



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

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**MARCH 2016**

## GDP growth at 2.6% in 2015

### Real GDP

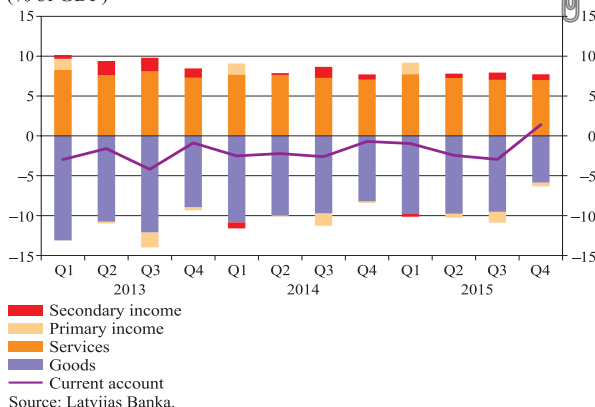
(annual growth rate; %; seasonally and calendar adjusted data)



sector output, while manufacturing output dropped. Latvijas Banka currently projects GDP growth at 2.3% in 2016. Within an unfavourable external environment, further growth will largely depend on the ability of Latvian companies to enhance competitiveness and find new markets.

## Current account posted improvement

### The main components of the current account (% of GDP)



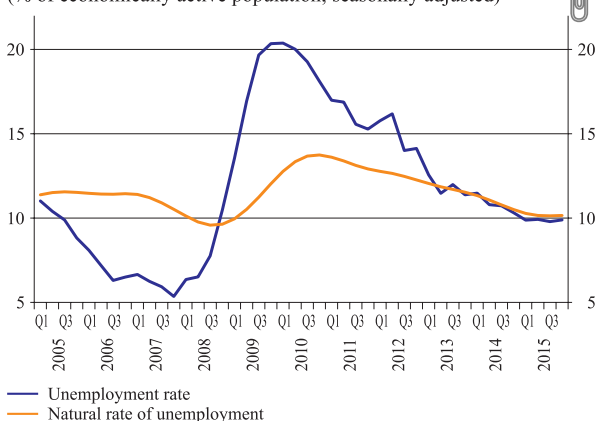
Overall, the current account deficit decreased to 1.2% of GDP in 2015. The current account improved as a result of a better balance of goods (deficit 8.7% of GDP). This development was driven by a small positive increase in exports of goods. At the same time, imports of goods contracted owing to weak domestic investment activity, slow development of exports and decline in global commodity prices. The balance of services (7.2% of GDP) remained close to the level of the previous year. Exports of services posted growth mostly driven by travel, financial services, telecommunications and IT services. The negative balance of primary income in the previous year rose slightly and was 0.3% of GDP. The surplus of secondary income in 2015 dropped somewhat to 0.5% of GDP. In 2015, the surplus of the capital account was also lower than in 2014 as a result of smaller inflows from

the European Regional Development Fund and Cohesion Fund. The financial account recorded a negative balance in 2015 (0.6% of GDP). Assets abroad dropped slightly faster than liabilities, and thus funds flowed into Latvia. Foreign direct investment in Latvia increased by 2.4% of GDP in 2015. The major investment flows came from Cyprus, Russia, Norway and the Netherlands. The most sizeable investment went to the financial, trade and transport sectors.

## Unemployment continues to decrease, but at a slower pace



### Unemployment and its natural rate

(% of economically active population; seasonally adjusted)



In the fourth quarter of 2015, 9.8% of the economically active population were job seekers (-0.4 percentage point year-on-year; +0.1 percentage point quarter-on-quarter). The figure is comparable with the EU and euro area averages, and it is twice lower than during the trough of the crisis. The unemployment rate will remain close to its natural rate, and the state of macroeconomic balance will stay unchanged. As the cyclical unemployment component is approximately zero, it is impossible to sustainably decrease unemployment by stimulating demand. Most probably, structural reforms, particularly successful implementation of active labour market policies, are a key to lower unemployment in the future. One of the main unemployment determinants is the education level. The unemployment rate among those with higher education hovers around 5%, while it is about 20% among people with basic education. Policies promoting regional and sectoral flexibility would be similarly important.



	Reporting period	Data (%)
<b>Gross domestic product (GDP)</b>		
Real GDP (year-on-year growth)	2015 Q4	2.3
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2015 Q4	-0.3
01.03.2016 <a href="#">End of 2015 was marked by slowing growth</a> 		
<b>Public finances</b>		
General government budget expenditure (since the beginning of the year, year-on-year growth)	2016 II	-0.8
Tax revenue (since the beginning of the year; year-on-year growth)	2016 II	-3.5
<b>Consumer price changes</b>		
Consumer Price Index CPI (year-on-year growth)	2016 II	-0.5
Harmonised Index of Consumer Prices HICP (year-on-year growth)	2016 II	-0.6
12-month average inflation (HICP)	2016 II	0.2
09.03.2016 <a href="#">Annual inflation still not in the positive range</a> 		
<b>Foreign trade</b>		
Exports (year-on-year growth)	2016 I	-10.9
Imports (year-on-year growth)	2016 I	-12.2
14.03.2016 <a href="#">The beginning of the year not gratifying</a> 		
<b>Balance of payments</b>		
Current account balance (ratio to GDP)	2015 Q4	1.4
Foreign direct investment in Latvia (net flows; ratio to GDP)	2015 Q4	1.0
04.03.2016 <a href="#">In the fourth quarter of 2015, a surplus, 1.4% of GDP, in Latvia's current account</a> 		
<b>Industrial output</b>		
Working day-adjusted manufacturing output index (year-on-year growth)	2016 I	-2.9
09.03.2016 <a href="#">A disappointing start to the year in manufacturing</a> 		
<b>Retail trade turnover</b>		
Retail trade turnover at constant prices (year-on-year growth)	2016 I	3.0
<b>Labour market</b>		
Registered unemployment (share in working age population)	2016 II	9.2
Job seekers rate (share in working age population)	2015 Q4	9.8
26.02.2016 <a href="#">Wages last year maintained their rate of growth</a> 		
<b>Monetary indicators</b>		
Resident deposits (year-on-year growth)	2016 I	10.3
26.02.2016 <a href="#">A seasonal drop in deposits was observed in January</a> 		

Sources: Treasury, CSB and Latvijas Banka data.

## Zero-based approach to government budgeting



**Baiba Traidase**  
Senior Economist of Monetary Policy Department

**A slight deficit of 1.0% of GDP is expected in Latvia's budget balance in 2015, and overall compliance with the European fiscal discipline requirements is noted in the medium-term. Nevertheless, it does not imply by default that public spending is effective and adequate in light of the national development goals and ca-**

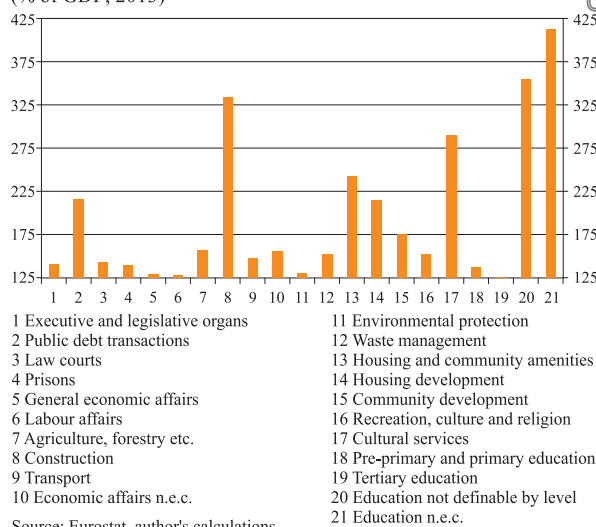
**pabilities. The government launched a review of the government spending based on two priority sectors of health and education this March, as well as started the implementation of the principles of zero-based budgeting.**

**"Looking by sector, baseline items are most often carried over by default, without any analysis whether the allocated funding has produced the targeted outcomes or not."**

Zero-based budgeting involves the following three key elements: (i) spending is justified by objectives rather than the previous year's budget; (ii) alternative scenarios are provided; (iii) spending is planned from zero. The theory was developed in the US towards the end of the 1970s and was welcomed by the private sector. Zero-based budgeting was introduced in public administration by Jimmy Carter's government, but the concept was abandoned once the economy started to recover. It was brought into the limelight again after the 2008 financial and economic crisis. The idea, however, has returned to the public sector only in the US, while Europe is still discussing its merits. Meanwhile, on 1 March 2016 Latvia's Cabinet passed a decision on reviewing the government budget and two working groups were established: one for reviewing the government expenditure, with a particular focus on the sector of education, and the other concentrating on the health area spending. One of the tasks is a broader implementation of the principles of zero-based budgeting.

Latvia's medium-term and annual budgets are built using both the incremental approach as well as some elements of zero-based budgeting which are applied to certain items, such as contributions to the EU budget, debt management and partly also social budget. Nevertheless, looking by sector, baseline items are most often carried over by default, without any analysis whether the allocated funding has produced the targeted outcomes or not. As a result, on average budget expenditure outpaced economic growth in the last 10 years. Given the ever-growing urgent needs, this is not a sustainable combination. Moreover, according to COFOG<sup>1</sup>, Latvia's general budget is significantly overfunded on several levels. In comparison with the average figures of Germany, United Kingdom, Ireland which are the most popular emigrant destinations as well as with Estonia and Finland mentioned as best examples with regard to achievements in education or innovations, Latvia spends more than 125% of the sample group's spending in the sectors of education, excluding secondary education, construction as well as housing development and culture. At the same time, it remains unclear whether the spending and the chosen solutions are the most effective. For example, Latvia's spending on education at 5.7% of GDP exceeds the EU average of 5.0% of GDP, yet the proportion of 15-year-olds with insufficient skills in reading, mathematics and science is also significantly above the EU average. This means that higher spending has failed to produce better results.

**Latvia's budget expenditure (COFOG) which is more than 125% higher than the average figure for the sample group including Germany, United Kingdom, Ireland, Estonia and Finland (% of GDP; 2013)**



Although the targeted medium-term budgetary deficit is low, the fiscal discipline needs to be tightened in times of economic growth, in order to achieve a balanced or a surplus budget. Latvia's general government budget ran a surplus only once within the last 20 years. Moreover, macroeconomic improvement has decelerated this year.

<sup>1</sup> Classification of the Functions of Government