

**LATVIJAS BANKA**
EIROSISTĒMA

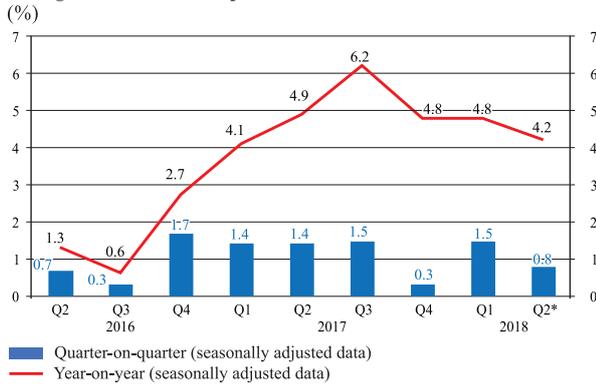


LATVIJAS BANKA
MONTHLY NEWSLETTER

AUGUST 2018

Economic growth remains robust

GDP growth at constant prices

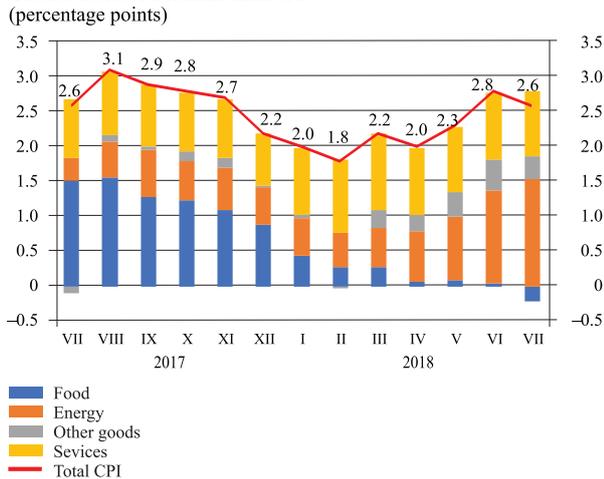


* – flash estimate.
Source: CSB.

The flash estimate published by the Central Statistical Bureau reveals that the Latvian economy grew by 4.2% in the second quarter of 2018 (in annual and seasonally adjusted terms). The expansion continued despite the headwinds from recent developments in the financial sector and somewhat slower growth in the euro area. On account of better absorption of EU structural funds and higher private investment activity, the construction sector expanded by an impressive 32% and continues to be one of the main contributors to growth. The expansion was evident in other sectors as well, although their growth rates were more moderate. Retail trade remained relatively strong (see the section below), whereas manufacturing increased by a mere 2%. Taking account of benign economic conditions, major challenges still relate to gradual tightening of Latvia's labour market and downside risks to the global outlook due to trade tensions.

Higher fuel prices continue to support inflation

Contribution to headline inflation

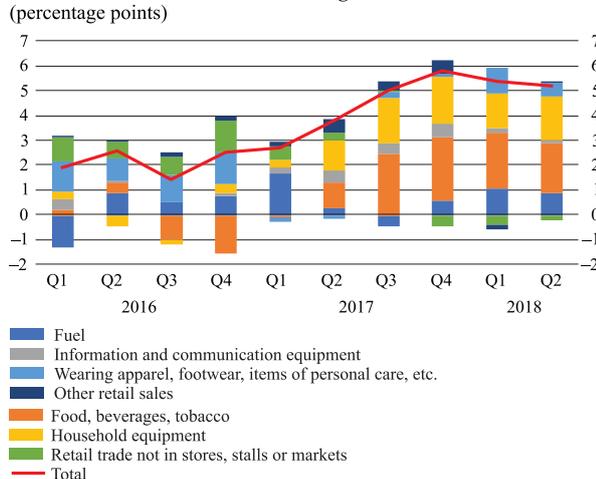


Source: CSB.

In July, consumer prices declined by 0.8% in monthly terms and increased by 2.6% in annual terms. Although fuel prices did not change notably compared to those recorded in June, they remained elevated as compared to the summer of 2017, thereby contributing to a year-on-year increase in consumer prices. The contribution from the services sector remained robust and rose by 3.2% in annual terms, reflecting strong domestic demand. Overall, inflation dynamics in July were somewhat lower than expected. This was partially due to the muted impact of higher excise duties on the prices of cigarettes. The above might suggest that a gradual price increase will follow in the coming months or that the anticipated tax hike was already reflected in prices before. Once the higher oil prices pass through to other energy prices, inflation is expected to accelerate.

Retail trade expands against the background of favourable economic conditions

Contribution to retail trade turnover growth



Source: CSB.

Favourable labour market conditions and stable private consumption continue to support a steady increase in retail trade turnover which expanded by 5.2% in the second quarter of 2018 (seasonally adjusted data). Despite somewhat volatile consumer confidence, retail trade growth has been robust in all major product groups, in particular, with respect to food, beverages and tobacco products as well as the goods used for house refurbishment or repairs. The retail trade sector is expected to remain on an upward trend in the coming quarters due to the ongoing economic expansion and one-off factors, inter alia, market entry by several retailers (most notably, IKEA).

	Reporting period	Data (%)
Gross domestic product (GDP)		
Real GDP (year-on-year growth, seasonally and calendar adjusted)	2018 Q2 <i>(flash estimate)</i>	4.2
Real GDP (quarter-on-quarter growth, seasonally adjusted)	2018 Q2 <i>(flash estimate)</i>	0.8
01.08.2018 The construction sector gives momentum to economic growth in the second quarter 		
Public finances		
General government budget expenditure (since the beginning of the year; year-on-year growth)	2018 VII	9.4
Tax revenue (since the beginning of the year; year-on-year growth)	2018 VII	9.8
Consumer price changes		
Consumer Price Index (CPI; year-on-year growth)	2018 VII	2.6
Harmonised Index of Consumer Prices (HICP; year-on-year growth)	2018 VII	2.7
12-month average inflation (HICP)	2018 VII	2.5
09.08.2018 Inflation in July: lower than expected 		
Foreign trade		
Exports (year-on-year growth)	2018 VI	10.7
Imports (year-on-year growth)	2018 VI	7.9
Balance of payments		
Current account balance (ratio to GDP)	2018 Q1	3.4
Foreign direct investment in Latvia (net flows; ratio to GDP)	2018 Q1	2.5
Sectoral performance		
Working day-adjusted manufacturing output index (year-on-year growth)	2018 VI	2.1
06.08.2018 Manufacturing was volatile in the second quarter 		
Retail trade turnover at constant prices (year-on-year growth)	2018 VI	5.6
31.07.2018 Despite fluctuations, retail trade growth remains strong 		
Labour market		
Average monthly wage (year-on-year growth)	2018 Q1	8.6
Jobseekers rate (share in working age population)	2018 Q2	7.7
16.08.2018 Unemployment continues on a downward trend, whereas people struggle to find jobs meeting their expectations 		
Monetary indicators		
Resident deposits (year-on-year growth)	2018 VI	3.8
Loans to residents (year-on-year growth)	2018 VI	-2.9
27.07.2018 Revival of lending remains slow 		

Sources: Treasury, CSB and Latvijas Banka.

Interaction between FDI and exports



Linda Vecgaile,
Economist,
Latvijas Banka

2017 and 2018 have been very favourable for Latvia's exports of goods and services so far. Income from exports of goods posted a steep rise, whereas exporters of services have demonstrated robust income growth for several years already, accounting for approximately one third of Latvia's total export value.

Strong overall global demand and high demand from Latvia's main trade partners were significant factors, while also driving up global prices. Thus, Latvia's export value increased not only due

to an expansion of exported volume but also because of a rise in export prices. Meanwhile, after the low levels observed in 2016, last year FDI inflows in Latvia were again close to their historical average, reaching 2.4% of GDP, and accumulated levels of FDI inflows amounted to 53.5% of GDP. Moreover, good inflows have continued also this year. Could FDI growth be considered a factor supporting Latvia's exports?

Research suggests that, in the receiving country, FDI fosters conditions favourable to export growth. For instance, factors such as the introduction of new and improved technologies, knowledge transfer and more successful style of management, all facilitate efficiency and productivity, thereby boosting international trade.

Correlation coefficients obtained through the comparison of exports by sector and the accumulated FDI in the respective sectors; 2009–2017 (European Community statistical classification of economic activities; Revision 2)



Source: Latvijas Banka, CSB.

which approximately 20% are close or very close (see Chart). When analysing in greater detail, it can be concluded that the list of the countries importing the largest shares of Latvia's exports of goods and services closely correlates with that of the countries accounting for the largest FDI inflows in Latvia.

When analysing the countries dominating in Latvia in terms of their accumulated FDI, it can be concluded that the allocation of FDI can be viewed as diversified. Among the countries with the largest volumes of accumulated FDI are Sweden, the Netherlands, Denmark, Russia and Lithuania. FDI is also spread across sectors, the largest of which are, e.g. the financial, retail trade, real estate, manufacturing and agricultural sectors.

When examining the relationship between exports in each of Latvia's sectors and the accumulated FDI in these sectors, one third of the results suggest significant correlation, of

Latvia's small and open economy is very dependent on exports, and diversified FDI inflows are also highly valuable. If both of the above positively affect each other, Latvia is in an advantageous position. To ensure further development of exports and FDI, the process of strengthening the investment environment and penetrating new export markets should be ongoing and should include systematic work on aligning the taxation and legal systems, combating the informal economy and improving the educational system and demographic trends.