



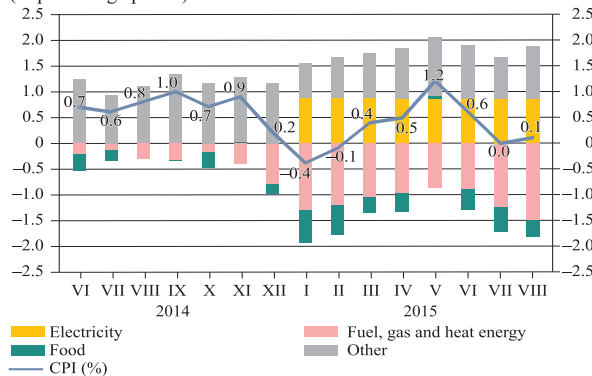
**LATVIJAS BANKA**  
**MONTHLY NEWSLETTER**

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**SEPTEMBER 2015**

## In August, annual inflation returns to positive territory

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

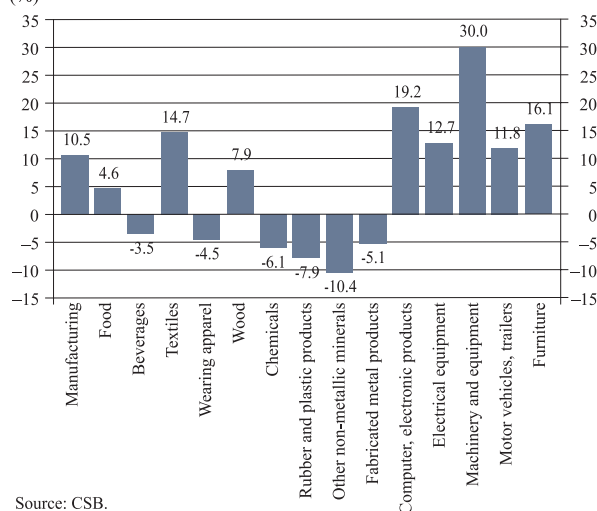


Source: CSB.

The above rise in prices is considerably steeper than the average inflation. Nevertheless, those sectors, too, partly benefited from the falling food and energy prices. Due to subdued energy and food prices, the current inflation (HICP) estimate for 2015 stands at 0.4%, slightly lower than the previous publicly stated estimate of 0.7%.

## Manufacturing growing fast in July

Growth of real manufacturing output, year-on-year growth rates in July 2015 (%)



Source: CSB.

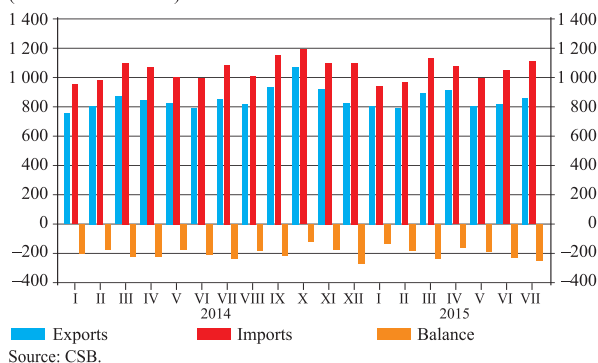
In August, the annual increase in consumer prices (CPI) stood at 0.1%. As was expected, in August energy prices continued to fall, thus hindering inflation growth. Meanwhile, resilient demand and changes in the excise tax on alcoholic beverages had a positive effect on the price growth.

Price levels in several groups of goods that are part of the core inflation basket and in some services sectors are continuously maintained by sustained demand. Over the first eight months of this year, the average price level in such sectors as catering, recreational and cultural services, services of hairdressing salons and personal grooming establishments, financial services, goods and services for routine house maintenance, etc. exceeded that of the corresponding period of the previous year by 3%–9%.

In July, the manufacturing output picked up 3.7% (month-on-month, seasonal effect excluded). Year-on-year, in turn, a pickup of 10.5% has been recorded. The majority of subsectors significantly increased their month-on-month production output in July. Food industry recorded an overall growth of 6.3% over one month as a result of a notable upswing in meat processing and the fishing industry, and wood industry posted a rise of 3.3%, a new record in output level, primarily on account of finished products. All the above contributed most to the total sector growth. The only sectors recording decreases in production output were the manufacture of electronic products (-0.8%) and repair of machinery and equipment (-1.1%).

## External complications do not impair Latvia's exports going uphill

External merchandise trade  
(in millions of euro)



Source: CSB.

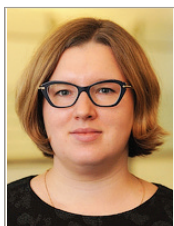
In July, the turnover of Latvia's foreign trade in goods rose by 5.6% over the month, with exports and imports of goods expanding by 5.0% and 6.1% month-on-month respectively. The largest month-on-month growth in July was recorded for exports of machinery and electrical equipment, base metals, articles of base metals, agricultural products (meat and dairy products, fish, grain), etc. However, the expansion in imports in July was primarily on account of growing volumes of intermediate and capital goods. This in turn gives rise to hopes for some momentum in exports in the coming months.

Speaking about Latvia's foreign trade outlook, several external risks to further export growth are in place. Nevertheless, Latvia's businesses continue to diversify their export markets.

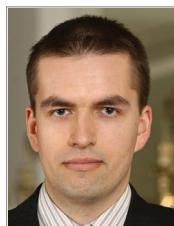
	Reporting period	Data (%)
<b>Gross Domestic Product (GDP)</b>		
Real GDP (year-on-year growth)	2015 Q2	2.7
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2015 Q2	1.2
31.08.2015 "KVV Liepājas metalurģs" behind the fast GDP growth in the second quarter 		
<b>Public Finances</b>		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2015 VIII	6.4
Tax revenue (since the beginning of the year; year-on-year growth)	2015 VIII	4.5
<b>Consumer price changes</b>		
Consumer Price Index CPI (year-on-year growth)	2015 VIII	0.1
Consumer Price Index HICP (year-on-year growth)	2015 VIII	0.2
12-month average inflation (HICP)	2015 VIII	0.5
10.09.2015 In August annual inflation returns to positive territory 		
<b>Foreign trade</b>		
Exports (year-on-year growth)	2015 VII	0.4
Imports (year-on-year growth)	2015 VII	2.2
10.09.2015 External complications do not impair Latvia's exports going uphill 		
<b>Balance of payments</b>		
Current account balance (ratio to GDP)	2015 Q2	-2.4
Foreign direct investment in Latvia (net flows; ratio to GDP)	2015 Q2	1.8
04.09.2015 The second quarter of 2015 sees current account deficit of 148.3 million euro 		
<b>Industrial output</b>		
Working day-adjusted manufacturing output index (year-on-year growth)	2015 VII	10.5
04.09.2015 Manufacturing growing fast in July 		
<b>Retail trade turnover</b>		
Retail trade turnover at constant prices (year-on-year growth)	2015 VII	4.3
<b>Labour market</b>		
Registered unemployment (share in working age population)	2015 VIII	8.5
Job seekers rate (share in working age population)	2015 Q2	9.8
31.08.2015 Wages are on the rise, but the economy still retains macroeconomic balance 		
<b>Monetary indicators</b>		
Resident deposits (year-on-year growth)	2015 VII	8.4
28.08.2015 Bank deposits rise substantially 		

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

## Research: Latvia's 2008-2009 Wage Adjustment Stronger than Thought Before



**Ludmila Fadejeva**  
Senior econometrician,  
Latvijas Banka



**Olegs Krasnopjorovs**  
Chief economist,  
Latvijas Banka

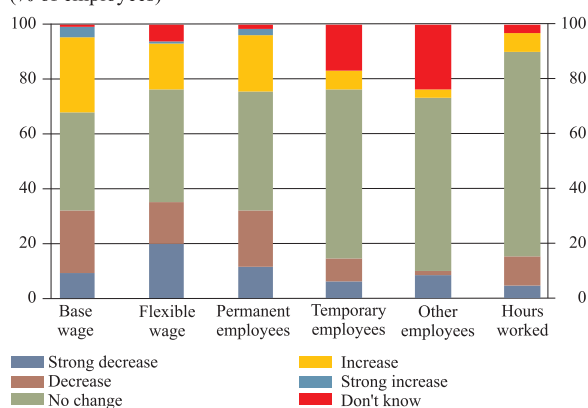
Our recent research<sup>1</sup> based on firm level data collected in Latvia within the framework of the Eurosystem's Wage Dynamics Network (WDN) shows much stronger wage adjustment during the 2008-2009 crisis than suggested by the macro data.

During the 2008-09 crisis, Latvia's gross domestic product (GDP) lost one fifth of its value, yet macro data reveal that the average wage in the private sector (including manufacturing) remained broadly flat, while competitiveness measured by unit labour costs was restored on the back of spectacular labour productivity rise. This apparent wage downward rigidity puzzled many international observers, including Olivier Blanchard<sup>2</sup> and Paul Krugman<sup>3</sup>. Yet the macroeconomic picture is likely to suffer from structural changes, particularly from labour hoarding of high-skilled employees, which may bias up the statistics of both average wage and productivity<sup>4</sup>.

This research based on firm level data shows that wage adjustment was one of the main tools for firms to decrease total costs. About 33% of firms decreased wages of their employees during 2008-2009. Base wages or piece work rates were as likely to be reduced as flexible wage components (see Chart), reflecting low collective bargaining coverage and over-optimistic wage growth prior to 2008. Wage cuts were particularly widespread in 2009 when a strong demand slowdown created the necessity to decrease labour costs significantly. Wage freezes, meanwhile, were mostly used in 2010 and 2011. In 2012 and 2013, in line with robust economic growth, the prevalence of wage cuts and freezes decreased markedly.

Wage freezes and cuts were applied relatively more by large firms. For instance, in 2009, 39% of employees

**Chart. Change in labour cost components during 2008-2009**  
(% of employees)



Source: authors' calculations.

working in large firms experienced a wage cut, while wages of other 20% of employees were frozen (twice as much as in small firms). The analysis of marginal effects from ordered logistic regressions shows that the elasticity of wage freeze to firm size increased with time, whereas the elasticity of wage cut to firm size declined.

If a firm had implemented the wage freeze strategy, wages of about 90% of employees were frozen on average. Meanwhile, the implementation of wage cut strategy affected 60% of employees on average. If a firm decreased the wage of a particular employee, the average decrease varied from 16% to 26% in different years. Small firms tended to decrease wages more sharply and for a larger share of employees.

It is noteworthy that before 2012, firms facing a strong decrease in demand were as likely to implement wage cuts and freezes as firms facing a strong increase in demand. It means that during the crisis some firms took advantage of the overall tendency to decrease wages and reduced labour costs despite favourable demand conditions. In later years, however, the situation changed significantly: in firms with a strong demand increase wage cuts were not implemented at all.

Overall, the analysis of firm level data suggests that wage adjustment in Latvia during 2008-2009 was much stronger than the macro data suggest.

<sup>1</sup> FADEJEVA, Ludmila, KRASNOPJOROV, Olegs (2015) - Labour Market Adjustment During 2008-2013 in Latvia: Firm Level Evidence. Bank of Latvia Working Paper (forthcoming).

<sup>2</sup> BLANCHARD, Olivier, GRIFFITHS, Mark, GRUSS, Bertrand (2013) - Boom, Bust, Recovery: Forensics of the Latvia crisis. Brookings Papers on Economic Activity, Fall 2013. Available: [http://www.brookings.edu/~media/projects/bpea/fall%202013/2013b\\_blanchard\\_latvia\\_crisis.pdf](http://www.brookings.edu/~media/projects/bpea/fall%202013/2013b_blanchard_latvia_crisis.pdf) [cited 09.2015].

<sup>3</sup> KRUGMAN, Paul (2013) - Latvian Adventures. The New York Times. Available: [http://krugman.blogs.nytimes.com/2013/09/19/latvian-adventures/?\\_r=0](http://krugman.blogs.nytimes.com/2013/09/19/latvian-adventures/?_r=0) [cited 09.2015].

<sup>4</sup> KRASNOPJOROV, Olegs (2011) - Average Wages in Latvia: How Big, How Credible, How Relevant They Are. Macroeconomics.lv, Latvijas Banka. Available: <https://www.macroecconomics.lv/average-wages-latvia-how-big-how-credible-how-relevant-they-are> [cited 09.2015].