

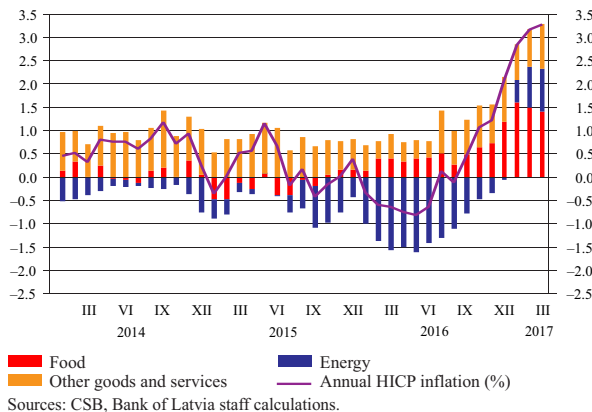


LATVIJAS BANKA
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Inflation stabilises, main risk stems from oil price fluctuations

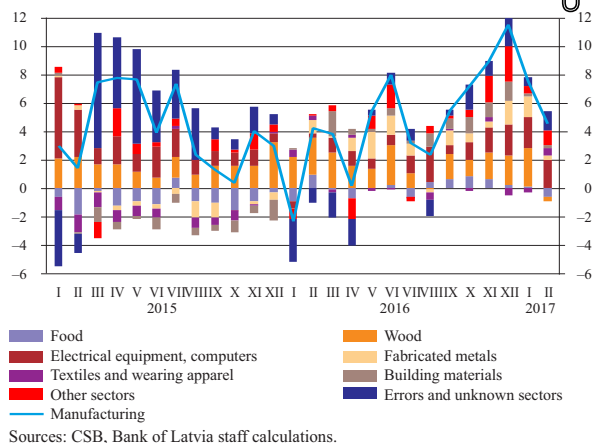
Contributions to annual HICP inflation
(percentage points)



Consumer prices (HICP) posted a 3.3% year-on-year rise in March. This outcome is in line with Latvijas Banka's expectations and has hardly changed since February (3.2%). In the coming months, the year-on-year inflation will hover around the 3% mark, with main risks stemming from oil price fluctuations. After losing one tenth of its worth in the world's market in mid-March, the price of *Brent* oil returned to 55 US dollars per barrel, reacting to decreased supplies in Libya and increased tensions in Syria. Since the oil price transmission to natural gas and heating prices takes a few months, any oil price hike would slow the decline of annual inflation only at the end of 2017. In turn, the global food price transmission to food retail prices is much faster. Month-on-month, global food prices declined in March, and so did wholesale and retail prices in Latvia.

Manufacturing retains high growth momentum

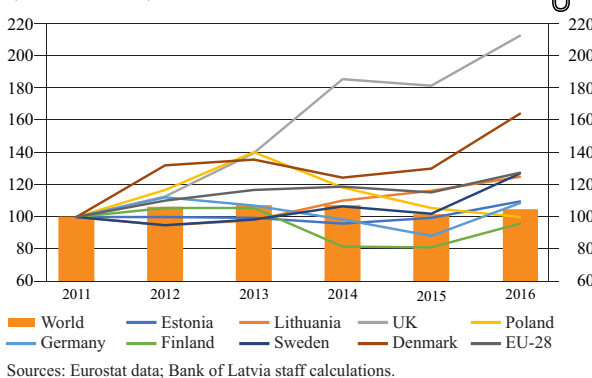
Contribution to manufacturing annual growth
(percentage points)







After posting robust growth in 2016, manufacturing output continues to expand, increasing by 4.6% year-on-year in February 2017. The structure of manufacturing is gradually shifting towards high-value-added goods, with the highest year-on-year growth rates recorded in the production of computers and electrical and optical equipment (+34.8%), chemical industry (+24.7%), production of motor vehicles and trailers (+17.4%) as well as equipment and mechanisms (+15.7%). The demand-side factors look hopeful for manufacturing, with confidence indicators (both in Latvia and foreign trade partners) being at a high level. Moreover, the expected rebound in domestic construction is likely to boost the production of building materials and metalworking. Although capacity utilisation in manufacturing is close to its historically high level, there is still room for increase towards the EU peers.

Exports of goods increase volume and diversity

Shares of Latvia's goods exports
(index; 2011 = 100)



Year-on-year, exports of goods rose by 9.3% in nominal terms during the first two months of 2017. The export rise was broadly based both in terms of products and countries. The structure of Latvian exports has improved over the recent years, with exports of goods becoming more varied and increasingly new, innovative and niche products being generated. Export diversification is also going on: in each group of goods exports, the dominance of a single kind of goods is weakening. Although unit labour costs increased moderately during the recent years (i.e. wages rose faster than labour productivity), Latvia's export share in world imports is still growing, possibly pointing to increasing non-cost competitiveness.

	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
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2017 III	1.4
Tax revenue (since the beginning of the year; year-on-year growth)	2017 III	6.0
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2017 III	3.4
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2017 III	2.6
12-month average inflation (HICP)	2017 III	1.0
10.04.2017 March brings inflation stabilization 		
Foreign trade		
Exports (year-on-year growth)	2017 II	5.7
Imports (year-on-year growth)	2017 II	6.5
12.04.2017 Foreign trade data still pleasing 		
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
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2017 II	4.7
04.04.2017 Manufacturing retains its high level 		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2017 II	1.2
Labour market		
Registered unemployment (share in working age population)	2017 III	8.3
Jobseekers rate (share in working age population)	2016 Q4	9.3
Monetary indicators		
Resident deposits (year-on-year growth)	2017 II	4.7
28.03.2017 Development of monetary indicators stable in February 		

Sources: Treasury, CSB and Latvijas Banka.

Tax reform



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Since the beginning of the year, political debates have been mainly focusing on reforming the tax system. Entrepreneurs have been highlighting the need for a growth enhancing tax reform as frequent changes in the current tax regulation have made the tax system complex and somewhat unfriendly to growth. In view of this, various reform strategies have been proposed. **Latvijas Banka has also come up with its "Tax Strategy 20/20" aimed at supporting competitiveness and raising the level of overall well-being. The key elements of the proposal include:**

- **Reduction of the personal income tax (PIT) rate by 3 percentage points from 23% to 20%;**
- **Unifying tax rates for different sources of income to 20%;**
- **Reforming corporate income tax (CIT) by introducing a 0% tax rate for retained earnings and 20% for distributed earnings;**
- **Widening the use of reverse charge for value added tax (VAT).**

The proposed reform is expected to stimulate economic growth through various channels. First, lower PIT rate increases the disposable income of households which in turn will be reflected in higher private consumption. Second, 0% tax rate for retained earnings motivates companies to build up equity, thus providing more financing options for investment. Estonia, which implemented the reform 15 years ago, serves as an example to follow. Furthermore, the proposed CIT regime could attract more foreign investment as it is less complex than the existing one. A lower tax burden and equal tax rate across all sources of income should also reduce the scale of the shadow economy in Latvia where it currently is the highest among the Baltic States.

It is important to stress that responsible action to avoid excessive deficits and ensure debt sustainability remains the paramount aim of the fiscal policy even in periods of relatively stable growth.

At first sight the proposed changes might seem costly in terms of government revenue. Moreover, they could raise questions of whether the reform will not result in excessive government deficit. However, when other measures, e.g the widening of the use of VAT reverse charge, and the effect on real economy are considered, the estimated impact of the reform on budget is broadly neutral in the first two years and turns positive henceforth. Since the reform supports higher private consumption, VAT and excise tax revenues should increase as well. Similarly, if changes in CIT increase investment activity, additional VAT revenue can be expected. Furthermore, broadening of the product groups covered in the VAT reverse charge regulation should be encouraged as this measure has so far proven to be effective in terms of generating revenue and reducing the shadow economy.

In the midst of the discussion, various other specific reform proposals have been put forward. However, they should be evaluated with caution as some of them incur additional costs which have to be offset by expenditure cuts and/or an increase in other tax rates.

It is important to stress that responsible action to avoid excessive deficits and ensure debt sustainability remains the paramount aim of the fiscal policy even in periods of relatively stable growth. Therefore, the implementation of the proposed tax reform in a budget-neutral way is critical at least in the medium term.