LATVIJAS BANKA

BANK OF LATVIA
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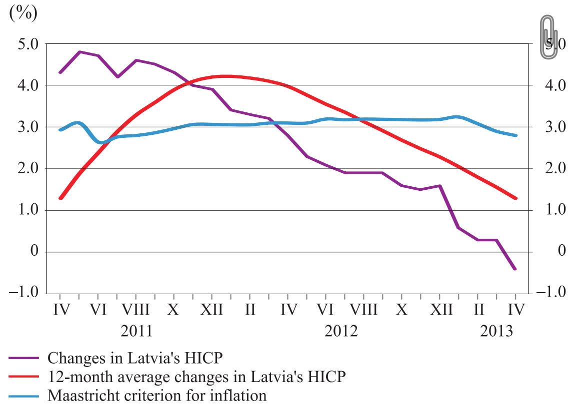
1. Highlights

Inflation low, Latvia meets Maastricht criterion with wide margin

Inflation in Latvia and the Maastricht criterion for inflation
(%)



Source: Eurostat.

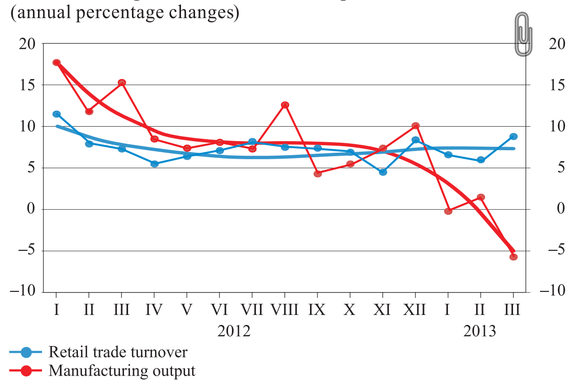
In April 2013, annual inflation turned negative (-0.4%). This low level of inflation is still rooted in both cost and other factor dynamics of the basis period. For instance, in April 2012, fuel prices hiked dramatically on account of high oil prices. However, in April 2013, they declined and thus alleviated cost pressures in many sectors.

This persistently low inflation has allowed Latvia to comply with the Maastricht inflation rate criterion with a comfortable margin.

At the same time, it is quite likely that the lowest level of the current year's annual inflation has already been reached. In the coming months, the effects stemming from low fuel prices, the reduction of the value added tax in July 2012, and the lowering of heating costs in November 2012 will all gradually disappear. On the other hand, prices in the electricity market are likely to be liberalised later than initially planned, thus reducing the scope for price increases this year. Moreover, potential price hikes for a number of widely used goods and services are likely to be curbed by the on-going price observation activities related to the expected euro changeover.

GDP growth slower due to manufacturing, but retail trade still holding up

Manufacturing and retail trade development in Latvia
(annual percentage changes)



Source: CSB.

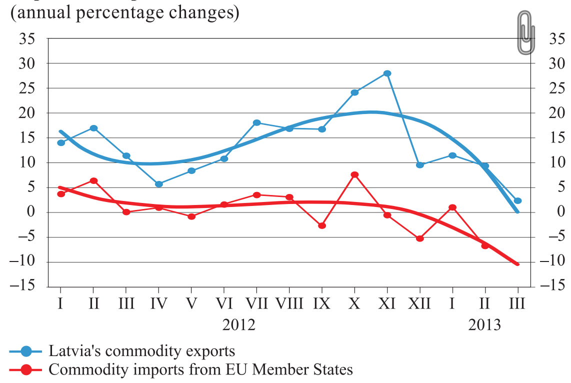
According to the CSB flash estimate, in the first quarter of 2013, the annual growth rate of gross domestic product (GDP) was 3.1%. This is a decline in comparison with the previous year; nevertheless, considering the unfavourable developments both in the external and the domestic environment, economic growth has moderated only slightly.

Looking by sector, however, the performance is uneven. While the manufacturing output shrank by 3.6% quarter-on-quarter in the first quarter, retail trade continued to report significant growth.

Even assuming that the domestic demand will continue to develop at a stable pace in 2013, it is unlikely that GDP growth will reach the levels observed in 2012 and 2011. Experience suggests that the domestic demand in Latvia will be unable to sustain the economic growth in the longer term in the absence of a recovery in the external demand.

Exports slow down amid stagnating external demand

Export development in Latvia and external demand
(annual percentage changes)



Source: CSB.

In March 2013, Latvia's foreign trade turnover grew by 10% despite the generally low external demand.

Although the annual growth of the commodity exports remained positive in March (2.6%), as a result of the weakening demand in the markets of partner countries and the base effect, the rate of growth decelerated significantly. The rises in the exports of products of the chemical industry, agricultural and food products, paper and articles of paper, building materials, machinery and equipment contributed positively to the annual growth of the commodity exports. Conversely, the annual growth rate of exports was dampened by a decline in the exports of transport vehicles and mineral products.

Latvia's export trends for the coming months should be viewed with caution because of the data reported from manufacturing in the most recent months as well as the external developments. The confidence indicators published by the European Commission also show deterioration in the outlook on new export orders in April for the second consecutive month for Latvia's ESI. On the other hand, a positive contribution to exports in the future could be made by the signing of the Trade and Investment Partnership Agreement between the European Union and the USA.

2. Macroeconomic Data

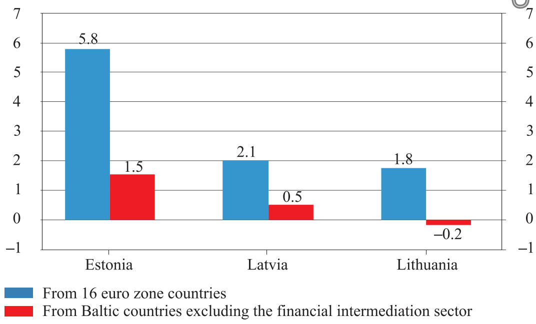
	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 14.05.2013 Problems in industry do not affect GDP growth in the first quarter of 2013	2013 Q1 *(flash estimate)*	**1.2**
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	2013 IV 2013 IV	**9.0** **7.1**
Consumer price changes Consumer Price Index CPI (month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 13.05.2013 Lowest annual inflation to have been likely reached	2013 IV 2013 IV	**0.0** **1.3**
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 13.05.2013 The prospects for Latvia's exports in the upcoming months should be viewed with caution	2013 III 2013 III	**2.6** **1.3**
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP)	2012 Q4 2012 Q4	**0.5** **3.4**
Industrial output Working day-adjusted industrial output index (year-on-year growth) 08.05.2013 Latest manufacturing data do not invite optimism	2013 III	**–5.7**
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 02.05.2013 The amounts of fuel sold in March up sharply. Where are we driving to?	2013 III	**8.8**
Employment and unemployment Registered unemployment (share in working age population) 16.05.2013 Unemployment on a downward trend; despite that, the high unemployment enclaves require structural policy	2013 IV	**10.8**
Monetary indicators Broad money M3 (year-on-year) 21.05.2013 Monetary aggregate dynamics reflects slower economic activity growth	2013 IV	**4.2**

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

3. In Focus

Situation in the Baltic States in terms of attracting foreign direct investment

Chart 1
FDI growth in the Baltic States from 31 December 2010 to 31 December 2012
(% of GDP)

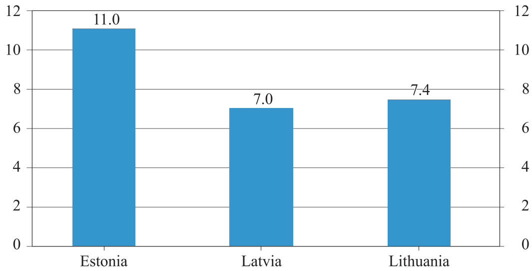


Sources: national central banks, Eurostat.

After the introduction of the euro, Estonia has been the Baltic State with the highest growth of foreign direct investment (FDI) from the 16 euro area countries as well as from the Baltic States, both in nominal terms and as percentage of GDP (Chart 1).

FDI inflows to Estonia from the euro area were supported by a rise in its credibility in the eyes of investors. In 2011, Estonia's first year as a euro country, 50 major investment projects received funding inflows in Estonia, 20% higher than in 2010. Moreover, more than half of the above projects were associated with industrial investment, mostly from Finland, Spain and Germany. For example, the company *Atienza & Climent Group* (representative of the *Hello Kitty* brand) from Spain invested 10 million euro in a plant in Estonia, claiming that the euro was a major factor underlying the company's investment choice. The rise in Estonia's credibility contributed to receiving FDI inflows from other Baltic States as well, e.g. *Latvijas Finieris* invested 20 million euro in a plant in Estonia.

Chart 2
Average income as a % of FDI to Baltic countries in 2004–2012



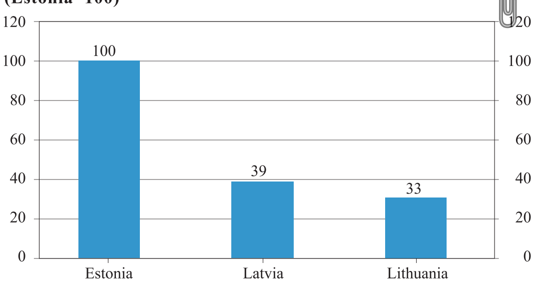
Source: Eurostat.

The very substantial fall in FDI observed in Latvia and Lithuania during the same period mostly reflected the restructuring of *Swedbank*.[1] Nevertheless, even omitting the restructuring of Swedbank (and FDI flows in the financial sector) from the calculation, the growth of the Baltic States' FDI to Estonia would be higher than that to Latvia, with the respective FDI in Lithuania even posting a decrease.

Apart from Estonia's higher credibility since the euro introduction, there are some other reasons supporting the FDI inflows in this Baltic country. First, from 2004 to 2011 the largest average income from FDI in the Baltic States was recorded in Estonia (Chart 2). Second, a favourable corporate income tax system is in place in Estonia. Third, Estonia continues to pursue responsible fiscal policy also after joining the euro area.

Obviously, responsible fiscal policy can also be pursued outside the euro area, and the introduction of the euro stimulates investment only subject to the condition that an economy implements responsible economic policy; nevertheless, it is expected that Latvia would encourage FDI inflows by introducing the euro in 2014. This is particularly important as Latvia currently lags behind Estonia in terms of FDI attraction. Already before the crisis reinvested earnings as a share of income from FDI were considerably higher in Estonia in comparison to Lithuania and Latvia; this means that the funds once invested in the Estonian economy remain there also in the future, continuing to promote its economic growth. Moreover, already in 2004–2012 the average FDI per capita in Estonia exceeded that in other Baltic States approximately three times (Chart 3). With such situation persisting, it is even more important for Latvia to introduce the euro and thus attract more FDI.

Chart 3
Average FDI per capita in the Baltic States in 2004–2012 (Estonia=100)



Source: Eurostat.

[1] The Estonian Swedbank, formerly the parent company of its daughter companies in Latvia and Lithuania, sold the shares of its daughter companies in a formal transaction to Swedbank in Sweden, thus reducing the FDI in Latvia and Lithuania considerably according to the principles underlying the balance of payments (the amount of the actual investment remained unchanged).