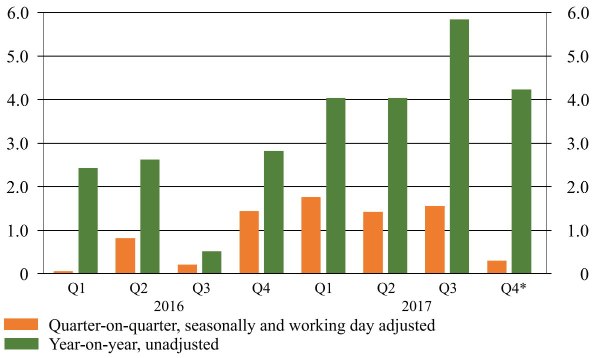
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

FEBRUARY 2018

Fastest GDP growth in 6 years

GDP growth rates
(%)

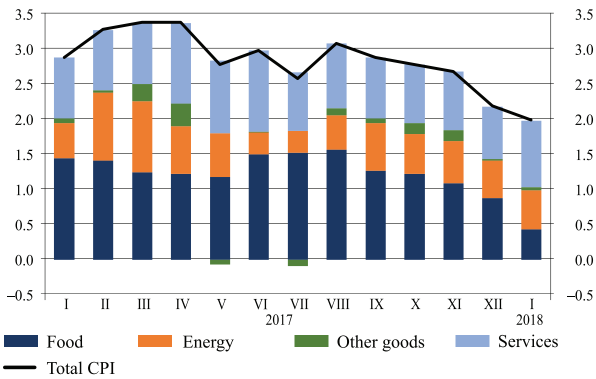


Source: CSB.
* – flash estimate.

With the pick-up in investment and exports, 2017 growth might have reached 4.5% as suggested by the CSB's flash estimate for Q4. The quarterly fluctuations of the GDP growth were influenced by the external environment benefitting exports. At the same time, the heavy rainfalls had a downward effect on agriculture and forestry and an upward one on electricity generation in hydropower plants. The mild weather observed at the end of the year also had a favourable effect on construction. This sector, in turn, influenced other sectors as well: mining and quarrying, manufacture of building materials, manufacture of metal products, etc. Gradually improving purchasing power contributed to the development of retail trade. Along with growth in external markets accelerating, manufacturing, with almost two thirds of its output exported, also expanded rapidly. Economic expansion, however, has also once again renewed the problems with labour shortages.

Inflation slightly down

Contribution of the main components to the year-on-year increase in consumer prices and year-on-year inflation
(contributions in percentage points; %)

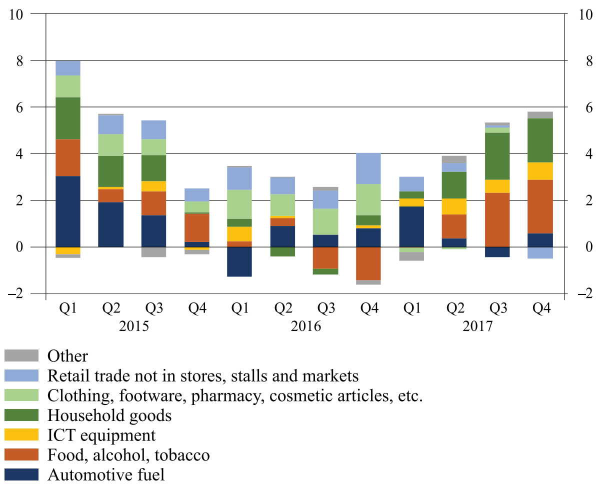


Sources: CSB, Latvijas Banka calculations.

The year-on-year inflation dropped to 2.0% in January with some base effects, like the ones stemming from the growing world food prices, vanishing. The changes in indirect taxes introduced as of January 2018, like a higher excise tax on fuels as well as a reduced VAT rate on some food products, partly offset each other; nevertheless, the overall effect is positive and is expected to increase slightly over the year with other planned changes to the excise tax taking effect. The year-on-year inflation is expected to pick up overall during the year as income growth remains stable due to both higher productivity and changes in legislation regarding the level of minimum wages. A positive contribution is also expected from the indirect effects of higher fuel prices on prices of other goods and services. As a result, the average annual 2018 inflation may remain at the level of 2017.

Dynamic year for retail trade

Contribution of the main components to the year-on-year increase in retail trade
(in percentage points)



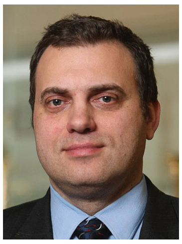
Sources: CSB, Latvijas Banka calculations.

The year 2017 has been dynamic for retail trade. This includes faster annual growth than in 2016, the entry of new brands and the building of new shopping venues as well as the expansion of the existing ones. The sector benefited from increasing purchasing power. The contribution of businesses selling household and renovation-related goods as well as food was particularly impressive. The former could retain its significance in 2018, with a healthy economic growth rate as well as the development of new housing projects. The changes in indirect taxes are unlikely to have a major effect on consumption and retail turnover as what is saved on one item would probably be spent on another one. Recent sentiment surveys show an increase in the optimism of both consumers and retailers. The views of the retail sector regrading a potential rise in employment have also become slightly more positive, somewhat overlapping with the views on labour shortage as a potential impediment for the overall economic development.

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth)	2017 Q4 *(flash estimate)*	**4.8**
Real GDP (quarter-on-quarter growth; seasonally adjusted)	2017 Q4 *(flash estimate)*	**0.3**
05.02.2018 Growth in 2017: fastest in the last six years		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2018 I	**4.8**
Tax revenue (since the beginning of the year; year-on-year growth)	2018 I	**6.9**
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2018 I	**2.2**
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2018 I	**1.7**
12-month average inflation (HICP)	2018 I	**2.8**
13.02.2018 The price level remained unchanged in January		
Foreign trade		
Exports (year-on-year growth)	2017 XII	**7.3**
Imports (year-on-year growth)	2017 XII	**6.4**
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**
Industrial output		
Working day-adjusted manufacturing output index (year-on-year growth)	2017 XII	**7.7**
06.02.2018 Manufacturing growth remains solid		
Retail trade turnover		
Retail trade turnover at constant prices (year-on-year growth)	2017 XII	**6.4**
Labour market		
Registered unemployment (share in working age population)	2018 I	**7.0**
Jobseekers rate (share in working age population)	2017 Q4	**8.1**
Monetary indicators		
Resident deposits (year-on-year growth)	2017 XII	**2.5**
29.01.2018 Lending recovery stalling		

Sources: Treasury, CSB and Latvijas Banka.

Four years in the euro area - have the promises come true?



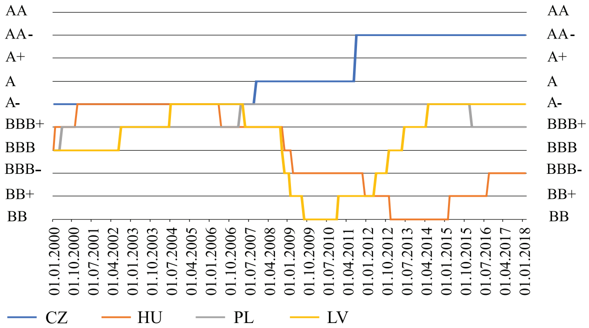
Egīls Kaužēns,
Economist,
Latvijas Banka

Already four years have passed since Latvia joined the euro area and the euro is our money. Before the euro changeover experts of Latvijas Banka promised that Latvia would benefit from that. Has it come true? The answer is yes.

According to Latvijas Banka's estimates before joining the euro area, this step would improve Latvia's credit rating by 1-2 notches. Since the announcement that Latvia (LV) had joined the euro area, Latvia's credit rating was revised upwards by two notches, i.e. from BBB to A- in a short period (2013–2014). If we look at the Czech Republic, Hungary and Poland (CZ, HU, PL), their credit ratings remained unchanged in the same period.

Before Latvia's joining the euro area Latvijas Banka emphasized that improvement of Latvia's credit rating by 1-2 notches would reduce Latvia's 10 year government bond rates by 150 basis points (bp). Since the announcement that Latvia had joined the euro area, Latvia's 10 year government bond rates have dropped markedly from 3.25% in the middle of 2013 to 0.71% in October 2017. Moreover, Latvia's 10 year government bond rates in the national currency have decreased by approximately 160 bp compared to those of CZ, HU and PL. This has resulted in savings of around 0.6% of GDP or 150 million euro in the government budget over the reference period of five years.

Chart 1. **Dynamics of S&P credit ratings**



Source: Bloomberg

Lower interest rates ensure more favourable conditions for private sector borrowers, thus affecting investment and consumption decisions. Latvia's joining the euro area and the improvement of its credit rating has also had an impact on the interest rates on loans; they were lower than those of CZ, HU and PL in October 2017. Latvia's interest rates on loans to enterprises and households decreased by approximately 90 bp compared to those of CZ, HU and PL. Meanwhile, the money market interest rates in Latvia could be 160 bp higher than they are now if Latvia had remained outside the euro area.

Latvia's interest rates on loans to enterprises and households decreased by approximately 90 bp compared to those of CZ, HU and PL.

Before joining the euro area Latvijas Banka had estimated that savings in the economy resulting from reduced currency conversion volumes of households and businesses would amount to 70 million euro per year. These estimates were based on real foreign exchange transactions conducted, taking into account the actual margins between the purchasing and selling rates of currencies. Statistics showed a steep year-on-year decline in currency exchange transactions in 2014 confirming the accuracy of Latvijas Banka's estimates. With the euro changeover, the risks and costs of businesses related to exchange rate fluctuations have decreased considerably having a positive effect on foreign trade related business.

What would happen if Latvia had remained outside the euro area? The assumption used in economic modelling is that Latvia's interest rates would exceed approximately 160 bp based on the above comparisons with countries outside the euro area, financing conditions would worsen whereas investment and profit would decrease. Within the reference period of five years, investment would decline by 5%, the number of unemployed would exceed the current level by 5000 persons, while Latvia's GDP per capita would decrease by 164 euro against a rising interest rate environment.

Overall, it may be concluded that Latvijas Banka's estimates before joining the euro area have proven to be accurate and the positive outcomes have materialised, namely, Latvian people and businesses have benefited from the euro.