



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

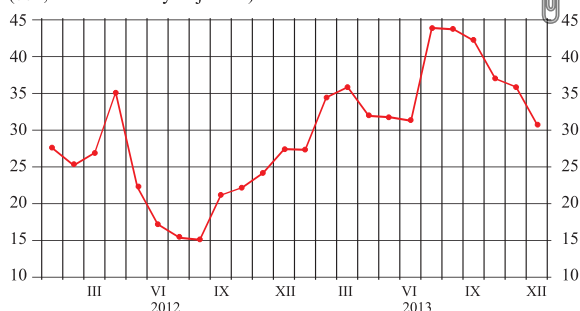
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**JANUARY 2014**



## Consumer prices remained unchanged in 2013 as compared to 2012

**Balance of answers regarding inflation perceptions**  
(%\*, not seasonally adjusted)



Source: European Commission.

\* difference between the fraction of respondents mostly expecting increase in prices and the ones mostly expecting decrease in prices

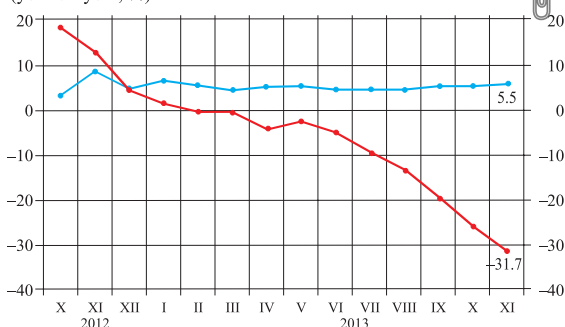
On 1 January 2014, with its inflation rate untypically low for a growing economy, Latvia joined a low-inflation monetary union. In 2013, the low inflation was essentially a result of external and/or supply side factors such as global oil and food price developments as well as modernisation of the thermal energy production. Similar factors determined the low year-on-year inflation rate in December (−0.4%), while the average level of consumer prices remained unchanged in 2013 as compared to 2012.

Moreover, following the Council's decision of July 2013 on Latvia joining the euro area, the low real inflation and euro-related activities acted to reduce the inflation expectations, particularly as of October 2013, with the start of the period of the dual price display. Chart 1 shows that the net percentage

of respondents expecting an increase in prices in the coming 12 months decreased in December pointing towards a smooth changeover process as well as expectations of price stability.

## Money supply has resumed to increase

**Domestic deposits and cash in circulation**  
(year-on-year, %)



— Deposits of domestic households and companies  
— Amount of LVL cash in circulation

Source: CSB.

Aggregate money supply continued to increase in November 2013. Cash and non-cash currency (M3) in the economy increased by 1.7% in November, with the rate of its annual growth at 0.7%. The amount of lats cash in circulation declined by 31.7% year-on-year. Household deposits grew for a tenth consecutive month, by 8.1% year-on-year, while corporate deposits increased for a second consecutive month. The balance of domestic deposits with banks reached a new high at the end of November: 8.4 billion euro or 5.9 billion lats.

Data clearly indicate that the amount of lats cash in circulation declined rapidly in November and December 2013. According to Latvijas Banka calculations, the amount of euro cash in circulation has exceeded that of the lats

already since 10 January 2014. For the sake of comparison, in the case of Estonia the amount of euro in circulation also exceeded that of krona on the tenth day following the euro changeover. Latvia has joined the euro area successfully and euro is the sole legal tender in Latvia as of 15 January.

## Manufacturing grows in November

**Volume index of production in manufacturing**  
(2010 = 100, seasonally adjusted)



Source: CSB.

Manufacturing output (seasonally-adjusted; at constant prices) increased by 2.1% month-on-month and by 2.6% (year-on-year) in November.

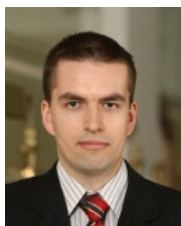
The growth of manufacturing in November was supported by the large sub-sectors, including the manufacture of fabricated metal products (16.5% month-on-month and 12.3% year-on-year respectively). Similarly, manufacture of wood and products of wood (except furniture) also registered substantial growth in November (3.4% month-on-month and 6.6% year-on-year respectively). Manufacture of food products expanded by 2.1% month-on-month and 10.3% year-on-year in November. Moreover, an increasingly larger part of the food products is exported (35% in the first three quarters of 2013 as opposed to 33% in the first three quarters of 2012).

Eurozone's ESI and PMI could also point towards further development of Latvia's manufacturing sector. In December, the ESI in the euro area climbed to 100.0 reaching its long-term average. In the final quarter of 2013, manufacturing PMI also showed the best result in the last two-and-a-half years. Particularly positive manufacturing PMI development has been observed in Germany and the United Kingdom, both of which are highly important markets for Latvia.

	Reporting period	Data (%)
<b>Gross Domestic Product (GDP)</b> (quarter-on-quarter growth; seasonally adjusted)	2013 Q3	1.3
<b>State budget</b> Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year, year-on-year growth)	2013 XII 2013 XII	8.6 4.5
<b>Consumer price changes</b> Consumer Price Index CPI (month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 13.01.2014 <a href="#">Last year ended with record low inflation in a growing economy</a> 	2013 XII 2013 XII	0.0 0.0
<b>Foreign trade</b> Exports (year-on-year growth) Imports (year-on-year growth) 10.01.2014 <a href="#">Latvian goods external trade balance improved in November</a> 	2013 XI 2013 XI	-7.7 -9.2
<b>Balance of payments</b> Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP)	2013 Q3 2013 Q3	3.0 1.1
<b>Industrial output</b> Working day-adjusted industrial output index (year-on-year growth) 06.01.2014 <a href="#">Manufacturing grows thanks to the largest sub-sectors</a> 	2013 XI	2.6
<b>Retail trade turnover</b> Retail trade turnover at constant prices (year-on-year growth)	2013 XI	5.0
<b>Employment and unemployment</b> Registered unemployment (share in working age population)	2013 XII	9.5
<b>Monetary indicators</b> Broad money M3 (year-on-year) 21.01.2014 <a href="#">The return of cash currency to banks behind a record rise in deposits</a> 	2013 XII	2.8

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

## Sustainable Economic Growth Under Way



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The year prior to Latvia's eurozone accession was marked by a rare combination of the fastest economic growth in the EU and zero consumer price inflation. It was the fourth consecutive post-crisis year of robust economic growth. Contrary to the pre-crisis period, this time economic growth is viewed as sustainable and not creating any internal or external imbalances. The output gap remained almost closed as headline GDP grew at par with its potential. Therefore, the impact of aggregate demand on consumer prices was modest, while supply factors, mainly fuel and heating prices, had a negative contribution.

Although real GDP growth decelerated somewhat from 5.2% recorded in 2012, it remained the fastest in Europe: the average GDP growth rate of the first three quarters of 2013 was 4.2%. Flash data for 2013 suggest a GDP per capita increase from 64% to 67% of the EU average in PPS terms, much higher than 59% reached in 2008 prior to the crisis and 47% in 2004 when joining the EU. During 2013, Latvia closed about 1/30 of its income gap vis-à-vis Germany, reflecting fast convergence of living standards.

Solid employment and real net wage growth made private consumption to become the main driver of GDP growth in 2013. In just three years the unemployment rate declined from the highest in the EU to a level just below the eurozone average, mainly due to job creation in the private sector. Real net wage growth reached a 5-year high, thanks to atypically low inflation and declining tax wedge on labour, whereas nominal gross wage dynamics remained stable and were broadly in line with labour productivity developments.

Fast income convergence, job creation and confidence restoration resulted in a gradual slowdown of labour outflow. Net emigration decreased three fold between 2010 and 2012, and shrank even further in 2013: the difference between passenger departures and passenger arrivals at Riga airport (flash indicator of migration trends) approached zero between the fourth quarter of 2012 and the third quarter of 2013.

Trade deficit in goods is partly compensated by trade surplus in services, resulting in a small current account deficit. Such a deficit is sustainable for Latvia, reflecting its FDI and EU funds net-receiver position, underlying its strong income convergence potential.

According to EC data, labour shortage claims are stable and modest; therefore, labour income share is not likely to rise beyond its historical average and wage growth is not expected to hamper competitiveness and/or undermine price stability, i.e. low and predictable inflation. Unit labour costs remained 15% and 21% below their historical peak in nominal and real terms respectively.

Supply-side driven income convergence is likely to continue in 2014 as well, and the output gap is expected to remain close to zero during the coming years. Prudent macroeconomic policies are likely to further strengthen investor climate and business activity. The already low budget deficit is likely to diminish further both in headline and cyclically adjusted terms; moreover, fiscal prudence is enhanced with the introduction of the Fiscal Council as of 2014. Two engines of potential GDP growth will be capital deepening and TFP, while labour contribution is unlikely to play a significant role as the working age population decline will be offset by a gradually increasing participation rate and a decreasing NAIRU.

All in all, 2014 is likely to become the fifth consecutive year of sustainable economic growth: fast income convergence without creating imbalances. GDP growth could reach 4.1% (4.0% according to the ECB methodology), while the HCPI inflation is projected at 1.7% (domestic CPI measure – 1.5%).