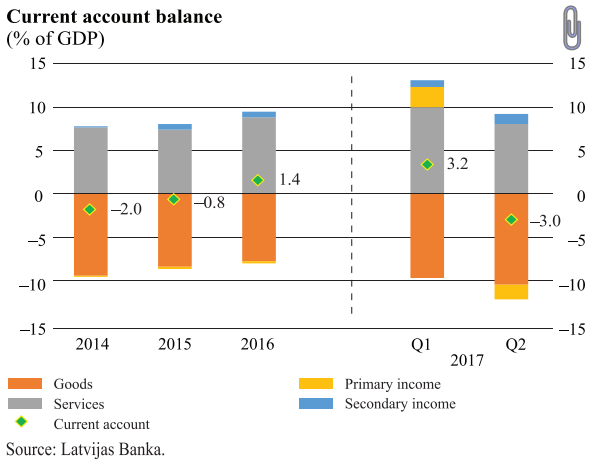
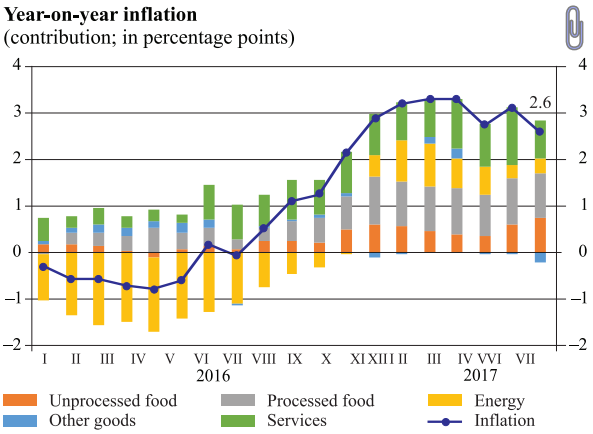
Current account reflects the recovering investment activity



Source: Latvijas Banka.

As the recovery takes hold, imports of both goods and services expanded more than exports in the second quarter. Furthermore, smaller inflows from agricultural funds of the European Union were recorded, since a large part of the overall inflows expected this year were received already in the first quarter. This resulted in a current account deficit of 3.0% of GDP in the second quarter, whilst in the first half of the year the current account was close to balance. Overall, construction, IT and transportation (air transport in particular) were the key drivers of services exports. Transportation along with financial services were also the main contributors to the services import growth. The main growth drivers in the case of exports of goods were prepared foodstuffs, articles of metal as well as animal products, whereas import growth was determined by higher investment activity and imports of aircraft. It is also important to note that this year exports are growing chiefly due to rising domestic exports rather than re-exports.

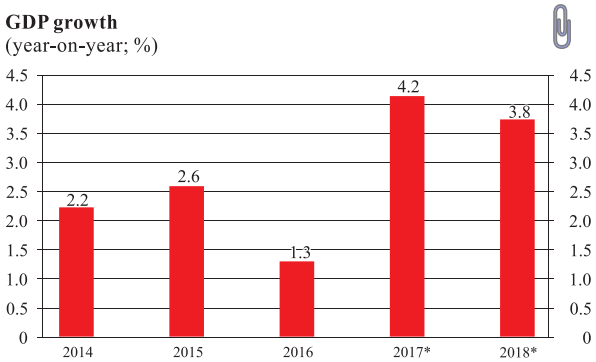
Annual inflation continues hovering around 3%



Source: CSB.

Global prices were divergent in August. Oil prices increased as OPEC's output fell and the International Energy Agency revised up its global oil demand forecasts. Concurrently, food prices decreased due to better cereal harvest forecasts, with dairy prices continuing to rise due to a higher demand for butterfat in Europe and North America. Overall, food prices remain the largest contributor to the year-on-year inflation in Latvia. Albeit fluctuating, core inflation (inflation excluding the direct impact of food and energy prices) is also on the rise this year. This reflects the increasing impact of domestic demand on inflation, which is an expected consequence, considering that unemployment is currently below the natural rate and salaries are steadily rising. According to the September forecast of Latvijas Banka, inflation is to stand at 2.9% this year and 2.8% in 2018.

GDP growth exceeds expectations and leads to revised forecasts



Source: CSB and forecasts by Latvijas Banka.
* Latvijas Banka forecasts.

This year the Latvian economy is growing at rates well above those seen in the last couple of years (4.0% year-on-year growth (in non-adjusted terms) in the first and second quarters). A pick-up was expected after a weak 2016, but the pace is faster than projected. Cyclical recovery is observed throughout Europe resulting in growth of Latvian exports and a related commendable performance of the manufacturing sector. Furthermore, investment is rebounding swiftly from the lows observed in 2016 due to both higher private investor activity and better absorption of EU funds. Consequently, in September Latvijas Banka increased the growth forecasts from 3.3% to 4.2% in 2017, and from 3.4% to 3.8% in 2018 (in non-adjusted terms). However, in order to achieve higher growth and living standards in the long-term, the supply-side capacity needs to be boosted. One key element is the labour market, where some tensions are already forming as evidenced by the high wage growth. Another potential growth bottleneck is investment which, despite currently increasing, is still at a rather low level.