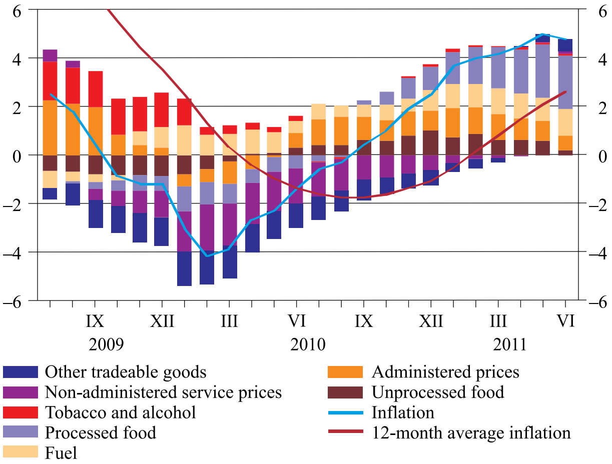
LATVIJAS BANKA

BANK OF LATVIA
MONTHLY NEWSLETTER • JULY 2011

1. Highlights

Inflation pressures easing in line with global trends

CPI changes
(in percentage points)

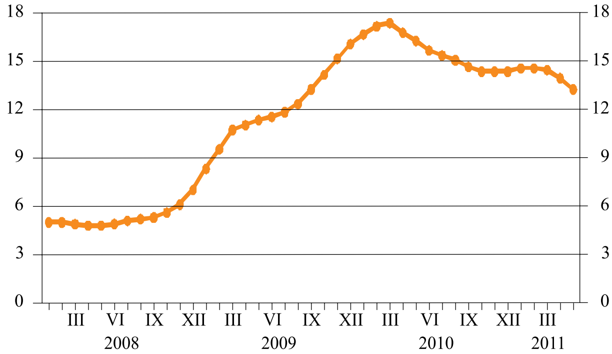


The pressure of global prices on the prices in Latvia has slightly abated, with the stabilisation reflected in both fuel and food price indicators. For instance, food prices went down for the first time in ten months. As a result, the annual inflation edged down to 4.8% in June.

At the same time, higher excise tax rates came into effect for alcohol and fuel. Moreover, the rise of global energy prices at the beginning of this year will continue to affect the prices of natural gas and thus also heating tariffs in Latvia. Hence, a more pronounced decline in inflation is expected only at the beginning of next year, as base effects gradually fade away.

Unemployment is shrinking due to stronger economy

Registered unemployment
(%)

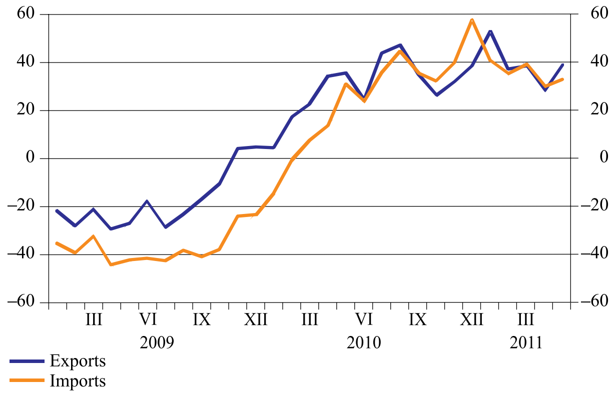


In June 2011, registered unemployment continued to drop sharply: in one month, it contracted for another 0.6 percentage points to 12.6% of the economically active population. The decline in unemployment has been faster than in the corresponding period of the previous year both in absolute figures and percentagewise.

Unemployment has contracted primarily on account of new jobs, as the economy is gradually recovering from the crisis. The fall in the number of registered unemployed matches the rising number of employees for whom social insurance payments are made. This is a clear indication that the primary reason for the drop in unemployment over the past year has been the rising employment, rather than emigration.

Foreign trade on the rise

Annual growth rates
(%)



In May 2011, both export and import volumes of goods rose month-on-month. Moreover, the annual growth rates remained high at 38.8% for exports and 32.7% for imports.

Looking by groups of commodities, exports followed the previous trends, with the exports of wood, base metals and articles of base metals, transport vehicles, machinery and electrical equipment growing at the fastest rates. Latvia's most significant export partners were Lithuania, Estonia, Russia, Germany and Sweden.

Confidence indicators published by the EC point to a slight improvement in the evaluation of export orders in June. At the same time, global developments as well as industrial confidence indicators point to a potential fall in external demand, and it can be expected that in the second half of the year exports will continue to grow but at a somewhat more moderate pace.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted)	2011 Q1	**0.3**
State budget		
Tax revenue (current month; year-on-year growth)	2011 VI	**14.9**
General government expenditure (since the beginning of the year; year-on-year growth)	2011 VI	**2.2**
Consumer price changes		
Consumer Price Index (CPI; month-on-month growth)	2011 VI	**0.3**
12-month average annual inflation (to comply with the Maastricht Criteria)	2011 VI	**2.4**
08.07.2011 Global price pressure on inflation abates, yet prices are driven up by tax changes		
Foreign trade		
Exports (year-on-year growth)	2011 V	**38.3**
Imports (year-on-year growth)	2011 V	**32.7**
11.07.2011 Latvia's foreign trade activity on the rise		
Balance of payments		
Current account balance (ratio to GDP)	2011 Q1	**1.7**
Foreign direct investment in Latvia (net flows; % of GDP)	2011 Q1	**1.4**
14.07.2011 Current account surplus increases on account of EU fund inflows		
Industrial output		
Working day-adjusted industrial output index (year-on-year growth)	2011 V	**12.1**
04.07.2011 In keeping with global trends, manufacturing slows in May		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2011 V	**0.7**
30.06.2011 Retail turnover dynamics still unstable		
Employment and unemployment		
Registered unemployment (share of working age population)	2011 VI	**12.6**
12.07.2011 Registered unemployment shrinking fast; new jobs created		
Monetary indicators		
Broad money M3 (year-on-year)	2011 VI	**5.4**
20.07.2011 Money supply levelled out; a pronounced rise not yet expected		

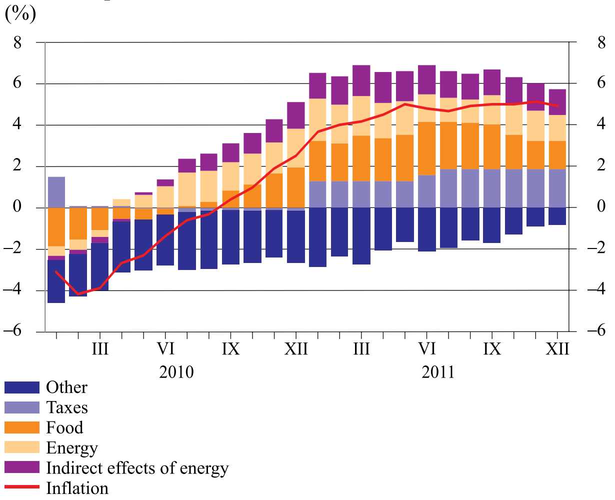
Sources: Treasury, Central Statistical Bureau of Latvia, and Bank of Latvia data.

3. In Focus

A Third of Annual Inflation Generated by Tax Hikes

Lower levels of inflation seen next year – 2.5–3.0%

Consumer price annual increases



June inflation data point to a small drop in annual inflation – to 4.8%. In May the annual inflation stood at 5%, which led some forecasters to expect a rise to 5.5% or even 6% in June. That has not materialized: the reason for the decline is a slower increase in heating tariffs compared to June of last year, as well as a fall in vegetable prices in response to shrinking demand.

In the last six months overall, the annual inflation was determined by rises in energy and food prices, which we had predicted, as well as raising of value added and excise taxes, which has generated one third of the current inflation. **The inflation forecast for this year is 4.7%.**

If we look at the inflation components, we see that the increase in food prices (2.0 percentage points) and the rise in energy prices, including its indirect effect, i.e. the pickup in production costs (2.9 percentage points overall) have contributed to inflation in almost equal measure. The raised tax rates (1.6 percentage points) are also a significant contributor. The other factors related to economic growth, on the other hand, are still acting toward lowering the inflation. Here we should also take into account the fact that lending amounts are not growing and no rapid change is expected in this respect.

The central bank's outlook regarding price dynamics in the medium term remains unchanged: the current upward move in inflation has been caused by one-off and temporary factors, and, as their influence dissipates, a further climb in prices will abate. As the impact of global price rises and tax increases moderates, **we will observe a much lower inflation as early as next year** – between **2.5 and 3.0 percent**.

While Latvia cannot affect or change the impact of the global markets on energy or food prices, it can choose its own taxation policies. As the Minister of Finance has declared, it is important not to raise the main tax rates or introduce new taxes. **Yet to bring the inflation down substantially, more must be done: no taxes should be raised either in 2012, or in 2013.**

That would also lead to more rapid economic growth. Such an approach should also be a part of **the anti-inflation measures** that the Ministry of Finance plans to have in place by the end of July. These measures should include provisions that salaries can only be raised alongside productivity growth and that the budget consolidation must be accomplished only on account of expenditure cuts instead of tax increases. Structural unemployment, which may act as an additional pressure on inflation, should also be brought down. That can be attained by changing the education process, allowing a wider participation by entrepreneurs themselves.