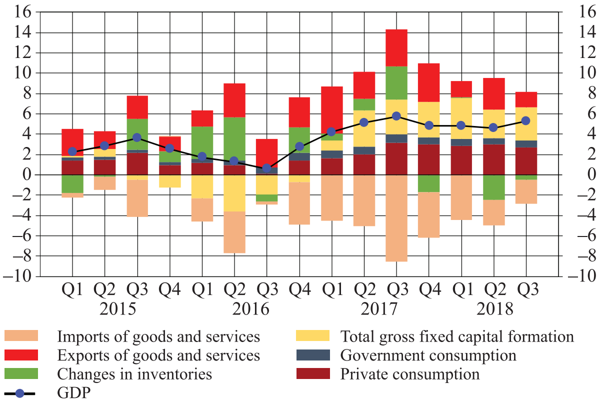
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

DECEMBER 2018

Latvia's economy has experienced rapid growth

GDP growth and contribution to GDP growth
(%; in percentage points; seasonally adjusted)

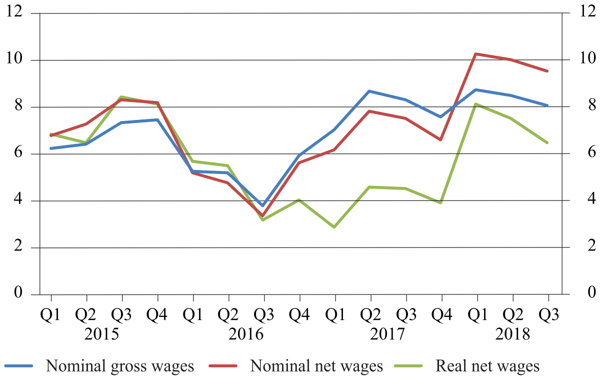


Sources: CSB, Latvijas Banka's calculations.

Latvia's economy has experienced rapid growth, i.e. 5.3% in the third quarter (in annual and seasonally adjusted terms). Domestic demand has been strong due to growing investment as well as increasing private and public consumption. With uncertainty in the external economic environment amplifying and export opportunities becoming increasingly unclear, it is possible to re-enter a situation where private consumption becomes a driver of the economy. Although private consumption is currently continuing on a stable upward path, its contribution to economic growth gives in to that of investment. A pick-up in investment activity currently looks encouraging, i.e. gross fixed capital formation, which had climbed at a slower pace in the second quarter, increased by 4.2% during the third quarter.

Wage growth remains quite solid

Average monthly wages
(%; year-on-year)

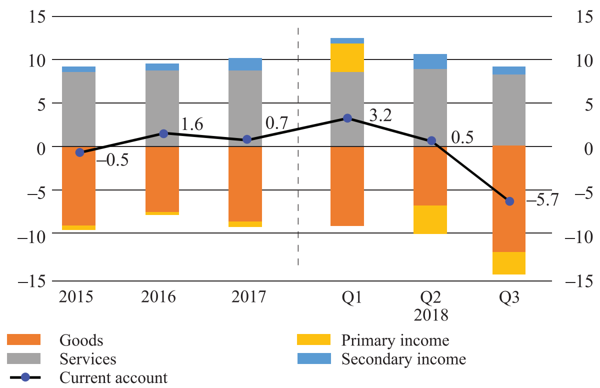


Source: CSB.

On the labour market, where unemployment is declining and labour demand is high, wage growth remains quite solid. In the third quarter of 2018, gross nominal wages increased by 8.0% year-on-year in Latvia, reaching 1 006 euro, and the growth rate of base wages was relatively stronger. The highest wages are earned by those working in the finance and insurance as well as information and communication services sectors in Latvia. Meanwhile, people working in accommodation and catering services on average are paid considerably smaller wages. Looking ahead, it seems that wages are likely to increase further, reflecting robust economic growth and strong labour demand, yet the growth rates will hardly be as strong as this year.

Current account ran a deficit of 1.0% of GDP in nine months of 2018

Current account balance
(% of GDP)



Source: Latvijas Banka.

Despite generating a surplus in the first half of the year, the current account returned a deficit of 1.0% of GDP in the first nine months of 2018. The reason for this was the sharp increase in goods trade deficit caused by unusually high imports of natural gas and mineral products from Russia and Lithuania (driven by higher volumes of imports as such and rising oil prices) as well as by slowdown in minor/fluctuating export flows (e.g. re-exports of electronic devices to the United Arab Emirates, exports of grain to Belgium) in the third quarter. The services account continued to post a surplus, i.e. strong growth in exports of transport, information and communication technology and other business services managed to offset the shrinking exports in the financial services and construction sectors. The rate of services imports also picked up noticeably. In the third quarter, inflows of foreign direct investment in Latvia (3.1% of GDP) exceeded the average quarterly investment level of the previous year.

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth, seasonally and calendar adjusted)	2018 Q3	**5.3**
Real GDP (quarter-on-quarter growth, seasonally adjusted)	2018 Q3	**1.7**
04.12.2018 The element of surprise has vanished, but growth is still present		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2018 XI	**11.6**
Tax revenue (since the beginning of the year; year-on-year growth)	2018 XI	**8.3**
Consumer price changes		
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2018 XI	**2.9**
12-month average inflation (HICP)	2018 XI	**2.5**
Consumer Price Index (CPI; year-on-year growth)	2018 XI	**3.0**
Foreign trade		
Exports (year-on-year growth)	2018 X	**6.8**
Imports (year-on-year growth)	2018 X	**18.8**
14.12.2018 Export data solid, but exporters' confidence weakened by external uncertainties		
Balance of payments		
Current account balance (ratio to GDP)	2018 Q3	**–5.7**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2018 Q3	**3.1**
07.12.2018 Negative trade balance has led to the largest quarterly current account deficit seen over the past years		
Sectoral performance		
Working day-adjusted manufacturing output index (year-on-year growth)	2018 X	**3.3**
Retail trade turnover at constant prices (year-on-year growth)	2018 X	**2.4**
Labour market		
Average monthly wage (year-on-year growth)	2018 Q3	**8.0**
30.11.2018 Wage growth still solid		
Jobseekers rate (share in working age population)	2018 Q3	**7.0**
Monetary indicators		
Resident deposits (year-on-year growth)	2018 X	**3.5**
Loans to residents (year-on-year growth)	2018 X	**–4.6**
29.11.2018 Ice between households and banks gradually melting		

Sources: Treasury, CSB and Latvijas Banka.

Lending development from a sectoral perspective

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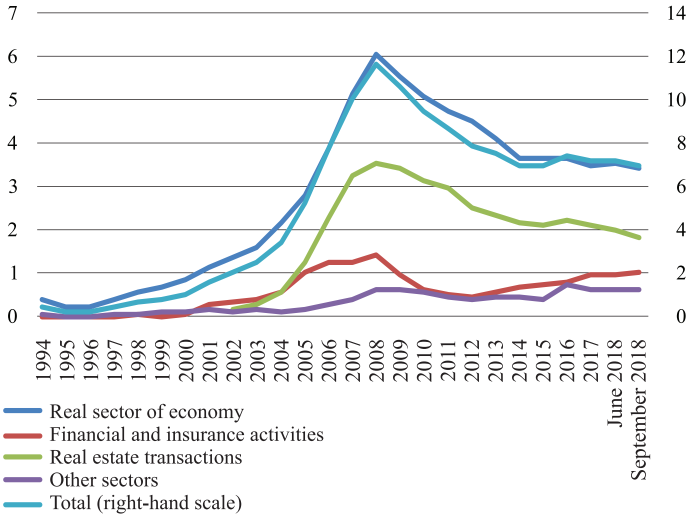
Bank loans represent one of the investment sources ensuring economic development. However, despite lasting lending stagnation and even its downward path, gross domestic product growth in Latvia has been one of the strongest among euro area countries for several years now. This means that businesses have increasingly benefited from other sources of funding to finance development, but the share of loans in their borrowed funds has decreased.

However, to ensure sustainable economic growth, wider access to loans for investment purposes is required. Also in years when the loan portfolio contracted substantially overall, several sectors found themselves in a more favourable situation than the economy as a whole, with loan investment continuing to contribute to economic recovery during the post-crisis period.

Loans to enterprises by sector of economy
(in billions of euro)



Source: Financial and Capital Market Commission.

The share of loans received by economic sectors in Latvia does not differ significantly from the euro area's common indicators as well as from analogous data in Estonia and Lithuania. This is related to Latvia's presence in the common economic area and its broadly similar economic structure.

When examining lending dynamics in the longer term (see the Chart), it is evident that the rapid expansion of lending in 2005–2008 was driven by both growth in loans to the real estate sector associated with the real estate bubble and by the increased lending to the real sector of economy. Meanwhile, the last five years have seen the loan portfolio stabilise; it has been continuing on a moderate downward trend primarily in real estate business. This development is positive from the point of view of portfolio diversification.

The loan portfolio, diversified to meet the needs of the economy, ensures more robust economic growth and also mitigation of risks to financial stability. In the case of Latvia, breakdown of the loan portfolio is broadly in line with the needs of the economy.

A large proportion of loan resources reaches the real economy indirectly, i.e. loans granted for carrying out real estate operations go into construction and related sectors, while loans to financial intermediaries granted through leasing agents allow businesses active in different sectors to purchase equipment and vehicles.

It is the real estate sector that has received most of loans since 2005 until today. In 2007–2012, the sector's share in the total loan portfolio reached a third of all loans and, despite the slight decrease in the above share, the sector continues to play the dominant role. At the same time, the share of financial intermediation is increasing in the portfolio of granted loans, with the financial sector being the second largest beneficiary of loans over the past two years.

Among the sectors of the real economy, the trade and manufacturing sectors stand out as the major beneficiaries of loans. Loan investment in the above two sectors and in construction surged until 2008, but decreased dramatically during the crisis. With loan investment in the construction sector continuing on a downward path and the loan portfolio of manufacturing companies slightly contracting, credit flows have been shifting towards the trade sector since 2015. Manufacturing is a sector which leaves more active inflows of loan resources to be desired as the fluctuating external demand and inadequate financial indicators have so far prevented banks from accelerated investment in the sector. On the other hand, trade is a sector whose growth has been enhanced both through the creation and expansion of the large shopping centres and development of traders' networks in conditions of robust domestic demand.

Lending development from a sectoral perspective (cont.)

Meanwhile, loan investment in the sectors such as transport, energy and agriculture has already been growing moderately and quite steadily for more than 20 years; the above sectors were marginally affected by the crisis. Banks have perceived the large businesses prevailing in the areas of infrastructure and energy supply as stable and able to borrow also during the crisis. Moreover, the availability of European Union funds has contributed to the desire of banks to lend both to the above two sectors and the agricultural sector and has supported the ability of these sectors to borrow.

The loan portfolio, diversified to meet the needs of the economy, ensures more robust economic growth and also mitigation of risks to financial stability. In the case of Latvia, breakdown of the loan portfolio is broadly in line with the needs of the economy. However, lenders, entrepreneurs and policy makers should constantly and jointly assess the situation to achieve the set growth and risk mitigation objectives.