



LATVIJAS BANKA

BANK OF LATVIA

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1 Highlights

2 Macroeconomic Data

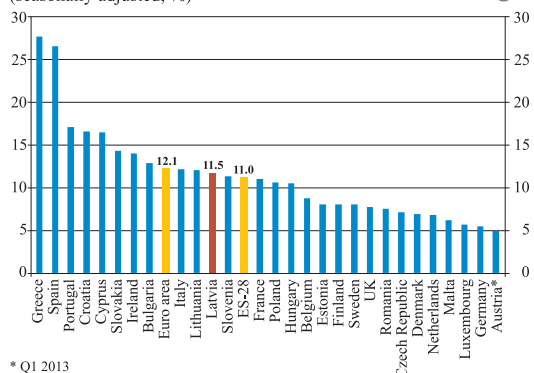
3 In Focus

1. Highlights

Job creation leads to lower unemployment

In the summer of 2013, registered unemployment dropped to a one-digit number for the first time in four years, reaching 9.1% in September. At the end of that month, 89 000 unemployed were registered with the State Employment Agency (SEA) which is less than half of the figure registered during the peak of the crisis at the beginning of 2010. The Labour Force Survey data published by the Central Statistical Bureau indicate a fall in both registered and also real unemployment. In the second quarter of 2013, real unemployment was 11.5%. Only three years ago, the unemployment rate in Latvia was the highest in the European Union, whereas now it has already dropped below the euro area average.

Official unemployment in Q2 of 2013
(seasonally adjusted; %)



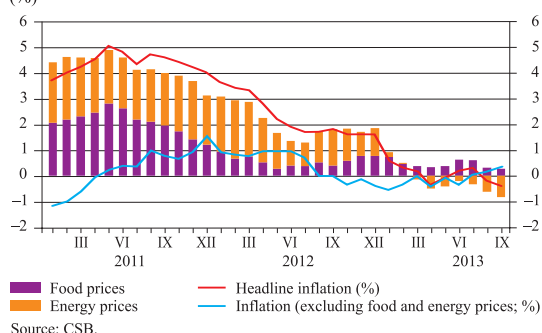
* Q1 2013
Source: Eurostat.

This decline in unemployment is supported by job creation. Employment increases on account of the private sector, with work-loads remaining stable, thus pointing to sustainability of the employment growth. A substantial role in the rise of employment, contributing more than 20% to the rise, was played by manufacturing. With Latvia's competitiveness restored, the increase in manufacturing output was substantially supported by the growing market shares in the imports of Latvia's trading partners.

The growing number of job vacancies also points to improved employment opportunities. In the summer of 2013, the number of vacancies registered at the SE A reached 6 000, the highest level since 2008.

Seasonality determines consumer prices also this month

Contribution of energy and food prices to annual inflation (%)



Source: CSB.

The month-on-month rise in consumer prices of 0.3% observed in September was a result of seasonal factors, as autumn/winter clothing and footwear collections hit the shops after the end of summer sales. Overall, this rise was lower than a year ago when there was an additional significant rise in fuel prices; therefore, the annual inflation remained in a negative territory in September, at -0.4%.

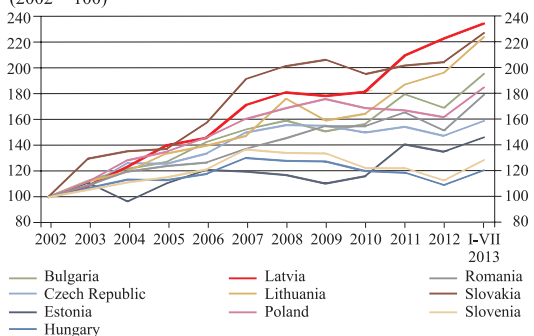
Price fluctuations in September displayed typical seasonality: prices of some services associated with tourists decreased (e.g. accommodation services by 7.3% and tourism services by 6.2%), whereas those of clothing and footwear grew by 5.6%.

The global oil prices have dropped slightly since the beginning of September and currently a corresponding trend is observed also in fuel prices. These declines will be reflected in the October inflation rate. The prices of domestically-produced energy will likewise have a downward effect on inflation in the coming months. As a result, inflation is and will be kept low primarily by the developments in the energy sector.

Exports of goods post a rise after a three-month decline

Exports of Latvian goods managed to post a 6.6% month-on-month rise after dropping for three consecutive months, whereas the imports of goods recorded a minor decline of 0.5%. In the first eight months of 2013, the year-on-year growth of Latvian exports was 4%. Despite the unfavourable global economic developments and the low aggregate demand in external markets, the Latvian export market share continues to increase.

Export market shares
(2002 = 100)



In the first eight months of 2013, a substantially positive year-on-year growth rate was achieved by one of the largest export branches, exports of wood and articles of wood (an increase of 8%). Moreover, the structure of those exports shows an increased activity in the case of products with a higher value added, thus confirming some positive changes in the wood industry. However, the growth in exports of base metals has decelerated, yet the recovery of the construction markets in Latvia's main European partners suggests that the prospects have improved for both metal and wood exporters. With confidence indicators improving in West European countries, the demand for Latvian goods might increase; therefore, further growth of Latvian exports could be expected.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted)	2013 Q2	0.7
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	2013 IX 2013 IX	4.5 6.7
Consumer price changes Consumer Price Index CPI (month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.10.2013 Consumer price level remains lower than a year ago 	2013 IX 2013 IX	0.3 0.5
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 10.10.2013 Latvian goods exports posts a rise after a three-month decline 	2013 VIII 2013 VIII	-8.2 -7.2
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP)	2013 Q2 2013 Q2	0.8 3.0
Industrial output Working day-adjusted industrial output index (year-on-year growth) 08.10.2013 Manufacturing output drops; future prospects could benefit for an improved situation in the export markets 	2013 VIII	-2.5
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 30.09.2013 Retail trade: a regular drop after a regular rise 	2013 VIII	2.1
Employment and unemployment Registered unemployment (share in working age population)	2013 IX	9.1
Monetary indicators Broad money M3 (year-on-year) 18.10.2013 Total currency in circulation down 	2013 IX	1.0

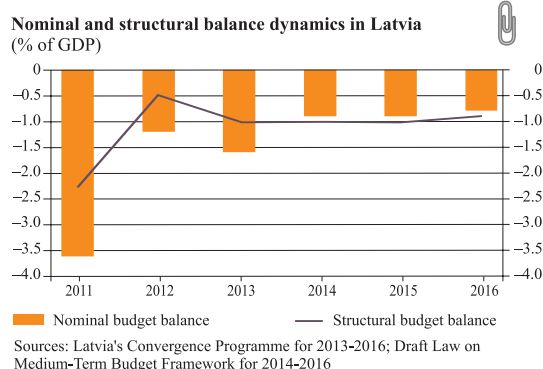
Source: Treasury, Central Statistical Bureau of the Republic of Latvia, and Bank of Latvia data.

3. In Focus

Budget 2014 and Structural Balance Dynamics

Budget 2014 is the first budget drafted in accordance with the Fiscal Discipline Law adopted earlier in 2013. Integration of the fiscal discipline principles in the national law was assumed by the ratification of the Fiscal Compact. Apart from requiring embedding the fiscal rules of the Stability and Growth Pact (SGP) in the national legislation, the Fiscal Compact stipulates introduction of an automatic correction mechanism in case of deviations and independent monitoring of the compliance to the rules by an independent authority.

This budget, the first to be drafted in euro, was passed in the first reading at the Parliament on 17 October. The Fiscal Discipline Law set a number of requirements for budgets: most importantly, it had to be drafted with a medium-term framework in mind, i.e. setting the path of the budget deficit for the next three years and limiting the expenditure for the said horizon accordingly. The budget deficit itself, measured in structural terms, has to target an objective to be reached in the "medium term" following a convergence path. According to the Draft Law on the Medium-Term Budget Framework for 2014–2016, the nominal budget target is set at -0.9% , -0.9% and -0.8% of GDP respectively for the three consecutive years of the planning period. As the economy is expected to grow broadly in line with the growth of its potential in the next three years, the deficit expressed in structural terms, i.e. without the effect of the economic cycle, turns out very similar: -1% , -1% and -0.9% of GDP respectively.



In the case of Latvia, the medium-term objective (MTO) deficit representing a "balanced budget" over the economic cycle is set at 0.5% of GDP. In 2012, this objective was reached: with -1.2% of GDP nominal budget deficit, the negative effect of the economic cycle was estimated at -0.3% of GDP and removed from the calculation of a cycle-neutral deficit accordingly. In addition, a capital injection of 0.5% of GDP to support the financial sector was made in 2012 and as such it was considered a "one-off" measure (unrelated to the normal course of the fiscal policy) and was excluded from the

calculation of the structural deficit. Thus Latvia has already completed convergence to its medium-term structural balance objective and the task for the future is to maintain the achieved balanced level of the government revenue and expenditure. Current forecasts (e.g. Latvia's Convergence Programme for 2013–2016) indicate that in 2013 the structural balance could turn out around -1% of GDP. Moreover, as mentioned above, it is expected to remain at that level throughout the medium-term planning period. Although the calculated deficit lies below the MTO, an important point has to be made: according to the Stability and Growth Pact derogations are possible from the MTO in specific cases, for example, with regard to pension reforms. Latvia is in the process of increasing the contribution to the 2nd pillar of the pension system: in 2013, the contributions were increased from 2% to 4% , thereby reducing the social security revenue by 0.5% of GDP. Since it is permitted to deviate from the MTO by the amount of the fiscal impact of the pension reform, Latvia is still expected to fulfil the MTO requirement in 2013. With the pension reform ongoing and prudent budget targets set for the medium-term horizon, Latvia is determined to remain on a sound fiscal path in accordance with the SGP.