



**LATVIJAS BANKA**  
**MONTHLY NEWSLETTER**

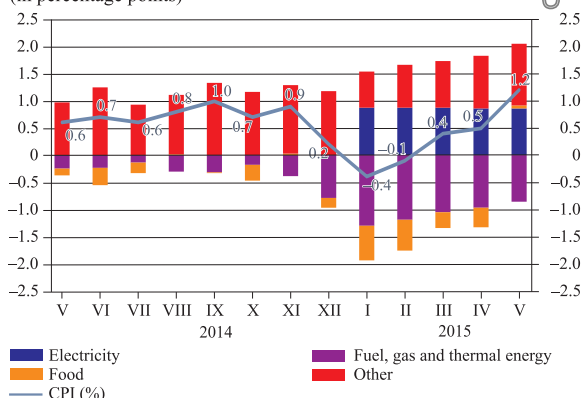
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**JUNE 2015**



## Annual inflation rose in May, indicating sustained demand

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



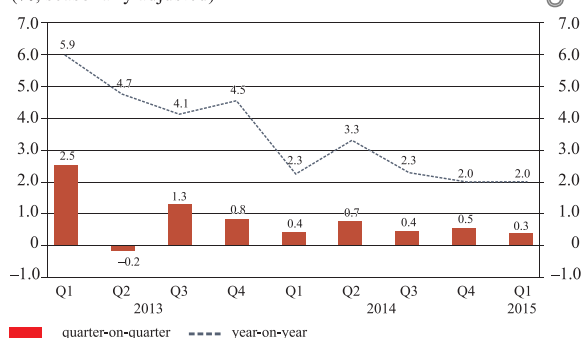
Source: CSB.

In May 2015, the annual inflation rose, reaching 1.2%. The rise was mostly due to price hikes in some core inflation goods and services groups. As the uplift in oil prices in May compared to the April average was a little faster, fuel retailers continued to raise prices gradually. The Food and Agriculture Organization's agricultural and food price index dropped also in May, primarily in dairy and cereal goods groups in which stocks were formed. In Latvian food retail, May was characterised by a faster than seasonally typical rise in the prices of fruit and, slightly, in vegetable and potato prices, whereas the prices of dairy products, for example, dropped in line with the world price trends. In May, core inflation grew slightly more than expected, which can be only partially explained by the Latvian Presidency of the Council of the European Union, because of which the prices of accommodation services might have risen more than usually. Yet the prices for wearing apparel,

vehicles and in almost all groups of goods and services related to leisure and culture grew faster on average than in May. Moreover, prices grew for technological goods related to both home improvement and leisure and culture, and also for communication services. In these cases, the effect of the small-scale market could have been worn out (competing for a market share by using prices), and a gradual rise in income may be motivating merchants and service providers to raise the price level, which indicates the effect of sustainable demand.

## GDP growth stable and moderate in the first quarter of 2015

Real GDP growth rate  
(%; seasonally adjusted)



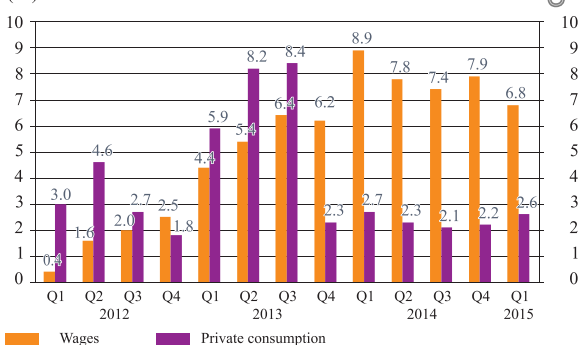
Source: CSB.

Seasonally adjusted GDP grew by 0.3% quarter-on-quarter and by 2.0% year-on-year (working day adjusted) in the first quarter of 2015. As previously expected, private consumption was the main driver behind growth rising 2.6% year-on-year. Along with the further increase in average wages, consumption was stimulated also by other factors. Among them were improved consumer confidence, a warmer winter with relatively lower heating expenses, and falling fuel prices. Due to geopolitical background, investors were more cautious last year, and investment decreased by 0.9% year-on-year also in the first quarter of the current year. Real exports of goods and services grew by 2.7% in the first quarter, which, along with the decline in imports by 1.8%, was an important

positive net export contribution to GDP growth of 2.7 percentage points. Amidst high external uncertainty, exporters have to search for new markets and improve competitiveness in the existing ones. Recent data show that exports of goods continued to grow also in April, by 7.0% annually in nominal terms. Moreover, in April, ten Latvian dairy producers obtained the permission to export their output to China, and in summer they will be joined by four fish processing enterprises.

## Annual wage growth gradually decreasing

Annual growth rate of average net real wages and real private consumption  
(%)



Source: CSB.

As expected, the annual gross wage growth has slightly diminished from 6.6% in the fourth quarter of 2014 to 6.1% in the first quarter of 2015, which means some slow-down also compared to the 2014 average. Annual inflation remained low, tax burden also continued to diminish slightly, and the year-on-year rise in net real wages determining purchasing power is faster than that of gross wages (6.8%). The majority of enterprises surveyed in the second quarter of 2015 do not consider labour force shortages a crucial limiting factor for entrepreneurship. This indicator dropped year-on-year in manufacturing, services, and construction; quarter-on-quarter, it has slightly increased only in manufacturing. Shortages of labour force thus do not exert pressure on wages, which in turn means that the wage pressure on inflation will not increase.

	Reporting period	Data (%)
<b>Gross Domestic Product (GDP)</b>		
Real GDP (year-on-year growth)	2015 Q1	2.0
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2015 Q1	0.3
01.06.2015 <a href="#">Latvian GDP stable and moderate in the first quarter</a> 		
<b>Public Finances</b>		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2015 V	6.0
Tax revenue (since the beginning of the year; year-on-year growth)	2015 V	6.1
<b>Consumer price changes</b>		
Consumer Price Index CPI (year-on-year growth)	2015 V	1.2
Consumer Price Index HICP (year-on-year growth)	2015 V	1.2
12-month average inflation (HICP)	2015 V	0.6
08.06.2015 <a href="#">Annual inflation rose in May, indicating sustained demand</a> 		
<b>Foreign trade</b>		
Exports (year-on-year growth)	2015 IV	7.0
Imports (year-on-year growth)	2015 IV	-1.4
10.06.2015 <a href="#">Latvian entrepreneurs successfully conquer new foreign markets</a> 		
<b>Balance of payments</b>		
Current account balance (ratio to GDP)	2015 Q1	-0.4
Foreign direct investment in Latvia (net flows; ratio to GDP)	2015 Q1	3.9
05.06.2015 <a href="#">In the first quarter of 2015, the current account deficit was 23.5 mil. euro</a> 		
<b>Industrial output</b>		
Working day-adjusted manufacturing output index (year-on-year growth)	2015 IV	10.9
05.06.2015 <a href="#">The rise in manufacturing output in April was the greatest since the end of 2012</a> 		
<b>Retail trade turnover</b>		
Retail trade turnover at constant prices (year-on-year growth)	2015 IV	4.0
<b>Labour market</b>		
Registered unemployment (share in working age population)	2015 V	8.6
Job seekers rate (share in working age population)	2015 Q1	10.2
28.05.2015 <a href="#">Rise in wages drops year-on-year</a> 		
<b>Monetary indicators</b>		
Resident deposits (year-on-year growth)	2015 IV	7.4
01.06.2015 <a href="#">Household deposits with banks rose in April</a> 		

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

## Economic situation and forecasts – growth slows down, risks remain high

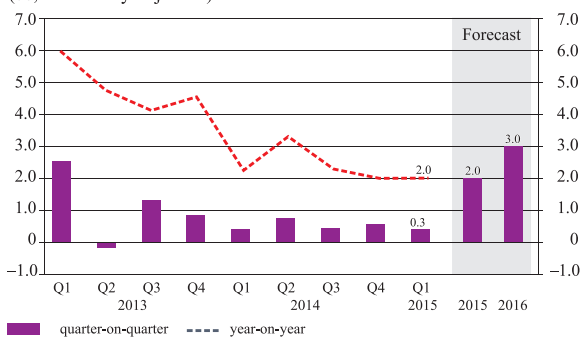


**Igors Kasjanovs**  
Chief Economist  
Latvijas Banka

At the beginning of June, Latvijas Banka published the latest Macroeconomic Developments Report, which describes the current state of the economy and provides a view on macroeconomic forecasts. In 2014, gross domestic product (GDP) grew by 2.5%. This was the slowest pace of the post-crisis period; however, taking into account the complicated external environment, this result should be considered as at least a moderate one. In 2014, the economy of Latvia was negatively

influenced by external events. On the one hand, the economic growth was held down by slow and uneven growth of the euro area. On the other hand, the economic conjuncture has been deteriorating in Ukraine, already since the start of the year. This escalation of the political situation in Ukraine has led to economic sanctions both on and on behalf of Russia. As a result, extreme depreciation and volatility of the Russian rouble and the related weakening of the Russian economy followed. However, the direct impact of economic sanctions on the economy of Latvia has been small, as sanctions were imposed only on a minor part of Latvia's exports of goods. Yet these sanctions and the weakening of the Russian economy had substantial negative confidence effects, with market participants' economic outlook deteriorating notably and their behaviour with respect to making purchases and investment becoming more conservative. The worsening economic situation has also been one of the main factors explaining the weak investment dynamics and contracting number of new loans.

Figure 1  
GDP growth  
(%; seasonally adjusted)



Sources: CSB and Latvijas Banka calculations.



In this very complicated external environment, the growth of Latvia's economy was mostly driven by the domestic-demand-oriented sectors. The largest contributors to overall GDP growth were trade, construction and public services. The economic growth based on domestic demand was determined by further improvements in the labour market, where the decreasing unemployment and strong wage growth further boosted disposable income. Private consumption was also positively influenced by low inflation level and oil prices, the latter leading to lower gasoline prices and heating tariffs. As a result, the private consumption growth has been somewhat lagging behind the growth of disposable income. Apparently, households have been increasing savings due to uncertainty in the economic environment.

Various economic and situational survey data suggest that in the initial part of 2015 the economic growth in the euro area has been slightly stronger than anticipated before. In the first quarter of 2015, euro area's GDP grew by 0.4% quarter-on-quarter (seasonally adjusted data), and the industrial output data have been modest. The monetary policy implemented by the ECB has improved market participants' confidence which is starting to positively affect also the real economy. However, the situation is still very fragile, especially taking into account the uncertainty regarding the situation in Greece.

Recently, Latvijas Banka revised the GDP forecast for 2015 down from 2.7% to 2.0%, taking into account the escalation of geopolitical tensions, depreciation of the Russian rouble, weakening of Russia's economy, and the latest macroeconomic data. Currently, Latvijas Banka considers these assumptions realistic, and there is no need to change the forecast, which for 2015 remains at 2.0%. Provided that the external market recovers further and geopolitical situation does not deteriorate, GDP in Latvia could grow somewhat faster in 2016, at around 3%, and be close to the potential growth level. Nevertheless, the risks, both positive and negative, to economic growth remain very high.

Meanwhile, the forecast of inflation (HICP) has been revised downwards, from 0.9% to 0.7%, due to lower oil and natural gas prices which also affect the heating tariffs. In 2015, inflation will be mostly maintained by the demand side, which in turn will be driven by a further wage growth. Additionally, some effects will come from previously made decisions regarding electricity market liberalisation and higher tariffs in the local public transport. It is expected that in 2016 inflation would recover to around 2% on the back of gradually rising commodity prices and improving economic growth in both the euro area and Latvia.