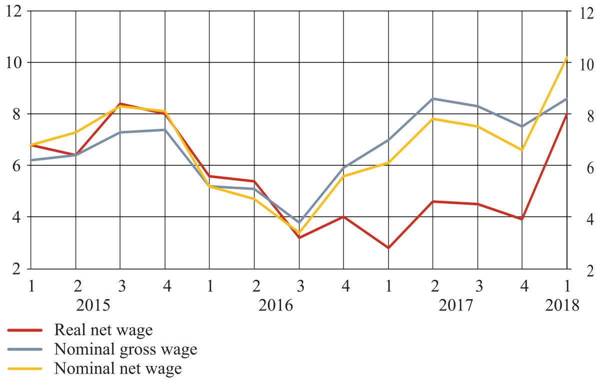
LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA MONTHLY NEWSLETTER

JUNE 2018

The purchasing power of employees is increasing

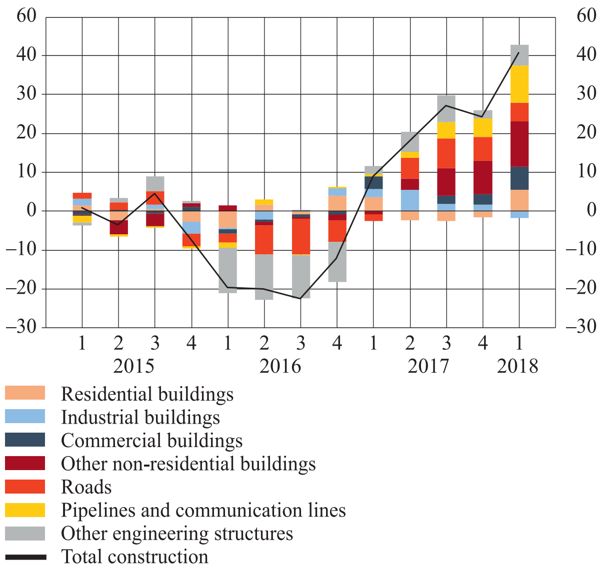
Average monthly wages and salaries
(%; year-on-year)



The labour market gradually becomes more favourable to employees. Both employment and participation rates have reached their historical high and exceed the EU average. To comply with the legislative amendments (i.e. higher minimum wages), to attract new employees and to retain the existing ones, businesses are forced to raise wages. Strong wage increases (the average gross wages posted an annual growth of 8.6% in the first quarter of 2018) combined with moderate inflation and legislative amendments have led to a notable boost in the growth rate of the real net wage, thus resulting in higher purchasing power of the employed. Considering that unemployment continues following a downward trend and the decline, although slowing down, is expected to persist throughout the year, wages are likely to keep rising steadily. All above factors will keep the private consumption strong.

Construction – the sector boasting the fastest growth in Latvia

Construction output growth and contributions by type of structure
(current prices; year-on-year; %; percentage points)

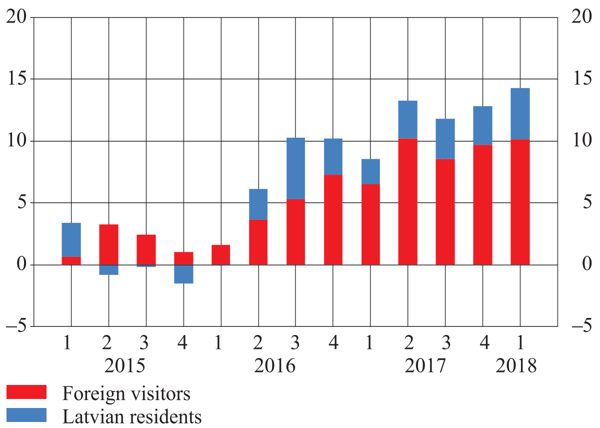


With the number of private sector construction projects growing and the absorption of EU funds intensifying, construction growth has already been increasingly showing signs of acceleration since the beginning of 2017. In the first quarter of 2018, construction output increased by 35.7% year-on-year (calendar adjusted data at constant prices). The construction output grows in all construction sectors, but the most important contribution comes from pipelines and communication lines as well as from non-residential buildings, including a dynamic rise in the office buildings segment. A considerable number of projects concerning construction of residential, commercial and office buildings are currently in the pipeline. Recovery of construction activities co-financed by EU funds is also ongoing. In the light of the above, the next few years will see strong construction growth.

The celebration of Latvia's centenary attracts the interest of tourists

The year 2017 was successful for the tourism sector, but 2018 is expected to be especially benevolent due to the celebration of Latvia's centenary. This may attract foreign tourists as well as encourage local inhabitants to attend special events organised on this occasion in all regions of Latvia. Latest data show that 454.2 thousand visitors stayed at Latvian tourist accommodation establishments in the first quarter of 2018, which is 14.3% more than in the first quarter of 2017. The number of nights spent by them at the above establishments increased by 12.8% year-on-year. The majority of foreign visitors came from Russia, Estonia, Lithuania, Germany, the United Kingdom and Finland. The agenda for the celebration of Latvia's centenary is vast and includes events in Latvia and abroad (programme). The increasing activity of tourists due to the celebrations not only stimulates accommodation and food service activities but also positively affects other sectors, e.g. trade, transportation and other sectors directly related to the organisation of celebrations, i.e. entertainment, marketing and printing services.

Visitors hosted at Latvian tourist accommodation establishments
(year-on-year, percentage points)



	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth, seasonally and calendar adjusted)	2018 Q1	**5.1**
Real GDP (quarter-on-quarter growth, seasonally adjusted)	2018 Q1	**1.6**
01.06.2018 The economy is growing, while the road ahead looks somewhat bumpy		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2018 V	**8.0**
Tax revenue (since the beginning of the year; year-on-year growth)	2018 V	**8.2**
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2018 V	**2.3**
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2018 V	**2.4**
12-month average inflation (HICP)	2018 V	**2.5**
11.06.2018 Global developments drive consumer prices up		
Foreign trade		
Exports (year-on-year growth)	2018 IV	**15.3**
Imports (year-on-year growth)	2018 IV	**11.0**
Balance of payments		
Current account balance (ratio to GDP)	2017 Q4	**3.4**
Foreign direct investment in Latvia (net flows; ratio to GDP)	2017 Q4	**2.5**
Sectoral performance		
Working day-adjusted manufacturing output index (year-on-year growth)	2018 IV	**2.2**
Retail trade turnover at constant prices (year-on-year growth)	2018 IV	**3.1**
Labour market		
Average monthly wage (year-on-year growth)	2018 Q1	**8.6**
Jobseekers rate (share in working age population)	2018 Q1	**8.2**
Monetary indicators		
Resident deposits (year-on-year growth)	2018 IV	**4.9**
Loans to residents (year-on-year growth)	2018 IV	**–3.6**
30.05.2018 Lending to businesses is still ebbing		

Sources: Treasury, CSB and Latvijas Banka.

Latvian inflation: 2.9% = 2.9% = 2.9%

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Latvian consumer prices posted a 2.9% increase in 2017, in line with our expectations (see June 2017 Monthly Newsletter). It seems now that inflation in Latvia is likely to stick at 2.9% for three consecutive years. In June, Latvijas Banka's Council kept the inflation forecast for 2018 unchanged at 2.9%, while raising it by 0.3 percentage points to 2.9% for 2019. What lies behind this decision? Overall, the inflation forecast was revised upwards due to climbing oil prices. In 2018, however, this effect has been compensated by lower-than-expected food prices at the beginning of the year.

In the first five months of 2018, headline inflation was somewhat lower than expected. This was partly on account of the lowering of the VAT rate on vegetables and fruit typical of Latvia from 21% to 5% as of January 2018, the impact of which exceeded expectations. Therefore, Latvijas Banka's inflation forecast for this year has remained unchanged despite the rise in oil prices.

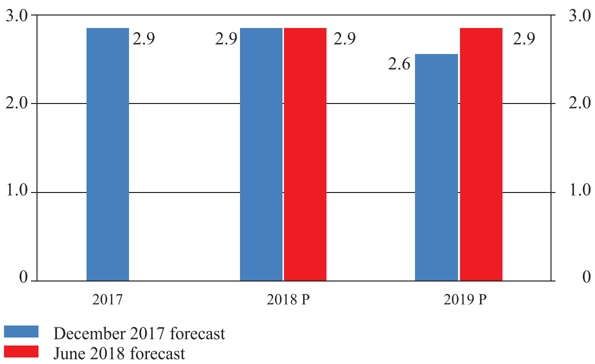
In May 2018, Brent oil prices climbed beyond 75 dollars per barrel reaching a level not seen since 2014. This was driven by several events, e.g. strong compliance with the agreed oil supply cuts by OPEC as well as its ongoing cooperation with Russia, military and political tensions in the Middle East, declining oil extraction in Venezuela and the US cancelling the Iran nuclear deal. Nevertheless, as a result of the rising oil prices, the US oil output reached new historical highs. With slight exaggeration, it could be said that, in the medium term, the US could offset any oil supply cuts by OPEC, leaving the global oil supply broadly unchanged. Therefore, as the oil price for a moment approached 80 US dollars per barrel, OPEC and Russia finally considered a possible increase in their oil output, and this announcement alone was enough to end the oil price rally or at least to put it on hold.

It seems now that inflation in Latvia is likely to stick at 2.9% for three consecutive years.

The recent oil price hike has already been transmitted to retail fuel prices. For instance, the price of 95 petrol rose to 1.30 euro, 16 cents higher than a year ago (about a quarter of this increase was driven by a rise in excise tax as of January 2018). Moreover, the impact on heating and gas prices is yet to be seen, even if the oil price is going to decrease moderately over the next few months as suggested by its future contracts. Another administrative price rise will come from the new water and sewerage tariffs in Riga in effect as of June 2018 (their impact on the overall price level is 0.1%).

After dropping at the turn of the year, global food prices resumed moderate growth in the spring. However, the global rise in dairy product prices mainly reflects tight supplies in New Zealand, with a limited impact on the European region. The global prices of cereals are climbing because the harvest estimations were revised downwards for this year and fell below both the growing demand and the previous year's record-high harvest.

Consumer price inflation
(HICP; %)



Our estimate of the impact of domestic demand on inflation remains almost unchanged. While it is true that wage growth accelerated to 8.6% in the first quarter of 2018, this was mainly driven by a more significant minimum wage rise this year. Core inflation (excluding taxes, food, energy and administrative prices) is lagging by a few quarters relatively to the slightly positive output gap. As a result, the core inflation is expected to nearly double this year to 2.4% and retain its level in 2019.