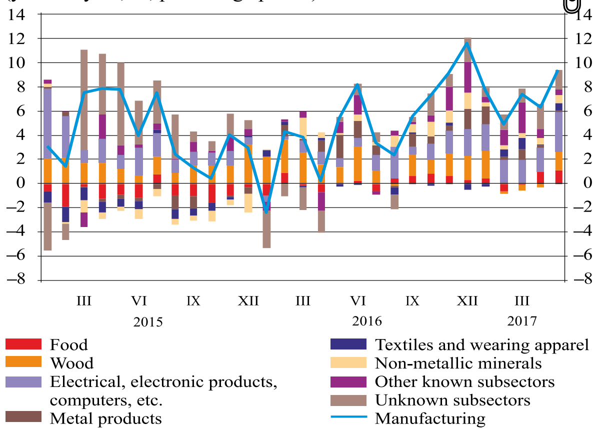
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

JULY 2017

Manufacturing growth supported by nearly all sectors

Contribution of main sectors to manufacturing growth
(year-on-year, %, percentage points)

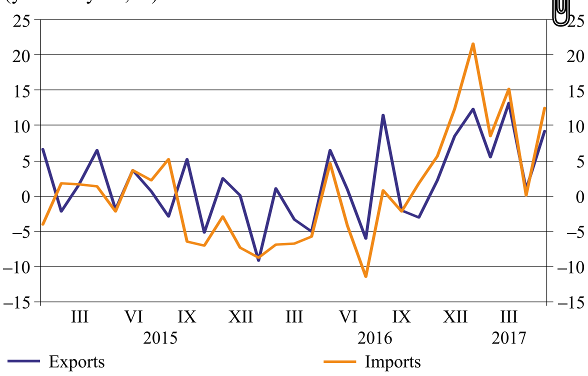


Source: CSB.

Manufacturing keeps breaking all-time output highs, and growth is broad-based across subsectors. The expansion is supported by a favourable economic background in trade partner countries and sentiment at home. Manufacturing output in May grew by 3.1% and the year-on-year growth reached 9.4%. Wood processing output rebounded after a three-month slump, denying any fundamental weakness in the sector. Exports of wood products to major partners, apart from the UK, continue to grow. Similarly, the food processing industry has gained strength lately due to external demand. The sector's capacity utilisation has reached the highest level seen since the end of the crisis. Since non-financial investment in food production dropped substantially last year, the fact that several enterprises of the food processing subsector have announced new investment plans marks a positive development in the context of future growth. Echoing the leading indicators around Europe, the estimates of new manufacturing orders reached new post-crisis highs in June, pointing to continued expansion of output.

Exports regain pace

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

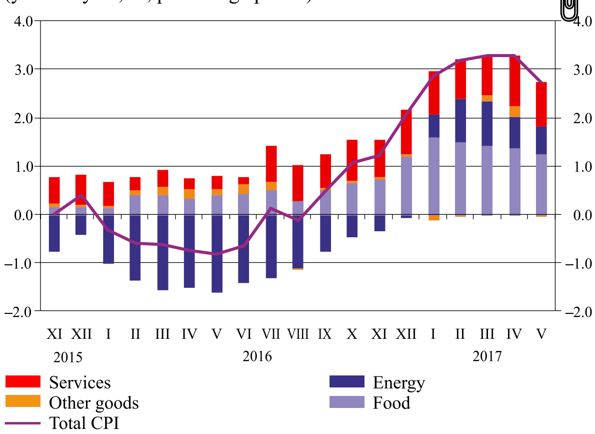


Source: CSB.

Latvian exporters continue to use the global economic recovery to their advantage. Rising external demand, gains in competitiveness and higher prices have enabled exports to regain their role as the main driver of growth in Latvia. During the first five months of 2017, exports grew by 8.2% year-on-year. Virtually all commodity groups contributed to growth, particularly those of food products, animal products and articles of wood. The leaders of the food processing industry, i.e. cheese exporters, have doubled their sales both on account of an increase in quantities produced and price rise. An agreement signed between the Latvian Railway company and DHL Global Forwarding could expand export opportunities of the food industry. This cooperation promises to improve logistics in relation to the Chinese market. Companies continue active expansion in new export markets, making use of the support provided by the Latvian Guarantee Agency in higher risk markets.

Inflation boosted by global food price growth while oil prices decrease

Contribution of main components to CPI inflation
(year-on-year, %, percentage points)



Source: CSB.

The annual inflation rate increased to 3.0% in June. The drop in fuel prices was offset by a rise in food prices. Moreover, service prices continued to grow gradually. In early July, fuel prices hit the lowest level seen this year, reflecting the decline in oil price amplified by the weakness of the US dollar. By contrast, global food prices picked up in June. Dry weather conditions in some EU wheat exporting countries and Ukraine could reduce wheat yields this year, exerting upward pressure on prices. With demand outpacing supply in the meat and dairy product markets, prices of these products also posted an increase. Service prices recorded a gradual pickup as household income growth spurred demand aided by a few one-off effects this year, e.g. the vehicle insurance premium hike and the rise in tariffs for mobile telephone services.

	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**
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2017 VI	**5.1**
Tax revenue (since the beginning of the year; year-on-year growth)	2017 VI	**6.8**
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2017 VI	**3.0**
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2017 VI	**2.1**
12-month average inflation (HICP)	2017 VI	**1.9**
10.07.2017 Oil price goes down, global food prices up		
Foreign trade		
Exports (year-on-year growth)	2017 V	**9.2**
Imports (year-on-year growth)	2017 V	**12.5**
14.07.2017 Latvian exports back in shape		
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**
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2017 V	**9.4**
05.07.2017 Almost all sub-branches support manufacturing growth in May		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2017 V	**3.8**
Labour market		
Registered unemployment (share in working age population)	2016 VI	**7.2**
Jobseekers rate (share in working age population)	2017 Q1	**9.4**
Monetary indicators		
Resident deposits (year-on-year growth)	2017 V	**2.1**
29.06.2017 The rise in money indicators abated in May		

Sources: Treasury, CSB and Latvijas Banka.

Comparison of the Baltic States' exports

Daina Pelēce,
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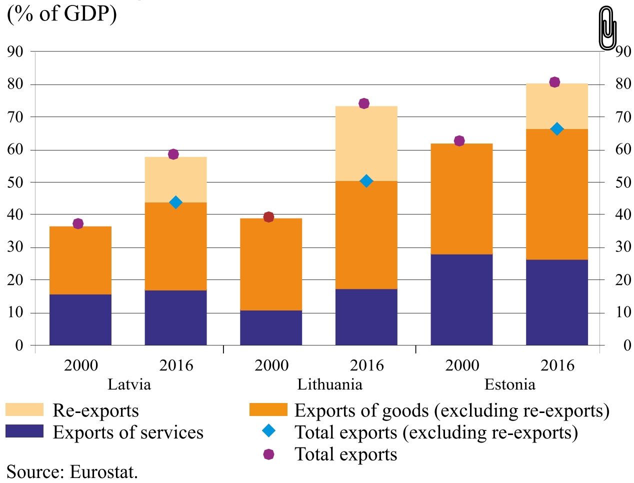
Business representatives often perceive the Baltic States as a single economic area: all three Baltic States are similar in terms of their geographic location, weather conditions and history; moreover, they are all open economies. Due to several factors, however, the structure and performance of exports vary across the Baltic States quite considerably.

In 2016, exports of services and goods accounted for 58%, 80% and 74% of GDP in Latvia, Estonia and Lithuania respectively. In this respect, Latvia historically falls behind both neighbouring countries, and its recent growth has not helped Latvia to catch up with Lithuania and Estonia. In 2016, the large difference between Latvia and Lithuania was mainly due to re-exports (see the Chart).

The share of goods and services in the Baltic States
(% of GDP)



Source: Eurostat.

The market share of Latvia's exports of goods in global imports is expanding at a faster rate than that of the other Baltic States suggesting an improvement in Latvia's competitiveness. However, the volume and the value of goods exported from Latvia are still lower compared to exports from Estonia and Lithuania. In 2016, almost two thirds or 29% of all goods exported from Latvia were sold in its neighbouring Baltic States, i.e. Estonia and Lithuania, while the share of goods exported from Lithuania and Estonia to the other Baltic States only accounted for 15%. In the course of the last decade, Lithuania, Estonia and Russia have been Latvia's major export partners. The adverse impact of Russia's sanctions and of its weakening demand on Latvia's exports decreased, as it was gradually offset by businesses penetrating new markets. As a result, the share of Latvia's exports to Russia declined. The top three destinations of Estonia's exports are Sweden, Finland and Latvia, while the major export partners of Lithuania are Russia, Latvia and Poland.

Machinery and transport vehicles and their parts account for the largest share of the Baltic States' exports. However, this commodity group constitutes a significantly larger share in Estonia's exports and GDP in comparison with Latvia and Lithuania. Latvia's exports of goods mainly differ from those of Estonia in terms of the share of machinery in total exports, whereas from those of Lithuania in terms of the share of mineral products and products of the chemical industry.

Due to several factors, however, the structure and performance of exports vary across the Baltic States quite considerably.

Although the share of high-tech products in Latvia's exports has increased in recent years, it still falls behind the respective share in Estonia's exports. High- and medium-tech products account for 40% of Estonia's total exports; meanwhile, these products constitute less than one third of Lithuania's and Latvia's total exports. Products which undergo little processing still account for a significant share of Latvia's exports.

In 2016, the share of exports of services was similar in Latvia and Lithuania representing 17% of GDP, while the services exports of Estonia constituted 26% of GDP. IT services, telecommunication services and other business services have been the fastest growing services sectors in the Baltic States over the past few years. Transportation services play a major role in exports of all three Baltic States. Besides, a characteristic feature of Latvia's exports of services is exports of financial services. In addition to that, although the contribution of financial services to Latvia's exports of services is modest, it is still significantly larger than in the other two Baltic States. Meanwhile, Estonia outpaces the other Baltic States with respect to travel services, business services and construction services. Lithuania, in turn, clearly holds the leading position with respect to transportation services. In the post-crisis period, the share of Latvia's exports of transportation services in global imports has declined year by year, whereas the respective share of Lithuania's exports has increased sharply. The market structure of Latvia's and Lithuania's exports of services is more diverse compared to that of Estonia exporting almost one third of its services to Finland.

The differences in the structure of exports of goods and services and in the choice of cooperation and trade partners can be largely explained by historical reasons, the geographic location and the neighbouring countries of each Baltic State, as well as by their success in drawing investment to ensure the development of manufacturing and services sectors and facilitate long-term economic growth.