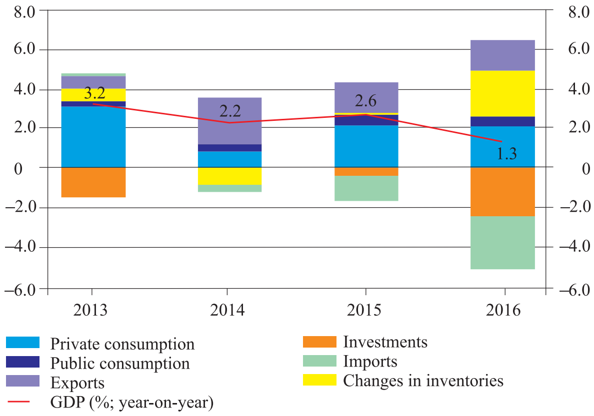
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

MARCH 2017

2016 passed in expectations of investment and in the environment of weak external demand

Real GDP growth and contribution to real GDP growth
(%; in percentage points; seasonally adjusted)

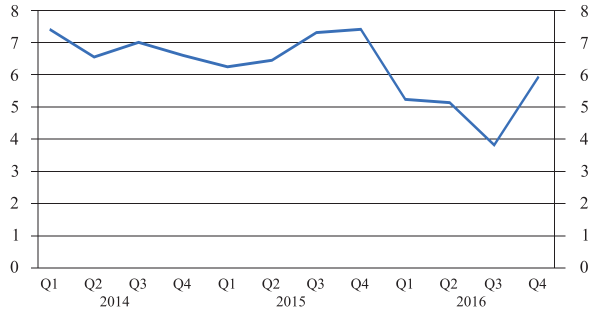


Sources: CSB, Latvijas Banka calculations.

In 2016, the Latvian economy grew by 1.3% (according to seasonally and calendar adjusted data), posting a temporary slowdown in the GDP growth due to contracting investment. Implementation of investment projects was hindered by delayed adoption of relevant legislative acts of the new EU funding programming period. This is expected to reverse as the implementation of projects picks up speed. The growth in real exports of goods and services was positive despite the weak external demand. The expansion of private consumption in 2016 reflects the latest wage increases, particularly in the private sector. Recent good performance of manufacturing (7.8% year-on-year in January) is mostly associated with the strengthening of external demand on account of the recovery of the EU economic growth and the rapidly improving industrial confidence indicators across the EU member states. In 2017, a more positive effect of the EU funding round on the economy is expected to result in stronger domestic demand and accelerated GDP growth, at 3.0%.

Wages grew at a slower rate last year

Gross nominals wage growth
(%; year-on-year)

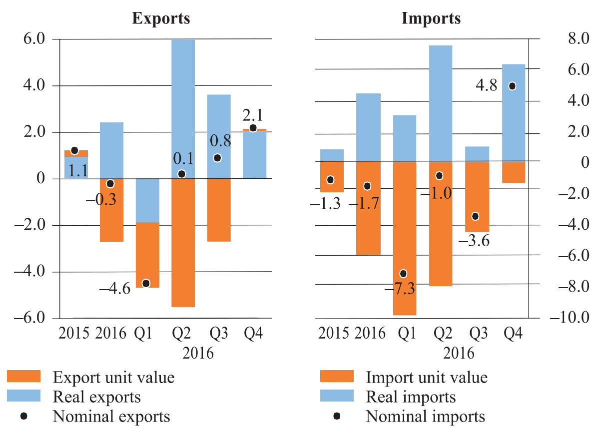


Source: CSB.

The annual rate of wage increase, albeit still robust, slowed to 5% in 2016. It was related to the slowdown in economic growth and a smaller positive impact of legislative changes. In 2017, wage growth is likely to remain similar. The growth around 5% still enhances income convergence in Latvia, and, at the same time, moderation is welcome from the perspective of competitiveness. Unemployment rate is decreasing slowly, and stood at 9.3% of the economically active population in the fourth quarter of 2016. This is close to the natural rate of unemployment and below the euro area average. The unemployment rate is expected to continue to drop gradually over the year. The labour market is flexible and characterised by decentralised wage bargaining and free labour mobility across sectors.

The current account recorded a surplus of 369.5 million euro or 1.6% of GDP in 2016

Growth of goods exports and imports
(%; year-on-year)



Sources: CSB and Latvijas Banka calculations.

The main driver of the current account's improvement has been the goods account. Despite the unfavourable external environment and the resulting weak foreign demand, the value of goods exports was unchanged from the year before. At the same time, a drop of imports resulted from both lower commodity prices and weak domestic investment activity, consequently causing a decline in imports of capital goods. In 2016, the growth was broad-based across product groups, with the largest positive contribution from exports of agricultural and food products, chemicals, wood products, construction materials, transport vehicles and furniture. Services exports showed good performance, too, especially in the IT and construction sectors. The economy of Latvia has recently become less sensitive to external shocks, and the export structure has become more diversified. Furthermore, Latvia's merchandise market share in world imports increased in 2016.

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth)	2016 Q4	**2.2**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2016 Q4	**1.1**
01.03.2017 The economic growth could revive this year from last year's weakness		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2017 II	**4.3**
Tax revenue (since the beginning of the year; year-on-year growth)	2017 II	**6.1**
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2017 II	**3.2**
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2017 II	**2.3**
12-month average inflation (HICP)	2017 II	**0.7**
10.03.2017 The steepest inflation jump is in the past		
Foreign trade		
Exports (year-on-year growth)	2017 I	**13.3**
Imports (year-on-year growth)	2017 I	**18.5**
14.03.2017 Foreign trade data positive in January		
Balance of payments		
Current account balance (ratio to GDP)	2016 Q4	**2.4**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2016 Q4	**2.5**
08.03.2017 Current account surplus in 2016 – 369.5 million euro		
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2017 I	**7.8**
07.03.2017 Industry takes a small step back		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2017 I	**3.7**
Labour market		
Registered unemployment (share in working age population)	2017 II	**8.4**
Jobseekers rate (share in working age population)	2016 Q4	**9.3**
22.02.2017 Both the unemployment rate and number of employed decreased		
27.02.2017 Wages and purchasing power grew at a slower rate last year		
Monetary indicators		
Resident deposits (year-on-year growth)	2017 I	**6.0**
28.02.2017 Lending rise stabilizes		

Sources: Treasury, CSB and Latvijas Banka.

Foreign direct investment globally and in Latvia

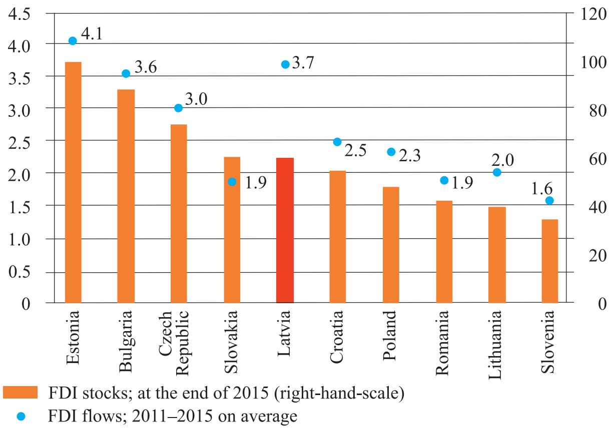
Santa Bērziņa,
Chief Economist,
Latvijas Banka

Competing for global foreign direct investment (FDI), Latvia has been among the Central and East European countries with the largest FDI inflows recorded in the post-crisis period. The activity of FDI flows is affected by global factors and the growth potential of the countries as well as the structural aspects. Thus, the political will and the efforts of institutions to create a more attractive investment climate in Latvia are more than welcome. In this regard, the government plans to present a new simple and competitive tax policy strategy in April 2017.

The global FDI activity remains volatile. 2016 saw a decline following a significant upswing in the year before; nevertheless, flows remained slightly above the average levels experienced in the post-crisis period. In the circumstances of heightened protectionism and weak global trade, it is even more important to establish a presence in the potential export markets. In 2016, the US, the UK and China were among the top three FDI host economies in the world. Along with an increase in global economic growth also high-level representatives of companies in different countries, surveyed by A.T. Kearney (global consulting company) point to further persistence of FDI global flows. 70% of them admit that they intend to make FDI in the three coming years.

Research suggests that FDI facilitates productivity spillovers through knowledge and technology transfers, and thus enables local companies' access to new markets. Integration in global the market, as measured by the stock of FDI, is vital for productivity and income growth. In the post-crisis period, FDI inflows in Latvia recording an average of 3.7% per year have been among the largest compared with other countries of the region.

Inward FDI
(in % of GDP)



Source: Eurostat.

From an analytical point of view, FDI inflows in 2016 continued to be similar to the average levels registered in previous years, at 3% of GDP. Statistical data record inflows at only 0.5% of GDP. Yet, this difference is related to a one-off transaction, namely, a commercial bank group's optimisation of the capital structure, that masks the activity of other foreign direct investment. However, Latvia still has the potential to increase integration into the global market. The stock of FDI accounted for 54% of GDP at the end of 2016 that is a lower level than the one recorded by several other countries of the region. The financial and real estate sectors, as well as trade and manufacturing sectors are the major holders of the stock of FDI, while the trade, transport, construction, IT and communication sectors recorded the largest FDI inflows in the previous year.

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FDI is an important source of investment in Latvia, and, according to UNCTAD data, accounts for close to 15% of total investment. This is a higher ratio than the global and the EU average. Taking account of the fact that access to EU structural funds is likely to be lower in the next programming period, it is even more urgent to support FDI. FDI flows are influenced by global factors such as the persistently weak growth, high political uncertainty and heightened protectionism, affecting all countries of the region. The growth potential of the countries and other economic aspects are not the only preconditions for FDI attraction. Moreover, a significant role is played by structural factors determining the investment absorption capacity and the attractiveness of business environment such as, for instance, effective governance, tax policy, infrastructure development, human capital potential and the like. Currently, the development of a simple and competitive tax policy and discussions with social partners are underway in Latvia. This new initiative strives for easing the tax burden on labour and introducing zero corporate income tax on retained earnings. A more attractive environment for companies and investors will strengthen the capacity for economic development in Latvia.