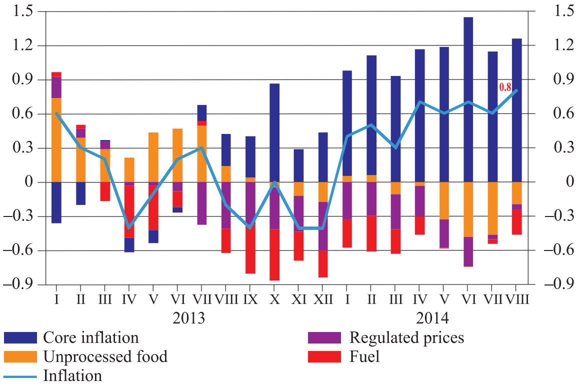
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

SEPTEMBER 2014

Inflation in August 0.8%

Annual inflation and contribution to the annual inflation
(%; percentage points)



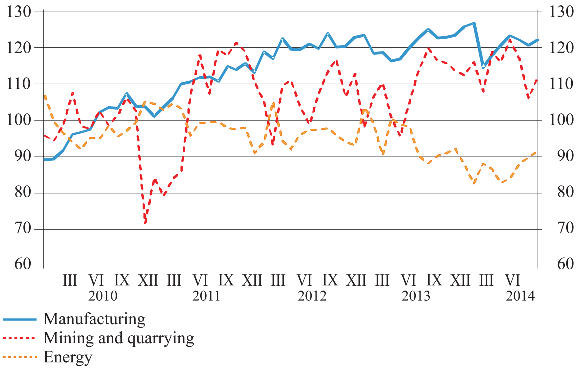
Source: CSB.

In August the annual inflation grew slightly to 0.8%, while the month-on-month changes were negative with -0.6%. Inflation trends in Latvia were determined by several developments: seasonal factors, the drop in oil prices and the strengthening of the U.S. dollar as well as the influence of Russian sanctions which was, however, not very pronounced. The fall in oil prices in the global market is reflected in the 2% drop in fuel prices. The strengthening of the US dollar meanwhile somewhat overshadows the effect of the oil price reduction. The seasonal factors were most pronounced in the prices of vegetables as well as discount sales of footwear, whereas in the sales of wearing apparel the prices of the new season began to dominate, therefore the average price level grew in this group of goods.

Further trends in price development will be determined by the drop in world food prices resulting from the favourable weather conditions as well as the impact of geopolitical factors.

So far, manufacturing has managed to avoid the negative impact of geopolitical developments

Volume indices of industrial production
(2010 = 100; seasonally adjusted)



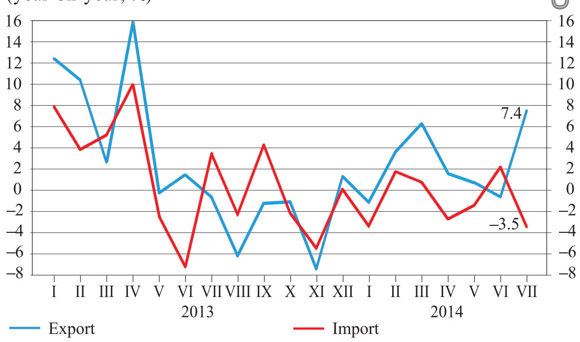
Source: CSB.

In July 2014 the volume of output in manufacturing grew by 1.2% (seasonally adjusted data). Year-on-year, the volume of output continued to diminish by 2.6%. Manufacturing growth is still experiencing the positive effects of positive growth rates in the manufacture of food products (+3.3%), of wood (+12.3%), of computer, electronic and optical products (+54.5%), as well as of chemicals (+21.9%). Substantial negative annual growth rates persist in the manufacture of wearing apparel (-20.4%) and machinery and equipment (-20.0%). After a longer interval, positive growth rates are observed in the electricity and gas supply sector (+4.9%).

The main topicality of the month related to Latvian manufacturing is the economic sanctions introduced by Russia; however, their direct impact on Latvian goods exports remains rather small from the macroeconomic point of view. On the list of exporters subject to sanctions there are only a few enterprises with sales above two million euro in Russia, and for none of them Russia is the main market. However, there are some enterprises with a turnover of less than two million euro whose proportion of sales in Russia is high. At the same time, the government has developed particular instruments to help limiting the negative consequences of these sanctions.

The Latvian external trade data held a pleasant surprise in July

Growth rates of exports and imports of goods
(year-on-year; %)



Source: CSB.

Despite the negative political and economic background, in July the Latvian external trade turnover of goods increased by 7.8% month-on-month, with the export and import of goods increasing by 9.0% and 6.9% respectively. Annually the export value of goods has risen by 7.4% while the import value of goods has dropped by 3.5%. The year-on-year growth has been fastest in the products of wood and manufacture of chemical products, building materials, transport vehicles, as well as machinery and mechanical appliances; electrical equipment sectors. However, the drop in the demand in Russia and fluctuations of the rouble as well as the slow and uneven growth in the euro area countries had a negative impact on exports of Latvian goods.

In the longer run, a significant role in preserving Latvian ex-Undiport growth will be played by increased competitiveness, investments in productivity of enterprises, development of innovative products as well as finding new markets.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2014 Q2 (flash estimate)	**2.5**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2014 Q2 (flash estimate)	**1.0**
Public Finances		
Tax revenue (since the beginning of the year; year-on-year growth)	2014 VIII	**3.8**
General government budget expenditure (since the beginning of the year, year-on-year growth)	2014 VIII	**2.7**
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2014 VIII	**0.8**
Consumer Price Index HICP (year-on-year growth)	2014 VIII	**0.8**
12-month average inflation (HICP)	2014 VIII	**0.3**
08.09.2014 August inflation data do not indicate a substantial impact of Russian sanctions on food prices		
Foreign trade		
Exports (year-on-year growth)	2014 VII	**7.4**
Imports (year-on-year growth)	2014 VII	**–3.5**
09.09.2014 Latvian external trade data present a pleasant surprise		
Balance of payments		
Current account balance (ratio to GDP)	2014 Q2	**–3.7**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2014 Q2	**1.2**
03.09.2014 Latvian current account deficit at 224 million euro		
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2014 VII	**–2.6**
03.09.2014 So far, manufacturing has managed to avoid the negative impact of geopolitical developments		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2014 VII	**3.9**
Labour market		
Registered unemployment (share in working age population)	2014 VIII	**8.4**
Job seekers rate (share in working age population)	2014 Q2	**10.7**
29.08.2014 Wage growth decelerated slightly in the second quarter		
Monetary indicators		
Resident deposits (year-on-year growth)	2014 VII	**10.6**
29.08.2014 Deposits continue to grow		

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

Development of Interest Rates in Latvia after Euro Adoption

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Senior Economist
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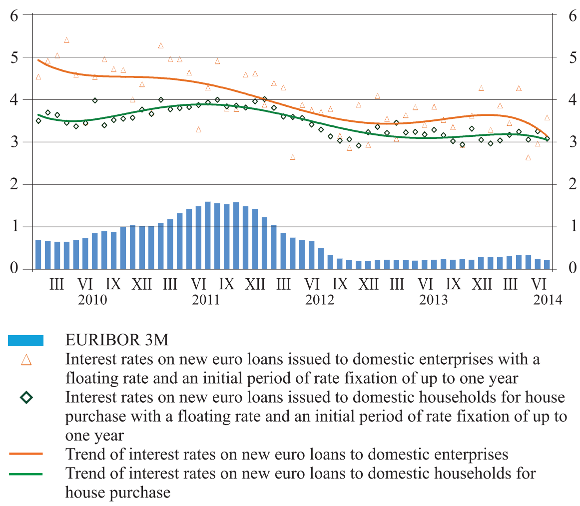
Economists widely agree that euro adoption leads to lower borrowing costs for households and enterprises in the medium term, thereby stimulating housing, consumption and investment activities. Historical evidence shows that small and medium-size enterprises usually benefit most from euro adoption. More than half a year has passed since Latvia adopted the euro; and one may wonder whether borrowing costs have already declined.

In principle, borrowers could benefit from euro adoption in two ways. On the one hand, those who took loans in the local currency (lats) would benefit immediately from re-fixing the loan from a higher and more volatile lats' money market index to a lower and more stable euro money market index. On the other hand, those who took loans in euro could save on currency conversion for loan monthly payments, since after the euro adoption income and monthly loan payments are in the same currency. Over the medium term, credit spreads that measure the difference between the new interest rates faced by households and enterprises and the respective money market rates should gradually decrease.

Borrowing costs and money market indices
(%)



Latvian borrowers have already been experiencing most of these benefits. Since the middle of 2013, the lats money market indices started to converge to the lower level of the euro money market indices faster than before. As a result, borrowers in lats could save on monthly payments even before the official date of re-fixing their loans to the euro money market index. Now they are in a favourable situation as their loans are fixed to the stable euro money market indices that could be hardly affected by the uncertainty regarding economic developments and geopolitical tensions, which currently are in the focus of society's attention across the globe. Moreover, savings from the conversion of monthly payments are self-evident.

The euro money market indices have been slightly decreasing since May when market participant expectations of further ECB monetary policy easing strengthened. The decline of euro money market interest rates was even more pronounced after the decisions of the Governing Council meetings of 5 June and 4 September lowering the key ECB interest rates and introducing additional monetary policy measures. The pass-through from money market interest rates to lending rates in Latvia is relatively high as the majority of loans in Latvia are fixed to money market indices, most often to 3 month EURIBOR. Therefore, as compared to April of this year, the overall borrowing costs in Latvia have decreased. The decline in lending rates exceeded that in money market rates in the segment of enterprise lending, suggesting that credit spreads in this segment have also shrunk.

The MFI interest rate on loans to domestic households and non-financial corporations fell from 4.9 percent in April to 4.2 percent in August, partly reflecting a drop in money market interest rates, partly a decrease in the margin on loans in several banks, and partly a fall in the share of riskier loans. Interest rates on loans in euro to domestic enterprises with a floating rate and an initial period of rate fixation of up to one year fell by 1.1 percentage point to 3.6% in the period from April till August. Interest rates on loans in euro to domestic households for house purchase with a floating rate and an initial period of rate fixation of up to one year remained at 3.3% in the same period.

The time span elapsed since euro adoption is too short to gauge whether the observed credit spread trends will persist. Tightness of the credit market as well as uncertainty of market participants about economic developments might limit a further decrease in credit spreads. Uncertainty about external developments is rooted in the observations of the economic activity slow-down in the main trading partners and of the geopolitical tensions in Ukraine. Uncertainty about internal developments arises mainly from the political debate and discussions about the necessity to amend the insolvency law by introducing the principle of "surrendered keys". In addition, credit risk of borrowers, as judged by the share of non-performing loans in the total amount of outstanding loans, has been decreasing slowly. At the same time, a further fall in credit spreads might be supported by the recently announced ECB monetary policy measures, and, in particular, targeted longer-term refinancing operations (TLTROs). These operations are aimed at improving bank lending to the euro area non-financial private sector. Banks operating in Latvia also have an opportunity to participate in those operations and borrow funds at very favourable rates in the long term.

Therefore, it can be concluded that almost all existing borrowers experienced some benefits from the euro adoption in the form of savings from conversion or lower and more stable money market rates. Now potential borrowers can obtain very attractive interest rates on loans due to the low level of euro money market rates. According to the financial market expectations, money market rates will stay low for a long period. But the decrease in credit spreads, as previously thought, would be gradual and would take several years.