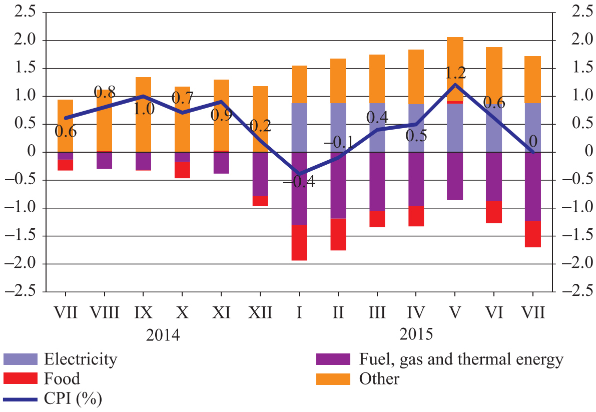
LATVIJAS BANKA MONTHLY NEWSLETTER

AUGUST 2015

Annual inflation down in July

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



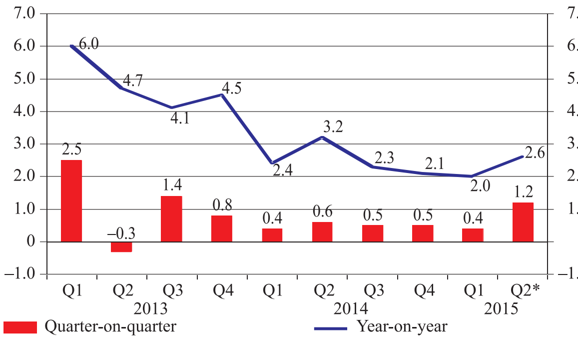
Source: CSB.

In July 2015, annual inflation dropped to 0.0%. This decline was determined by a decrease in energy and food prices as well as a larger than usual contraction of seasonally fluctuating prices.

The downward shift in oil prices in the global market in July was similar to the one in June, and fuel retail prices gradually decreased. As expected, heating prices continued to decline because the average heavy fuel oil price, and, consequently, that of natural gas, had been going down for an extended period. In July, natural gas tariffs for households dropped as well. The recent agreement on curtailing Iran's nuclear programme implies a possible increase in oil supply in 2016, which means that energy prices in Latvia could remain at the current level or even fall. Food prices continued to go down globally in July and were determined by lower dairy product and vegetable oil prices. Annual inflation in July was significantly decreased by a fall in seasonally fluctuating food prices (mostly vegetables), which exceeded the traditional July price contraction. As already on several occasions in 2015, seasonal effects on some groups of goods and services differed, both in downward and upward directions, from what was observed in previous years. Nevertheless, the July inflation data prevent any hasty conclusions on average annual inflation. However, some other factors, like the extension of Russian sanctions or eventual cautiousness of consumers, might retain their effect on inflation in the nearest quarters.

Rapid GDP growth in the second quarter

Real GDP growth rate
(%; seasonally adjusted)

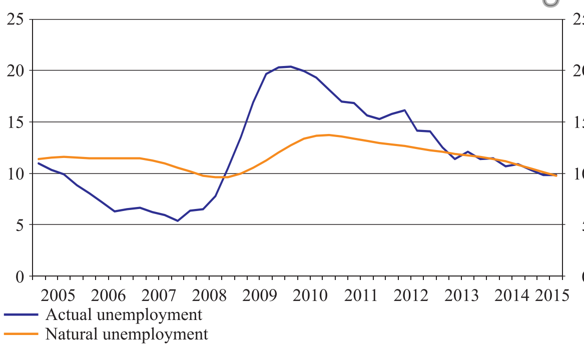


Source: CSB.
* Flash estimate.

Seasonally adjusted GDP increased by 1.2% quarter-on-quarter in the second quarter of 2015, which is the fastest quarterly GDP growth recently seen. According to working day adjusted data, GDP grew by 2.6% year-on-year. This rapid GDP growth was mainly on account of one-off factors in manufacturing, with the sector's output picking up 6.2% year-on-year. The factor of "KVV Liepājas metalurgs", where the strongest effect of resuming operation was particularly felt in the second quarter, was once again underpinning the success. The annual growth rate was positive in a substantial part of manufacturing subsectors, while negative growth was still observed in the majority of branches directly or indirectly exposed to the consequences of weak demand in Russia. However, the energy sector output also recovered somewhat after a very unsuccessful first quarter. Meanwhile, the GDP growth was curtailed by the performance of transport industry – the indicators of port and railroad operation were still gloomy.

Latvia returns to single-digit unemployment

Actual and natural unemployment in Latvia
(% of economically active population)



Source: CSB, Latvijas Banka staff calculations.*
* For the description of methodology, see Latvijas Banka Discussion Paper: Natural and Cyclical Unemployment in Latvia: New Insights from the Beveridge Curve Model.

For the first time in seven years, unemployment in Latvia has contracted below the 10% mark, standing at 9.8% of the economically active population in the second quarter of 2015. That is slightly less than in the euro area overall. However, it does not have a substantial impact on inflation, for the natural level of unemployment is also decreasing. This contraction is not a statistical phenomenon. The rest of the labour market indicators are also gradually improving, thus pointing to better employment opportunities. For instance, the share of economically inactive population who have lost hope of finding a job is undergoing a stable decline. The number of those who were forced to work part-time because they were unable to find a full-time employment has also gone down. The rise in employment is slow, and, as a consequence, the economic growth is taking place on account of productivity, which underpins a steady rise in wages.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2015 Q2*	**2.6**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2015 Q2*	**1.2**
30.07.2015 Gross domestic product growing rapidly in the second quarter		
Public Finances		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2015 VII	**6.6**
Tax revenue (since the beginning of the year; year-on-year growth)	2015 VII	**4.6**
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2015 VII	**0**
Consumer Price Index HICP (year-on-year growth)	2015 VII	**–0.2**
12-month average inflation (HICP)	2015 VII	**0.5**
11.08.2015 The annual inflation down in July: an essential impact of energy and food prices		
Foreign trade		
Exports (year-on-year growth)	2015 VI	**3.4**
Imports (year-on-year growth)	2015 VI	**5.2**
12.08.2015 Spokes in the wheels of export do not prevent the caravan from moving ahead		
Balance of payments		
Current account balance (ratio to GDP)	2015 Q1	**–0.4**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2015 Q1	**3.9**
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2015 VI	**4.4**
03.08.2015 Manufacturing performs well in the second quarter		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2015 VI	**6.8**
31.07.2015 What's so good about the minimal growth in retail turnover?		
Labour market		
Registered unemployment (share in working age population)	2015 VII	**8.6**
Job seekers rate (share in working age population)	2015 Q2	**9.8**
12.08.2015 Latvia returns to single-digit unemployment		
Monetary indicators		
Resident deposits (year-on-year growth)	2015 VI	**7.3**
28.07.2015 Deposits resume rising		

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

Challenges of Latvia's exports in the shade of Russia's sanctions

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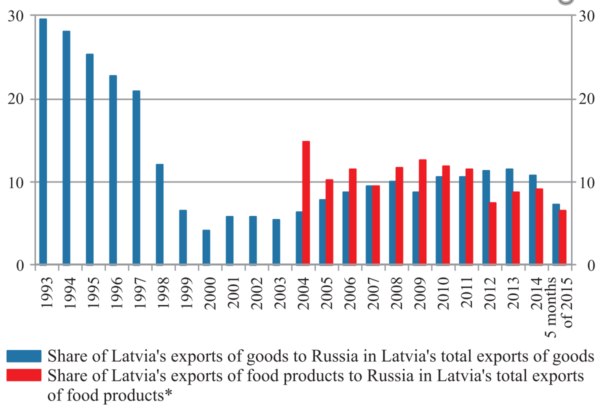
Over the last year, the external economic environment was particularly difficult. One of the main challenges was the intensification of risks surrounding exports to the Russian market. Russia's decisions on sanctions along with its economic problems and declining demand highlighted the need to diversify Latvia's export markets.

The unfavourable external environment notwithstanding, overall exports performed fairly well. Income from exports of goods grew by 3% in the first half of 2015 in comparison with the corresponding period of the previous year. Nevertheless, exports to Russia dropped substantially (by 20%) and in many commodity groups. This was partially due to Russia's embargo, which caused stronger competition in the region's food industry leading to a fall in prices. However, the sanctions are not the only factor hampering exports since they apply only to a part of food products. Other factors include the unfavourable economic situation in Russia, declining global dairy product prices reinforced by the lifting of the EU milk quotas as well as weakening demand in several trade partners.

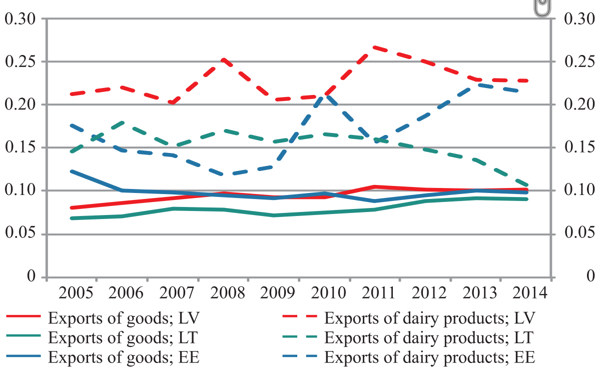
Over the past 20 years, Russia's role in Latvian exports of goods has changed significantly with exports to Russia following both downward and upward trends (see Figure 1) depending on developments in this large and hardly predictable market. Over the past 3 years, exports of food products[1] to Russia accounted for less than 10% and thus did not dominate the export market. One way of securing exports against any country's trade-restrictive decisions is diversifying risks by expanding the geographical region of markets. In this respect, diversification of Latvia's export markets by country, as measured by the widely applied Herfindahl-Hirschman Index, is relatively high and similar to that of Estonia and Lithuania (see Figure 2). **In 2015, Russia's role in Latvian exports continued to lose its significance** not only due to Russia's restrictions but also as a result of the companies' own initiatives to redirect their exports to more predictable markets.

Figure 1
Share of exports to Russia in Latvia's total exports of goods and in Latvia's total exports of food products
(% of the total exports)



Source: CSB.
* Food products excluding beverages: data for comparable calculations available as from 2004.

Figure 2
Herfindahl-Hirschman Indices for total exports and exports of dairy products in the Baltic States in 2005–2014*



Source: Eurostat; author's estimates.
* A lower index reveals a higher degree of diversification by country and vice versa.

Sanctions affected part of exports of food products. Although several Latvian food industry companies relied extensively on Russia's market, only 14%[2] of all products subject to the sanctions were exported to Russia. Thus, **the direct impact of the sanctions on the overall exports is insignificant.** On average, losses amounted to slightly more than 6 million euro per month[2] accounting for 0.7% of the total exports of goods.

In the first half of 2015, however, income from total exports of food products excluding beverages decreased by 97 million euro year-on-year, with the sanctions representing only one of the causes of the decline. The conditions are particularly difficult for the producers of dairy products. Their exports have dropped not only to the Russian market but also to the Lithuanian and Estonian markets. Latvian exporters faced growing competition in these countries since Russia was an important dairy products market also for the neighbouring Baltic countries. The situation deteriorated further due to the fall in milk prices driven by the global price trends. Meanwhile, the good news is that the dairy product exporters have been able to open up new markets such as Malaysia, Morocco, Turkmenistan and Turkey, with some of the dairy products exported to China as well. Several Latvian companies received certificates allowing them to trade their dairy products in China's market and thus opening new doors and providing a fertile ground for developing exports of dairy products.

Although the "closed" Russian market is substituted with other markets in every group of food products, the lost income has not yet been recovered since the period was most likely too short to perform thorough studies and research for acquiring new markets. However, **geographic expansion of Latvia's export markets and the forecast recovery of the demand in the euro area trade partners allow projecting increased exports in the future.**

[1] Food products excluding beverages.
[2] This is the annual average amount before the introduction of the sanctions, i.e. from August 2013 to July 2014.