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EIROSISTĒMA

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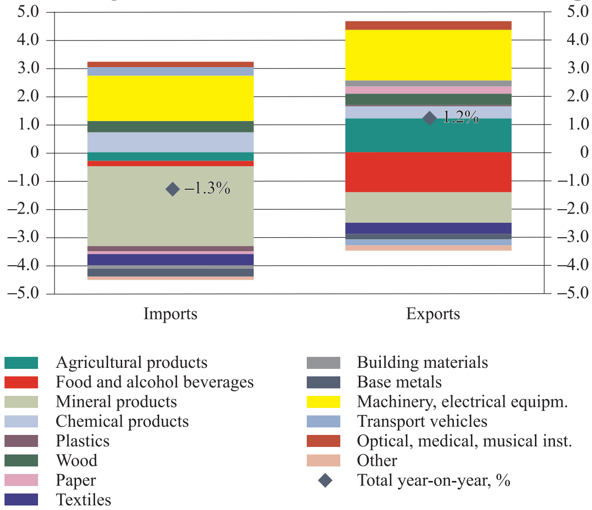
Export growth resists adverse external environment

Contribution of product groups to the annual growth of merchandise exports and imports (percentage points) and annual growth (%) in 2015



Source: Central Statistical Bureau of Latvia, Latvijas Banka's staff calculations.

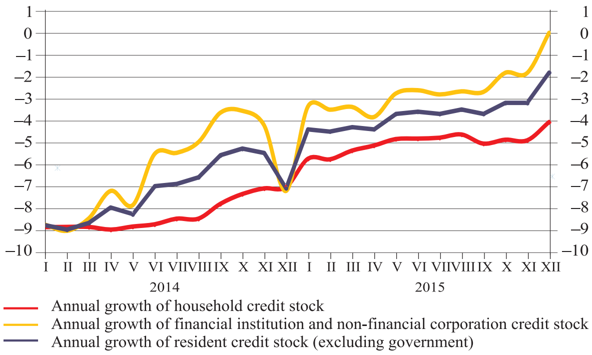
Latvia's exports of goods managed to show a small rise of 1.2% last year despite reduced Russian demand and depreciation of the rouble as well as the sluggish and uneven development in the euro area countries. Food exports suffered notably, while exports of many other goods such as electrical equipment and machinery, pharmaceuticals, wood products, etc. grew.

According to the preliminary data provided by the World Trade Organisation, an increase in the market shares of Latvian goods exports was observed in global imports in 2015 after two years of stagnation. This means that exporters have worked vigorously to penetrate new markets.

Imports of goods stagnated for a third consecutive year with a small year-on-year drop of 1.3%. Even though this continued to improve the balance of foreign trade in goods, the decline in imports is related to the slow growth in exports, weak investment activity and a decrease in oil prices.

Money indicators develop favourably

Lending to the private sector
(year-on-year; %)



Source: Latvijas Banka.

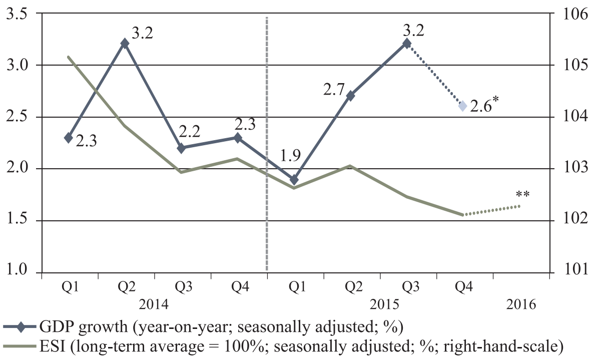
The positive developments in the Latvian economy continue to be borne out by the dynamics of monetary aggregates. The growth rate of domestic deposits was three times faster in December 2015 than in December 2014, whereas the rate of decline in loans has decreased from –7.1% to less than –2% within 12 months.

The repayment of short-term loans and write-off of bad loans in December led to a moderate contraction of the domestic loan portfolio. Yet the drop was less than half of that seen in December 2014. As a result, the annual rate of decrease in lending drastically improved by 1.4 percentage points, to –1.8%.

The annual rate of decrease in total domestic loans decelerated substantially, while the annual rate of change in loans to domestic financial institutions and non-financial corporations moved slightly into positive territory (+0.02%) for the first time since 2009.

Economic sentiment tends to improve

GDP growth rate and the Economic Sentiment Indicator



Source: CSB.
* – flash estimate; ** – 3-m moving average in January 2016.

According to the flash estimate for the fourth quarter of 2015 by the Central Statistical Bureau, gross domestic product (GDP) grew by 2.6% in 2015 despite no quarter-on-quarter increase in the fourth quarter. With the complicated geopolitical situation remaining the main factor impeding growth in 2015, this could be a slight acceleration of growth as compared to 2014. Meanwhile, the reduced oil prices had a positive impact on consumption.

The Economic Sentiment Indicator, though, points to possible acceleration in GDP growth as the indicator improved in all kinds of economic activity in January as compared to December (seasonally adjusted). Construction, manufacturing and trade confidence has gained most, with improvement in expected assessment of orders and employment expectations. Some optimism in these indicators might have also been brought about by the reduced energy costs.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2015 Q4 *(flash estimate)*	**2.6**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2015 Q4 *(flash estimate)*	**0.0**
01.02.2016 GDP growth slackens at the end of the year		
Public Finances		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2016 I	**–4.6**
Tax revenue (since the beginning of the year; year-on-year growth)	2016 I	**–0.2**
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2016 I	**–0.3**
Consumer Price Index HICP (year-on-year growth)	2016 I	**–0.3**
12-month average inflation (HICP)	2016 I	**0.2**
11.02.2016 The impact of global factors on inflation still persists		
Foreign trade		
Exports (year-on-year growth)	2015 XII	**–0.4**
Imports (year-on-year growth)	2015 XII	**–10.7**
10.02.2016 Despite external risks, goods exports in 2015 maintained a small increase		
Balance of payments		
Current account balance (ratio to GDP)	2015 Q3	**–3.0**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2015 Q3	**2.5**
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2015 XII	**3.0**
04.02.2016 Manufacturing ends the year on a negative note		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2015 XII	**2.0**
01.02.2016 Retail trade: one of the engines of growth in 2015		
Labour market		
Registered unemployment (share in working age population)	2016 I	**9.1**
Job seekers rate (share in working age population)	2015 Q4	**9.8**
23.02.2016 Insufficient education is the main unemployment risk factor		
Monetary indicators		
Resident deposits (year-on-year growth)	2015 XII	**9.0**
29.01.2016 Money indicator development trends remain favourable		

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

Allocation of resources in Latvia improved after the crisis

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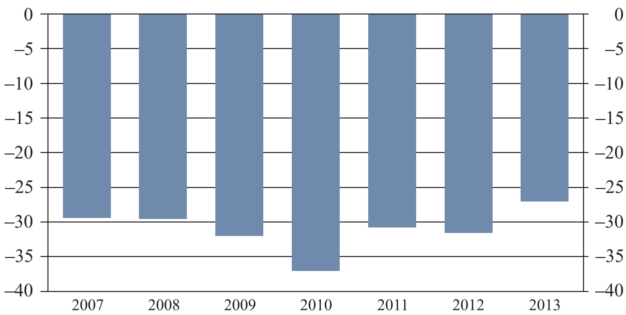
Aggregate productivity and income of a country can be boosted in two ways. One way is to increase the productivity of individual enterprises which is closely related to innovations and education reforms. Alternatively, redistribution of labour and capital from less productive to more productive firms improves the so-called allocation of resources. Productive firms will make better use of production factors and generate larger aggregate output.

What determines the allocation of resources? The economic theory states that it depends on productivity of individual firms: more productive enterprises will attract more labour and capital. However, "distortions" faced by individual firms matter a lot. If firms' access to labour resources (e.g. because of trade unions) and financial capital (e.g. due to credit supply conditions) differs, or legislation treats economic agents differently, the "distorted" firms are likely to underuse labour and capital and produce less output. Thus, the **removal of various "distortions" may improve the allocation efficiency and total output**.

Contribution of misallocation of resources to aggregate productivity
(%)



In my recent empirical study (see Benkovskis, 2015), I use anonymised firm-level data for 2007–2013 and apply the model of Hsieh and Klenow (2009) to the analysis of allocation of resources in Latvia. According to my estimates, the contribution of misallocation of resources to aggregate productivity losses was close to 27% in 2013 (see Figure). However, such **contribution of misallocation of resources in Latvia is relatively low by international standards**. Hsieh and Klenow (2009) argued that full liberalisation would boost aggregate manufacturing productivity by 86%–115% in China, 100%–128% in India, and 30%–43% in the US. García-Santana et al. (2015) reported an impressive rise in misallocation of resources in the Spanish economy, with potential gains from reallocation approaching 50% in 2007. Dias et al. (2014) showed that removing distortions would lead to a 30% gain in output in Portugal in 2011.

Specifically **in Latvia**, the **allocation of resources has improved since 2010**. The in-depth econometric analysis performed in the paper reveals that improved allocation of resources is to some extent related to growing competition in the domestic market. After the crisis, tighter competition in the Latvian market redistributed labour and capital to export-oriented firms that were on average more productive, thus contributing to an overall economic growth after 2010.

In general, the analysis led to the conclusion that labour "distortions" are minor in Latvia due to high flexibility of the labour market. However, there is still some room for improving allocation of resources by **stimulating further competition in the domestic market and ensuring better access to financial capital for export-oriented enterprises**.

References

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Dias, D., Robalo, C., and Richmond, C. (2014) "Misallocation and productivity in the lead up to the Eurozone crisis", Banco de Portugal, Working Paper No. 11.

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