

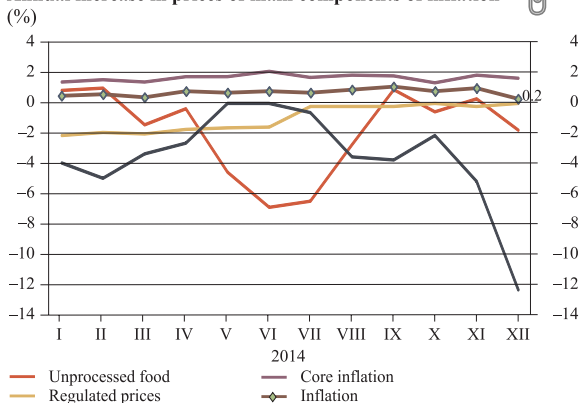


LATVIJAS BANKA
MONTHLY NEWSLETTER

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Inflation stood at 0.6% in 2014

Annual increase in prices of main components of inflation (%)

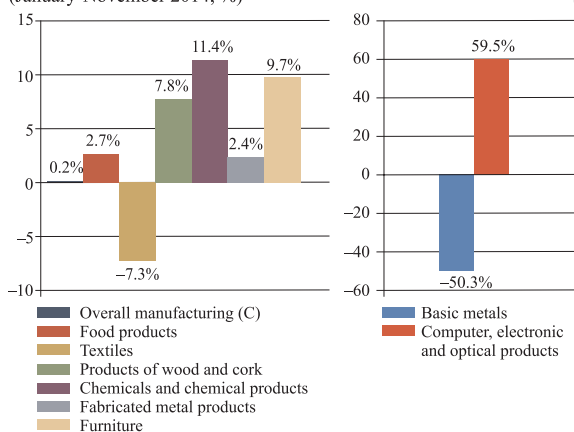


Source: CSB.

In 2014 the average annual inflation stood at 0.6%, one of the lowest inflation rates in the context of positive economic growth in Latvia. In December, the global oil prices continued to fall sharply, and the monthly decrease in fuel prices reached 6.5%, a new record in Latvia since December 2008. As expected, subsequently, "Latvijas Gāze" published new natural gas tariff projections for industrial consumers, suggesting a falling trend in thermal energy prices up to March. Moreover, the world food prices also dropped both in December and in 2014 overall. These global price factors, along with the weak growth and low inflation in the euro area, were the main factors reducing inflation in Latvia in 2014. Meanwhile, the weakening of the euro slightly reduced the negative contributions to inflation. Domestic factors, such as a rise in indirect taxes (tobacco excise tax) and in some regulated prices (water and sewerage tariffs) as well as, to some extent, gradual income growth and the impact of one-off costs of the euro changeover constituted a positive contribution.

Manufacturing posted growth in the first 11 months of 2014

Annual output changes in manufacturing and selected sub-branches (January-November 2014; %)



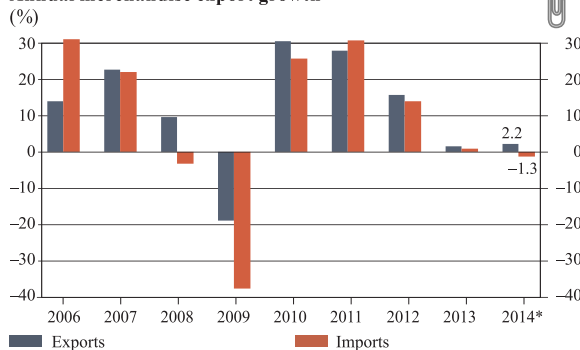
Source: CSB.

In September and October, output in wood industry and electrical equipment production was at a historical high. However, a month-on-month fall in the production of electrical equipment and the two largest sub-branches of manufacturing (food production and wood industry) followed in November; consequently, the total manufacturing output decreased as well. Since the output of the two largest sub-branches of manufacturing saw an overall increase in the first 11 months of 2014 (+7.8% for wood industry and +2.7% for food production), manufacturing posted 0.2% growth over the above period. Given the current geopolitical situation and the weak growth in the euro area, this outcome can be considered a success.

Last year, manufacturing faced many challenges, one of them being the continued problems in metal manufacturing. However, in case production is resumed at JSC KVV Liepājas metalurģs, the failing sub-branch of manufacturing could turn into its top performer next year.

Exports sustained growth in the first 11 months of 2014 despite unfavourable external conditions

Annual merchandise export growth (%)



Source: CSB.

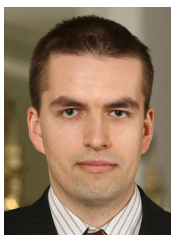
* 11 months

Latvian exports of goods contracted in November. In the first 11 months of 2014, however, goods exports recorded a 2.2% increase year-on-year, posting growth in exports of foodstuffs, products of the chemical industry, wood and wood products, construction materials, machinery and electrical equipment, etc. The drop in Russian demand and the falling rouble as well as the weak growth in the euro area in 2014 were the main obstacles to boosting exports of Latvian goods. Representatives of several industries have admitted to having been able to improve their positions in some export markets despite unfavourable conditions in external markets. This is also confirmed by an increase in Latvian export market shares in global imports. Latvian exporters have reacted differently to the situation in the Russian market: some are actively looking for new markets, e.g. planning to export milk and ice-cream to China as early as March; planning to begin beef cattle exports to the countries of Central Asia and the United Arab Emirates. Other exporters continue working with losses while some have adopted a wait-and-see attitude cutting their production to a minimum. There are also companies which are using this lull to modernize and/or build new production facilities.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2014 Q3	2.4
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2014 Q3	0.5
Public Finances		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2014 XII	5.0
Tax revenue (since the beginning of the year; year-on-year growth)	2014 XII	3.9
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2014 XII	0.2
Consumer Price Index HICP (year-on-year growth)	2014 XII	0.3
12-month average inflation (HICP)	2014 XII	0.7
14.01.2015 The annual inflation in December again down because of dropping oil prices 		
Foreign trade		
Exports (year-on-year growth)	2014 XI	-0.8
Imports (year-on-year growth)	2014 XI	0.0
10.01.2015 External trade optimism down in November 		
Balance of payments		
Current account balance (ratio to GDP)	2014 Q3	-4.0
Foreign direct investment in Latvia (net flows; ratio to GDP)	2014 Q3	0.2
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2014 XI	-3.8
07.01.2015 Both the wood industry and the embargo-hit food industry had a positive impact on manufacturing in 2014 		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2014 XI	3.6
Labour market		
Registered unemployment (share in working age population)	2014 XII	8.5
Job seekers rate (share in working age population)	2014 Q3	10.6
Monetary indicators		
Resident deposits (year-on-year growth)	2014 XI	7.9
30.12.2015 As the year end approaches, deposits grow faster 		

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

Latvia's economic development robust in environment of external vulnerabilities



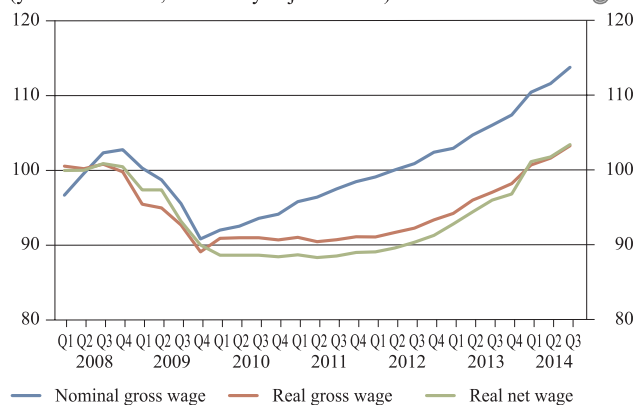
Dr. oec. Olegs Krasnopjorovs,
Chief Economist,
Monetary Policy Department,
Latvijas Banka

2014 was the year of successful euro introduction and the fifth consecutive post-crisis year of robust economic growth. This marked Latvia's further sustainable step on its road to prosperity and income convergence to the level of the old EU countries only partly hindered by external vulnerabilities. The output gap remained almost closed, with the economic growth reflecting the rising potential of the national economy.

Despite geopolitical tensions and sanctions, the economic growth in Latvia remains one of the strongest in the EU (2.6% year-on-year on average during first three quarters of 2014). The volume of industrial production showed positive year-on-year changes in September and October. The performance in 2015 is likely to be further improved by the impending resumption of JSC *KVV Liepājas metalurģs* operation. Already in October 2014, the amount of monthly exports of goods exceeded 1 billion euro for the first time in Latvia's history. The number of tourists welcomed by Latvia's hotels meanwhile hit a record high threshold of half a million visitors in the third quarter of 2014. Consequently, an increase in trade with and tourist flows from the EU countries, partly also on account of Latvia's euro area membership and Riga's status as the European Capital of Culture, and closer economic relations with other more distant countries may give an opportunity to fully compensate a decrease in exports to and tourist flows from Russia.

Moreover, the labour market continues to improve with the participation rate close to historical maximum. The unemployment rate gradually declined to 10.6% in the third quarter of 2014, being slightly below the euro area average and two times lower than during the crisis trough. It should be emphasised that this did not result from authorities' desperate efforts to "stimulate the economy" by running unsustainably large budget deficits or creating large numbers of temporary jobs combined with part-time job/early retirement schemes. On the contrary, it primarily is the result of restored competitiveness and private employment growth, while the budget deficit is low and decreasing.

Figure. Average monthly wage (for full-time job) index
(year 2008 = 100; seasonally adjusted data)



Source: Central Statistical Bureau of Latvia data; author's calculations.

Net real wage returned to the pre-crisis level, slightly exceeding it (see Figure) and partly reflecting a gradual decline of labour tax wedge. This fuelled private consumption as a main growth driver despite the still ongoing deleveraging process. Moreover, the competitiveness gains are sustainable, as unit labour costs are substantially lower compared with the pre-crisis period, and the labour income share is one of the lowest in the EU. Thus, Latvia's export market shares in global imports continued to rise. Business survey data reveal that labour shortage claims are moderate and stable, implying that the wage growth in the medium term is not expected to exceed productivity gains and undermine price stability significantly (annual HCPI inflation was 0.9% in November). Demo-

graphic trends are improving steadily, further minimising the population decline.

According to the Eurostat estimate, the euro changeover increased January inflation by 0.12–0.21 percentage point, while the effect during subsequent months was not statistically significant. Therefore, its impact on prices in Latvia is in line with what was observed in the other countries.

In 2015, GDP is expected to rise by 2%. Therefore, despite the recession in Russia, slow growth in the euro area and continuing deleveraging, 2015 is likely to become the sixth consecutive year of sustainable economic growth without creating imbalances. Inflation is likely to remain subdued, at 0.9%, the main upside factor being the opening of electricity market for households.