

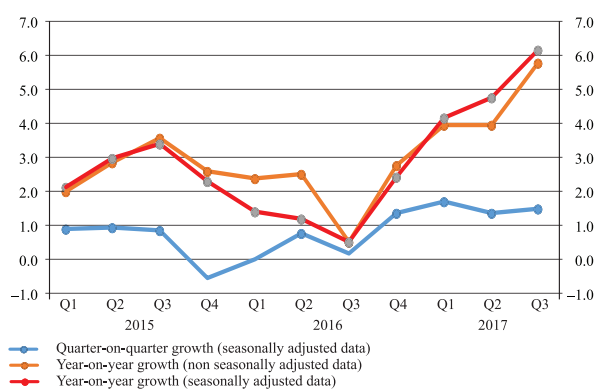


LATVIJAS BANKA
MONTHLY NEWSLETTER

DECEMBER 2017

Healthy growth, but caution warranted

GDP growth (%)



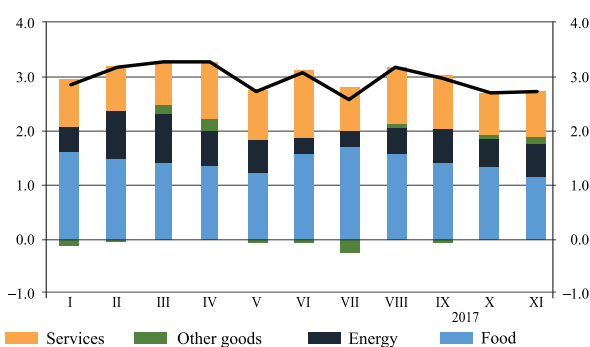
Source: CSB.

Latvia's economy is growing at a healthy rate, recovering from the last year's weakening. Alongside positive developments in investment and increasing purchasing power, individual signs of imbalances have also emerged. Reportedly shortage of labour is restricting businesses, pointing to an upward pressure on wages and prices that can have a negative effect on competitiveness. The third quarter economic growth of 6.2% year-on-year was broad-based. Construction is developing at a particularly high rate, yet it might face labour shortages. Exports of Latvian goods and services continue to expand, albeit at a decelerating rate. Although at the moment the contribution of the growing investment to GDP growth is already higher

than that of private consumption, the latter also steadily remains on an upward track.

Inflation growth decelerating

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



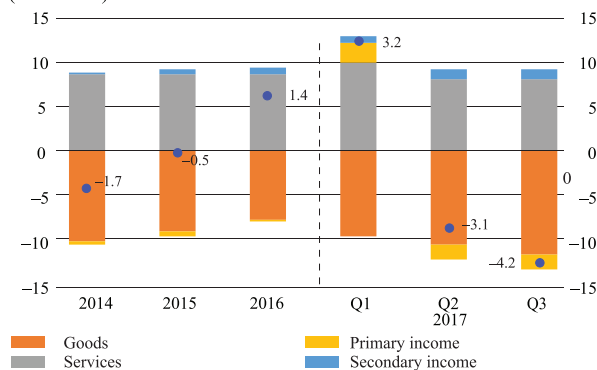
Source: CSB.

Annual inflation growth continued to decelerate in November and the monthly increase in prices was negligible. The main contributors to the changes in inflation were the rising oil prices ahead of the OPEC meeting and lower prices in food groups like meat, butter and other fats. Annual inflation amounted to 2.7% in November. The highest growth was reported in the energy sector, whereas the increase in food prices decelerated. With the previous forecast remaining unchanged, the earlier assumptions about the core inflation and its development are also confirmed. Regardless of the overall decline resulting from the base effect, core inflation will remain stable.

In the near term, an upward effect on inflation can be expected from demand side factors caused by the rapidly growing wages in the circumstances of shrinking unemployment.

Recovery of imports increased current account deficit






Current account balance (% of GDP)



Source: Latvijas Banka.

The current account of Latvia's balance of payments continued to reflect the recovery of the imports of goods. This resulted in a significant build-up of the deficit, to 4.2% of GDP in the third quarter. Robust global demand and that of Latvia's major trade partners also supported an increase in exports. Imports of goods are supported by a recovery in investment in production equipment. The annual growth of exports of goods was 6.7% in the third quarter, whereas imports of goods grew by 18.7%. Income from exports of services continued on an upward trend, with the main contribution coming from transport services. Exports of computer services

and construction services also expanded further. FDI totalled 5.5% of GDP representing the largest quarterly inflow of the last few years. Largest recipients were finance, transport and storage as well as manufacturing.

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth)	2017 Q3	6.2
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2017 Q3	1.5
04.12.2017 Healthy growth, but caution required to avoid limping 		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2017 XI	6.4
Tax revenue (since the beginning of the year; year-on-year growth)	2017 XI	7.7
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2017 XI	2.7
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2017 XI	1.8
12-month average inflation (HICP)	2017 XI	2.9
11.12.2017 Inflation growth decelerating 		
Foreign trade		
Exports (year-on-year growth)	2017 X	9.7
Imports (year-on-year growth)	2017 X	10.9
13.12.2017 Successful year for Latvian exporters 		
Balance of payments		
Current account balance (ratio to GDP)	2017 Q3	5.5
Foreign direct investment in Latvia (net flows; ratio to GDP)	2017 Q3	5.5
05.12.2017 Current account deficit totalled 300.8 million euro or 4.2% of GDP in the third quarter of 2017 		
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2017 X	5.9
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2017 X	4.5
Labour market		
Registered unemployment (share in working age population)	2016 XI	6.7
Jobseekers rate (share in working age population)	2017 Q3	8.5
Monetary indicators		
Resident deposits (year-on-year growth)	2017 X	2.5
29.11.2017 Monetary aggregates back to moderate growth 		

Sources: Treasury, CSB and Latvijas Banka.

2018: opportunity to make economic growth inclusive



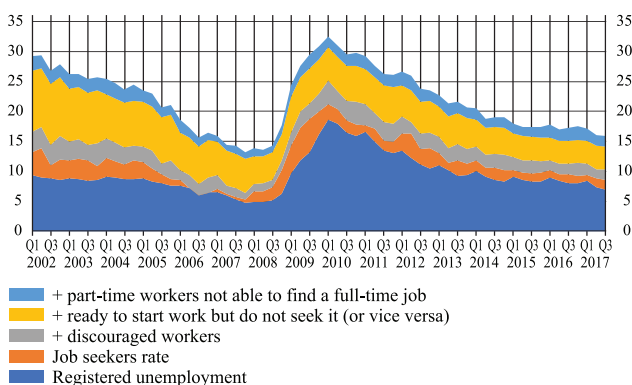
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After a weak 2016, economic growth more than doubled in 2017, accelerating to the fastest pace in almost six years, i.e. to about 6% year-on-year in the third quarter. In addition to expanding manufacturing, buoyant growth rates are recorded in previously ill-starred investment and construction activities. This is partly inspired by the renewed EU fund inflows. Yet investment growth potential is far from exhausted given high levels of capital utilisation but still modest investment-to-GDP ratio.

The labour market tightened further with unemployment dipping below the natural rate. A survey shows that many entrepreneurs are planning to increase the number of employees in the coming months, and the number of vacancies is on a rise. Despite shrinking working age population and already historically high employment rates, labour reserves are not exhausted yet. There are persistent employment rate disparities across regions, education levels, age and ethnic groups with some municipalities still posting unemployment rates in excess of 20%. Therefore, strong labour demand should be regarded as an opportunity to make economic growth inclusive. First, it should return long-term unemployed and inactive discouraged workers to productive activities. Second, strong labour demand is a precondition for those thousands of necessity-driven emigrants that left Latvia in the wake of economic crisis to think over coming back. Securing stable jobs with high income and good prospects seems to be the most efficient "plan" to promote return migration.

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Alternative unemployment definitions
(% of economically active population)



Latvia is gradually losing the competitive advantage of low wages. The labour income share, after climbing up during the past few years, has currently stabilised close to the EU average level. This is bad news for firms operating in labour-intensive low-value-added sectors and/or in the shadow economy. Instead of investing and modernising production processes, some of these firms might support immigration. However, low-skilled immigration would only slow income convergence and impede growth inclusiveness. A country able to compete only with low wages will never achieve high living standards, and is likely to stuck in the so-called middle income trap.

It seems that 2018 is going to be another year of cyclical expansion, and the economy might slightly exceed its full potential. Strong demand for labour and a substantial minimum wage increase by 13% are likely to push the average monthly wage beyond the 1 000 euro threshold. How sustainable will this economic upswing be? It depends on whether labour productivity will keep pace with the wage growth. Labour productivity stemming from capital accumulation, technology and efficiency could be enhanced, inter alia, by raising quality of education, healthcare and institutions. The necessity of structural reforms in these areas has been highlighted by Latvijas Banka for years.