

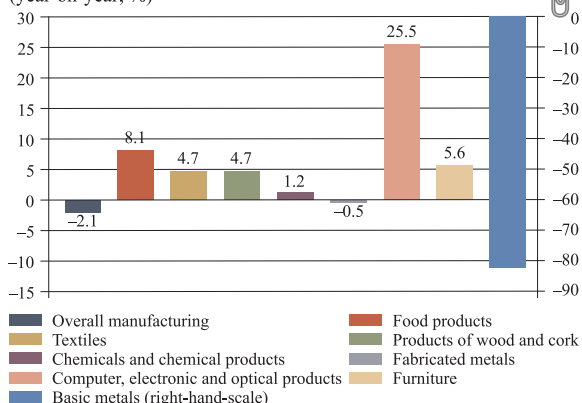


LATVIJAS BANKA
MONTHLY NEWSLETTER

APRIL 2014

Substantial annual growth in the largest manufacturing sub-sectors

Changes in output of manufacturing and selected sub-sectors in the first 2 months of 2014 (year-on-year, %)



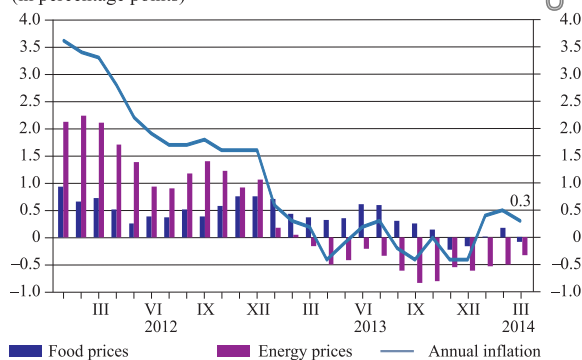
Source: CSB.

Manufacturing output grew 3.3% month-on-month (seasonally adjusted data) in February. Despite a minor overall annual drop of 0.6% in manufacturing (working day adjusted data), substantial annual growth was observed in manufacture of computers, electronic and optical products, and manufacture of non-metallic mineral products as well as in the largest manufacturing sub-sectors: manufacture of food products and wood products. The negative effect from the wind-up of *Liepājas Metalurģs* in the first half of 2013, a company which used to be by far the largest player in manufacture of basic metals, was still evident.

Moreover, the January plunge in manufacturing was adjusted from -17.3% to -9.9% month-on-month and from -11.3% to -3.5% year-on-year. The latest data release is based on revised value added weights to capture the structural changes affecting the weight of the basic metals sub-sector.

Annual inflation was 0.3% in March

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



Sources: CSB; Latvijas Banka calculations.

Annual inflation dropped to 0.3% in March. Seasonal factors (spring collections of clothing and footwear coming to shops) had an upward effect on the monthly inflation in March. Nevertheless, the price rise fell short of the 2013 level (e.g. vegetable prices even moved in the opposite direction as compared to the previous year), resulting in a minor decline in the annual inflation.

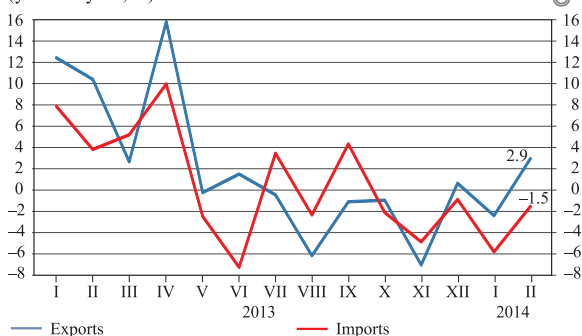
Despite the slight month-on-month drop in the oil prices and the postponement of the energy market liberalisation, the main inflation risks are related to the uncertainty surrounding both energy and global food price developments.

Consumer survey conducted by the European Commission indicates that inflation expectations are contained in Latvia. The percentage of respondents expecting substantial price increases in the nearest 12 months dropped in March, whereas

the percentage of those anticipating minor or no changes rose. The low real inflation may have also played a role in this assessment.

Export growth has improved the foreign trade balance of Latvian goods

Growth rates for exports and imports of goods (year-on-year, %)







Source: CSB.

In February 2014, foreign trade turnover of Latvian goods grew by 5.1% month-on-month. Exports and imports of goods increased by 7.9% and 2.8% month-on-month respectively, resulting in a slight improvement of the foreign trade deficit in goods. Despite the negative effect from the wind-up of *Liepājas Metalurģs*, the annual growth rate of goods exports reached 2.9% in February on account of an increase in the exports of agricultural and food products, wood, textile articles, electrical equipment, and building materials.

Within a month, exports of goods increased to almost all main trading partners, including Russia which is the third largest export partner. In 2013, 11.5% of all goods exports went to Russia and 0.9% to Ukraine. As concerns the impact of the events in Russia and Ukraine on exports, reactions from Latvian businesses have been mixed: some businesses have

frozen a part of their output volumes for now and are expecting to find other markets. Others are even expanding their exports in those two countries, since some of the international players have left their markets, thus opening up trade opportunities.

The economic situation in the EU where Latvia sells over 70% of its total exports of goods is gradually improving, giving rise to expectations of a more robust external demand in these markets which could offset the potential negative effect from the conflict between Russia and Ukraine.

	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
Public Finances		
Tax revenue (since the beginning of the year; year-on-year growth)	2014 III	3.4
General government budget expenditure (since the beginning of the year, year-on-year growth)	2014 III	1.5
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2014 III	0.3
Consumer Price Index HICP (year-on-year growth)	2014 III	0.3
12-month average inflation (HICP)	2014 III	0.0
08.04.2014 In March, consumer prices undergo a seasonal rise; annual inflation drops 		
Foreign trade		
Exports (year-on-year growth)	2014 II	2.9
Imports (year-on-year growth)	2014 II	-1.5
09.04.2014 Export growth has improved the external trade balance of Latvian goods 		
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
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2014 II	-0.6
04.04.2014 January drop revised substantially; a month-on-month growth in February 		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2014 II	2.0
Labour market		
Registered unemployment (share in working age population)	2014 III	9.8
Job seekers rate (share in working age population)	2013 Q4	11.3
Monetary indicators		
Resident deposits (year-on-year growth)	2014 II	9.3
28.03.2014 Monetary aggregates stabilized 		

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

Fiscal developments and projections in Latvia 2013–2016



Guntis Kalniņš

Economist

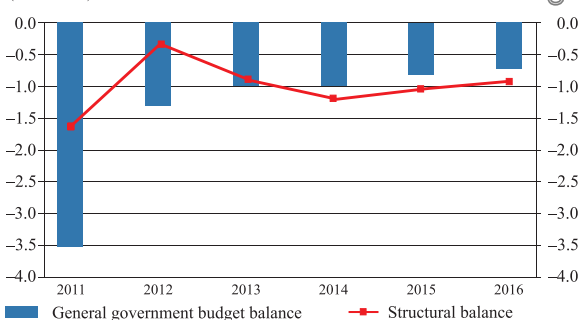
Latvijas Banka

The budget deficit of Latvia in 2013 declined to 1.0% of GDP according to the Eurostat notification on General Government Budget Deficit and Debt published on 23 April 2014. This marks another milestone on the track to fiscal sustainability for Latvia. Putting a stop to the era of irresponsible spending when hit hard by the world financial crisis in 2008, Latvia has made certain steps towards achieving fiscal balance and creating a culture of fiscal discipline. First, the massive fiscal consolidation effort of around 16% of GDP in three years brought the budget deficit to slightly above 3% of GDP in 2011. The new direction of the fiscal policy and improvement of the macroeconomic outlook compressed the deficit further in 2012 achieving the structural deficit target set at 0.5% of GDP.

Subsequently, the dedication to fiscal discipline was reaffirmed by signing the Fiscal Compact even before becoming bound by its requirements as a member of the euro zone as of 1 January 2014.

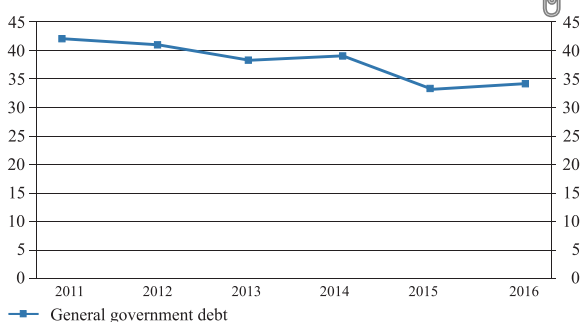
Following the signing of the Fiscal Compact, a Fiscal Discipline Law was adopted in 2013 and applied to the budget 2014 already. The Law focuses on medium-term budgeting, numerical budget rules and independent surveillance.

General government budget balance
(% of GDP)



Ministry of Finance, Stability Programme 2014-2017

General government debt
(% of GDP)



Ministry of Finance, Stability Programme 2014-2017

Another important step towards creating a framework to promote the culture of fiscal discipline was the establishment of an independent Fiscal Discipline Council in accordance with the Fiscal Compact and the Latvian Fiscal Discipline Law. The Fiscal Discipline Council will monitor the implementation of the Fiscal Discipline Law and provide an independent assessment of adherence to the numerical rules of the law and underlying macroeconomic assumptions.

Notwithstanding the sharp rise in government debt in the wake of the financial crisis, the debt level remained relatively low. After successfully re-establishing Latvia on the sovereign credit market as a high quality borrower, the debt is on the track of gradual reduction as the stability programme loans are being repaid as planned.

The ability of the Latvian government to shift the fiscal course towards sustainability has been deservedly praised internationally; however, even after reducing the deficit further in 2013 a few points of caution should be noted. First of all, the macroeconomic forecasts on which the budget 2014 as well as the medium term framework for 2014–2016 was based were finalised in autumn 2013. That means that the macroeconomic assumptions will need to be reassessed in preparation of the budget 2015. The adverse geopolitical events that have taken place recently in Ukraine will most likely have a downward

effect on the economic outlook implying a lower revenue base.

The recent success in achieving fiscal discipline cannot be taken for granted, regardless of the commitment to financial discipline embedded in the national law. Stakeholders, led by the newly-formed Fiscal Discipline Council, should closely monitor the budget preparation process both leading up to and after the Parliamentary election in autumn.

There are further considerations on the income side: the overall tax level in Latvia is low by European standards and the current policies are aimed to keep it that way. However, specifically labour is taxed comparatively more heavily and policies have been set up and implemented to reduce this burden. On top of the social security contribution reduction in 2014 and the personal income tax reduction in 2013, two more subsequent 1-percentage-point cuts in personal income tax are scheduled for 2015 and 2016. Moreover, personal income tax allowances have been increased. The tax rate reduction will surely cut into budget revenue. Hence, probably the only way to bolster tax income remains to continue with efforts to improve tax compliance. This is recognised in the budget by allocating funds for measures to fight both grey economy and tax evasion.