



Quarterly Macroeconomic Developments Report, January 2014

About the report

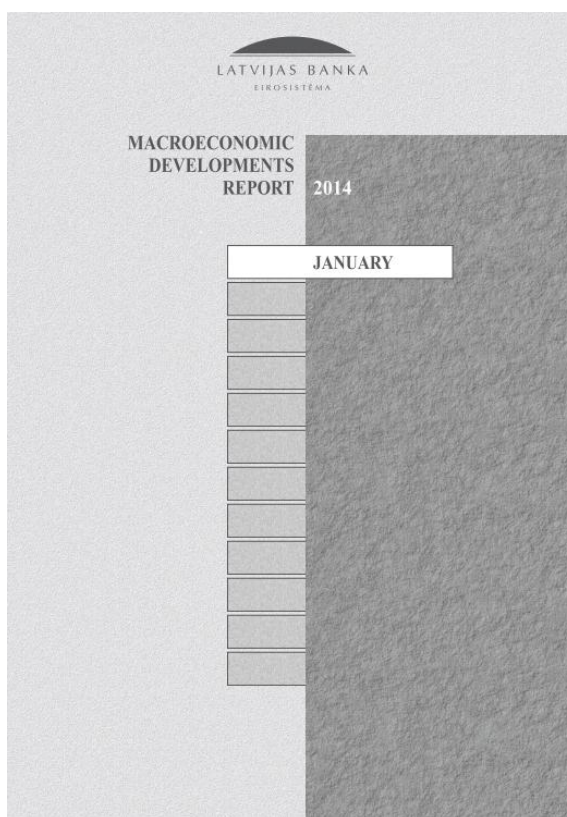
The **Macroeconomic Developments Report** is a quarterly publication, based on data from the Latvijas Banka, Central Statistical Department of Latvia, Ministry of Finance and Financial and Capital Market Commission. The publication assesses developments of the external sector and exports, financial market, domestic demand and supply, prices and costs and balance of payments, and provides forecasts for economic development and inflation.

Executive summary

In October, the IMF revised downwards the world economic outlook for 2013 and 2014. Of Latvia's major trade partners, the growth forecast was lowered significantly for Russia, Estonia and Finland. As a positive trend, the economic growth forecast for the euro area remained unchanged for 2013 and was even revised upwards for 2014.

In the third quarter of 2013, both exports and imports of Latvian goods contracted year-on-year. Foreign trade in goods was losing momentum as a result of weakening demand in the markets of trade partners and the strong base effect. Nevertheless, Latvia's export market shares in global markets continued to expand, albeit at a slower pace than in the previous year. Labour costs elevated, yet their rise was offset by improved productivity supporting the preservation of competitiveness. Diversification of products and markets can also be observed. Looking into future, with the economic situation in Europe gradually stabilising, Latvia's export opportunities could improve somewhat, yet the ability to continue with productivity improvements will become increasingly more significant.

In response to a steeper-than-expected drop in euro area inflation, the ECB unexpectedly lowered the rate on the main refinancing operations from 0.5% to a record low of 0.25% in November. Considering the fact that Latvia's inflation was also low and the rate of economic development posed no risks to





price stability in the medium term, Latvijas Banka Council resolved to lower the refinancing rate from 1.5% to 0.25% in November. The rates of the marginal lending facility were also reduced. As a result of persisting excess lats liquidity, the money market rates shrank from August to November. The decline in market rates was supported by the approaching euro changeover and Latvijas Banka resolutions on the reduction of interest rates.

Overall situation with lending remained broadly unchanged: the moderate shrinking of the loan portfolio in September and October was followed by a slight increase associated with an improvement in corporate lending. Household indebtedness continued on a slow but stable downward trend, mostly on account of repaid loans for house purchase. Credit institutions are still reluctant to use their free liquidity to grant loans and keep fairly large amounts on accounts with the central bank or place them abroad. It is likely that the most of this money will not be channelled into the economy also in 2014. Nevertheless, the credit risk score in the case of successfully working businesses should go down following the euro changeover, while the demand for loans from those businesses should increase; therefore, the corporate lending prospects for 2014 should be viewed as favourable. This is confirmed also by the minor increase in lending observed in November, although it is too early yet to be certain that the free liquidity of the credit institutions will be used to boost lending in the near term.

The average annual growth of the Latvian GDP has been 4%–5% since mid-2012; however, exports have given up the role of the main driver of development to domestic demand. Private consumption remained the largest contributor to GDP growth in the third quarter of 2013, supported by a rise in disposable income and more active spending of savings.

Meanwhile, the growth of the real exports of goods and services decelerated in 2013, entering a negative territory in the third quarter at –1.3%. Although exporters managed to retain high competitiveness, the weakness of the external demand continued to weigh on exports. With public sector investment reporting higher growth rates, a moderate increase in investment was also observed which could be supported by the inflows of EU funding and foreign direct investment in the coming quarters as well.

Following a short-lived slowdown at the beginning of the year, the development of manufacturing continued to exert a positive influence on GDP growth. Preliminary data for October also suggest that with gradual recovery of the external environment further growth in manufacturing could be expected.

As expected, there was a minor increase in the rate of jobseekers in the third quarter, largely mirroring the fluctuating rate of participation reversing the fall observed in the previous two quarters. At the end of 2013, due to seasonal factors and the crisis affecting JSC *Liepājas Metalurģis* registered unemployment slightly increased. Overall, job opportunities are ever more ample, as confirmed by a higher employment rate and number of vacancies. Wages and salaries accelerated slightly in the third



quarter, whereas the increase in nominal unit labour costs was only minor, confirming that the revival of competitiveness was sustainable. Compensation to employees is expected to continue to grow somewhat faster than the value added, with the unemployment rate gradually approaching its natural level.

Annual inflation remained low in September–December 2013. This was a result of the stabilisation of oil prices, further decline in heating tariffs and stable food prices on the global market. The price rise in other groups of goods and services in the course of the year was offset by commensurate wage and productivity growth as well as the absence of any pressure from energy prices. Overall, inflation in 2013 is deemed to be unusually low. The contribution of principal components (energy, food, other groups of goods and services) differs substantially both from the long-term average rate of inflation and inflation rates associated with economic growth. As in 2013, average inflation for 2014 will be primarily affected by the supply-side factors, but the direction and magnitude of their effect could differ considerably from that observed in 2013.

Further information

The full report can be read and downloaded on the Latvijas Banka website at: <http://www.bank.lv/en/publications/macroeconomic-developments-report/3638> or <http://www.slideshare.net/LatvijasBanka/mdr-january-2014>. The publication is available only in electronic form.