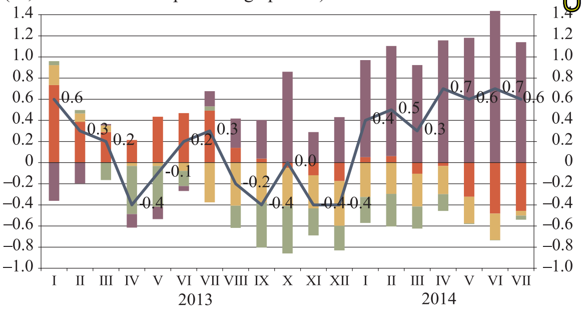
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

AUGUST 2014

Annual Inflation was 0.6% in July

Annual inflation and its main components
(%; contributions in percentage points)

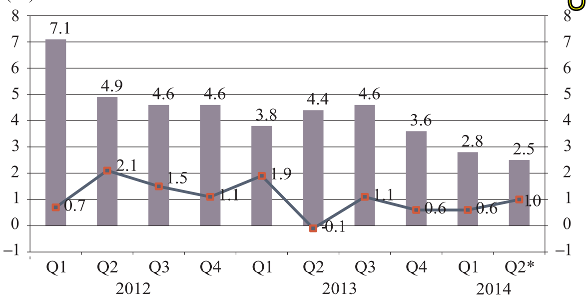


Source: CSB.

In July, the annual inflation remained low at 0.6%, with the month-on-month growth rate slightly negative at –0.4%, which is typical for July. Some factors had an immediate effect on inflation in July while others could have a lagged effect. The global prices of oil and agricultural goods dropped, mostly due to the stabilisation observed on the supply side (the political situation in oil producing countries; increased harvests). These factors eased the pressure on food and fuel prices in Latvia, but were not fully reflected in the July data yet. Seasonal and domestic factors exerted a downward pressure on food prices. The prices of vegetables and, possibly because of the African swine fever, those of meat products, dropped. An upward trend was seen in the prices of thermal energy and utility services (both administered and non-administered prices). Since July saw a great influx of tourists and an increase in consumption by non-residents, the rise in hospitality- and catering-related services is associated with the demand factor.

Latvian GDP Continues to Grow

Real GDP growth
(%)



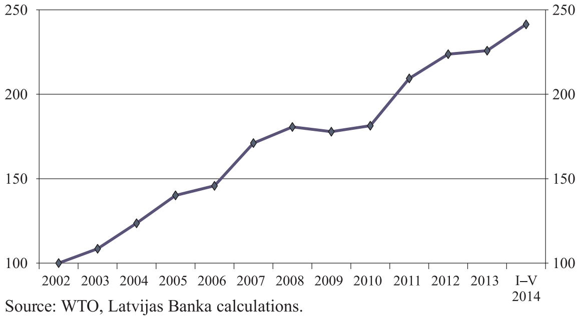
Source: CSB.
*flash estimate.

According to the flash estimate, GDP grew by 1.0% quarter-on-quarter in seasonally-adjusted terms and by 2.5% year-on-year in the second quarter of 2014. That the second quarter result could be positive was already suggested by the preliminary sectoral statistics. Manufacturing output grew by 3.7% quarter-on-quarter, whereas retail trade turnover increased by 2.2%.

The focus today is on the Russian sanctions banning the imports of certain food products to Russia. Nevertheless, the sanctions are highly selective and would have applied to a mere 0.53% of the total Latvian goods exports in 2013. In their current form, the sanctions do not affect the overall Latvian economy in a fundamental way. Yet the potential impact of these sanctions on the regional economy and particular enterprises should not be ignored.

Exports Grow in the First Half of 2014

Market shares of goods exports in world imports
(2002=100)



Source: WTO, Latvijas Banka calculations.

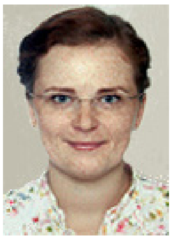
Despite weaker June performance, exports grew by 1.6% while imports shrank by 8.2% year-on-year in the first half of 2014. In June, the export value of goods dropped by 3.8% month-on-month and by 0.7% year-on- year, whereas the import value contracted by 0.2% month-on-month and increased by 2.1% year-on-year. Regardless of a month-on-month increase in June, exports to Russia dropped by 6.5% year-on-year in the first six months of 2014.

Rising external risks are associated with the impact of the geopolitical situation involving Russia and Ukraine on the exports of Latvia's goods. Nevertheless, according to the preliminary data of the WTO, the Latvian export market shares in global imports continued to grow in the first five months of this year. This suggests that Latvia was able to respond swiftly to the drop in demand reported with regard to some commodity groups and specific countries. Also the European Commission's data suggest that the Latvian business confidence indicators concerning the assessment of the level of export orders improved in July.

	Reporting period	Data (%)
Gross Domestic Product (GDP)		
Real GDP (year-on-year growth)	2014 Q2 (flash estimate)	**2.5**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2014 Q2 (flash estimate)	**1.0**
11.08.2014 Gross domestic product grows in the second quarter, the annual growth rate drops slightly		
Public Finances		
Tax revenue (since the beginning of the year; year-on-year growth)	2014 VII	**3.6**
General government budget expenditure (since the beginning of the year, year-on-year growth)	2014 VII	**3.3**
Consumer price changes		
Consumer Price Index CPI (year-on-year growth)	2014 VII	**0.6**
Consumer Price Index HICP (year-on-year growth)	2014 VII	**0.6**
12-month average inflation (HICP)	2014 VII	**0.3**
08.08.2014 Price trends in consumption groups formed unevenly in July		
Foreign trade		
Exports (year-on-year growth)	2014 VI	**–0.7**
Imports (year-on-year growth)	2014 VI	**2.1**
11.08.2014 Risks for an impact of the geopolitical situation on the exports of Latvian goods on the rises		
Balance of payments		
Current account balance (ratio to GDP)	2014 Q1	**–2.2**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2014 Q1	**0.4**
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2014 VI	**–2.2**
04.08.2014 The geopolitical situation causes a small drop in manufacturing in June		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2014 VI	**2.8**
30.07.2014 Merchants do not sing the same tune during the World Choir Games		
Labour market		
Registered unemployment (share in working age population)	2014 VII	**8.6**
Job seekers rate (share in working age population)	2014 Q2	**10.7**
14.08.2014 Improvement in the labour market is stable		
Monetary indicators		
Resident deposits (year-on-year growth)	2014 VI	**9.9**
28.07.2014 Deposit growth in banks has resumed		

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

European Union Funds in the Period 2014–2020



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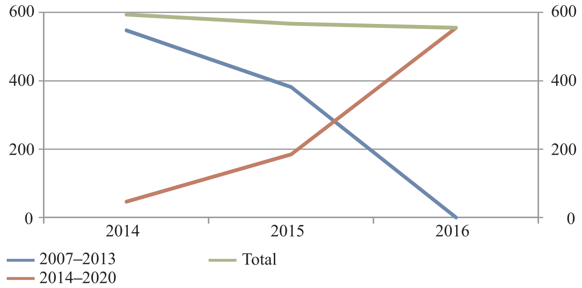
On 20 June, the European Commission approved **the Partnership Agreement for the EU Funds 2014-2020 Programming Period** developed by Latvia. This is the most important planning document in the EU funds hierarchy. The Partnership Agreement outlines the strategy, priorities and procedures for a 4.4 billion euro investment into the Latvian economy from the cohesion policy and a 1 billion euro investment from the agricultural policy.

Member States can access the EU funding based on the principle of N+2. Therefore, in 2014 and 2015 Latvia will implement projects using the funding for the period of 2007–2013 and that for the period of 2014–2020, with almost 600 million euro drawn from the EU cohesion policy funding (ERDF, ESF, Cohesion Fund) every year.

The targeted sectors and priorities have remained broadly unchanged in the new programming period in comparison with the previous one. Projects of several sectors have been moved to other priorities, streamlining the resources and changing the planned distribution of funding.

Chart 1
Indicative flows of the EU cohesion policy funding in the programming periods
(millions of euro)



Source: Ministry of Finance

Table 1
Breakdown of the EU cohesion policy funding by sector (thematic objectives) as a % of total

Sector	2007–2013	2014–2020
Transport and ICT	30.2	30.8
Environment (and climate change in the new programming period)	16.6	13.0
Education	10.4	11.8
Entrepreneurship and innovations	10.2	7.2
Employment, social inclusion	7.3	12.6
Urban environment	6.1	na
Science (and innovations in the new programming period)	5.9	10.7
Health	4.8	na
Energy (and energy efficiency in the new programming period)	4.4	11.2
Culture	0.8	na
Administrative capacity building	0.5	0.4
Tourism	0.4	na
Assistance for the EU funds management	2.5	2.3
TOTAL (billions of euro)	**4.6**	**4.4**

Source: Ministry of Finance

The main positive trends in the new programming period are related to the changes in the available financial instruments as well as promotion of targeted investment. Support to the transport sector will remain significant, despite the initially strong objections from the EC. Contrary to the current programming period, hereinafter the administrative functions will be carried out by a single institution, namely, the Central Finance and Contracting Agency (CFCA). Various measures to relieve the administrative burden are also planned, including e-cohesion and simplified costs (lump sums, flat rate financing).

The Ministry of Economics has carried out an assessment of gaps in the financial market. As a result, several new early venture capital instruments will be potentially available in the new programming period in order to promote business start-ups, including early venture capital funding by means of a technology transfers as well as pre-seed capital funding. In addition to that, it is planned that heat insulation projects for multi-dwelling houses will be further implemented by using financial instruments rather than a grant scheme, thereby also reducing the problems associated with receiving bank loans, particularly for projects in remoter regions. Moreover, all the available financial instruments will be managed by a single institution, JSC Development Finance Institution, combining the programmes previously implemented by Latvian Guarantee Agency, Rural Development Fund and Latvian Mortgage and Land Bank.

With a view to encouraging innovation, the Research and Innovation Strategy for Smart Specialisation (RIS3) was developed, in order to strengthen the building of the innovation triangle (entrepreneurship, science and education). Several new and broadened support schemes are planned, including the development of international cooperation projects, research infrastructure, commercialisation of research outputs as well as development of cross-sectoral products and services. It is also planned that RIS3-oriented projects will be eligible to apply for the above financial instruments.

The transport sector will receive around 26% of the cohesion funding envelope in the new programming period, similarly as in the previous one. As regards road infrastructure, Latvia was one of the first Member States to start investing from the funding of the programming period 2014–2020: the first contract of the new programming period was signed at the beginning of July for the reconstruction of Riga–Liepāja section of the state main road A9. At the same time, the funding of the programming period 2007–2013 is also used actively. Thus the transition from one programming period to another will cause no disruptions in the EU funding flows in this sector. The operative restrictions in project implementation, however, are a potential source for concern. Delays in approving the state budget for 2015 in the context of the Parliamentary elections could, however, pose a near-term risk, as this could lead to a failure to launch new procurement tenders in due time.

Ministries and other stakeholders are currently actively working on a further development of the national legislation and the EU funds management and control system in order to ensure business continuity and a smooth transition between both programming periods.