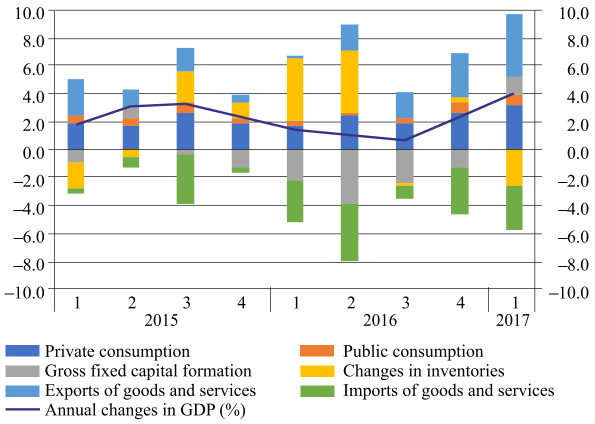
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

JUNE 2017

Economic growth in Latvia is gathering momentum

Contribution to annual changes in GDP
(demand side; percentage points)

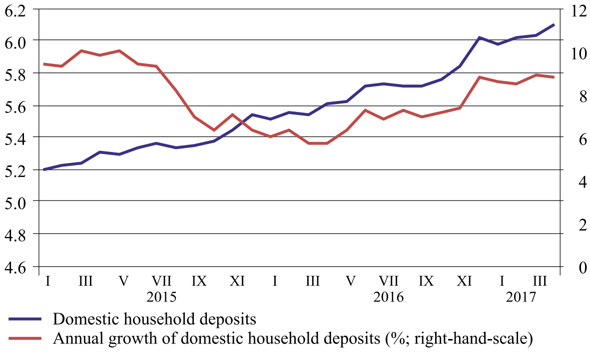


Source: CSB.

In the first quarter, GDP grew by 4% year-on-year, and, consequently, Latvia is presently recording the fastest pace of growth over the last five years. Fuelled by a wage increase of 7.2% over the year, a decrease in unemployment to stand at 9.4% in the first quarter of 2017 as well as improving consumer sentiments, private consumption and the services sector have acted as primary drivers of the economy. Moreover, for the first time in two years, the investment growth has also become positive in year-on-year terms, primarily on account of private sector investment recovery, partly translating into stronger construction sector dynamics as well. With exports of goods reaching ever higher levels, the year started well for the manufacturing sector, which surprised with positive attainments already in the previous year. Investment projects launched in manufacturing also provide for an optimistic outlook. However, to preserve sustainable pace in the long run, the potential of the economy should be boosted by structural reforms in education, health care and other sectors, including also legal and business environment.

Household savings in banks on the rise

Domestic household deposits
(billions of euro; year-on-year)

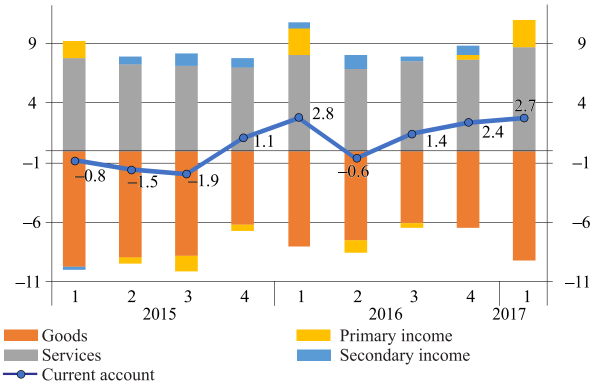


Source: Latvijas Banka.

In April, household deposits attracted by banks posted the fastest month-on-month growth since December, whereas their year-on-year growth was within the almost invariant 8%–9% range. This suggests that the growth in wages has had only a partial effect on the consumption dynamics while ensuring a significant rise in savings. The increasing household savings in banks could also have a positive effect on the availability of loans, for instance, by prospective borrowers coming up with down payments as part of qualifying for a housing loan. While the actual data of recent months point to a very moderate recovery in lending, in the second half of the year lending growth could accelerate, providing a larger stimulus to the growth of the economy. Lending growth also will be continuously facilitated by the low interest rates and the growing interest of entrepreneurs in carrying out development projects and attracting investment amidst stabilising external demand.

Surplus in the current account for third consecutive quarter

Current account and its components
(% of GDP)



Source: Latvijas Banka.

For the third consecutive quarter, the current account had a surplus in the first quarter of 2017. The surplus, representing 2.7% of GDP, formed primarily as a result of inflows from the European Union agricultural funds (EU funding inflows resulted in an increase of surpluses of the primary income and secondary income accounts) and expanding surplus in the services account, representing 8.7% of GDP. The share of telecommunication, computer and information services in Latvia's exports of services and that of construction services continued to expand. The year 2017 began with a significant increase in exports and imports of goods. It was determined by the improving demand from Latvia's major trade partners, the increase in global prices as well as a recovery of the domestic demand and particularly investment activity. Export value of goods demonstrated the highest rise of the last four years, at 11.9%, whereas the growth of imports of goods even slightly outpaced that of exports. Thus, the deficit of the balance of goods increased year-on-year in the first quarter of 2017. The capital account, however, saw no inflows from the EU structural funds during the first quarter. Inflows into the capital account are expected to resume with gradual absorption of the EU structural funds in the coming periods. Meanwhile, the inflows of foreign direct investment (FDI) amounted to 2.4% of GDP. The largest inflows of FDI were recorded in real estate activities, electricity, gas supply and heating.

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth)	2017 Q1	**4.0**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2017 Q1	**1.6**
01.06.2017 Economic growth gathers momentum		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2017 V	**2.2**
Tax revenue (since the beginning of the year; year-on-year growth)	2017 V	**6.0**
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2017 V	**2.7**
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2017 V	**1.6**
12-month average inflation (HICP)	2017 V	**1.6**
09.06.2017 Inflation down for the first time in nine months		
Foreign trade		
Exports (year-on-year growth)	2017 IV	**1.0**
Imports (year-on-year growth)	2017 IV	**0.2**
14.06.2017 Month-on-month drop in foreign trade is likely short-lived		
Balance of payments		
Current account balance (ratio to GDP)	2017 Q1	**2.7**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2017 Q1	**2.4**
06.06.2017 Current account surplus totalled 158.5 million euro in the first quarter of 2017		
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2017 IV	**6.2**
09.06.2017 The manufacturing sector continues on an upward trend		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2017 IV	**2.8**
Labour market		
Registered unemployment (share in working age population)	2016 V	**7.4**
Jobseekers rate (share in working age population)	2017 Q1	**9.4**
Monetary indicators		
Resident deposits (year-on-year growth)	2017 IV	**4.0**
30.05.2017 Household savings in banks on the rise		

Sources: Treasury, CSB and Latvijas Banka.

About Latvijas Banka's inflation forecast revisions in March and June 2017

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Latvijas Banka

In the first half of 2017, the Council of Latvijas Banka made two upward revisions to inflation forecast – on 23 March and 9 June. The first revision was rather large and was based on increasing global food and energy prices, whereas the second revision was only minor and reflected slightly higher than expected domestic economic activity. Currently, Latvijas Banka expects 2.9% annual inflation this year.

After four years of very low (close to zero) inflation, consumer prices started to rise at the turn of the last year. Initially the inflation pickup was solely driven by external factors: global oil and food prices reached the 12-year and 7-year lows respectively in January 2016, and both were on an upward trend until spring 2017.

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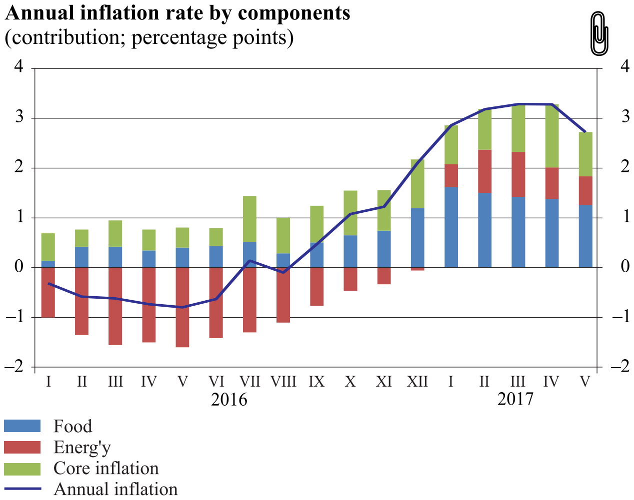
The first inflation forecast revision from 1.6% to 2.7% on 23 March was entirely based on rising global food and energy prices. Among food components, major upward price surprises came from dairy products. Industrial dairy products worldwide appreciated by half in just few months. This coincided with an upswing in regional demand for raw milk, partly coming from launching a new milk processing factory in the city of Bauska. As a result, milk farm-gate price rise was the steepest in more than 15 years, reaching a level not seen after the 2014 EU–Russian trade embargo. Moreover, the beginning of 2017 was marked by short-lived surprises from upward fish and vegetable prices.

Annual inflation rate by components
(contribution; percentage points)



Source: CSB data; Latvijas Banka staff calculations.

On 9 June, the Council of Latvijas Banka acknowledged that global markets have stabilised in a sense that any major food and oil price corrections are likely in the nearest months. For instance, currently the market expects the oil price to hover somewhat below 50 dollars in the second half of the year. On 25 May, OPEC decided to extend the period of reduced oil production for another nine months. That had a negative effect on oil prices, since several investors expected more vigorous actions from the cartel.

However, somewhat higher than expected economic activity in the beginning of 2017, reflected in the gradual acceleration of private sector wage growth, was a reason to slightly increase the inflation forecast to 2.9% this year. A somewhat stronger impact of domestic demand on inflation, reflected in appreciation of services not regulated administratively, was already seen in spring 2017. In May 2017, the annual inflation rate eased for the first time in nine months, i.e. in line with the forecasts of Latvijas Banka.