growth. Moreover, rising prices of primary goods dampened the demand for other goods and services, providing additional restraint on the expansion of domestic consumption.

While the domestic tax-related consolidation measures and the global oil and food price rallies will continue to shape inflation in 2011, return to low inflation is expected over the medium term as the world commodity prices ease. Significantly lower inflation is anticipated already in 2012, making compliance with the Maastricht inflation criteria likely as early as late 2012/early 2013. Moreover, the commodity price surge is affecting the inflation rates globally, including the EU member states. Along with the inflation rise in Latvia, it is expected to increase the value of the Maastricht criteria as well. In addition, weak domestic demand and loose labour market conditions are likely to exert the downward pressure on inflation over the medium term, thus contributing positively to a low-inflation environment.