GDP growth to remain robust

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According to the data of the Central Statistical Bureau of Latvia, on the backdrop of a very gradual euro area recovery Latvia's GDP growth remains robust, despite slowing down in the first quarter of 2014. The quarterly GDP increase of 0.6% was slightly below the 0.7% reported in the fourth quarter of 2013. Although the year-on-year growth was down to 2.8% (seasonally non-adjusted data), Latvia remains one of the euro area leaders in annual terms.

There are a number of factors that caused the latest data to be weaker than expected and that make us slightly cautious looking forward.

First of all, like in many other euro area countries, the unusually mild winter constituted a big drag on the output in the energy sector. Nevertheless, the warm winter was not all bad news for Latvia: partly due to the favourable weather conditions, the construction sector's annual growth in value added was the largest since the second quarter of 2012.

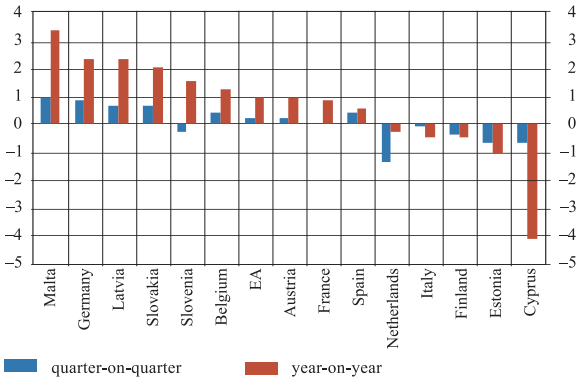
Second, the manufacturing sector presented a fairly unpleasant surprise in January, resulting in a 5.6% quarterly fall in manufacturing output in the first quarter of 2014. However, we cannot talk about an economy-wide weakness in manufacturing since the decline was partly due to statistical changes as well as, to a large extent, to the plummeting output in the basic metals subsector going down 49.3%. This subsector has been underperforming not only as a result of last year's production halt in AS *Liepājas Metalurgs*, but also because of recent problems in other smaller businesses.

Third, some of the key trading partners have been facing tougher times recently. For instance, Estonia's GDP dropped by 1.1% year-on-year, whilst the Finnish economy experienced yet another quarter of contraction shrinking by 0.5% year-on-year.

Last, but not least, an important concern in the first half of the year has been the Russian–Ukrainian conflict and its influence on the ruble, Russia's domestic demand and, consequently, on the Latvian exports as well as business and consumer confidence. The encouraging first quarter data on exports suggest that the Latvian exporters are highly competitive, flexible and have so far been able to adapt well to the market situation. Despite the positive first quarter investment data and due to the lagged nature of this variable, the Russian–Ukrainian conflict can still leave its mark on the future investment activity. Furthermore, an escalation of the said conflict would put the transport sector in a particularly vulnerable position because of its close links with Russia. Nevertheless, the first quarter transport data have been very positive due to an increase in cargoes loaded and unloaded in ports as well as a rise in rail freight turnover. Industry experts partly relate this to some businesses re-directing their cargoes from Ukrainian to Latvian ports.

Turning to price developments, despite the geopolitical uncertainty external factors have this far exerted no upward pressure on prices, even though their previously negative contribution has somewhat diminished. Core inflation has stabilised above 1% this year, which, contrary to its development in 2013, is more in line with the prevailing environment of economic growth. The key domestic determinants of the price level point to continued low inflation. For example, labour productivity remains the main driver of the compensation of employees. Moreover, the substantial acceleration of wage growth in the first quarter was mostly caused by one-off factors like raising the minimum wage, cutting the social insurance contributions etc. Finally, the sluggish credit recovery is unlikely to lead to a significant rise in domestic demand and a consequent upward pressure on prices.

GDP growth in selected euro area countries
(Q1 2014; seasonally and working day adjusted; %)



Source: Eurostat.

To conclude, despite the good performance as compared to its euro area peers, the Latvian GDP growth came as a bit of a disappointment to the forecasters. In light of the latest data, the slowdown in such important export partners as Estonia and Finland as well as the uncertainty and risks stemming from the Russia–Ukraine conflict, Latvijas Banka has reduced its GDP forecast for 2014 by 0.7 percentage point to 3.3%. Although the price developments have this far been in line with the forecasts, Latvijas Banka has also reduced its inflation forecast by 0.6 percentage point to 1.1%, considering that the Parliament has postponed the liberalisation of the electricity market until January 2015.