

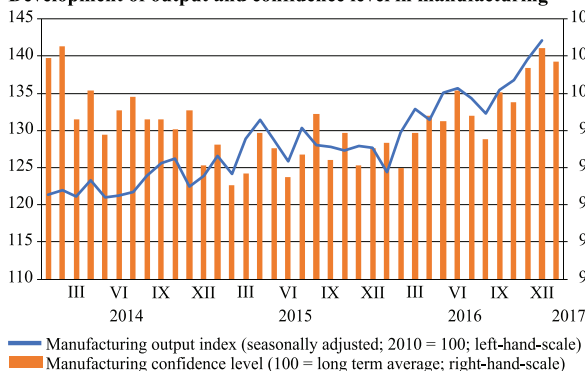


LATVIJAS BANKA
MONTHLY NEWSLETTER

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Manufacturing growth accelerated in the second half of 2016

Development of output and confidence level in manufacturing



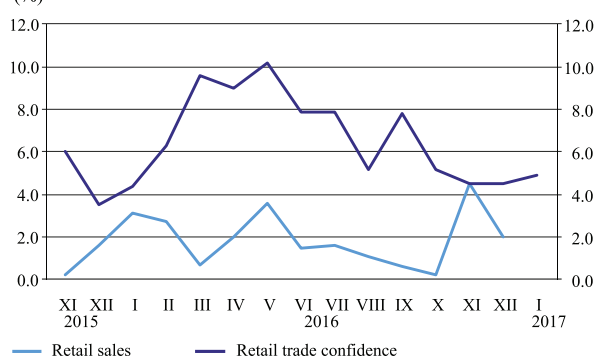
Sources: CSB, EC.

In calendar-adjusted terms, manufacturing output increased by 11.7% year-on-year in December. In 2016 overall manufacturing with its 5.0% growth rate became a major contributor to the growth of GDP. This was the highest growth rate achieved in recent years. Even though Brexit still is a cause for concern, at the moment it seems that the effect cannot be considered significant. This is proved, for instance, by the fact that the wood industry, with the UK as an important export destination, was the main contributor to growth in 2016. Other fast-growing sectors were manufacture of computer, electronic and optical products as well as manufacture of machinery and equipment.

Manufacturing is expected to continue growing at a similar pace in 2017; however, manufacturers are likely to keep a close watch on the development of the domestic taxation policy as well as the economic developments in the UK before making any further investment decisions.

Retail trade reported higher growth at the end of 2016

Year-on-year growth of retail sales turnover in real terms and retail trade confidence indicator (%)



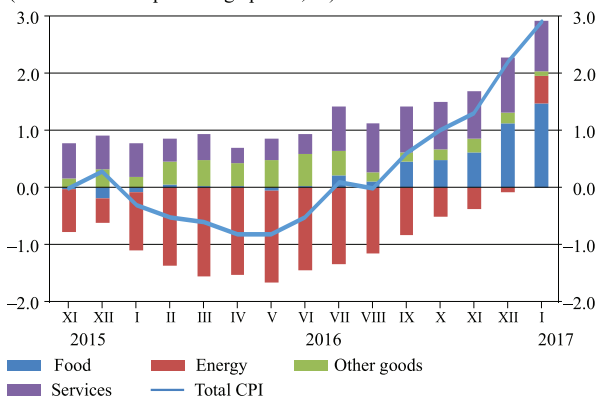
Sources: CSB, EC.

Recent months' data on retail trade turnover in real terms show some positive signs as compared to the third quarter of 2016. Retail sales of automotive fuel and household equipment resumed growth, especially in November. Unlike last year, the national holiday happened to fall on a Friday, hence larger purchases and more local trips were made during this extended weekend, thereby increasing the fuel consumption. The positive effects were felt in December as well, yet the retailers mostly selling food in non-specialised stores reported a year-on-year drop in sales. In 2017, the average growth of consumers' income is expected to remain at the 2016 level or slightly higher and some improvement in lending is also evident; however, in real terms retail sales could be rather affected by inflation rising and building up higher energy bills

and expenses on food. From this point of view, no fast acceleration of the retail sales turnover in real terms is expected in 2017 as suggested by the retail trade confidence.







Consumer prices pick up reflecting an increase in commodity prices

Main contributions to year-on-year growth of consumer prices and year-on-year inflation (contributions in percentage points; %)



Source: CSB.

Annual inflation continued increasing in December 2016 and January 2017, with the national CPI posting a 2.2% and 2.9% year-on-year growth respectively. As expected, the negative contribution of global energy prices faded quickly during the second half of 2016 and was mirrored by consumer prices, especially those of fuel and gas for households. Moreover, the world food commodity prices remained on a slightly upward trend and contributed rather notably to the increase in food consumer prices in Latvia. In 2017, an additional slight upward pressure is coming from the domestic indirect tax changes (such as natural resources and excise taxes) while the effects of the natural gas market liberalisation on inflation still remain uncertain. Demand side pressure is not likely to intensify, while the influence of the supply side factors is expected to push inflation higher than the level prevailing during the previous 4 years.

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth)	2016 Q4 <i>(flash estimate)</i>	1.6
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2016 Q4 <i>(flash estimate)</i>	0.8
30.01.2017 At the end of the year, GDP growth has sped up 		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2017 I	8.6
Tax revenue (since the beginning of the year; year-on-year growth)	2017 I	9.4
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2017 I	2.9
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2017 I	2.4
12-month average inflation (HICP)	2017 I	0.4
13.02.2017 Annual inflation rate approximates 3% 		
Foreign trade		
Exports (year-on-year growth)	2016 XII	7.6
Imports (year-on-year growth)	2016 XII	11.4
13.02. 2017 Latvian exports creep forward in a determined way 		
Balance of payments		
Current account balance (ratio to GDP)	2016 Q3	1.5
Foreign direct investment in Latvia (net flows; ratio to GDP)	2016 Q3	3.6
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2016 XII	11.7
03.02.2017 At the end of the year, manufacturing fosters economic growth 		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2016 XII	2.0
30.01.2017 Retail trade flourishes but for now for one-off reasons 		
Labour market		
Registered unemployment (share in working age population)	2017 I	8.5
Jobseekers rate (share in working age population)	2016 Q4	9.3
Monetary indicators		
Resident deposits (year-on-year growth)	2016 XII	7.7
27.01.2017 Changes in money indicators in December mostly seasonal in character 		

Sources: Treasury, CSB and Latvijas Banka.

Reshaping of Latvia's energy sector continues

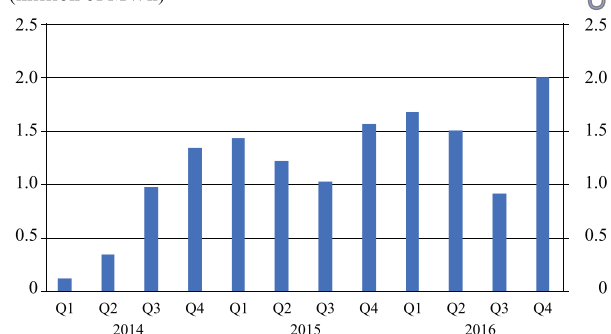


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Chief Economist
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The last quarter of 2016 was very favourable for electricity generation and its exports to Scandinavia. Latvia's energy sector will undergo further transformation in 2017, with the next agenda item being liberalisation of the natural gas market and challenges related to decarbonisation of the economy in the long run.

The end of 2016 proved to be highly successful for the energy sector of Latvia. Due to low temperatures and relatively low natural gas prices, electricity output reached historical highs. Generation and exports of electricity were also fostered by the unusually high electricity prices in Southern Sweden which in turn were affected by low utilisation of their hydroelectric plants. This was the first time when Latvia could fully benefit from the new electricity interconnection launched between Lithuania and Sweden earlier in 2016. This

Electricity generation
(million of MWh)



Source: <http://www.nordpoolspot.com/>.

interconnection has helped to reduce the differences in electricity prices between the Baltic countries and Scandinavia as well as opened additional export opportunities which can be utilised at generation peaks. Further work on the development of infrastructure is currently ongoing. At the moment, several large domestic grid reconstruction projects are being implemented. Moreover, in the next few years, work will begin on a new electricity interconnection between Latvia and Estonia that should further integrate the Baltic countries into the Scandinavian electricity market. Most likely this will eliminate the differences in the electricity tariffs between Estonia and Latvia.

Latvia's electricity market is also undergoing changes with respect to its tariff-setting policy. In 2016 differentiated distribution tariffs were introduced making the tariffs dependant on how efficiently households and industries utilise their connection capacity. A similar scheme will be introduced as of 2018 for the mandatory procurement component (MPC) paid by electricity users to the energy companies which produce electricity using renewables or (mostly) natural gas in a cogeneration process. Further growth of the MPC is also limited as no new entrants are allowed into the MPC scheme. Moreover, a grant from the central government budget also helps to stabilise the MPC payment at the current level. Should this grant be cancelled, the MPC would stay above the current levels at least till 2024. Various estimates show that energy intensive manufacturing companies historically have been paying higher electricity tariffs than most of similar companies in other EU countries. Nevertheless, all the changes made to the tariff-setting policies are at least partially addressing the problem of the high final tariffs faced by energy intensive users in manufacturing, thus improving their price competitiveness.

In 2017 another event will take place that will shape the future of Latvia's energy sector. The natural gas market will be opened for new entrants. *Latvijas Gāze* currently holding the monopoly will become two legally-independent companies. One of them will be in charge of the gas transmission and storage system (Conexus Baltic Grid was established on 22 December 2016), whereas the other will be responsible for the natural gas distribution and sale. An open market will enable other companies to participate in trading natural gas along with *Latvijas Gāze*. Moreover, the natural gas transmission and storage operator will be obliged to grant access to its infrastructure. This will enable Latvian companies to buy natural gas abroad, for instance, from the Lithuanian liquefied natural gas terminal. The opening of the natural gas market could lead to some increase of the final natural gas tariffs due to higher fixed costs in the short-term. Yet it should also support the development of the distribution infrastructure, including interconnections, and the entrance of new natural gas importers. Thus, in the medium and long term the opening of the market should secure the availability of supplies and potentially lower the tariffs.

The last quarter of 2016 was a record breaking period for electricity generation in Latvia