



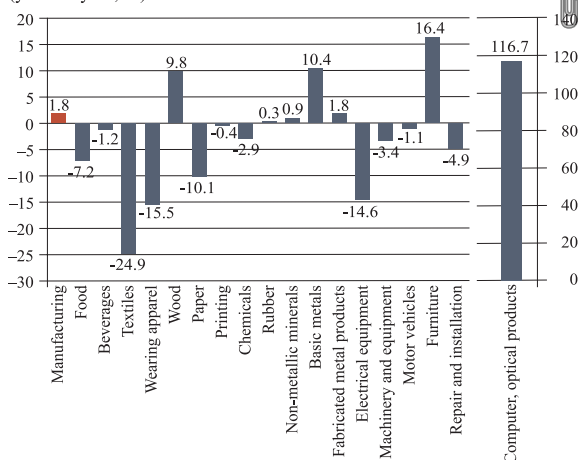
LATVIJAS BANKA
MONTHLY NEWSLETTER

APRIL 2015

Slight growth in manufacturing with a positive outlook

In February, manufacturing output grew by 0.7% month-on-month (seasonally adjusted data) and by 1.8% year-on-year (calendar adjusted data). The relatively positive dynamics of manufacturing was overshadowed by a weak

Changes in volume of manufacturing output January-February 2015
(year-on-year, %)



Source: CSB.

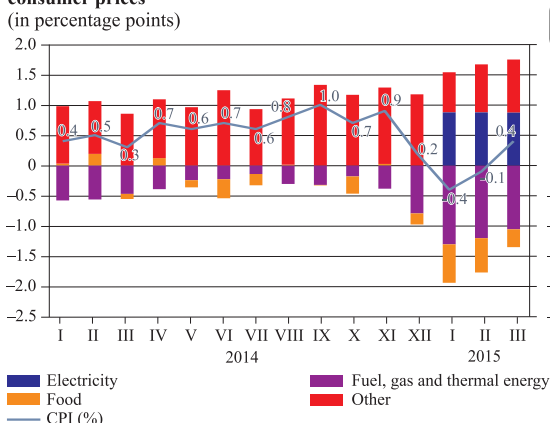
performance of the energy sector, remaining low for the second consecutive month. The increase in manufacturing output was mainly on account of the wood industry, and this upward trend was supported by manufacture of basic metals, furniture and computers. Meanwhile, a negative contributor to the total manufacturing output was the food industry, as was manufacture of textiles, wearing apparel and electrical equipment.

In the past three years, the performance of manufacturing was described as "stagnating". Currently the situation is improving as suggested by the news favourable to the industry: the resumed operation of KVV *Liepājas metalurģs* is expected to have a positive impact on the performance indicators of the industry already in the next few months. In addition, the latest macroeconomic indicators of the euro area countries give rise to hope, and the investments initiated last year indicate that manufacturing output could record moderate growth this year.

In March inflation increased due to domestic factors

In March, inflation stood at 0.4%, reaching a positive annual price increase. Global factors, such as oil and food prices, continued to play a leading role in headline inflation, which remained low. Meanwhile, the negative impact of

Contribution of selected components to the annual increase in consumer prices
(in percentage points)



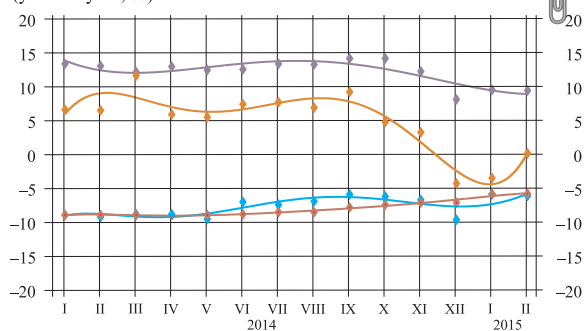
Source: CSB.

global factors on annual inflation tended to decrease. World oil prices went up somewhat at the end of February and the beginning of March. However, this rise was short-lived. At the same time, core inflation increased slightly, possibly as a result of channelling consumption expenditure from the goods sector to the services sector.

A continued rise in prices of services due to the sustained demand is expected to have a positive effect on the average annual inflation. In addition, the reduction of the personal income tax rate by 1% and the resumed operation of KVV *Liepājas metalurģs* could contribute to a gradual increase in the real income of employees. Other indicators, including changes in the excise tax and a rise in parking tariffs in Riga, will have a very insignificant impact on inflation development.

Bank deposits on the rise again, and favourable conditions for lending expected

Changes in selected money indicators
(year-on-year, %)



Source: Latvijas Banka.

In February, total deposits received by banks rose by 1.2% month-on-month and by 4.9% year-on-year, with both businesses and households increasing their savings. Despite economic slowdown, they are still in a reasonably comfortable position to expand deposits.

The domestic loan portfolio of banks, however, contracted slightly by 0.5% month-on-month, with the annual rate of decrease in lending remaining close to 4.5%.

Legislative amendments, providing an option of receiving housing loans with or without the application of the clause of returned keys, took effect in March. Moreover, the monetary stimulation measures by the Eurosystem, including an asset purchasing programme, was launched on 9 March. The above two developments are expected to ensure favourable conditions for improvement in lending.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2014 Q4	2.1
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2014 Q4	0.6
Public Finances		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2015 III	9.3
Tax revenue (since the beginning of the year; year-on-year growth)	2015 III	5.9
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2015 III	0.4
Consumer Price Index HICP (year-on-year growth)	2015 III	0.5
12-month average inflation (HICP)	2015 III	0.6
13.04.2015 Annual inflation in March increased under the influence of both global and, slightly, also domestic factors 		
Foreign trade		
Exports (year-on-year growth)	2015 II	-3.6
Imports (year-on-year growth)	2015 II	-5.1
10.04.2015 Latvian exporters must look for new niches for their products 		
Balance of payments		
Current account balance (ratio to GDP)	2014 Q4	-1.4
Foreign direct investment in Latvia (net flows; ratio to GDP)	2014 Q4	4.0
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2015 II	0.7
08.04.2015 Slight growth in manufacturing in February 		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2015 II	9.3
Labour market		
Registered unemployment (share in working age population)	2015 III	9.2
Job seekers rate (share in working age population)	2014 Q4	10.2
Monetary indicators		
Resident deposits (year-on-year growth)	2015 II	4.9
27.03.2015 Bank deposits on the rise again 		

Sources: Treasury, Central Statistical Bureau of the Republic of Latvia, and Latvijas Banka data.

Main characteristics of core inflation trends



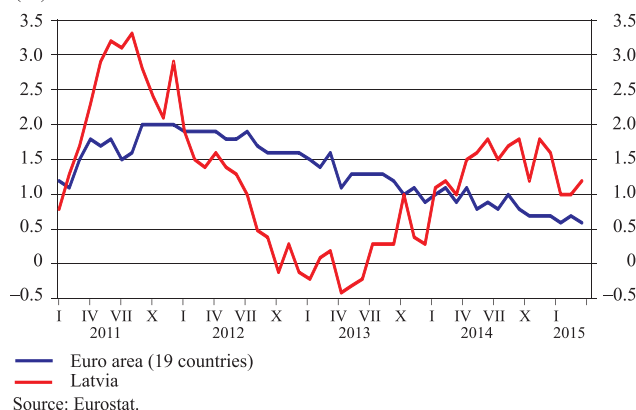
Dr. oec. Daina Paula
Chief Economist
Latvijas Banka

Currently, inflation is at a low level both in the euro area and Latvia. This phenomenon has been widely discussed, though mainly from the economic policy perspective. In fact, it largely stems from the global food and energy price developments that are often supply-side-driven. Core inflation is often thought to be an indicator of an underlying long-term inflation trend stemming from the economic growth and demand side influence. However, at the same time, it lives a slightly different life.

The concept of core inflation is very common; however, its measuring methods vary from quite simple statistical to model-based ones that do not always produce the same results and are not easily interpreted. One of the most often used methods to measure core inflation is to exclude the most volatile components related to global market developments, such as energy and unprocessed food prices. Even though these components tend to be associated with the supply side due to production depending on natural resources, weather and political conditions, the remaining part of inflation is indirectly influenced by the cost-push effects, i.e. higher costs of production and higher costs of raw materials. Therefore, volatility of core inflation may differ across countries.

Figure 1

Year-on-year HICP excluding unprocessed food and energy (%)



The enclosed figure presents core inflation developments in Latvia and its average indicators for the 19 euro area countries. The line representing core inflation of Latvia is more volatile as the weights of processed food are higher in the consumption basket, while the processed food prices are still related to the commodity market. The figure shows that Latvia's core inflation is also higher in certain periods (for instance, in 2011 and 2014) due to larger contribution from indirect taxes and the income effect, a common characteristic for a catching-up country.

In Latvia, core inflation picked up gradually in the course of 2013 and continued to grow somewhat in 2014, reflecting resumed economic growth and a moderate increase in average income. Moreover, in 2014, it reflected some euro introduction effects (Eurostat estimated effect is up to 0.2 pp) and an increase in the excise tax on tobacco. In early 2015, core inflation decreased somewhat, reflecting one-off effects of the euro introduction as well as some slowdown of the economic growth. With the cost-push pressure (in terms of commodity prices such as food and energy) largely nonexistent, also the year-on-year pickup in prices of some core components could have decreased. It refers, for instance, to package holiday prices due to lower fuel costs in February.

However, it is also possible that the income redistribution effect has played a role as well. Lower expenditure necessary for food and energy due to prices falling year-on-year and much lower physical consumption of energy because of the warmer winter could have shifted a share of income towards the demand for services or industrial goods. After having decreased to 1% in January-February, core inflation rose to 1.2% year-on-year in March supporting this view. With the economic growth resuming, core inflation in Latvia is also expected to pick up in the medium run.