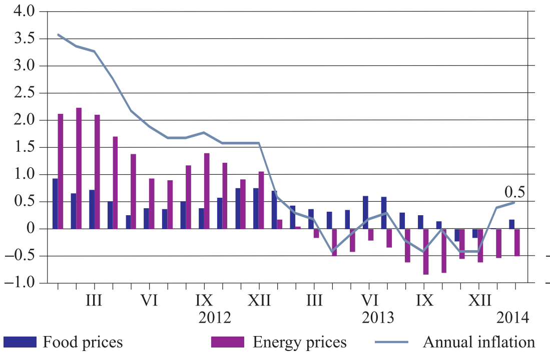
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

MARCH 2014

Annual inflation reaches 0.5% in February

Contribution of food and energy prices to annual inflation
(in percentage points)



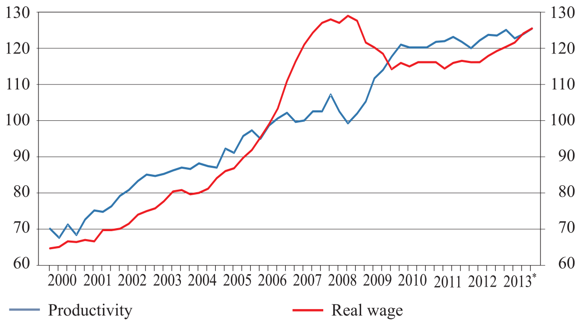
Sources: CSB; Latvijas Banka calculations.

In February, consumer prices remained broadly unchanged, with the annual inflation reaching only 0.5%. As regards the monthly seasonal factors, the impact of the sales of winter clothing and footwear was offset by the rising prices on seasonal tourist services. External factors mostly had an upward effect on prices in February. The average level of oil prices was slightly higher month-on-month which translated into a marginal rise in fuel prices. Moreover, the global food prices (except the prices on meat products) also increased. Meanwhile the price of natural gas for industrial consumers continued to drop exerting a downward pressure on thermal energy prices.

In the next few months, the annual inflation is expected to remain positive, although it could be somewhat lower than previously anticipated due to the postponed liberalisation of the electricity market (until January 2015).

Wage growth remains moderate

Productivity based on working hours and real wage index
(historic average = 100; seasonally adjusted)



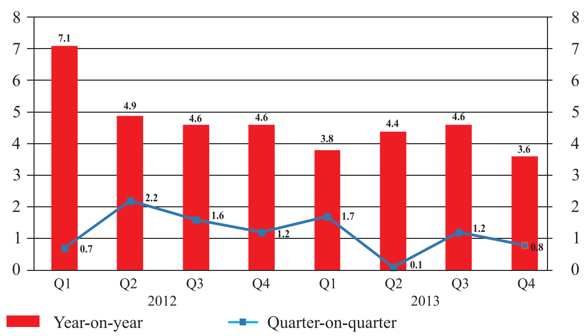
Source: CSB; Latvijas Banka calculations
*2013 Q4: provisional productivity data

Wage growth remained moderate with 4.8% year-on-year in the final quarter of 2013, thus neither creating any substantial inflationary pressures, nor deteriorating competitiveness.

There are several factors indicating that Latvia has achieved macroeconomic balance: the output gap is close to zero, the unemployment rate is close to the natural rate of unemployment and the average wage matches productivity. Looking forward, Latvia's economy can be expected to remain close to the macroeconomic balance: inter alia, real wage rise will be mostly based on productivity gains and will therefore pose no threat to competitiveness and create no substantial inflationary pressure.

GDP growth adjusted upwards relative to the flash estimate

Real GDP growth rate
(%)



Source: CSB.

In the final quarter of 2013, GDP grew by 0.8% quarter-on-quarter (adjusted upwards by 0.1 pp. relative to the flash estimate) and by 3.6% year-on-year (adjusted upwards by 0.1 pp.). Private consumption was the main engine of economic growth throughout 2013 and it retained the leading role also in the fourth quarter, increasing by 4.3% and contributing 2.6 percentage points to the GDP growth. Mostly as a result of higher employment and rising real wages, the purchasing power of residents continued to grow. Moreover, the price dynamics remained favourable to consumers at the end of the year. From a sectoral perspective, the highest contribution to the GDP growth in the fourth quarter was made by services – real estate activities, commercial services, as well as public administration.

This year, GDP growth is projected to remain at approximately 4%. Taking into account the recent developments concerning Russia and how it might affect Latvian exports, such projections are no longer seen as too conservative.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2013 Q4	**3.6**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2013 Q4	**0.8**
11.03.2014 Previous year concluded successfully, but global background points to uncertainty about future		
Public Finances		
Tax revenue (since the beginning of the year; year-on-year growth)	2014 II	**6.2**
General government budget expenditure (since the beginning of the year, year-on-year growth)	2014 II	**2.6**
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2014 II	**0.5**
Consumer Price Index HICP (year-on-year growth)	2014 II	**0.5**
12-month average inflation (HICP)	2014 II	**0.0**
10.03.2014 Consumer price level in February unchanged		
Foreign trade		
Exports (year-on-year growth)	2014 I	**–2.4**
Imports (year-on-year growth)	2014 I	**–5.8**
12.03.2014 Due to several factors, Latvian external trade activity down in January		
Balance of payments		
Current account balance (ratio to GDP)	2013 Q4	**0.8**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2013 Q4	**3.5**
06.03.2014 A surplus in Latvia's current account in the fourth quarter of 2013; a small deficit in the year overall		
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2014 I	**–11.3**
07.03.2014 Statistical fine points and problems in the metals branch cause a large drop in manufacturing output in January		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2014 I	**3.2**
Labour market		
Registered unemployment (share in working age population)	2014 II	**9.9**
Job seekers rate (share in working age population)	2013 Q4	**11.3**
28.02.2014 Wage growth remains moderate		
Monetary indicators		
Resident deposits (year-on-year growth)	2014 I	**9.8**

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

Moderate current account deficit – sustainable for Latvia

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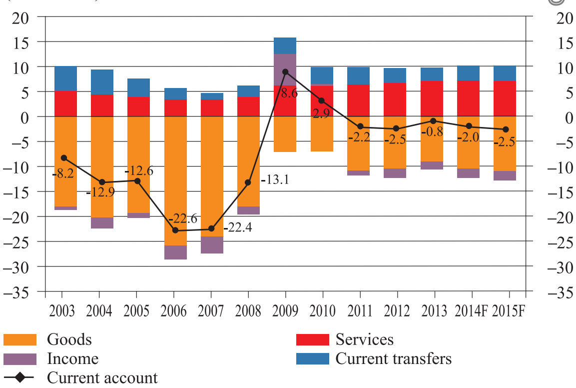
Latvia's balance of payments data over the last three years suggests that after several "peaks and troughs" the level of the current account deficit has stabilised.

In 2013, the deficit was merely 191.1 million euro, i.e. 0.8% of GDP (2.5% and 2.2% of GDP in 2012 and 2011 respectively). The deficit is expected to remain broadly similar also in the following years. According to one of the indicators included in the scoreboard for the surveillance of macroeconomic imbalances used by the European Commission to evaluate the risks to stable and sustainable development, the threshold for the current account deficit is 4% of GDP. Latvia's current account deficit is well below this threshold; therefore, there are no doubts about the sustainability of its macroeconomic development.

Balance of payments
(% of GDP)



Source: Latvijas Banka.

Latvia's current account runs a deficit mainly because the imports of goods exceed the respective exports. Latvia is unable to produce all the necessary products itself. Moreover, further development and strengthening of exports requires investment goods and intermediate goods and these goods are mostly imported. In 2013, the foreign trade deficit in goods totalled 2093.6 million euro or 9.0% of GDP. This deficit was smaller than a year ago because of lower imports. Export growth has also decreased in comparison with the previous year because in 2012 Latvian exports were strengthened by record-high exports of agricultural products, thereby forming a high basis. Additionally, the suspension of operations at Latvia's metallurgical plant "Liepajas metalurgs" had a downward effect on both exports as well as imports of metals and their products.

There is a small deficit also in the income account suggesting that foreign direct investment (FDI) inflows into Latvia are significantly larger than Latvia's direct investment abroad. In 2013, this deficit was 332.2 million euro (1.4% of GDP).

Latvia has performed better in the services sector, where exports exceeded imports significantly and covered more than 2/3 of the foreign trade deficit in goods. Due to Latvia's geographical location and access to ports, transportation has traditionally been an important services subsector in Latvia. The exports of transportation services, however, decreased in 2013 both due to cyclical reasons and weak foreign demand as well as increased competition from other ports of the Baltic Sea region. Nevertheless, better performance of many other services subsectors (including travel, financial services, computer and information services etc.) enabled exports of services to increase faster than imports. As a result, the surplus of external trade in services increased to 1658.3 million euro or 7.1% of GDP.

In addition to that, inflows of current transfers, both from EU funds (such as the European Social Fund and agricultural funds) as well as in the form of other transfers, also help to improve the current account balance every year. In 2013, net current transfers amounted to 576.3 million euro or 2.5% of GDP.

Latvia's current account deficit is fully covered by FDI and EU funds inflows that increase the capital stock. In 2013, the EU funds inflows into the capital account totalled 567.6 million euro or 2.4% of GDP. These inflows consisted mostly of financing for large-scale infrastructural development projects from the Cohesion Fund and public infrastructure improvement and business support projects from the European Regional Development Fund.

Moreover, FDI inflows into Latvia's economic sectors enhancing the export potential (i.e. excluding FDI in real estate activities and in financial and insurance activities) amounted to 452.9 million euro or 1.9% of GDP in 2013. It is obvious that the availability of EU funding, foreign direct investment and a sustainable macroeconomic environment leaves no doubt about Latvia's capability to finance the current account deficit. Based on the planned EU fund flows and FDI forecasts for the next years, Latvia's current account deficit can be expected to remain moderate, but sustainable.