LATVIJAS BANKA

BANK OF LATVIA
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1. Highlights

Foreign trade still showing positive signs

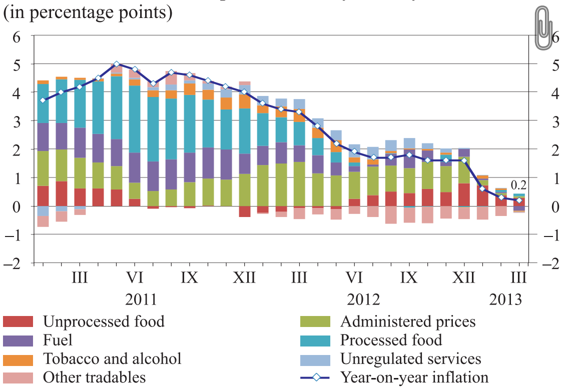
Annual increase in exports and imports of goods
(%)

Source: Central Statistical Bureau of Latvia.

In February 2013, the annual rise in Latvian exports reached 9.6%, which is a good result, especially considering the unstable external environment. Almost all export commodity groups significant for Latvia retained growth in annual terms; a particularly healthy rise was observed in the exports of articles of wood as well as electrical machinery and equipment. Month-on-month, the fastest increase in commodity exports was observed to Germany and Russia. Exports to the euro area posted positive growth both month-on-month and year-on-year confirming the competitiveness of Latvian exporters. Analysing the changes in the economic sentiment indicator (ESI) of Latvia's trade partners, it is obvious that confidence has deteriorated particularly in the euro area countries (Germany and Estonia), whereas improvements are observed in partners outside the euro zone. Both the retained optimism of the non-euro area trade partners and the successful development of the above-mentioned sectors give rise to hope that the total Latvian exports will continue to grow in 2013. Nevertheless, the growth rate of commodity exports will be significantly lower than in 2012, provided that the external demand does not pick up more robustly.

Inflation stays at record lows

Contribution of main components to the year-on-year inflation rate
(in percentage points)



Sources: Central Statistical Bureau of Latvia, Bank of Latvia's calculations.

The annual inflation remained at a low level (0.2%) in March 2013. This was determined by the developments observed in individual factors in earlier (including base) periods rather than any new factors.

First, the average oil price was lower in the first three months of 2013 compared to last year and even dropped slightly month-on-month in March, thus bringing the price of fuel down by 1.3%.

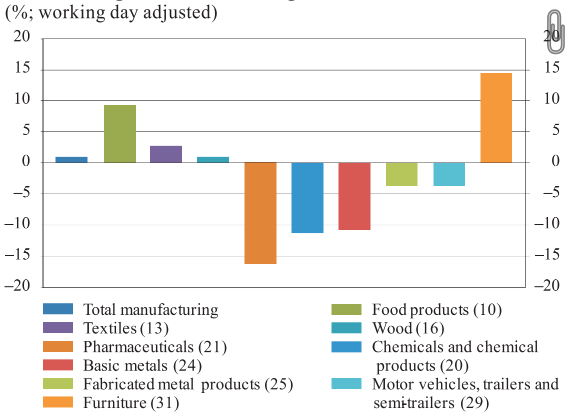
Second, the natural gas tariffs for households and those producers of thermal energy that use natural gas were reduced gradually in January and February, remaining at a lower level also in March.

The average consumer prices rose mostly on account of the seasonal prices on clothing and footwear in March of this year.

On the one hand, the inflation is already low and further declines are unlikely. On the other hand, the demand-side pressure on inflation is not expected to resume in the near future. Therefore, the average annual inflation will remain low; however, with the impact of base factors fading, the annual inflation will gradually climb to about 2% in the second half of the year.

Manufacturing holds up well, yet challenges await in the future

Annual changes in manufacturing in the first two months of 2013
(%; working day adjusted)



Source: Central Statistical Bureau of Latvia.

In February, manufacturing output (seasonal effects excluded) grew by 0.2% month-on-month. The annual growth rate has once again returned to a positive territory, at 1.9%. The total industrial output (including the energy sector and mining and quarrying) dropped by 2.6% as a result of the relatively warm February.

Looking by sub-sector, the monthly developments did not reveal any fundamental changes in trends, with the exception of the negative trend observed in the case of the manufacture of basic metals were a month-on-month drop of 19.5% was reported. In February, the output of this particular sub-sector was 27.2% lower than the 2012 monthly average. That, of course, is explained by the drop in the production levels of the financially troubled metallurgical company "Liepājas Metalurgs".

Moreover, the European Commission's confidence indicators and the Purchasing Managers' Index (PMI) point to a worsening in the European industry. In addition to that, stagnation is also observed in construction in Europe which has a negative impact on Latvia's exports generated by the wood and metal sectors. Signs of recession are observed in the automotive industry, adversely affecting the Latvian enterprises producing parts for the manufacture of motor vehicles. Furthermore, no positive signs are so far evident in the European metallurgical industry. Thus the negative effects originating in Europe are expected to increase in the near future.

2. Macroeconomic Data

	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted)	2012 Q4	**1.4**
State budget		
Tax revenue (current month; year-on-year growth)	2013 III	**5.4**
General government expenditure (since the beginning of the year, year-on-year growth)	2013 III	**6.0**
Consumer price changes		
Consumer Price Index CPI (month-on-month growth)	2013 III	**0.5**
12-month average annual inflation (to comply with the Maastricht Criteria)	2013 III	**1.6**
21.03.2013 Producer prices drop, supply side pressure on prices still low		
09.04.2013 The low annual inflation determined by factors from previous periods		
Foreign trade		
Exports (year-on-year growth)	2013 II	**9.6**
Imports (year-on-year growth)	2013 II	**–0.6**
09.04.2013 External trade indicators testify to the sustained competitiveness of Latvian producers		
Balance of payments		
Current account balance (ratio to GDP)	2012 Q4	**0.5**
Foreign direct investment in Latvia (net flows; % of GDP)	2012 Q4	**3.4**
Industrial output		
Working day-adjusted industrial output index (year-on-year growth)	2013 II	**1.8**
03.04.2013 Manufacturing volumes growing, yet tougher times ahead		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2013 II	**5.7**
28.03.2013 Prediction confirmed: retail trade down in February		
Employment and unemployment		
Registered unemployment (share in working age population)	2013 III	**10.8**
Monetary indicators		
Broad money M3 (year-on-year)	2013 III	**0.4**
19.04.2013 Household deposits on the rise		

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

3. In Focus

Latvian fiscal policies: building on consolidation success

In 2012, the first year after the completion of the EU/IMF Balance-of-Payments assistance programme, Latvia continued on a sustainable fiscal path on its own. On the back of responsibly handled public finances and over-achieving economic growth, the budget deficit turned out well below the initial target of 2.1% of GDP (1.2%).

After implementing large-scale consolidation in the midst of the crisis, the economy recovered much faster than expected and public spending was reduced in a sustainable manner. This was achieved by planning a restrictive expenditure policy for 2012, including nearly 1% of GDP in consolidation measures on top of the massive package (17% of GDP) completed within the framework of the programme in 2008–2011. Tax revenue growth remained buoyant throughout the year: several priority areas where pressing financial needs had accumulated during the years of tough spending restriction could be addressed. Regardless of the budgetary amendments, the annual increase of the general government expenditure was contained at 3% while the revenue grew by almost 10% in ESA terms.

Thus the general government balance improved from 3.6% in 2011 to 1.2% in 2012. The primary driver was obviously the better-than-expected economic growth, yet the improvement was more than a percentage point even in cyclically-adjusted terms. Good fiscal discipline with respect to discretionary spending created room for structural adjustments in tax policy. The value added tax rate was cut by 1 percentage point to 21% from July 2012 to align VAT rates with the neighbouring countries and boost the purchasing power of the population.

The much-improved sustainability of public finances enabled the government to return to the implementation of the pension reform: the contribution rate to the 2nd pillar of the pension system was raised by 2 percentage points to 4% in 2013. In addition, to shift the tax burden away from labour, a 1 percentage point cut in the personal income tax rate was introduced in 2013, with the overall objective of reducing the rate from 25% in 2012 to 20% in 2015. Even with these necessary structural changes in the public finances, the headline budget deficit is certain to fall below the 3% benchmark leaving a safety margin also in the near future, eliminating any concerns about sustainability.

Another fact that confirms the confidence in Latvian fiscal policy in the longer term is the return of market trust in Latvia's sovereign debt. Latvia successfully returned to international capital markets already in 2011 but the latest bond issue in December 2012 was sold at a historically low rate. The proceeds of the said issue were used for early repayment of the IMF portion of the stabilisation programme loan. Although general government debt increased by some 335 million lats in 2012, it declined by a percentage point to 40.7% of the GDP. As a result of the Treasury's refinancing plan, the debt is projected to increase slightly in 2013; nevertheless, after the expected large repayments of the European Commission share of the programme loan coming up in 2014 and 2015, the debt ratio will be firmly set on a downward path.

Latvia's fiscal policy clearly satisfies the Maastricht criteria and, by ratifying the Fiscal Compact, Latvia officially demonstrated the commitment to participate in the building of prudent fiscal governance in Europe. Since the beginning of this year, the principles of the Fiscal Compact are transposed into Latvia's national law in the form of the Fiscal Discipline Law, in force since 6 March 2013. The main features of the law are the concept of a balanced budget over the economic cycle (represented by the structural balance below 0.5% of GDP restriction in the law), and expenditure growth restriction in line with the potential GDP growth. The above principles will be implemented through medium-term budgeting stipulated in a law setting expenditure limits for three years. A Fiscal Council consisting of 6 fiscal policy experts is expected to start operating from the beginning of 2014. Its task will be to monitor the correct application of the Fiscal Discipline Law in the medium-term budget framework law and in the annual budget.