



LATVIJAS BANKA

BANK OF LATVIA

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1 Highlights

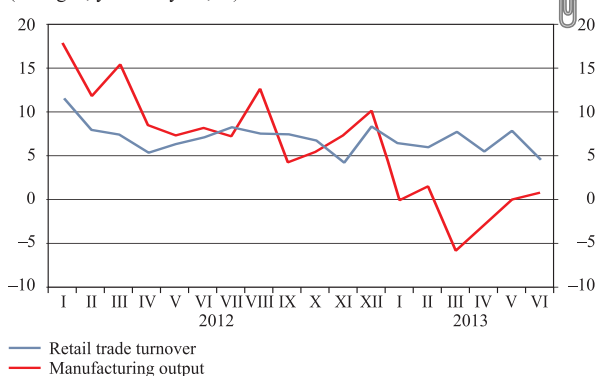
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1. Highlights

GDP growth prospects remain promising

Retail trade and manufacturing developments in Latvia
(changes; year-on-year; %)

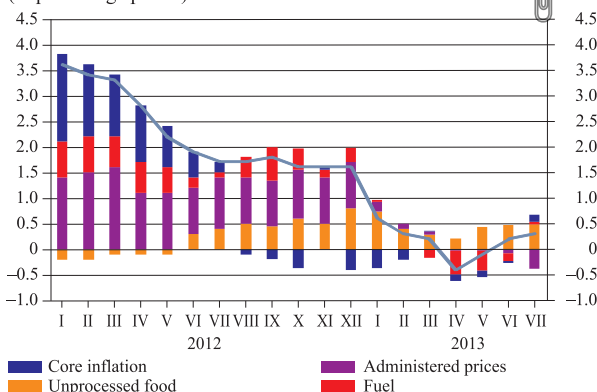


Source: CSB data.

PMI data point to an improving situation in Europe giving hope that the brief spell of weakness in the Latvian economy is a short-lived and transitory phenomenon.

Seasonal factors affect consumer prices

Contributions to annual inflation
(in percentage points)



Source: CSB data.

consumer protection initiatives related to the upcoming changeover to the euro make steep price revisions in the near future unlikely.

Job creation results in further unemployment decrease

Unemployment rate
(%)



Source: CSB, SEA, data corrected to allow for the recent census.

In the second quarter of 2013 the flash estimate showed a 3.8% year-on-year GDP growth, thus the country retains its position as the fastest growing economy in the EU.

Manufacturing output grew 1.0% quarter-on-quarter, but decreased by 0.6% year-on-year making it a likely negative contributor to the GDP annual growth. Whilst the retail turnover did not change in the first quarter, it grew by 6.0% in year-on-year terms, suggesting it was the biggest positive contributor to the second quarter GDP growth.

The quarterly rate (0.5%) points to a decelerating pace of GDP growth – hardly surprising given the developments in the country's major trading partners during the first half of 2013. Lately, economic growth is mostly supported by private consumption; however, recovery in exports will be crucial to sustain the pace of growth in the medium term.

The European Commission's survey data as well as the latest

July saw a 0.3% month-on-month decline in consumer prices, primarily due to seasonal factors and favourable dynamics of global prices in the preceding months. Nevertheless, the year-on-year inflation was positive (0.3%), due to the base effect and the accumulated price increases over the course of the year.

Seasonality exerted a downward pressure on the prices of vegetables, footwear and clothing, while an upward tendency was observed for hotel prices and tourism services. The oil product price dynamics, observed in the previous months, pushed the administered prices of gas and heating down. Moreover, the gradual global *Brent* price increase in July did not result in an unexpected fuel price rise in the domestic market.

Annual inflation is expected to stay low in the near term due to moderate global price dynamics and balanced national economic growth. The growing public awareness and the

Since May, for the first time in the last four years, the registered unemployment in Latvia stands below 10%. Furthermore, the Labour Force Survey shows that the share of the unemployed in the total active population has decreased to 11.4%, which is 4.9 percentage points lower than in the second quarter of 2012. Three years ago, Latvia was amongst the countries with the highest unemployment rate in the EU, but currently it is close to the EU average.

Here, the manufacturing sector played the most important role in the rise in employment. Most likely, this is due to the growing market shares that Latvian companies managed to acquire in the economies of the main trade partners.

The decrease in unemployment takes place largely thanks to the creation of new jobs, in particular in the private sector. This, coupled with a stable average workload, leads to the conclusion that the increase in Latvian employment is sustainable.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 09.08.2013 GDP growth somewhat down yet prospects remain promising 	2013 Q2 (flash estimate)	0.5
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	2013 VII 2013 VII	5.4 7.5
Consumer price changes Consumer Price Index CPI (month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.08.2013 Seasonal factors push consumer prices down 	2013 VII 2013 VII	-0.3 0.8
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 09.08.2013 Goods exports, without metals, maintains a good rate of annual growth 	2013 VI 2013 VI	1.8 -9.9
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP)	2013 Q1 2013 Q1	-1.4 2.7
Industrial output Working day-adjusted industrial output index (year-on-year growth) 07.08.2013 Manufacturing output expands for the third consecutive month 	2013 VI	0.8
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 30.07.2013 Fluctuation in retail trade continues but future outlook still good 	2013 VI	4.6
Employment and unemployment Registered unemployment (share in working age population) 14.08.2013 Job creation decreases unemployment further 	2013 VII	9.5
Monetary indicators Broad money M3 (year-on-year) 20.08.2013 Pronounced reduction in demand for cash currency 	2013 VII	1.8

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

3. In Focus

GDP prospects

The economic growth rates observed at the beginning of this year were higher than previously forecasted and the preliminary data on the second quarter of 2013 also point to further growth and a substantial rise in private consumption. In light of that, the Bank of Latvia's GDP growth forecast for 2013 was revised upwards by 0.5 percentage point, to 4.1%. The medium-term risks to the national economic growth prospects can be considered broadly balanced.

On the one hand, unfavourable external environment will continue to weigh on the economic development in 2013. As a result, it is unlikely that exports could be the main engine of Latvia's economic growth in 2013. Private consumption and investment will therefore have a significant role in Latvia's economic development. Latvia's economy is expected to retain overall positive and relatively high growth rates against the European background; nevertheless, the quarterly growth could gradually decelerate slightly in comparison with the recently observed rates. This will be determined by weaker-than-expected export development which is mainly caused by the deteriorating demand factors in manufacturing: the winding-up of the JSC *Liepājas metalurģs* will have a downward effect on the annual growth rates in manufacturing throughout 2013.

On the other hand, provided that disposable income continues to increase as expected and inflation remains low thereby improving the purchasing power of the population, private consumption will retain its leading position also in the future. Moreover, considering Latvia's accession to the euro area, the successful economic development in comparison with other European countries as well as the new round of the EU funds inflows, the contribution from investment is also likely to remain positive. A favourable resolution to the situation faced by the JSC *Liepājas metalurģs* and resuming its business would also be a factor supporting higher GDP growth this year.

As to inflation, the Bank of Latvia forecasts that the average annual inflation could decrease to 0.7% in 2013 as a result of decreasing direct impact of energy prices and its cost effects. The risks to this forecast are balanced.

The expected euro changeover could motivate many businesses to leave the prices unchanged as long as their costs allow them to do that both for the sake of ease (the so-called round prices in public transport, vending machines, parking meters etc.) as well as for retaining attractive pricing policies in the existing currency. Moreover, the energy price developments observed in the first six months of 2013 also do not call for more often resetting of prices or reviewing of the pricing policies. Although the risks stemming from oil prices have aggravated as a result of the political situation in Egypt, there have been no leaps in the price developments and at the moment their value in lats is even lower than the average value registered in the first two months of the year. The latest estimates of global cereal harvests for 2013/2014 marketing season are higher than those for 2012/2013 marketing season and therefore exert a downward pressure on prices.