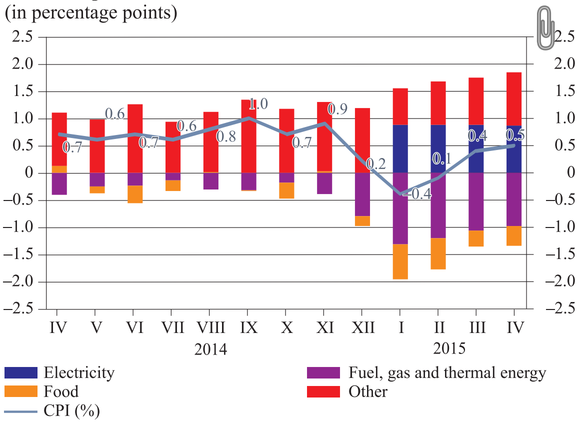
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

MAY 2015

Annual inflation was stable in April

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

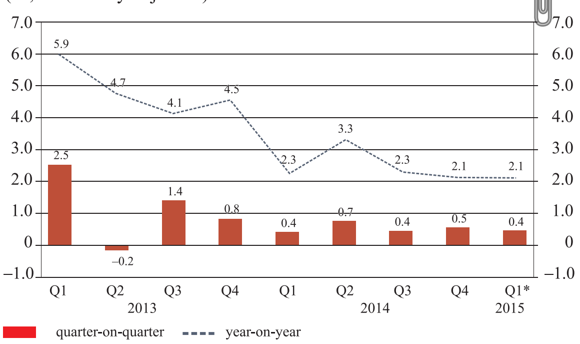


Source: CSB.

In April 2015, annual inflation did not change substantially and stood at 0.5%. A slight rise was caused by a more pronounced increase in seasonally fluctuating prices of goods. The uplift in oil prices in April compared with the average level in March was not sharp, and, except for some special sales, fuel merchants continued to gradually increase retail fuel prices, which on average went up by 0.3% in April. The rising global oil prices were offset by the food price trends, which were in part impacted by the European Union lifting its milk production quotas. However, the global trends in food prices were not fully reflected in the price dynamics of consumer goods in Latvia. As had been expected, the services price level remained stable, with the annual rise in non-administered services prices exceeding 2% in April and core inflation remaining at 1.5%.

GDP growth maintained by retail trade and impeded by energy sector

Real GDP growth rate
(%; seasonally adjusted)



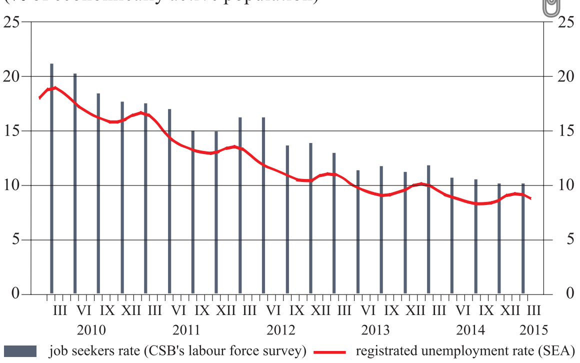
Source: CSB.
* *flash estimate*

In the first quarter of 2015, GDP grew by 0.4% quarter-on-quarter (seasonally adjusted data) and 2.1% year-on-year (working day adjusted data). A positive annual growth of 4.2% was also recorded for manufacturing output in the first quarter. An important factor explaining the growth of industry could be the fact that in March manufacturing was partially resumed at *KVV Liepājas metalurgs*. In addition, several other enterprises are planning to start operation or to launch new production lines this year. One of the largest contributors to GDP growth has been retail trade, which grew by 7.5% in annual terms in the first quarter.

With the situation in the labour market gradually improving and disposable income increasing, consumer confidence is rising and has reached its highest point since 2007, which is also reflected in spending. Moreover, low fuel prices and household maintenance costs (lower bills because of warmer weather) have had a positive effect on the disposable income of households and consumption. However, the warm weather conditions in January and February had a fundamentally negative impact on the output of the energy sector, thus the contribution of the energy sector to GDP growth was expressly negative.

Labour market gradually becoming more favourable for employees

Unemployment
(% of economically active population)



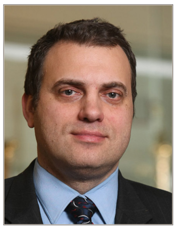
Sources: CSB; SEA; Latvijas Banka calculations

As predicted earlier, unemployment continues to decrease in Latvia. At the beginning of 2015, 10.2% of economically active population were jobseekers. Despite a noteworthy annual drop of 1.7 percentage points, the proportion of jobseekers has changed very little over the last three quarters, with unemployment rate remaining slightly above 10%, i.e. close to its natural level. Both headline unemployment and natural level of unemployment are gradually decreasing and are likely to continue to go down in the future as well. A drop in natural unemployment will result from both better employment opportunities and active labour market policy measures like training programmes and competency development courses. Thus the situation of macroeconomic balance will last: wage rises will not significantly exceed labour productivity growth. The increase in the number of unemployment benefit recipients (to 40 thousand) reflects the largest number of registered short-term unemployed ever recorded. However, it does not point to a deteriorating situation in the labour market as the number of long-term unemployed was still larger. The EC consumer survey conducted in April indicates that the number of people in Latvia who expect a drop in unemployment has exceeded the number of people expecting an increase.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2015 Q1 *(flash estimate)*	**2.1**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2015 Q1 *(flash estimate)*	**0.4**
05.05.2015 The growth of gross domestic product is maintained by retail trade and it is impeded by the energy sector		
Public Finances		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2015 IV	**6.3**
Tax revenue (since the beginning of the year; year-on-year growth)	2015 IV	**4.9**
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2015 IV	**0.5**
Consumer Price Index HICP (year-on-year growth)	2015 IV	**0.6**
12-month average inflation (HICP)	2015 IV	**0.6**
13.05.2015 Annual inflation was stable in April		
Foreign trade		
Exports (year-on-year growth)	2015 III	**–0.3**
Imports (year-on-year growth)	2015 III	**–3.7**
11.05.2015 The drop in exports to Russia is compensated by other countries		
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 III	**7.6**
05.05.2015 Rebirth of metallurgy helps to improve the manufacturing situation		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2015 III	**6.5**
30.04.2015 A champion's leap in retail trade in the first quarter		
Labour market		
Registered unemployment (share in working age population)	2015 IV	**8.8**
Job seekers rate (share in working age population)	2015 Q1	**10.2**
13.05.2015 The labour market gradually becomes more favourable for employees		
Monetary indicators		
Resident deposits (year-on-year growth)	2015 III	**5.9**
30.04.2015 Monetary indicators remained stable in March		

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

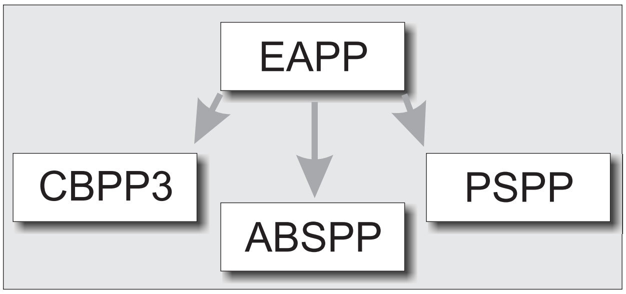
Eurosystem's monetary policy - Expanded Asset Purchase Programme



Dr. oec. Egils Kaužēns
Chief Economist
Latvijas Banka

The objective of Eurosystem's monetary policy is to maintain price stability defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below, but close to, 2% over the medium term. In 2014 the euro area HICP was below 1% and approached 0%, creating a risk of a too prolonged period of a very low inflation. After reaching the zero lower bound on interest rates, the ECB responded by announcing unconventional monetary policy measures. At the end of 2014 the Eurosystem launched three programmes: Third Covered Bond Purchase Programme (CBPP3), Asset-backed Securities Purchase Programme (ABSPP) and Targeted Longer Term Refinancing Operations (TLTRO). However, all these programmes were niche programmes with relatively small volumes compared to the ECB's balance sheet. When the euro area HICP became negative (-0.2%) in December 2014, a large scale programme appeared to be essential for supporting effective transmission of monetary policy decisions to the financial system, the real economy and inflation.

Figure 1
Eurosystem's EAPP components

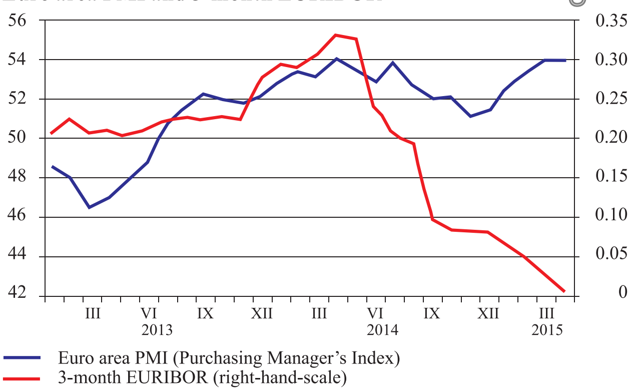


In January the ECB Governing Council decided to start the Expanded Asset Purchase Programme (EAPP) consisting of CBPP3 and ABSPP, which were both launched late last year, and a new programme – the Public Sector Purchase Programme (PSPP). EAPP is intended to last from March 2015 till September 2016 or in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. EAPP monthly purchases will amount to €60 billion, PSPP being the core programme. Volumes of each programme separately were not announced and the amount for PSPP will be determined by the success of CBPP3 and ABSPP. Assets under PSPP will be purchased by the ECB (8% of PSPP) and all national central banks (NCB) according to the capital key. The latter will buy home country government sector bonds and international institutions' bonds issued by euro area residents and denominated in euro. The maturity of PSPP bonds will be between 2 and 30 years. There is a 25% issue limit and a 33% issuer limit on outstanding securities to be bought.

EAPP will work through the direct price effect channel by reducing credit and bond interest rates; portfolio rebalancing (reducing other financial asset yields); and the signalling effect which could be felt already before the launch of PSPP in the form of increasing confidence and reducing interest rates.

Latvijas Banka will participate in PSPP, but not in CBPP3 and ABSPP as no eligible covered bonds and asset backed securities are issued in Latvia. In March and April 2015, Latvijas Banka purchased securities issued by the Latvian government and international organisations located in the euro area amounting to 354.8 million euro (according to the balance sheet of Latvijas Banka). The Latvian government debt consists not only of euro denominated bonds, but also of USD denominated bonds and European Commission and World Bank credit, which reduce eligible bonds under PSPP. Assuming that Latvia will issue eurobonds this year and applying issue limits, the available amount of bonds for PSPP purchases will reach 1 billion euro. Since the main holders of Latvian bonds issued abroad are foreigners, the positive impulse for the Latvian economy and financial market will come from increasing growth prospects in the euro area and smaller interest rates on lending to households and businesses and on government borrowing.

Figure 2
Euro area PMI and 3-month EURIBOR



In the long-term EAPP will have a positive impact on the euro area growth only if the euro area countries continue to maintain a strong fiscal discipline and implement structural reforms, otherwise the benefits of the EAPP might be short-lived.