



LATVIJAS BANKA

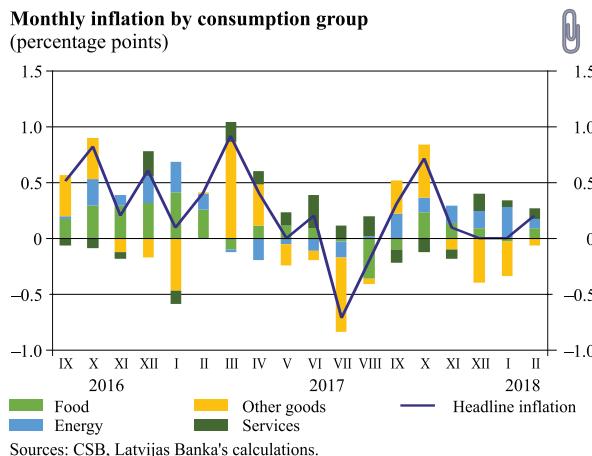
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LATVIJAS BANKA MONTHLY NEWSLETTER

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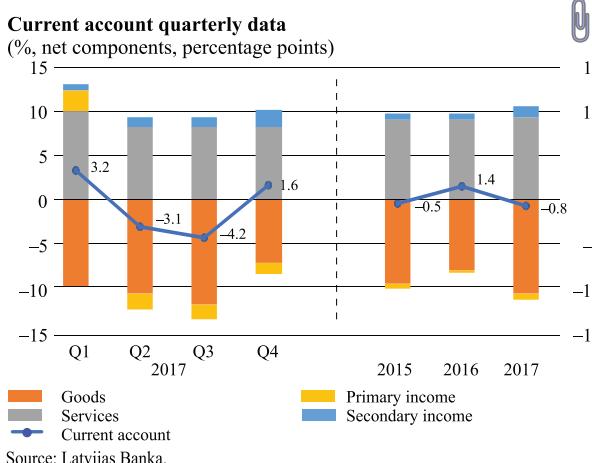
Wage dynamics reflect moderate warming up of the labour market



In 2017, the average full-time wage in Latvia grew by 7.9% in line with previous projections. In the private sector, where wages are more sensitive to economic upturns, remuneration increased more swiftly (8.5%) than in the public sector (6.1%). The current pace of wage growth has raised concerns about warming up of the labour market caused by the decreasing unemployment rate and weak labour productivity growth. Consequently, competitiveness of Latvian producers and service providers might be potentially hindered. To ensure a sustainable wage increase, it has to go hand in hand with labour productivity growth. This can be achieved through investment in human capital and the business environment.

Nevertheless, Latvia's global market share was on the rise in 2017. Labour productivity along with an increase in investment is starting to pick up as well. However, the risks associated with wage growth, which translates into wellbeing of the labour force and according to the current outlook is expected to continue on a similar scale in 2018, should be monitored.

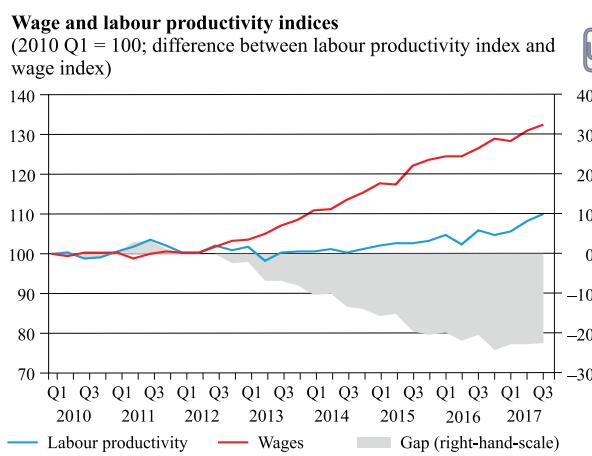
Current account ran a deficit of 0.8% of GDP in 2017 despite strong export growth



In 2017, Latvian exporters benefited considerably from the strengthening of the global economy and more active international trade. However, due to recovery of domestic economic activity the current account ran a deficit in 2017 as a whole. The outlook for export expansion remains strong. Solid external demand and global economic growth will continue to be the main driving factors in 2018. As regards an increase in imports, it picked up in 2017 after a slight slump in 2016. This upward path was driven by a multitude of factors, i.e. recovery of EU funding and investments overall, stronger domestic consumption and rising global prices of goods and services. The current outlook suggests that import growth will

continue to pick up owing to the continuing presence of the above factors. Therefore, it is expected that the current account deficit will gradually increase over the coming years.

February saw slower price rises due to pick up in the near term



In February, the inflation rate decelerated to 1.8% year-on-year. It is the slowest growth rate recorded since November 2016 after which inflation spiked upwards owing to global food and energy prices, building up a strong base effect for the coming year. The annual inflation rate seen in February is likely to have bottomed out and is expected to climb in the months ahead. Evidence of this is the slow monthly price rise observed over the past months despite the existing pressure from wage growth and elevating energy costs. The 2018 inflation will reflect changes in tax and minimum wage rates as well as rising prices of goods and services triggered by wage growth in the labour market and a price increase for natural resources, i.e. crude oil, natural gas, etc.

	Reporting period	Data (%)
Gross domestic product (GDP) Real GDP (year-on-year growth) Real GDP (quarter-on-quarter growth; seasonally adjusted) 02.03.2018 Repeating last year's performance – a challenge already 	2017 Q4 2017 Q4	4.7 0.3
Public finances General government budget expenditure (since the beginning of the year; year-on-year growth) Tax revenue (since the beginning of the year; year-on-year growth)	2018 II 2018 II	2.9 10.2
Consumer price changes Consumer Price Index (CPI; year-on-year growth) Harmonised Index of Consumer Prices (HICP; year-on-year growth) 12-month average inflation (HICP) 09.03.2018 February saw slower prices rises 	2018 II 2018 II 2018 II	1.8 1.9 2.7
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 14.03.2018 Exports are likely to sustain the momentum that started in 2017 	2018 I 2018 I	18.1 7.9
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; ratio to GDP) 07.03.2018 Current account deficit totalled 204 million euro or 0.8% of GDP in 2017 	2017 Q4 2017 Q4	1.6 -1.0
Industrial output Working day-adjusted manufacturing output index (year-on-year growth)	2018 I	4.4
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth)	2018 I	7.1
Labour market Registered unemployment (share in working age population) Jobseekers rate (share in working age population) 23.02.2018 Average labour market indicators mask "two-speed" Latvia  02.03.2018 Wage dynamics reflects moderate warming up of the labour market 	2018 II 2017 Q4	7.1 8.1
Monetary indicators Resident deposits (year-on-year growth) 28.02.2018 Loan portfolio contracted also in January 	2018 I	5.6

Sources: Treasury, CSB and Latvijas Banka.

Human capital in Latvia



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It is human capital that primarily determines our satisfaction with life. Therefore, it should be among the top policy priorities, while various economic indicators like industrial output or export competitiveness may be regarded as tools, not targets themselves. Three dimensions of human capital – health, education and work life – are closely interrelated. Good health is a prerequisite for undertaking long-term investments like education. Good education increases the prospects to have exciting and high-paid jobs. More high-paid jobs with a value to society raise tax revenues from which education and healthcare systems are financed.

Despite significant progress in terms of life expectancy, Latvia still lags 5–10 years behind the EU and OECD peers; and the difference is twice larger when we look at healthy life expectancy. Low public spending and a high share of private out-of-pocket healthcare expenses decrease the accessibility of healthcare services, particularly for low income households. Expensiveness of healthcare services and long queues clearly contribute to large differences in the self-perceived health status across income quintiles. Moreover, people with lower income smoke more and spend less time on physical activities; overall, compared to other developed countries, people in Latvia smoke much but exercise little. Therefore, structural reforms in the healthcare sector, accompanied with public spending rise and promotion of a healthy life style could improve the health status of the society and substantially extend healthy life expectancy.

The fact that we compare Latvian human capital with the EU and OECD level without even thinking of trying to relate it to the world or the former USSR average is an apparent achievement in itself. Moreover, the state of human capital in Latvia continues to improve over time. However, it is true that large room for further improvement still exists.

While Latvia scores only slightly below the OECD average in the PISA test, there is a major shortage of pupils with outstanding skills. This is a modest result, given that Latvia spends a larger part of its budget on education than any other EU country. Recent Latvijas Banka research clearly identified three main characteristics of underperforming schools: low number of pupils, low teacher salaries, shortage of young (under age 45) teachers¹. Although maintaining a wide school network eats much funding, school merging that would free resources to substantially raise teacher salaries has been slow and often challenged by municipalities. Higher education prevalence in Latvia slightly exceeds the EU average, but this to some extent reflects the rather low study requests. Too many higher education institutions are competing (mainly with price and advertisement) for an ever decreasing number of students. And although there are notable examples of very good study programs, secondary school graduates lack information that would allow them to make an objective choice.

Although average labour indicators look decent, with participation and employment rates exceeding the EU average, human capital is being wasted via the still quite large shadow economy, emigration and very high unemployment in some districts of Eastern Latvia.

The fact that we compare Latvian human capital with the EU and OECD level without even thinking to relate it to the world or the former USSR average, is an apparent achievement in itself. Moreover, the state of human capital in Latvia continues to improve over time. However, it is true that large room for further improvement still exists. If people living just a few hundred kilometres from Latvia – in Finland, Sweden or Estonia – enjoy an even better state of human capital, there is no clear reason why Latvia should be predestined to perpetual lagging behind. The only question is how and when the progress will accelerate, and that mainly depends on ourselves.

¹ Krasnopjorovs (2017) – Why is Education Performance so Different Across Latvian Schools? Latvijas Banka Working Paper #3/2017. Available: https://www.macroeconomics.lv/sites/default/files/2017-11/wp_3-2017_en.pdf