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Abbreviations

APP – asset purchase programme
CSB – Central Statistical Bureau of Latvia
DSGE model – Dynamic Stochastic General Equilibrium Model
EC – European Commission
ECB – European Central Bank
EONIA – euro overnight index average
EU – European Union
EURIBOR – Euro Interbank Offered Rate
FRS – US Federal Reserve System
GDP – gross domestic product
HICP – Harmonised Index of Consumer Prices
IMF – International Monetary Fund
MFI – monetary financial institution
MRO – main refinancing operation
OFI – other financial intermediaries excluding insurance corporations and pension funds
OPEC – Organization of Petroleum Exporting Countries
SEA – State Employment Agency
SIA – limited liability company
TLTRO – targeted longer-term refinancing operation
UK – United Kingdom
US – United States of America

Introduction

Latvijas Banka's outlook for economic growth in 2019 and 2020 has remained broadly unchanged since the revision of its forecasts in September. However, in view of the changes in the GDP data time series as a result of the revisions to the national account time series made by the CSB, GDP growth is likely to stand at 2.3% in 2019, with the forecast for 2020 remaining unchanged at 2.6%.

Despite the weak external demand, Latvia's export growth was driven by a short-term factor, i.e. a record high grain harvest. With uncertainty persisting and the economic sentiment indicators recording no significant improvement in the euro area, several trade partner growth forecasts for 2020 have become more pessimistic, thus preventing a more rapid rise in Latvia's external demand as well. The geopolitical tensions observed elsewhere in the world resulting in weaker than previously projected global economic growth will also weigh on it. The pronounced global uncertainty also serves as a factor moderating Latvia's domestic demand, particularly the investment activity, to a lower level than projected before.

Owing to the ECB's accommodative monetary policy stance, the financial conditions remain favourable in the euro area; however, this opportunity has not been fully used in Latvia so far and credit institution lending remains sluggish, with the external risks and growth decline slowing down the increase in the loan portfolio. At the same time, the financial conditions are affected by the credit institution sector changes made as a result of the financial sector improvement process.

Despite the economic growth slowdown, labour demand is high, but its supply is limited, therefore unemployment is declining and accelerated wage growth persists. Mostly as a result of oil price dynamics, the inflation forecast has been revised slightly downwards: in 2019, inflation is expected to stand at 2.8%, slipping down to 2.4% in 2020.

1. External Demand

The protracted trade wars and Brexit negotiations, geopolitical tensions and persistently high uncertainty are the main factors underlying the slowdown of the global economic growth, particularly in industry. Although robust private consumption is currently still supporting the growth, the first signs of moderation have also been observed in this respect. Therefore, it seems that the weakness in industry is gradually passing on to other sectors of the economy as well. Along with the growth slowdown in other countries, Latvia's external demand is also likely to decrease in 2020.

The latest IMF estimates suggest that in 2019 the global economy saw the slowest growth of the last few years. With the largest global economies facing slower growth, several major central banks have already taken measures to ensure more accommodative financial conditions. In its October meeting, in line with market expectations, the FRS reduced the target range for the federal funds rate by 25 basis points, to 1.5%–1.75%. At the same time, it was a signal that no further cuts are expected in the near term. Meanwhile, with inflation and its expectations remaining low in the euro area, the ECB decided to reduce the deposit facility rate and resume asset purchases under the APP until the moment the inflation has been seen to robustly converge to a level sufficiently close to the ECB inflation target. To ensure progress towards achieving the price stability objective, the Bank of Japan, amidst persistently growing risks, pointed to its readiness to introduce further interest rate cuts. As to the Bank of England, it has taken a wait-and-see stance, given the uncertainty associated with Brexit which has been postponed again.

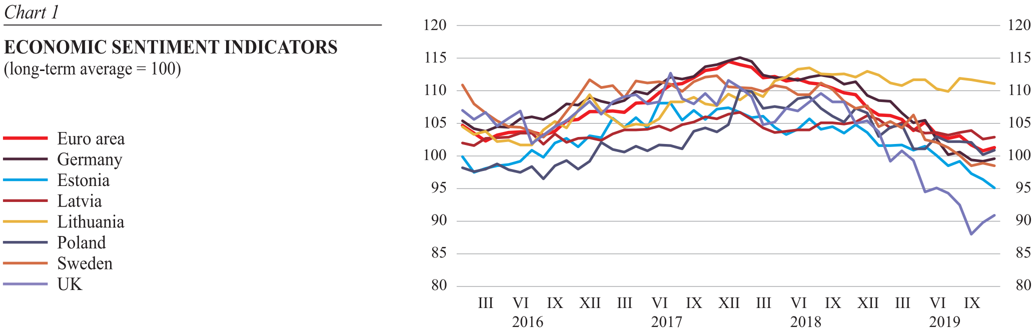
On account of the depressing global background, market participants are expecting the economic growth to decelerate. Nevertheless, in the third quarter of 2019, the growth momentum provided a positive surprise in the US economy. Market participants expected the US GDP to increase by 1.7% in the third quarter, but according to estimates, the growth stood at 2.1%. According to FRS forecasts, next year is likely to see weaker growth, i.e. below 2%. The pessimistic outlook has been mostly associated with the performance in industry where the amount of both orders and investment is declining. Although the US economic growth is supported by private consumption, it is also turning weaker, with an increase of 2.9% in the third quarter vis-à-vis 4.6% in the second quarter. Over the last 12 months, the US personal consumption expenditure inflation stood at 1.5% (the underlying inflation was 2.1%), i.e. below the FRS target level; this, along with the trade tensions, served as a motivator to lower the target range for the federal funds rate. In early October, the US-China relations continued to worsen as the US Commerce Department, on the basis of human rights violations, put 28 Chinese companies and government agencies on a US trade blacklist. However, both parties have achieved progress with respect to their mutual trade relations, with the US postponing a tariff increase on Chinese exports to the US from 25% to 30% in the amount of approximately 250 billion US dollars and both superpowers pointing out that Phase 1 trade deal could soon be reached.

Industrial activity in Japan continued on a downward trend; following a fall to a three year low of 48.4 observed in October, the business confidence indicator moved up to 48.9 in November. A considerable fall was registered not only in new orders, but also in exports and production. This can be partly explained by the raising of the consumption tax from 8% to 10%: economic activity strengthened before the new tax rate took effect, but moderated afterwards. At the same time, the services sector still demonstrates optimism. Meanwhile, in China, its rapid economic growth notwithstanding, it continues to slow down. In the third quarter, its annual growth rate was 6.0%, as per the minimum official growth target set by the Chinese government; this was a low of the last 30 years. IMF estimates also point to 6.1% and 5.8% growth in 2019 and 2020 respectively. Although retail trade still demonstrated growth (7.8%), business confidence had already been on a downward trend for a longer time.

As to the euro area, economic growth continued reaching 1.1% in the third quarter, down from 1.2% seen in the second quarter, and exceeding expert expectations. However, growth in euro area countries differs notably, with Germany and Italy posting the most pronounced economic growth rate slowdown. The global trade tensions particularly strongly affect the euro area due to its market openness, industry in particular, where output has already been decreasing for ten consecutive months. In September, industrial output volume was 1.7% lower year-on-year. For the time being, issues in industry had not yet affected the services sector and labour market notably overall. Despite the fact that unemployment in the euro area had stabilized at 7.5%, a low since the fourth quarter of 2007, and the wage rise remained high at 2.7% in the second quarter, consumer sentiment was deteriorating and the previously robust business confidence of the services sector was weaker than in the first half of 2019. A decline in the euro area inflation continued mostly on account of the impact of global energy price changes. Meanwhile, in November the results exceeded the expectations as the inflation and underlying inflation rose to 1.0% and 1.3% respectively. However, from the perspective of reaching inflation target, it is still considered a weak result.

Chart 1

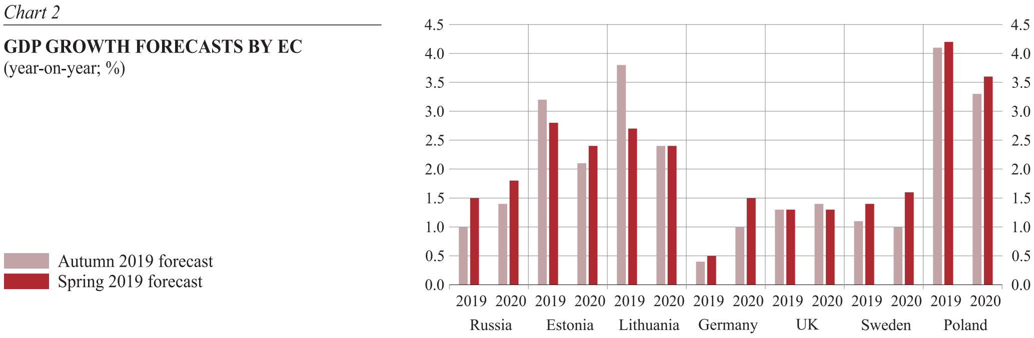
ECONOMIC SENTIMENT INDICATORS
(long-term average = 100)



Looking at Latvia's major trade partners, we see economic growth moderating there; nevertheless, data for the first half of 2019 in our Baltic neighbouring countries were better than expected, therefore Latvia's foreign demand forecast for 2019 has remained broadly unchanged since June. However, with uncertainty persisting and the economic sentiment indicators in the euro area reporting no significant improvement, growth forecasts for 2020 in most trade partners have become more pessimistic and are also suggesting a slower increase in Latvia's external demand in 2020.

Chart 2

GDP GROWTH FORECASTS BY EC
(year-on-year; %)



Germany shows no signs of sustainable economic improvement: production output and production capacity utilisation continue on a downward trend. External uncertainty remains a drag on exports; nevertheless, their level has slightly increased in the last few months. For the time being, however, unemployment remains low and data available for the third quarter point to a slight retail trade increase suggesting a positive dynamics of private consumption. A more accommodative fiscal policy is still being discussed, and it is not clear for how long the domestic demand will be able to offset the external environment challenges. Therefore the EC has revised Germany's GDP growth forecast for 2019 slightly downwards from 0.5% in the spring forecast to 0.4%, and from 1.5% in the spring forecast down to 1.0% for 2020.

As regards our Baltic neighbouring countries, they enjoyed stable growth in the first half of 2019, also followed by signs of a slowdown later in the year. In Lithuania, economic growth in the third quarter was negatively affected by the shrinking manufacturing output as a result of the decreasing mining output. At the same time, the positive impact of the domestic demand on growth persisted, on the back of robust private consumption and investment. Estonia's economic growth continued on a sustainable path, despite the negative external environment developments. Investment dynamics had a positive effect on its domestic demand; despite the robust consumption and the declining unemployment, employment expectations had become more pessimistic, pointing to a slowdown in the economic growth. In autumn, the EC revised upwards its 2019 GDP growth forecasts for both Lithuania and Estonia: from the previous 2.7% up to 3.2% and 3.8% respectively. The previous 2020 forecast of 2.4% was revised down to 2.1% for Estonia, while remaining unchanged for Lithuania.

For 2019, Latvia's non-euro area trade partners are expected to register slower economic growth than projected before. Russia saw its economy grow faster in the third quarter, albeit still being sluggish overall. The economic activity was further limited by the weakening external demand, having a negative effect on exports as suggested by confidence indicators. The slower than planned inflow of government investment in the national infrastructure projects also weighed on growth. The EC revised its 2019 GDP growth forecast for Russia from 1.5% in the spring forecast down to 1.0%; the 2020 forecast from 1.8% in the spring forecast down to 1.4%. To stimulate economic growth, the Central Bank of Russia repeatedly cut the key rate by 25 basis points; without the fiscal stimulus, however, the growth is likely to be slow and hence will also be reflected in a sluggish increase in imports, thus affecting Latvia's exports.

As projected before, the third quarter saw a growth slowdown continue in Poland on account of the negative impact of the external environment on exports. At the same time, the domestic demand remained the main GDP driver. Private consumption was supported by low unemployment and a wage rise, as well as a rapid increase in private investment. Meanwhile, government investment growth moderated as the use of EU funding contracted. On account of slower trade partner growth, the EC revised Poland's previous GDP growth forecast down from 4.2% to 4.1% for 2019 and from the previous 3.6% to 3.3% for 2020.

Economic growth in Sweden, albeit somewhat faster in the third quarter, still remained sluggish. Despite the slightly higher unemployment rate, private consumption increased as wages and salaries rose. However, confidence indicators were still on a decline, the Purchasing Managers' Index pointed to further problems in industry, production capacity utilisation had also contracted. Export growth remained subdued and weak investment in the housing market persisted, therefore the EC revised Sweden's GDP growth forecast for 2019 downwards from the previous one of 1.4% to 1.1% and from 1.6% to 1.0% for 2020.

Although the UK avoided slipping into a technical recession in the third quarter, the uncertainty associated with Brexit and the weak external environment continues to dampen economic activity. Manufacturing is stagnating and the number of job vacancies is decreasing. Meanwhile, the wage rise continues to exceed inflation notably, thus boosting consumption. The UK and the EU have reached a new agreement by extending the Brexit deadline to 31 January 2020. The agreement will improve growth in the short term, while it is still unclear how the situation will evolve further. Therefore the EC has left the UK GDP growth forecast broadly unchanged.

2. Financial Conditions

In response to weaker-than-expected economic activity, both the ECB and the FRS implemented measures to amplify their accommodative monetary policies. At the current juncture, however, markets no longer expect any further easing from the ECB, whereas the FRS has already announced no intention to continue with rate cuts in the near term. Up to October, uncertainty, primarily caused by the US-China trade conflict, weighed on the financial markets. Yet increasingly more positive news about the trade negotiations and a decreasing probability of a no-deal Brexit have brought more optimism to the stock markets, while the yields on debt securities are recovering from the record-lows reported at the end of summer.

2.1 Decisions of the ECB and other major central banks

At its July meeting, the Governing Council of the ECB decided to keep the key ECB interest rates unchanged, while its forward guidance suggested potential cutting at some point in the future. In addition to that, the Governing Council tasked the respective committees of the ECB with examining options to reinforce monetary accommodation and mitigate the adverse effect of the negative interest rates on banks.

At its September meeting, the Governing Council of the ECB decided to act and take further monetary easing measures. First, it decided to lower the interest rate on the deposit facility by 10 basis points to –0.50%. Forward guidance was modified stating that the Governing Council of the ECB now expects the key ECB interest rates to remain at their present or lower levels until the inflation outlook is seen to robustly converge to a level sufficiently close to, but below, 2% within the projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics. Second, the Governing Council announced a restart of net purchases under the APP at a monthly pace of 20 billion euro as from 1 November. Asset purchases under the APP will run for as long as necessary to reinforce the accommodative impact of the ECB's policy rates, and they will end shortly before the Governing Council of the ECB starts raising the key ECB interest rates. Third, the principal payments from maturing securities purchased under the APP will continue to be reinvested, in full, for an extended period of time past the date when the Governing Council of the ECB starts raising the key ECB interest rates. Fourth, the Governing Council decided to change the modalities of the quarterly targeted longer-term refinancing operations (TLTRO III), making the interest rate of these operations more appealing to banks as well as extending the maturity of the operations from two to three years. Fifth, a new two-tier system for reserve remuneration was announced, in which part of commercial banks' holdings of excess liquidity will be exempt from the negative deposit facility rate.

Following the introduction of the above-mentioned measures to increase the degree of monetary accommodation, the Governing Council of the ECB did not implement any further significant changes in its monetary policy stance at the October meeting and left the key ECB interest rates unchanged, merely remarking that the previous decisions remain in effect and net purchases at a monthly pace of 20 billion euro will restart as from 1 November. The start of the functioning of the previously-announced two-tier reserve remuneration system was also confirmed. At the press conference following the meeting, Mario Draghi, President of the ECB, pointed out that the incoming data since the Governing Council's meeting in early September confirm the ECB's previous assessment of a protracted weakness in euro area growth dynamics, the persistence of prominent downside risks and muted inflation pressures. Mario Draghi mentioned that the slowdown in growth mainly reflects the ongoing weakness of international trade in an environment of persistent global uncertainties, which continue to weigh on the euro area manufacturing sector and are dampening investment growth.

Chart 3

MARKET IMPLIED ECB'S MRO RATE
(%)

June 2019
November 2019

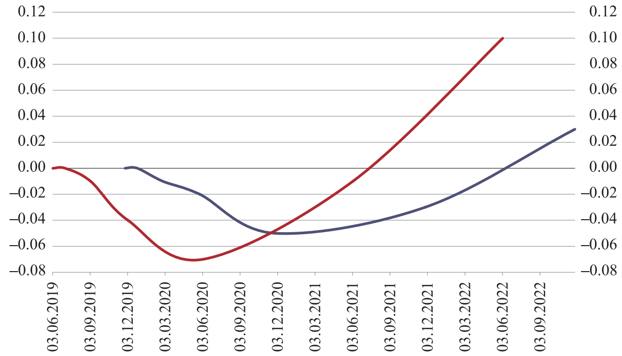
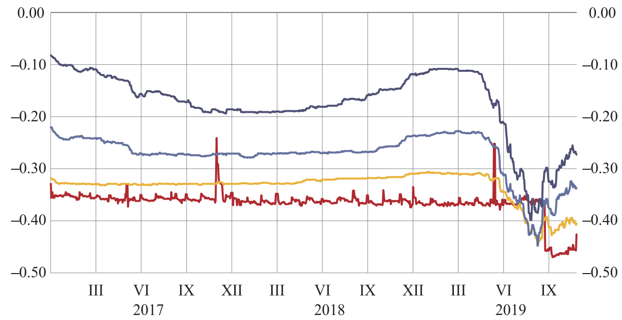


Chart 4

EURO MONEY MARKET RATES
(%)

EONIA
3-month EURIBOR
6-month EURIBOR
12-month EURIBOR



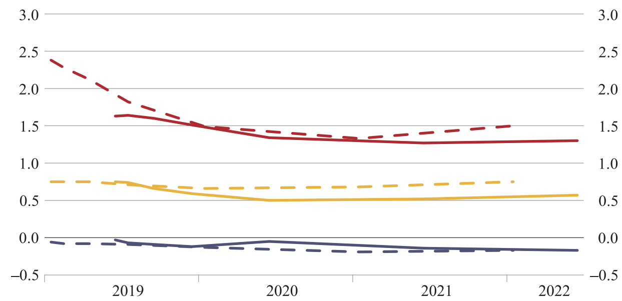
In each of the three meetings held from July to October, the Federal Open Market Committee of the FRS reduced the target range for the federal funds rate by 25 basis points (to 1.5%–1.75%). Making the last reduction at the end of October, the FRS also signalled that no further cuts can be expected in the near term. The Chair of the FRS Jerome Powell said that he believed that the full effects of the implemented rate adjustments on economic growth will be realised over time. In addition to that, he confirmed that investment is contracting, yet the labour market remains strong and household spending, which is the main driver of the US economy, continues to grow. Financial markets have taken a similar view and are currently not pricing in any new cuts of the target range for the federal funds rate in a foreseeable future.

There have been no changes in the monetary policy of the Bank of England since the beginning of summer and it is still taking a wait-and-see approach. At the November meeting, the Monetary Policy Committee pointed out that the economic growth has been weak, primarily reflecting Brexit-related uncertainties and weak external demand. Nevertheless, as a result of the Brexit extension successfully negotiated by Boris Johnson the risks of a no-deal Brexit have fallen. This has allowed the Bank of England to become more optimistic when projecting the results of 2020. Nevertheless, the Bank of England will be ready to respond should the reduced uncertainty fail to result in an improvement of economic indicators. Two out of nine members of the Monetary Policy Committee expressed their preference to a cut in the Bank Rate already at the November meeting.

Chart 5

MARKET IMPLIED CENTRAL BANK POLICY RATES
(%)

US (June 2019)
US (November 2019)
UK (June 2019)
UK (November 2019)
Japan (June 2019)
Japan (November 2019)



No changes have been introduced to the Bank of Japan's policy rates and asset purchase programmes since the beginning of June. Yet at its end of October meeting, the Bank of Japan announced changes to its forward guidance stating that it is ready to introduce further rate cuts. In addition to that, it was pointed out that the downside risks to economic activity and prices were mainly associated with trade disputes between major overseas economies. Should those downside risks materialise, the central bank will not hesitate to take additional easing measures.

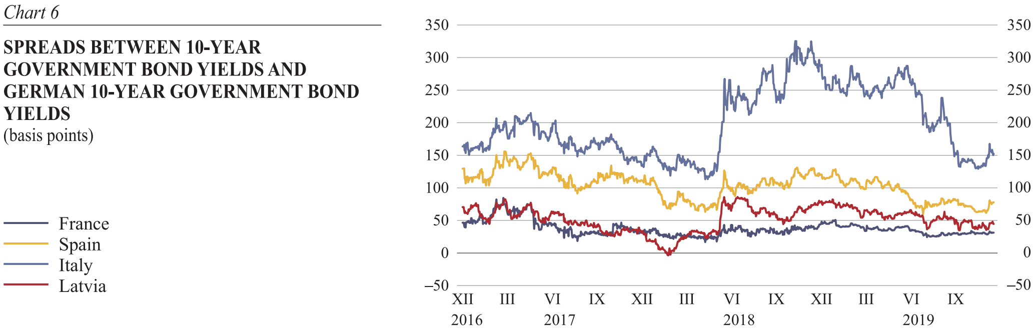
2.2 Global financial market developments

From the beginning of June to early September, sovereign bond yields in the advanced economies decreased. September was a volatile month for government bonds, yet already at the beginning of October, the US-China announcement of the imminent signing of Phase 1 trade deal triggered an upward movement in yields. Overall, the weighted average yield on German 10-year government bonds declined by 15 basis points from the beginning of summer to the end of November (to –0.37%), sinking as low as –0.70% just in the first days of September. The weighted average yield on comparable US Treasury bonds decreased by 35 basis points (to 1.74%), also falling considerably lower at the end of summer (to 1.49%). At the same time, the weighted average yield on UK government bonds declined by 9 basis points. The steep dive of the bond yields over the summer months was explained by the signals of further monetary easing coming from both the ECB and the FRS. Yet, following the announcement the ECB September policy package and the subsequent press publications revealing some internal opposition to the continuation of the APP, it now seems that most market participants consider the chances of continued monetary easing as limited. Deceleration of the US economy is also proceeding not as fast as projected by analysts. Moreover, the yields are increasing supported by the progress made in the US-China trade deal negotiations. Successful avoiding of a non-agreement Brexit also means less downward pressure on yields than at the beginning of September.

The weighted average yields on French, Italian, Spanish and Portuguese 10-year government bonds also fell by 26, 142, 30 and 40 basis points respectively. In the case of Italian government bonds, the decline can be explained by the resolution of the domestic political crisis in September, with one of the previous populist government parties involved in a heated debate with the EC about the acceptable size of its 2019 budget deficit being left outside the governing coalition. The yields on Spanish 10-year government bonds fell as a consequence of the international rating agency S&P Global upgrading the country's sovereign rating from A– to A, while in Portugal's case it was a result of the same agency revising the outlook on rating from stable to positive. The most impressive fall in sovereign bond yields was reported in Greece where the weighted average yield on 10 year government bonds declined by 147 basis points. A supporting factor was the fact that the centre-right party New Democracy of Greece gained majority at the national elections at the beginning of July and this party is considered more investor-friendly. Moreover, S&P Global raised Greece's sovereign credit rating from B+ to BB–. The spreads of other euro area government

Chart 6

SPREADS BETWEEN 10-YEAR GOVERNMENT BOND YIELDS AND GERMAN 10-YEAR GOVERNMENT BOND YIELDS
(basis points)



bonds vis-à-vis German government bonds narrowed in the reporting period, suggesting that investors believe that country-specific risks have declined.

Stock markets have been volatile since the beginning of June. This was mainly a result of the US-China trade negotiations and negative economic news that scared investors leading to temporary sell-offs. Stock markets were saved from an even stronger adjustment by changes in the monetary policy stances of the ECB and the FRS. US-China Phase 1 trade deal announced in early October, although still unsigned and in the process of being negotiated, in combination with further monetary easing measures adopted by central banks slightly cheered up the stock markets. US stock market index S&P 500 has increased by 14.6% since the beginning of June (by 7.3% since the beginning of October), reaching an all-time high. S&P 500 Banks index characterising the US banks rose most impressively growing by 22.1% since the beginning of summer, whereas Dow Jones Industrial Average increased by 13.5%. As regards bank stocks, the good trading results reflect recovery from the poor performance observed in spring when the derivatives markets just started to price in the FRS cuts of the target range for the federal funds rate. Another contributing factor were the incoming data revealing a slower-than-expected deceleration of the US economy. Moreover, the announcement made at the end of October that there would be no further cuts of the target range for the federal funds rate in the near term has made investors even more confident that bank stocks have previously been undervalued.

European stock markets have also been volatile in the period under review. Nevertheless, with minor adjustments, the euro area stock prices have been growing already since the mid-August. The euro area stock market index Euro Stoxx 50 has increased by 13.2% since June, while the STOXX Europe 600 index characterising Europe's overall market has picked up by 10.8%. The Euro Stoxx Banks index characterising the European banking sector has climbed 8.5%. The banking sector received support from the ECB through its introduction of a two-tier reserve remuneration system and improving the TLTRO III terms at the September meeting of the Governing Council. At the moment, it seems that the financial markets do not anticipate any further interest rate cuts from the ECB, yet the weak euro area growth prevents the stock prices from rising more substantially. At the same time, the UK stock market index FTSE 100 increased by 3.1% and the UK banking sector index FTSE 350 Banks declined by 2.4%. Although Brexit related risks have recently subsided, they continue to weigh on the UK stock market.

Japan's stock market index Japan Nikkei 225 has grown by 13.1% in the period under review, whereas the emerging markets stock index MSCI Emerging Markets has moved up by 5.3%. The future path of stock prices will mostly depend on geopolitical factors, i.e. finalisation of the announced US-China Phase 1 trade deal which has already been largely priced into derivatives. Moreover, the ultimate Brexit terms still remain unclear and this is likely to cause some renewed stress in financial markets when the exit deadline of 31 January draws nearer. Also in the absence of more robust corporate profit growth, the rise in stock prices will be unsustainable, and the former will depend on the global economic growth.

The exchange rate of the euro against the US dollar has decreased by 1.6% since the beginning of June (to 1.099 US dollars per euro). The euro's depreciation against the US dollar reflects deceleration of the euro area's economic growth which was stronger than expected. At the same time, despite slowing down, the US economy is still growing at a solid pace. Another factor contributing to the rise of the US dollar was the uncertainty surrounding the US-China trade arrangement, with investors giving preference to safer US dollar assets. Meanwhile, the mounting concerns over a no-deal Brexit had a downward effect on the exchange rate of the euro. Looking into the future, analysts believe that the euro is getting an upward pressure from the internal resistance within the ECB to additional monetary easing. Yet the FRS has also announced that no further cuts of the target range for the federal funds rate can be expected in the near term. The most recent positive news concerning the US-China trade negotiations and the declining probability of a disorderly Brexit are the factors supporting appreciation of the euro. That being said, the actual development will rather depend on whether the euro area economy has already reached the trough.

Chart 7

EURO EXCHANGE RATE AGAINST US DOLLAR AND FUTURE EXPECTATIONS

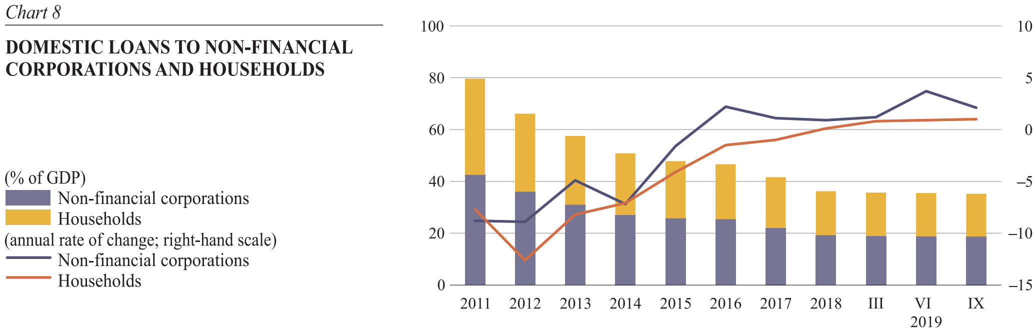
2.3 Conditions for financing the Latvian economy

Overall, so far Latvian credit institutions have failed to make full use of the advantages provided by the accommodative monetary policy pursued by the ECB. The effect of economic deceleration on the developments in monetary aggregates (annual rate of change of received deposits and granted loans) has so far been limited. Nevertheless, the external risks and the slowdown of growth will continue to weigh on lending, while caution in assessing the future prospects will stimulate accumulation of savings, with businesses and households increasing their current account deposits. The level of interest rates offered by credit institutions remained favourable for lending development. Monetary policy measures implemented by the ECB will ensure favourable development of lending conditions and support their improvement. At the same time, the lending conditions are increasingly more affected by the ability of credit institutions that were previously focussed on non-resident business to find a new niche.

At the moment, lending is not an economic growth-supporting factor yet. Financing is available and its costs are low, yet credit institutions are holding over 4 billion euro of their excess liquidity with the central bank instead of channelling into the real economy to improve economic competitiveness and stimulate domestic demand. Monthly developments in outstanding loans have been volatile and the annual rate of increase in the domestic loan portfolio remained low (1.9% in October, including 3.5% for loans to non-financial corporations and 0.8% for household loans). The amount of new loans was also unchanged. Loan-to-GDP ratio continued to shrink, with the ratio of loans to domestic non-financial corporations and households declining to 39.6% of GDP at the end of the third quarter of 2019 (41.6% of GDP at the end of the third quarter of 2018). Non-bank lending also decelerated: at the end of June 2019, the growth rates of non-bank loans to non-financial corporations and households were merely 2.2% and 11.9% respectively.

Chart 8

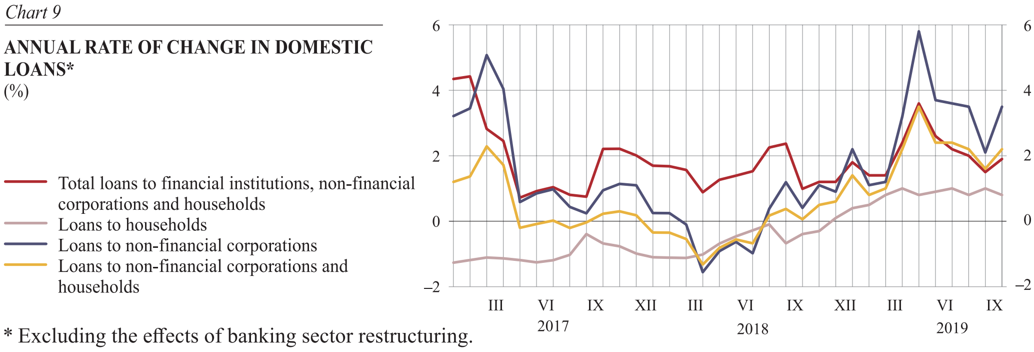
DOMESTIC LOANS TO NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS



From May to October, domestic loans to non-financial corporations and households overall increased by 1.1%, rising by 0.3% in the third quarter. Despite the sluggish growth rate, lending to households has been much more stable than lending to non-financial corporations. This was determined by the steadily growing household loans for house purchase (1.8% in annual terms; October was already the 15th consecutive month when an increase of this particular loan portfolio was reported, inter alia supported by the government's housing guarantees programme) as well as expanding consumer credit (3.0% in annual terms in October).

Chart 9

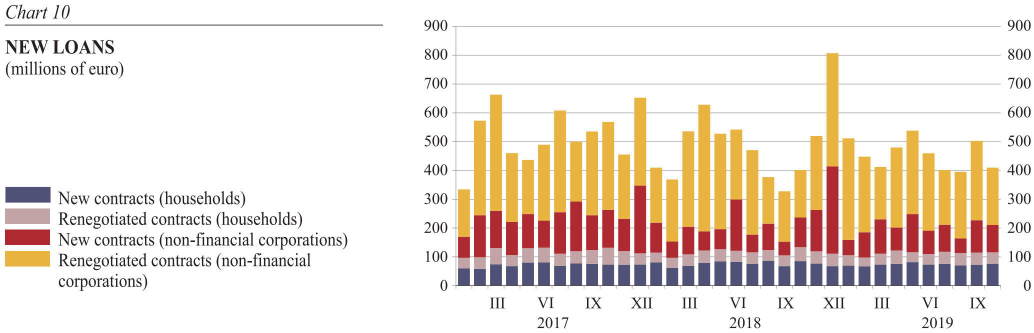
ANNUAL RATE OF CHANGE IN DOMESTIC LOANS*
(%)



* Excluding the effects of banking sector restructuring.

Chart 10

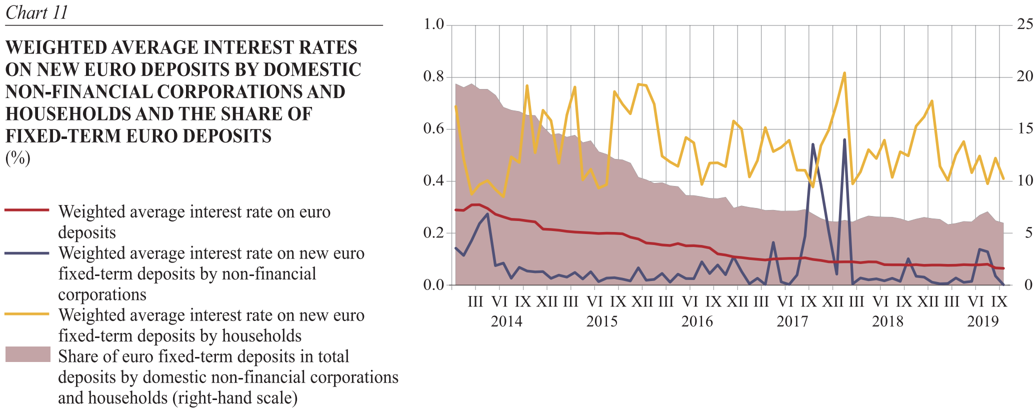
NEW LOANS
(millions of euro)



The financing costs of Latvia's credit institutions on the domestic deposit market remained broadly unchanged. Interest rates on domestic deposits, the main financing source of credit institutions, increasingly approached zero, yet remained positive. In October 2019, the interest rate on euro deposits of domestic non-financial corporations and households stood at 0.06% (0.08% in April 2019). Meanwhile, the interest rates on new fixed-term euro deposits by non-financial corporations and households were 0.00% and 0.4% respectively (0.03% and 0.5% in April 2019). Deposit rates could be potentially affected by the ECB's decision of 15 September 2019 to lower the deposit facility rate by 10 basis points (to –0.50%). Nevertheless, the effect of this decision is limited by the fact that Latvia's credit institutions are reluctant to apply negative rates on small deposits to prevent accumulation of cash

Chart 11

WEIGHTED AVERAGE INTEREST RATES ON NEW EURO DEPOSITS BY DOMESTIC NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS AND THE SHARE OF FIXED-TERM EURO DEPOSITS
(%)

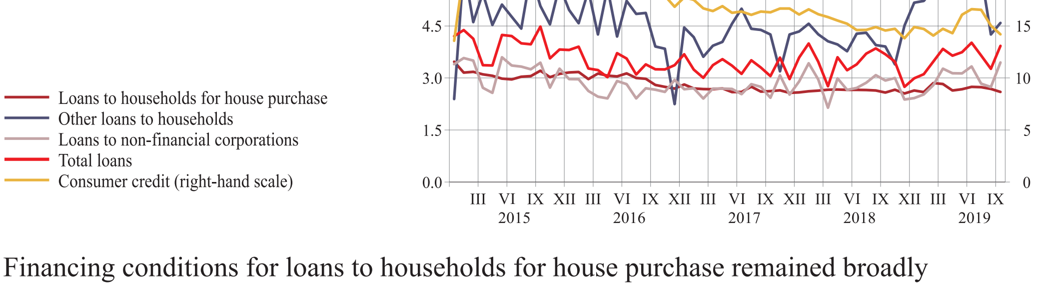


savings. The low level of deposit rates also enables Latvia's credit institutions to offer loans to domestic non-financial corporations and households on relatively more attractive terms. At the same time, lending is also influenced by factors like the lending policies pursued by particular credit institutions and their financial strength, costs of other sources of credit institution financing and borrowers' risk profile. As a consequence, Latvia as well as the other two Baltic states range among euro area countries with the highest average interest rates.

Availability of loans to non-financial corporations slightly deteriorated in the second quarter of 2019. In the third quarter, however, with the demand from non-financial corporations contracting as well as the ECB announcing further monetary easing, major Latvia's credit institutions overall reduced their lending rates to non-financial corporations. At the same time, credit institutions that were previously mostly focussed on non-resident business started to grant more loans to domestic non-financial corporations at higher interest rates. In their responses to the euro area bank lending survey covering major Latvia's credit institutions, a couple of credit institutions reported tightening of individual credit terms and conditions applied to loans to non-financial corporations in the second quarter of 2019 (one of them mentioned margins, whereas the other one referred to collateral requirements and other contract terms). At the same time, one of the four surveyed Latvia's credit institutions reported a slightly lower demand for large loans to non-financial corporations. Nevertheless, in the third quarter, already three respondent credit institutions reported lower demand for long-term loans to non-financial corporation, quoting lower need for long-term investment, deterioration of economic outlook and loans from other credit institutions as the underlying reasons. Demand for loans to non-financial corporations contracted at the time when the ECB announced several additional measures to stimulate the economy. Interest rate statistics show that the interest rate on new euro loans in four Latvia's credit institutions with the biggest portfolios of loans to non-financial corporations decreased by 0.2 percentage point (to 3.0%) in the period under review. Nevertheless, in the third quarter of 2019, several credit institutions that were previously focussed on non-resident business announced their intention to step up lending to domestic non-financial corporations. In other credit institutions, the interest rate on new euro loans to non-financial corporations rose by 1.0 percentage point (to 3.9%) in the period under review, with the share of those loans in total new business also increasing. Availability of financing to non-financial corporations in Latvia is dependent on their risk scores, and the proportion of risky loans in new loans has a significant effect on the weighted average interest rates on loans to non-financial corporations. In the next reporting period, the interest rates on loans to non-financial corporations will be affected by the following counteracting factors: on the one hand, the continued transmission of further monetary easing implemented by the ECB; on the other hand, riskier non-financial corporations will find it easier to draw more expensive financing from specialised credit institutions.

Chart 12

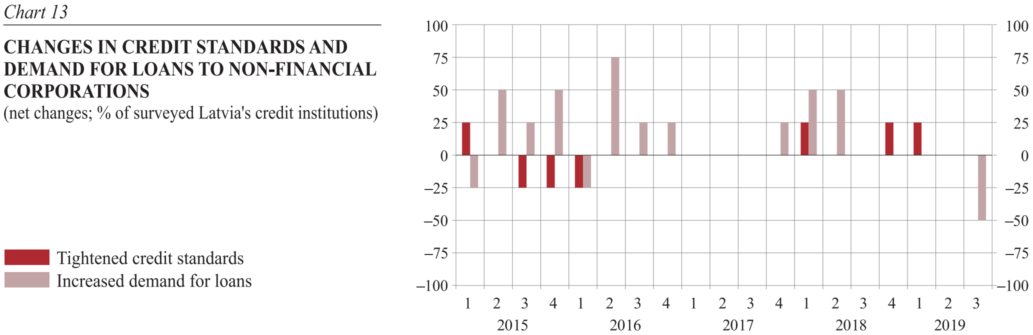
INTEREST RATES ON NEW MFI LOANS BY TYPE OF LOAN
(%)



Financing conditions for loans to households for house purchase remained broadly unchanged in the reporting period. The monetary policy measures implemented by the ECB supported a decline in interest rates. Because of competition, credit institutions had limited possibilities of somewhat tightening individual credit terms and conditions, without risking a significant decrease in granted loans. At the same time, a higher demand resulting from an improvement in consumer sentiment facilitated an easing of terms and conditions. Overall, the weighted average interest rate on new loans to households for house purchase decreased by 0.2 percentage point in the period under review (2.6% in October 2019). The ECB's monetary policy will continue to support a further decline in interest rates on loans to households for house purchase also over the next six months: one of the four Latvia's credit institutions participating in the euro area bank lending survey pointed out that the negative deposit facility rate will support a decrease in interest rates on loans to households for house purchase in the fourth quarter of 2019 and first quarter of 2020. At the same time, balance sheet constraints and cost of funds will continue to have an upward effect on the respective rates in individual credit institutions. Overall, interest rates on loans to households are likely to remain broadly unchanged or somewhat decrease, while divergent interest rate development across credit institutions will result in a gradual change of the market shares of those institutions in the segment of loans to households for house purchase.

Chart 13

CHANGES IN CREDIT STANDARDS AND DEMAND FOR LOANS TO NON-FINANCIAL CORPORATIONS
(net changes; % of surveyed Latvia's credit institutions)



Cost of funds for consumer credit to households decreased in the period under review. Many credit institutions tried applying different pricing models for consumer credit: e.g. increased the agreed rate instead of charging large commissions on consumer credit. Thus the agreed rate on consumer credit declined at a slower pace than the actual percentage rate of charge. The agreed rate on new consumer credit in euro contracted from 14.7% in April 2019 to 14.2% in October 2019, and the actual percentage rate of charge also decreased from 18.7% in April 2019 to 16.1% in October 2019. The agreed rate on other new euro loans to households also went down from 5.4% in April 2019 to 4.6% in October 2019. This decline of interest rates in the consumer credit segment was primarily supported by consumers giving preference to credit institutions offering lower rates. Although non-bank competition has decreased following the coming to effect of amendments to the Consumer Rights Protection Law as of July 2019, competition among credit institutions remains strong. In the previous quarters, credit institutions reported also some tightening of credit standards for consumer credit and other lending to households, thereby limiting the risks associated with those loans and supporting a decrease in interest rates. In the case of other lending to households, government guarantees to study loans also have a downward effect on interest rates.

Economic deceleration and higher uncertainty surrounding the future prospects continue to stimulate an increase in deposits by non-financial corporations in credit institution accounts. At the same time, with the labour market conditions remaining favourable, household deposits have also grown quite steadily. At the end of October, the annual growth rate of domestic deposits was 10.3%, with household deposits and deposits by non-financial corporations increasing by 7.5% and 14.4% respectively. Domestic deposits have been exceeding the size of the loan portfolio for almost a year already; therefore, credit institutions do not need to resort to the money market or foreign financing. This has allowed credit institutions to reduce liabilities to foreign credit institutions by 8.7% from May to October 2019. At the same time, non-resident deposits have also contracted by 6.8%. The share of non-resident deposits in total deposits had decreased to 16.8% at the end of October (20.0% in the same period of the previous year).

Overall, the monetary policy measures implemented by the ECB in combination with other factors have had a downward effect on interest rates in the period under review. Hence, the lending conditions have become more favourable. Moreover, some further minor decreases in deposit and lending rates are likely in the coming months. Provided that there will be no further expansionary policy measures implemented, given time, some factors with an upward effect on interest rate developments could reemerge. For the economy to develop in the circumstances of a shrinking external demand and decelerating growth, availability of credit institution loans for making productive investment and financing current assets to support shorter-term cash flows would be quite important. Availability of loans house purchase and consumer credit is also important in the context of stimulating the domestic demand. However, with the risk appetite of credit institutions decreasing and businesses becoming increasingly more cautious to resort to external sources of financing, the impact of upward factors will be insufficient to underpin dynamic lending development in the near term. Considering the uncertainties currently surrounding the global economic outlook, this is understandable and, although the credit cycle is presently in an expansionary phase, significant changes in lending are quite unlikely in the coming months.

Chart 14

ANNUAL RATE OF CHANGE IN DOMESTIC DEPOSITS
(%)

Total deposits by financial institutions, non-financial corporations and households
Deposits by financial institutions and non-financial corporations
Deposits by households
Deposits by non-financial corporations

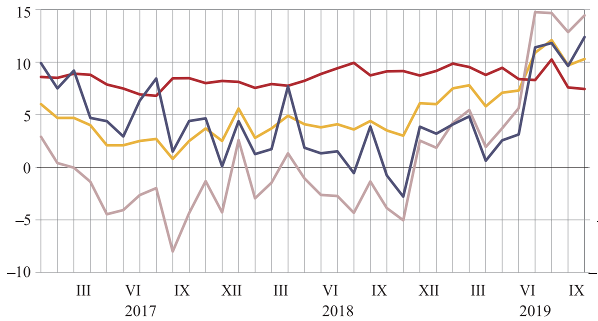
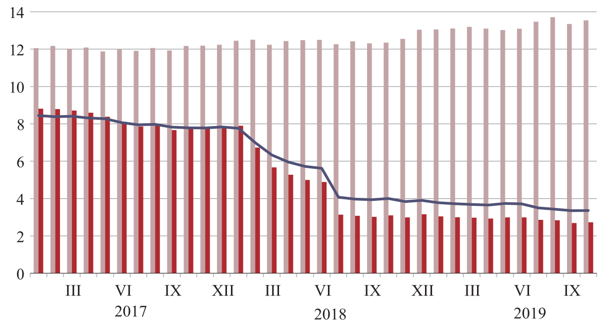


Chart 15

DOMESTIC DEPOSITS AND FOREIGN CUSTOMER DEPOSITS WITH MFIs
(billions of euro)

Domestic deposits
Foreign customer deposits
Share of foreign customer deposits in total deposits (%; right-hand scale)



The international rating agency S&P Global affirmed Latvia's 'A' credit rating with a stable outlook. The international rating agency Fitch Ratings affirmed Latvia's long-term local currency and foreign currency issuer default rating at 'A–' with a stable outlook. Meanwhile, at the beginning of December, Japanese rating agency R&I upgraded Latvia's credit rating from 'A–' to 'A', preserving a stable outlook.

In the period from June to November 1029, the Treasury of the Republic of Latvia launched nine 5-year bond issues on the domestic securities market. Supply totalled 250.4 million euro, whereas the bids amounted to 835.4 million euro. The average interest rate at the auctions declined from 0.15% in June to 0.08% at the last auction of November, and in the period from August to October, for the first time in the history of 5-year bonds in Latvia, it was even negative. Previously, only 3-year bonds used to have negative interest rates on the primary market. As the average interest rates at the actions decreased and remained negative for several months, credit institutions reduced their bids at competitive auctions: while in June the bid-cover ratio was 7.2, at the last auction of November it was only 1.8.

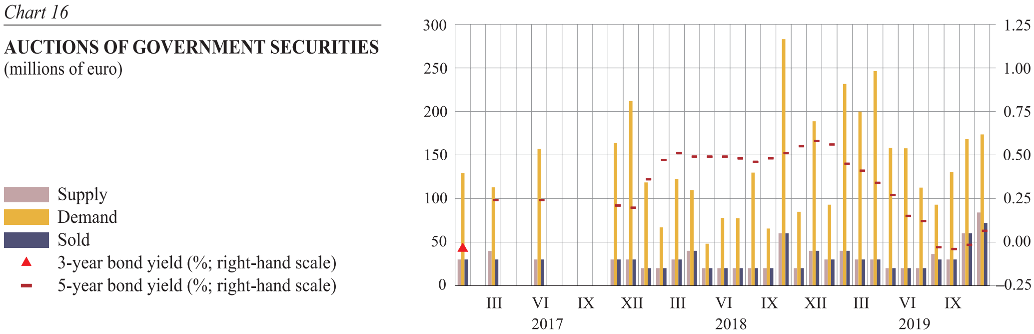
On the secondary market, the yield on Latvian government bonds with a residual maturity of 9 years decreased from 0.42% at the end of May 2019 to 0.13% at the end of November 2019, whereas the spread over the same maturity German government bonds narrowed from 73 basis points to 55 basis points. The narrowing of the spread was determined by the fact that the yields on German government bonds rose in autumn as a result of decreasing Brexit uncertainties and trade wars, whereas the reaction of the yields on Latvian government bonds to those developments was less significant, as the investors' risk appetite increased.

At the end of November, Latvia's share price index OMXR was 0.6% lower than at the end of May, while the Baltic share price index OMXBBGI grew by 3.7% over the same period. Overall, the latest corporate results pointing to deceleration of Latvia's economic growth and a more cautious assessment of the future had a downward effect on Latvia's share price index. The fall of AS VALMIERAS STIKLA ŠĶIEDRA and AS GROBIŅA share prices (by 51.2% and 86.6% respectively) was the most impressive as a workout procedure was started against the former, while the latter was rendered insolvent. The share price of AS Latvijas Gāze, the largest company in terms of capitalisation, also decreased by 6.3%. The highest turnover was reported for the shares of AS Olainfarm: 7.7 million euro or 65.9% of the total share turnover at Riga Stock Exchange AS Nasdaq Riga.

On 24 July, AS Air Baltic Corporation issued 5-year bonds in the amount of 200 million euro at an interest rate of 6.75%. The airline's bonds were purchased by more than 100 investors from 25 countries, with bids exceeding the supply. The bonds of AS Air Baltic Corporation are listed on Euronext Dublin. Only those European airlines that subsequently wound up their business or underwent restructuring have borrowed at higher interest rates. Nevertheless, positive news is that this is the largest corporate bond issue in Latvia and AS Air Baltic Corporation is the first airline in Central Europe and Eastern Europe that has launched euro-denominated securities in international market.

Chart 16

AUCTIONS OF GOVERNMENT SECURITIES
(millions of euro)



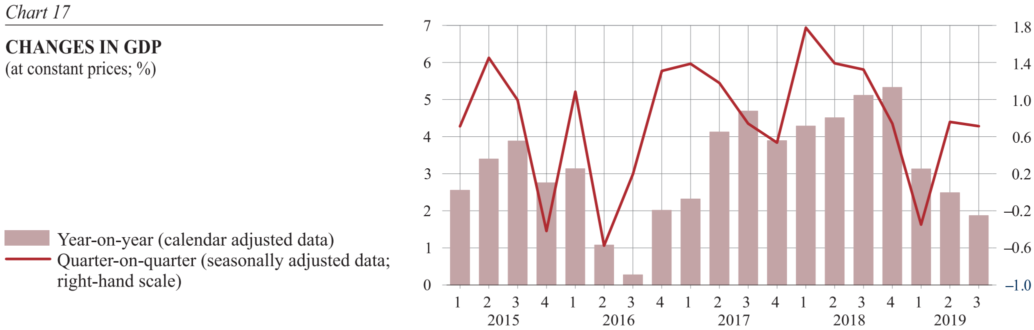
3. Sectoral Development[1]

Following a decline at the beginning of the year, in the last two quarters the economic growth rate levelled out again and stabilised at a level below the previous years' average. However, it should be noted that growth is currently partly supported by temporary factors such as good grain harvest and an increase in energy production from a low level.

In the second and third quarters of 2019, Latvia's GDP grew by 0.8% and 0.7% respectively. Due to revisions to the national account time series made by the CSB, the annual GDP growth rate of each quarter of 2019 has been assessed lower than previously estimated, thus negatively affecting the GDP growth forecast for 2019.

Chart 17

CHANGES IN GDP
(at constant prices; %)



3.1 Manufacturing and energy

The weakening of external demand continues to weigh on the performance of manufacturing, and the competition for export markets is becoming increasingly tougher. Furthermore, the domestic demand growth is also decelerating. On a quarterly basis, the dynamics was rather volatile. Overall, however, growth of value added in manufacturing moderated. In view of an output contraction in the wood industry, the largest manufacturing subsector, and forecasts of further decline as well as a deterioration in the assessment of export orders observed in the past few months, at the end of 2019 and the beginning of 2020 growth indicators are expected to be weaker than projected.

After a stable performance in the first quarter of 2019, the sector's value added declined significantly in the second quarter of the year. Nonetheless, in the third quarter of 2019 the manufacturing sector saw relatively positive results recording increases of 0.8% and 2.3% quarter-on-quarter and year-on-year respectively.

While the decline in the wood industry output was expected, the fall in wood prices was amplified by new developments. Forests in Europe, Germany and Czechia in particular, suffered significant damage from insect infestation necessitating large-scale logging. As a result, the supply of wood surged pushing down the prices even more than before. Previously, wood prices were already negatively affected by factors such as the previous year's strong winds, a fall in demand from the Scandinavian countries, dumping prices in the plywood production segment due to exceedingly high production capacity, etc. The forest area damaged by insect infestation also expanded significantly in Latvia. Unfortunately, industry experts project even weaker results for the wood and logging sectors in the fourth quarter. It should be noted though that this cannot be said about all wood processing sectors as the conditions vary from sector to sector. For instance, producers creating products with higher value added can use much cheaper raw materials and thereby improve their corporate profitability. Segments that used to be less profitable and were limited in their capacity to purchase wood for higher prices, e.g. manufacturing of wood pellets, are now also better

[1] This chapter analyses GDP and sectoral value added at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

off. Since raw materials are currently cheaper and more available, the production volume of these products has increased. This is confirmed by the record-high volume of wood pellets handled at the Port of Riga. According to the data provided by the Port of Riga, the volume of wood pellets shipped from the port over the first nine months of 2019 exceeded that of the previous year's respective period by 50%.

Other manufacturing subsectors reported different output dynamics. Food production, the second largest subsector, even stagnated, and the sizeable investment made in recent years has not yet resulted in more dynamic growth. Meanwhile, the performance of technologically advanced sectors (electronic and electrical equipment and other machinery and equipment) and manufacture of metal products has remained solid. According to the EC data, however, business sentiment indicators for October point to some deterioration in the assessment of export orders in these sectors, thus suggesting slower growth in the near future.

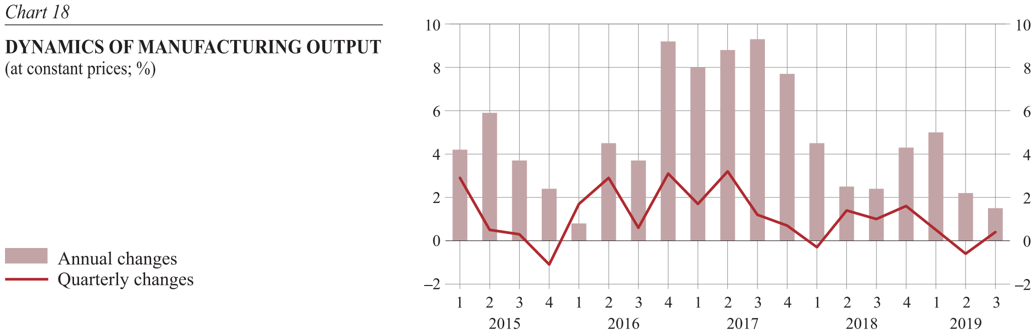
The assessment of capacity utilisation suggests corresponding trends in the sectoral output dynamics. The sectors experiencing output declines or stagnation report lower capacity utilisation (these include wood processing, manufacture of pharmaceutical products, manufacture of building materials, manufacture of textiles), while the capacity utilisation of metal-based manufacturing industry and high-performance industries continues to increase (October forecast for the fourth quarter). The only exception to the above dynamics is the pharmaceutical sector which has seen a significant decline in its capacity utilisation. Nonetheless, the performance of AS Olainfarm and AS GRINDEKS, the largest pharmaceutical companies, cannot be assessed as poor.

With the volume of electricity generated in cogeneration increasing significantly, in the third quarter of 2019 the energy, mining and water supply sectors performed much better than at the beginning of the year. According to the Nord Pool Spot data, in October and November the annual increase in the volume of generated electricity remained strong and provided overall support for the sector's development in the fourth quarter.

The legislative amendments on the establishment of the single Baltic-Finish natural gas market, put forward as a matter of urgency, have been adopted. If the regional natural gas market becomes successfully operational in the near future, it might allow better use of the storage and management infrastructure and facilitate a gradual increase in the turnover of Latvian businesses trading in natural gas already in 2020.

Chart 18

DYNAMICS OF MANUFACTURING OUTPUT
(at constant prices; %)



3.2 Construction and the real estate sector

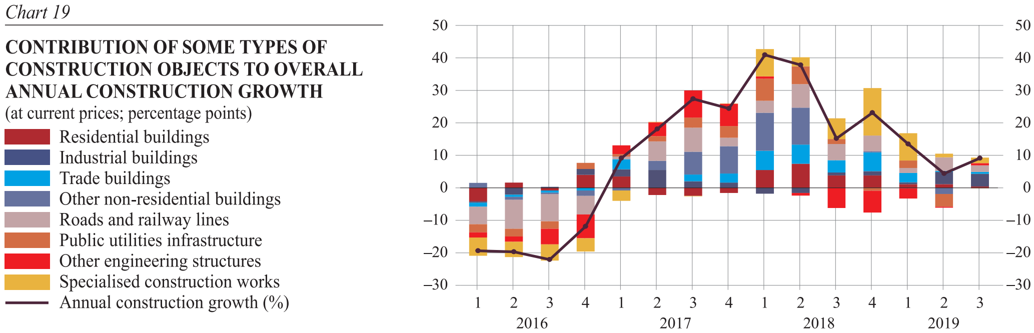
The construction sector has lost its growth momentum. In the third quarter of 2019, the value added of the construction sector grew by 2.6% quarter-on-quarter, while the year-on-year increase remained strong (6.3%) and covered almost all subsectors of construction. The sector's growth momentum was already expected to decline taking account of weaker investment activity and the achieved maximum absorption of EU funds, developments which do not provide additional stimulus for investment and construction. In the third quarter of

2019, the construction output declined by 0.6% quarter-on-quarter: while the output of the construction of buildings shrank by 10.4%, that of the civil engineering and specialised construction activities grew by 2.4% and 1.7% respectively. The growth momentum of the construction sector slowed down notably as compared to the corresponding periods of the previous two years, posting 6.3% growth in the third quarter of 2019. In addition, the above increase was recorded based on a decline observed in the third quarter of the previous year, i.e. due to the low base.

The annual increase in the real volume of construction works, which exceeded the rise in construction costs, was more important for the construction sector growth in the third quarter of 2019. Along with decelerating annual growth rates of wages and salaries and maintenance costs of machinery and mechanical appliances, the annual rate of increase in the overall construction costs continued declining for the third consecutive quarter. The collective agreement on the minimum wage in the construction sector took effect on 3 November 2019. According to the agreement, the minimum wage in the sector is set at 780 euro. Thus, given that a significant share (approximately half) of workers in the construction sector will have their wages raised, the increase in construction costs might accelerate again at the end of the year.

Chart 19

CONTRIBUTION OF SOME TYPES OF CONSTRUCTION OBJECTS TO OVERALL ANNUAL CONSTRUCTION GROWTH
(at current prices; percentage points)



Amid moderating global economic growth, persisting external uncertainties and weakening investment activity, the sentiment of construction contractors, which has been increasingly negatively affected by insufficient demand, has deteriorated further since March. The achieved maximum absorption of EU funds suggests that the public sector is not expected to provide any additional stimulus to the construction sector. Nonetheless, the rising number of building permits gives reason to believe that private sector demand for construction services has remained sufficiently strong. The activity observed in the segments of apartments, private houses and commercial real estate as well as the growing number of building permits in almost all segments (residential buildings, industrial production premises, etc.) gives us hope that the growth in the construction sector will continue, albeit at a much slower pace than in the previous two years. Growth of Latvia's construction sector is driven by individual large projects. Therefore, future projects such as Rail Baltica and significant road infrastructure projects, are particularly important for the sector's overall outlook. The construction plans for Rail Baltica station building at VAS STARPTAUTISKĀ LIDOSTA "RĪGA" as well as for the related infrastructure and the ramp were completed at the end of 2019 in preparation for the construction works scheduled to start at the beginning of 2021.

The real estate market has seen moderate development. This is confirmed both by the activity observed in various real estate market segments (such as the segments of standard apartments and premium real estate) and the volume of transactions in Latvia's regions. In the third quarter of 2019, the value added of the real estate sector increased by 3.7% quarter-on-quarter and by 3.0% year-on-year. The market for standard apartments remains the most active real estate market segment accounting for approximately 80% of all transactions. However, with the supply of new projects gradually growing, the share of transactions with standard apartments is shrinking. The real estate market development in the category of residential buildings is steady, and the demand for new housing continues rising. In the segment of standard apartments, buyers still prefer two- and three-room apartments. The prices of standard apartments have stabilised over the last few months, with the average price per square meter fluctuating around 820 euro in August and September. In the first nine months of 2019, standard apartment prices increased approximately by 3% overall. Latvian cities, including Riga, are facing a large shortage of rental apartments since their supply is much lower than demand. The rental market development is dampened by the slow progress in the new draft Law on Residential Tenancy.

In the first 10 months of 2019, the number of the real estate purchases registered with the Land Register increased by 1.7% in Latvia overall and by 6.5% in Riga. With the implementation of several reforms facilitating the sector's productivity, the structural reorganisation of the construction sector continues. As from 1 January 2020, any new construction projects will be launched via the Construction Information System (BIS). The electronic system for work time tracking introduced in the construction sector ensures the electronic recording and tracking of the time worked on a building site by every worker as well as the storage of such data on the single database of electronic work time tracking. The system might help reducing the shadow economy in the sector.

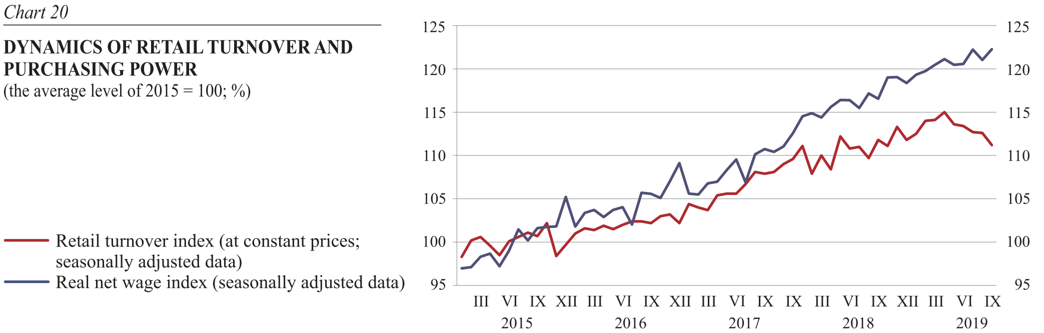
3.3 Trade

In the third quarter of 2019, the dynamics of the trade sector significantly improved on account of the wholesale of agricultural products. As a result, the sector recorded increases of 0.4% and 5.5% quarter-on-quarter and year-on-year respectively. Retail trade growth rate has decelerated already since the beginning of the year, with the third quarter recording 1.6% decline quarter-on-quarter and only 1.1% increase year-on-year. The annual growth rate of retail trade was already expected to decline in September (e.g. on account of the fading effect of the opening of the IKEA store in Riga); however, data suggest a fall in the volume of sales both in monthly and annual terms, with a similar trend observed in October. The contribution from trade of housing improvement and renovation-related goods to the overall retail trade growth has declined over the last few months, which could point to cautious spending behaviour. At the moment, sentiment indicators do not suggest a stable trend. In October, most sentiment indicators deteriorated, with the exception of the consumer sentiment indicator which remained stable; however, an opposite trend was already observed in November. The high savings ratio could stabilise the private consumption if the revival of external demand turned out to be weaker than currently projected.

The trade sector is currently supported by favourable short-term factors. The impact of the new logistics centres, i.e. Lidl and Rimi, is more likely to be reflected in the performance of the transportation and storage sectors rather than in that of the trade sector since the competition in retail trade remains fierce.

Chart 20

DYNAMICS OF RETAIL TURNOVER AND PURCHASING POWER
(the average level of 2015 = 100; %)



3.4 Transport

As already projected, the performance of the transport sector remained weak also in the second half of 2019, with the sector's value added decreasing by 4.7% in the third quarter. The volume of cargoes loaded and unloaded at the largest Latvian ports as well as the volume of freight transport by rail and road continued contracting in the third quarter of 2019. Although air transport is still witnessing positive development, the balance of payments data point to some moderation in the expansion of transport services exports.

In the third quarter of 2019, the volume of cargoes loaded and unloaded at Latvian ports declined by 8.6% year-on-year owing to lower volumes of handled coal and general cargoes. The volume of wood loaded and unloaded at ports has also shrunk. The volume of bulk cargoes handled at the Port of Riga contracted most notably due to the diversion of coal cargoes to Russia's ports. Moreover, the contribution of containerised and oil product cargo volumes was also negative. The cargo volume at the Port of Liepāja stopped declining in the third quarter. As expected, the decrease in the coal and general cargo volumes was offset by a rise in the volume of grain cargoes at the beginning of the new harvest season. Meanwhile, the cargo volume growth observed so far at the Port of Ventspils moderated in the second half of the year as the flow of coal cargoes was redirected to the Port of Riga. The volume of oil product cargoes at Lativan ports continued on a long-established downward trend. Although the third quarter saw some improvement, there are currently no compelling reasons to believe that this trend will persist.

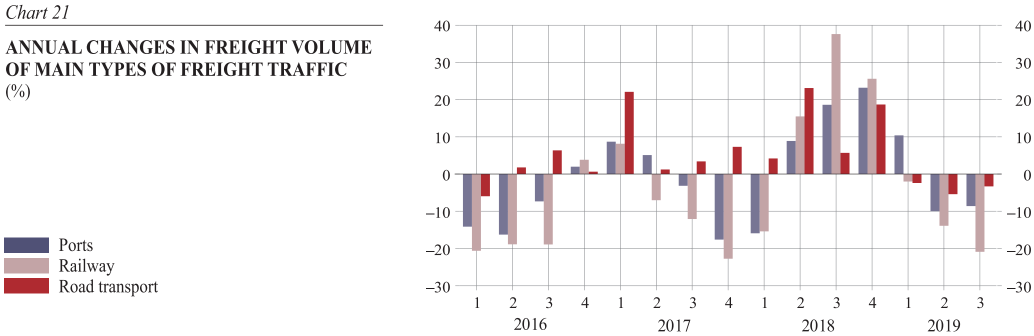
The development of the land transport sector also continues to be negative. In the third quarter of 2019, the fall in the volume of freight transported by rail and road accelerated. With the international freight transportation services still contracting, in the third quarter the volumes of freight by rail and road declined by 20.9% and 10.7% year-on-year respectively. Sector representatives continue raising the issue of the negative impact of the Mobility Package on the competitiveness of Latvia's road freight transport sector. In this context, tripartite negotiations are currently held to reach an agreement on the Mobility Package conditions.

In the third quarter, the number of passengers transported by air continued to rise and recorded a 12.6% year-on-year increase. With a new airline, Lauda Airlines, entering Latvia's market and other airlines increasing their destinations, the number of flights also keeps rising. Despite the fact that freight transportation by air has been negatively affected by external environment in Europe, the sector has seen some improvement. Furthermore, the construction of a cargo platform is expected to be completed in the near future, and this will allow VAS STARPTAUTISKĀ LIDOSTA "RĪGA" to double its freight-handling capacity. Upon signing an agreement with DHL Latvia SIA, a project was launched to construct a modern freight-handling and logistics centre.

The latest data suggest that, with foreign demand declining, the performance of the transport sector will most likely remain weak in 2020, thus negatively affecting the GDP.

Chart 21

ANNUAL CHANGES IN FREIGHT VOLUME OF MAIN TYPES OF FREIGHT TRAFFIC
(%)



4. GDP Analysis from the Demand Side[1]

4.1 Domestic demand

While domestic demand is becoming ever more important for GDP growth, its rate of increase has decelerated considerably as compared to the previous year, with the weakening of external demand also increasingly affecting domestic economic decisions. Both final consumption and investment growth rates fall, thus confirming the growing cautiousness of investors and the public.

Private consumption, accounting for a significant share in the nominal GDP (59%) and recording rapid growth, ensured the largest contribution to GDP growth in 2019. In the third quarter of 2019, GDP increased by 1.3% and 4.3% quarter-on-quarter and year-on-year respectively. Consumer sentiment remained rather positive, although some moderation in consumption and trade growth vis-à-vis the real wage bill observed already earlier suggested the accumulation of precautionary savings. With the rise in real net wages moderating, employment indicators taking a downward trend and the future outlook declining, income growth is decelerating more rapidly.

A sharp drop in the investment growth rate was observed already before, with its annual rate of increase declining more than two times year-on-year. In the third quarter of 2019, the quarterly and annual rates of investment growth stood at 1.6% and 5.2% respectively. Investment growth is primarily driven by government investment. Meanwhile, interest of private investors has lessened considerably: although investment in machinery is still on the rise, other segments report a rapid decline in private investment.

At the end of the third quarter of 2019, government expenditure grew by 5.7% year-on-year to stand at 7.9 billion euro. As previously, increases were recorded for all types of expenditure, except interest payments for government debt servicing. Expenditure on wages and salaries and contributions to the EU budget grew the most. The tendency observed in the previous months suggests some moderation in the government expenditure growth. However, it is expected to accelerate due to the pension indexation performed in October.

Expenditure items characterising government consumption have recorded trends similar to the overall expenditure development: the rise in compensation has declined since the beginning of the year and, in recent months, has stabilised at 7.3%. The decline in the growth momentum can mainly be explained by the disbursement of service pensions for special rank officials at the beginning of the year as well as by lower wage growth in municipalities. Furthermore, in the first nine months of 2019 the government expenditure on goods and services only grew by 0.1% year-on-year. At the same time, it should be noted that this development was no surprise: any changes in the current year's defence needs are reflected in the specific nature of purchases and, thus, an increasingly larger share of defence expenditure is channelled into capital expenditure or investment. Since the beginning of the year, expenditure on social benefits (almost one third of the total budget expenditure) has expanded by 5.9%. The increase was driven by a rise in the average wage subject to social insurance contributions. It should be noted, however, that in the first nine months of 2019 expenditure on sickness benefits picked up by as much as 25.1 million euro or 20.5% year-on-year. Following the pension indexation which was performed at the beginning of October and involved the application of the highest pension index in recent years as well as the indexation of pension supplements for years of insurance, expenditure on social benefits is expected to have risen more notably at the end of the year. According to the estimates of the Ministry of Welfare, the average pension rose approximately by 6% in 2019.

[1] This chapter analyses GDP and demand components at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

Government investment growth has moderated since the beginning of the year, recording a 12.0% increase in the first nine months of 2019. The gradual moderation of growth can be explained by significant capital expenditure on defence at the beginning of the year as well as by the restrictions on municipal debt for the purposes of implementing investment projects.

Chart 22

CONTRIBUTION TO ANNUAL CHANGES IN GDP
(demand side; percentage points)

Imports of goods and services
Exports of goods and services
Changes in inventories
Public consumption
Gross fixed capital formation
Private consumption
Annual changes in GDP (%)

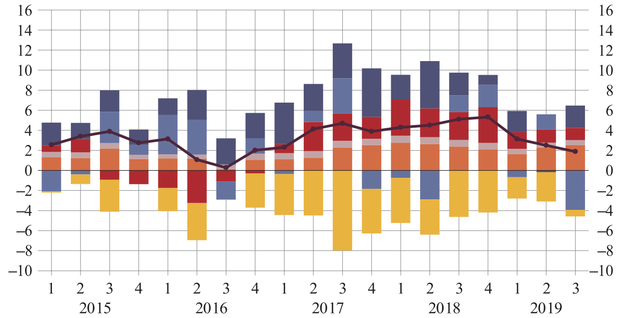


Chart 23

INDICATORS CHARACTERISING CONSUMPTION
(2015 = 100; consumer confidence; net responses; %)

Private consumption
Retail trade turnover
Consumer confidence (right-hand scale)

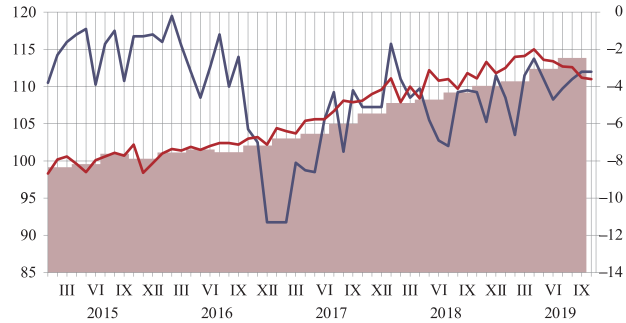


Chart 24

CONSUMER CONFIDENCE AND UNDERLYING FACTORS
(net responses; percentage points)

Financial position of a household in the next 12 months
Financial position of a household in the previous 12 months
Economy's outlook for the next 12 months
Large purchases planned for the next 12 months
Consumer confidence

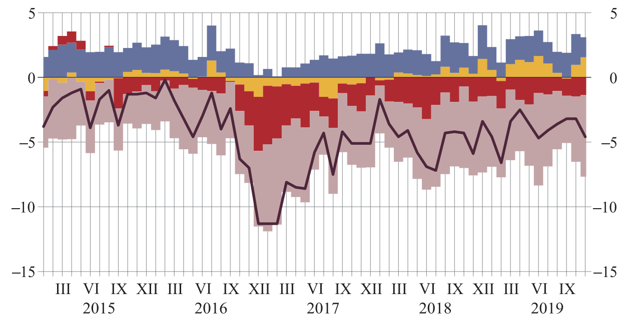
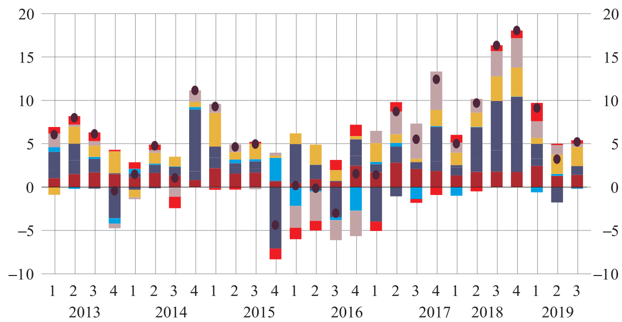


Chart 25

RATE OF CHANGE IN GENERAL GOVERNMENT CONSOLIDATED BUDGET EXPENDITURE AND CONTRIBUTION OF SELECTED ITEMS
(year-on-year; %)

Compensation
Goods and services
Subsidies and grants
Social benefits
Capital expenditure
Other expenditure
Interest expense
Total



According to forecasts, the general government budget deficit is expected to stand at 0.7% of GDP in 2019. The forecast was left unchanged in comparison with that of June. At the same time, it was revised downwards by 0.1 percentage point as compared to the September forecast ensuring more accurate forecasts for the government consumption and expenditure on social benefits and accounting for higher personal income tax revenue. The general government budget deficit is also expected to stand at 0.7% of GDP in 2020 – unchanged from the June forecast and lower than the September forecast (0.9% of GDP). Changes are largely reflecting a slowdown in the projected growth rate of municipal expenditure on wages and salaries and intermediate consumption, as municipalities plan to receive less grants than expected earlier. In addition, following the buoyant economic growth observed over the last few years, government investment growth is expected to moderate.

4.2 Trade balance

External uncertainty and weakening external demand are reflected in lower growth rates of exports and imports significantly affecting foreign trade in goods, while trade in services is more resilient. Unfortunately, uncertainty in the external markets remains; hence, competition for export markets is becoming tougher. At the same time, the import growth rate is also expected to decelerate due to declines in consumption, investment and external demand.

Various recent developments with respect to the potential resolution of the US-China trade disputes and Brexit continue to suggest high uncertainty in the global economy and necessitate the revision of the growth and trade forecasts for Latvia's major trade partners. At the same time, many Latvian businesses see these challenges as opportunities. Being niche players, Latvian businesses are more flexible when changing export markets and adapting their output. Moreover, they are used to working in difficult conditions and therefore they have certain competitive advantages.

In January–September 2019, nominal exports of goods stagnated recording a 0.6% year-on-year decrease. This was on account of declines in the value of exports of individual groups of goods associated with re-exports (mechanisms and base metals) and in the value of exports of wood observed over the last few months. Re-exports of mechanisms to the US shrank significantly. This is related to the aircraft engines exported and imported for repair purposes in the previous year. Meanwhile, countries importing goods of lower value saw a decline in re-exports of metals. The value of exports of wood decreased due to several factors such as wood price adjustments and weaker external demand, including that from the UK where, after the provisioning effect observed in the first half of the year, the value of wood imported from Latvia has declined over the last few months. So far, exports of agricultural products, cereals in particular, have seen positive growth since the favourable weather conditions observed at the beginning of the year facilitated good harvest, thus making it possible to increase the value of exports.

In January–September 2019, the value of services exports grew by 6.8% year-on-year, slightly faster than in the first two quarters of 2019. However, individual groups of services show significant differences. Looking at transport services exports, the export value of sea and rail transportation services shrank as expected. Over the past few months, however, the decline has been offset by faster expansion in exports of road transportation services (while the freight turnover saw no substantial improvement, exports of road transportation services expanded on account of higher prices) and air transportation services. Despite the prolonged period of tight labour market conditions with regard to the respective professionals, exports of information and communication services continue recording annual growth of more than 10%; however, the value of telecommunication services exports has declined over the past few months. Exports of business services also continued on a steep upward trend posting a 32.1% increase in the first 11 months of 2019. In this group of services, advertising and trade-related services recorded the fastest growth in the value of exports.

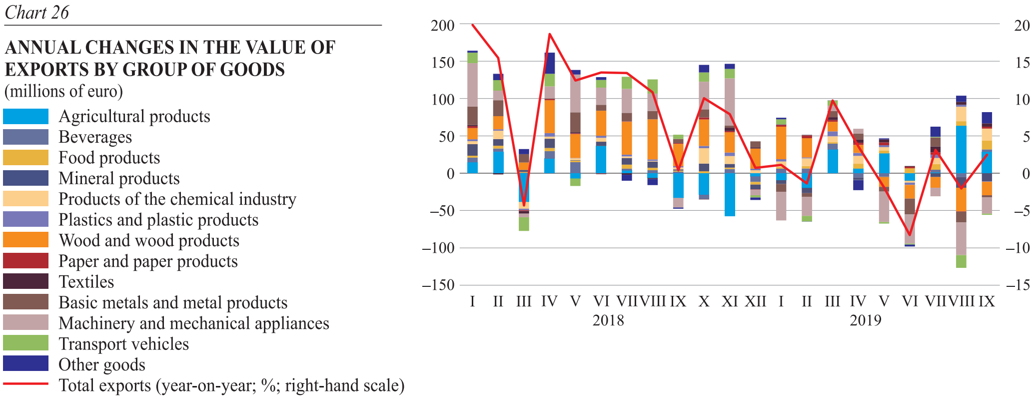
Overall, in the third quarter of 2019 real exports of goods and services grew by 2.1% quarter-on-quarter and 3.6% year-on-year. Meanwhile, imports of goods and services increased by 0.4% and 1.0% respectively. The structure of imports of goods shows trends similar to the dynamics of GDP expenditure, recording a more pronounced decline in the volume of capital and intermediate goods. Meanwhile, imports of consumer goods shrank at a more moderate rate due to more stable household consumption. Overall, in January–September 2019 nominal imports of goods stagnated (similar to exports), growing by a mere 0.3% year-on-year. Imports of mechanisms decreased on account of both weaker investment activity and a fall in re-exports. Furthermore, in the first nine months of 2019 imports of mechanisms accounted for the largest negative contribution. Imports of mineral products also shrank significantly due to a fall in the value of imports of natural gas observed in recent months. This can be explained by earlier injection of cheaper natural gas into Inčukalns Underground Gas Storage Facility. Products of the chemical industry have increased the value of imports in the first nine months of 2019 and are likely to have increased it over the remainder of the year, with imports of pharmaceutical products and fertilisers accounting for the largest growth.

In January–September 2019, imports of services also expanded by 5.9% year-on-year, faster than imports of goods; however, the expansion rate was slower than in the first two quarters of 2019. While the value of imports of sea and rail transportation services declined, overall imports of transportation services expanded, inter alia, on account of higher value of imports of air and road transportation services. Furthermore, the value of imports of information and communication services as well as that of business services grew by more than 10%. Imports of construction services continue on a surprisingly steep upward trend which could suggest insufficient domestic supply of services or a loss of price competitiveness.

With the external demand and domestic activity weakening, real imports of goods and services are also recording slower growth. Terms of trade continued improving, as the fall in export prices was less pronounced than that in import prices.

Chart 26

ANNUAL CHANGES IN THE VALUE OF EXPORTS BY GROUP OF GOODS
(millions of euro)



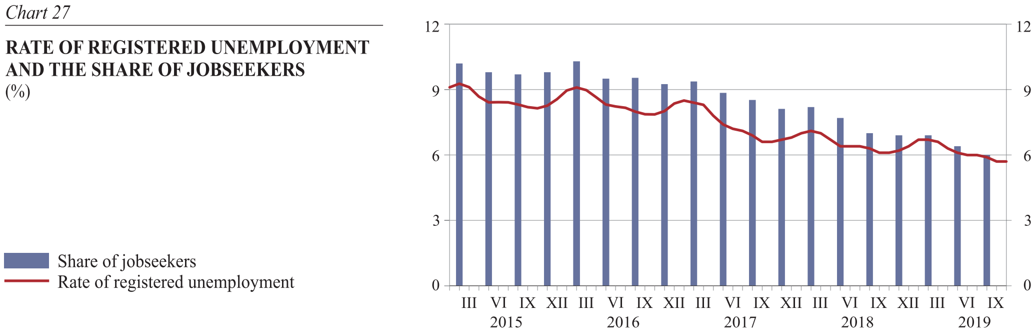
5. Labour Market, Costs and Prices

Despite a slowdown in the economic growth rate, the continuously high demand for labour and the limited supply are the main drivers of the labour market development. Thus, unemployment is on a downward path and the average remuneration is on the rise. The deceleration of economic activity is reflected in the consumer price dynamics with a lag. This already partly occurs in the dynamics of services prices as they were somewhat lower than projected in September and October.

In 2019, the unemployment rate continues to decline, with the share of jobseekers declining to 6.0% of the economically active population in the third quarter. The information provided by the SEA suggests that in October, registered unemployment remained at levels seen in September (5.7%), recording a drop of 0.4 percentage point over the year.

Chart 27

RATE OF REGISTERED UNEMPLOYMENT AND THE SHARE OF JOBSEEKERS
(%)



Although the share of businesses in the construction and services sectors referring to labour shortages as an essential drag on their activity decreased somewhat in the third quarter of 2019, the share of such businesses in all sectors together remained at a high of the last decade in 2019. Business sentiment regarding the employment outlook for the next three months has deteriorated overall; however, an increase in the rate of employment is still expected. The only exception is the construction companies having planned to reduce the number of the employed since July.

Latvijas Banka's unemployment forecast for 2019 is 6.4% and has remained unchanged in comparison with September (the unemployment forecast published in June was revised downwards from 7.0% to 6.4% in September, based on the actual data). The perception of the dynamics of unemployment has not changed as labour demand remains high despite a slower economic growth rate. The unemployment forecast for 2020 is unchanged (6.3%; 6.9% in June).

Due to the continuously high labour demand, the average remuneration continues to rise, falling only slightly behind the year-on-year trend despite the deceleration of the economic growth rate. Employers mention the requirement to include the potential salary in the job advertisements as an additional factor encouraging employees to move to higher paid jobs as an additional factor contributing to wage growth (particularly for lower level employees). In the third quarter of 2019, the annual rate of increase in remuneration was higher than projected, standing at 8.3%. In view of the fact that labour demand still persists, while labour supply (the share of working age population) continues to decrease somewhat, the average remuneration is expected to increase also in the future. This is also confirmed by preliminary monthly data. The wage growth forecast has remained unchanged since September, and the forecast for 2019 stands at 7.8% (the forecast made in June has been revised upwards already in September on account of the actual outcome recorded in the first half of the year), while the forecast for 2020 stands at 6.0% (previously, 5.9%).

The annual growth rate of services prices (the inflation component that is most pronouncedly and rapidly affected by economic activity changes) declined below 3%. It partly reflected the weakening of economic activity and partly – the impact of one-off factors (a decrease in the prices of accommodation services which is unusually steep for September and could reflect weather conditions unfavourable for tourism).

Chart 28

ANNUAL RATE OF CHANGE IN THE NOMINAL AVERAGE MONTHLY GROSS WAGE AND SALARY FOR FULL-TIME JOB
(%)

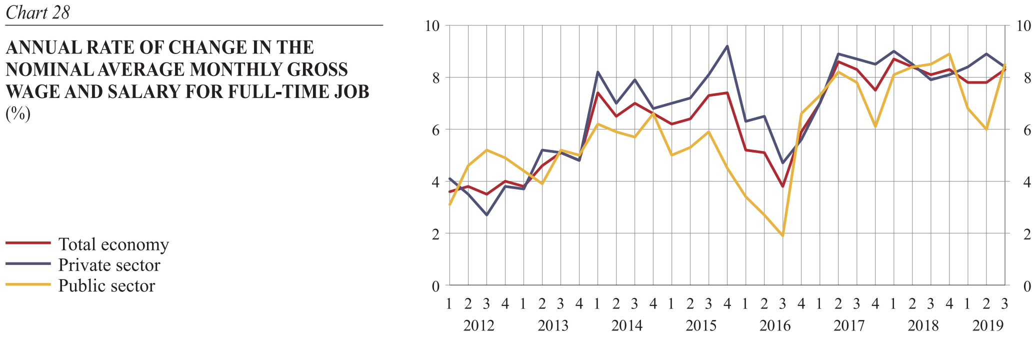
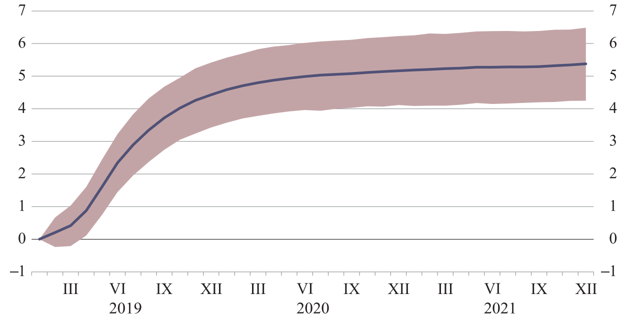


Chart 29

PASS-THROUGH OF A 10% INCREASE IN LABOUR COSTS TO CONSUMER PRICES OF SERVICES IN LATVIA
(%)



Notes. The monthly data for 2005–2018 have been used in the estimates. The simulation assumes that the average remuneration increases by 10% in January 2019. The chart shows the score with the plausibility interval of 68%.

Chart 30

CHANGES IN HICP BY COMPONENT
(percentage points)

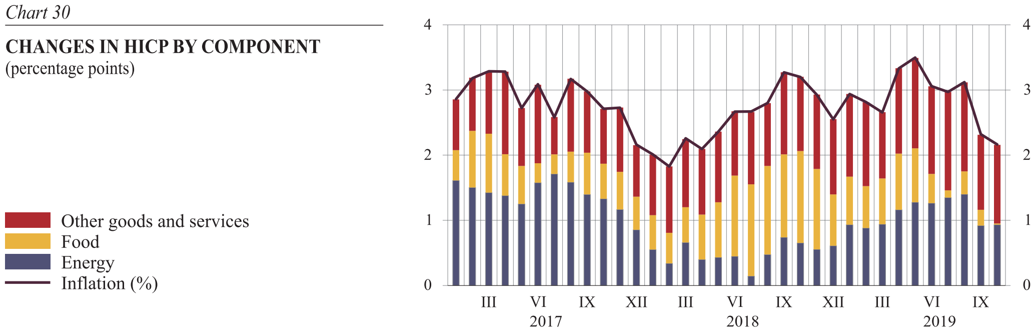
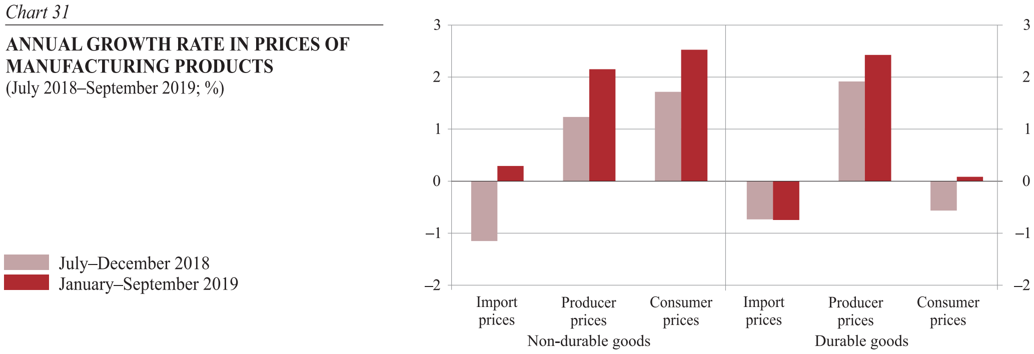


Chart 31

ANNUAL GROWTH RATE IN PRICES OF MANUFACTURING PRODUCTS
(July 2018–September 2019; %)

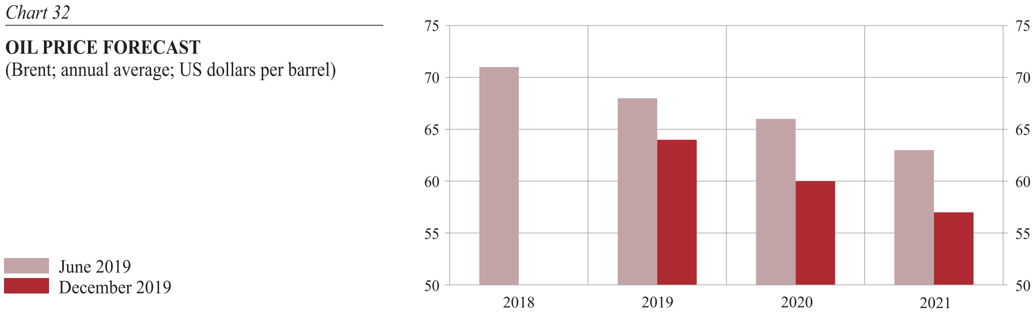


Consumer prices for industrial goods are rising faster than usually, owing to two factors. First, producer price inflation of fabricated products continues to soar up gradually, responding to higher labour costs with a lag. Second, import prices of non-durable goods also rose somewhat, and this could reflect a slight depreciation of the euro against the US dollar.

Global oil prices directly driving energy consumer prices and having an indirect effect on the prices of food and some services decreased over the past months. In response to the downward trend in oil prices, fuel prices dropped slightly. Market participants have been voicing concerns about both a slower pace of the global economic growth (which also means lower demand for oil products) and a continuous increase in oil production in the US. Although the attack on Saudi Arabian oil plants on 14 September caused the biggest-ever disruption in oil production[1], oil prices surged just for two weeks. The effect on oil prices did not last long as Saudi Arabia managed to resume oil production faster than expected by market participants. While there are signs that oil output in the US will grow slower than expected, the geopolitical situation in the Middle East remains tense and the OPEC decided on further oil production cuts in early December, market participants are expecting a gradual decrease in oil prices. According to Latvijas Banka's current forecast, the average Brent crude oil price in 2020 will be 60 US dollars per barrel (the June forecast was 66 US dollars per barrel).

Chart 32

OIL PRICE FORECAST
(Brent; annual average; US dollars per barrel)



The global food price indices directly affecting food consumer prices and being indirectly reflected in the prices of catering services did not follow a uniform trend in the last months. Meat prices remained high as the widespread outbreak of swine fever in Asia negatively affected the global pork supply. At the same time, the outbreak of swine fever reduced the demand for fodder and thus also the prices of cereals; this was additionally adversely affected by weather conditions favourable for the grain harvest (especially in Russia and Ukraine). Food prices declined due to a relatively good vegetable harvest and also on account of a temporary cut in excise tax on strong alcoholic beverages. At the same time, the prices of dairy products in Europe increased somewhat as a result of the high demand. Overall, the price dynamics of both imported food and food produced in Latvia and sold in the domestic market is stable in line with forecasts.

[1] Oil production was cut by 5.7 million barrels per day (more than at the time of Iraq's invasion of Kuwait in 1990 and during the Iranian Islam Revolution in 1979).

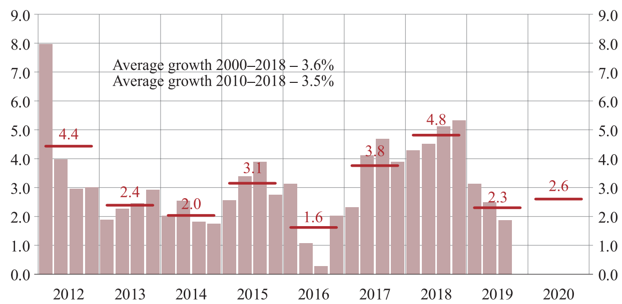
6. Conclusions and Forecasts

The outlook on economic growth in 2019 and 2020 has remained broadly unchanged. However, in view of the changes in the GDP data time series as a result of the benchmark revision to the national accounts made by the CSB, GDP growth is likely to stand at 2.3% in 2019 falling behind the September projections (2.5%). Meanwhile, the forecast for 2020 has remained unchanged at 2.6%. It should be noted that, with the global and euro area economic growth decelerating and high uncertainty persisting in the external economic environment, in September Latvijas Banka already revised downwards its June growth projections for 2019 and 2020 (2.9% and 3.1% respectively).

Although overall the GDP assessment changed only slightly, the expenditure structure projections were revised taking account of the GDP data revision and based on the latest data. The expansion of domestic demand was more moderate than previously estimated, with investment growth expected to be particularly weak. In the first half of 2019, export growth improved on account of the data revision. Furthermore, in the third quarter exports expanded more rapidly due to a short-term factor, i.e. a record-high grain harvest. However, with uncertainty persisting and the economic sentiment indicators in the euro area reporting no significant improvement, growth forecasts for 2020 in several trade partners are more pessimistic, also hindering a faster recovery in Latvia's external demand growth in 2020. The weakening of domestic and external demand is projected to be largely offset by a decline in imports, those of investment goods and intermediate goods required for the production of export goods in particular.

Chart 33

ANNUAL CHANGE IN GDP
(at constant prices; seasonally and calendar adjusted data; 2019 and 2020: Latvijas Banka forecast; %)

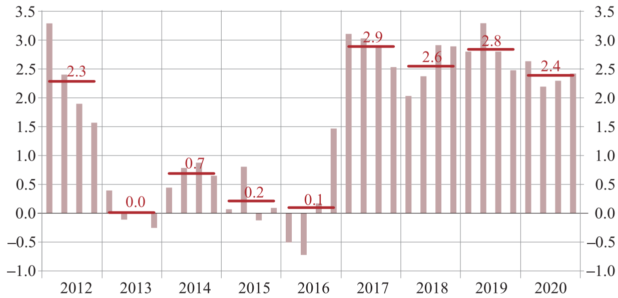


By sector, some positive medium-term impact might be created by the planned investments in the development of the transport infrastructure, i.e. the airport, as well as a successful operation of the regional natural gas market. This might allow better use of the storage and management infrastructure as well as facilitate an increase in the turnover of Latvian businesses trading in natural gas. Stronger growth momentum might also be expected in the construction sector where the level of value added achieved so far has been revised downwards. Nonetheless, the construction works of large infrastructure objects are expected to be implemented as planned. At the same time, however, uncertainty surrounding the implementation of individual projects, e.g. Rail Baltica, remains. The performance of the manufacturing and financial services sectors might be weaker than previously estimated: the development of the manufacturing sector has been discouraged by the ongoing negative impact of low prices on the wood industry, as well as the financial services sector has recorded a year-on-year decline in profits with businesses facing persistently high competition for customers and searching for better models of operation.

According to the data for the first 11 months of 2019, inflation is expected to stand at 2.8% in 2019 as compared to 2.9%, the forecast included in Latvijas Banka's June 2018 Macroeconomic Developments Report and updated in September. On account of the downward trend in oil prices, the inflation forecast for 2020 has been revised downwards to 2.4% (2.5% in June and September).

Chart 34

HICP ANNUAL CHANGE
(2019 and 2020: Latvijas Banka forecast; %)



Table

FORECASTS OF MACROECONOMIC INDICATORS

Indicator	**2019**	**2020**
GDP (annual change at constant prices; seasonally and calendar adjusted data; %)	2.3	2.6
INFLATION (annual HICP; %)	2.8	2.4
LABOUR MARKET		
Unemployment (% of the economically active population)	6.4	6.3
Nominal gross wage (annual change; %)	7.8	6.0
CURRENT ACCOUNT BALANCE (% of GDP)	–0.2	0.0
FISCAL SECTOR (% of GDP)		
General government debt	36.8	37.0
General government consolidated budget surplus/deficit (–)	–0.7	–0.7

7. Analysis of Scenarios

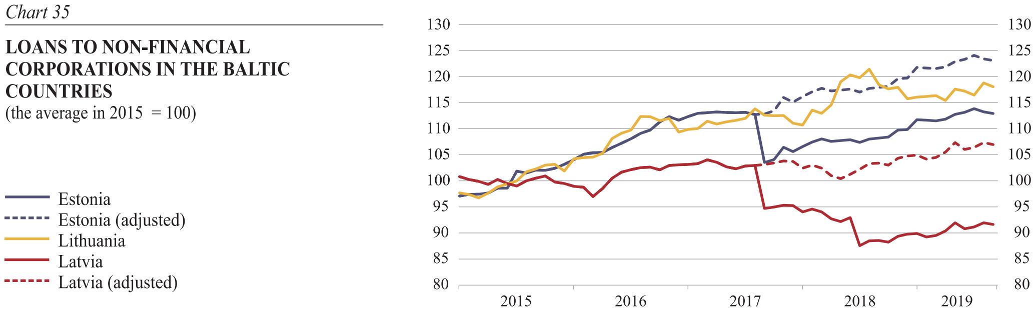
7.1 The impact of more subdued lending on the economy

Motivation

The pace of Latvia's economic growth has been among the most buoyant in the EU for several years. 10 years have passed since the economic crisis, and currently it is the longest economic growth period since the restoration of Latvia's independence. Despite that, lending activity in Latvia has been rather constrained. Loans granted to non-financial corporations in Lithuania and Estonia have increased significantly already for several years, while the dynamics in Latvia has been much more subdued (see Chart 35).

Chart 35

LOANS TO NON-FINANCIAL CORPORATIONS IN THE BALTIC COUNTRIES
(the average in 2015 = 100)



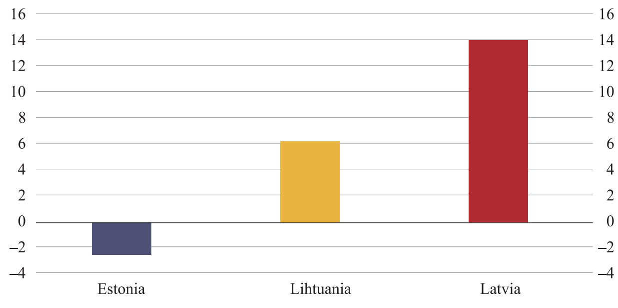
Notes. The adjusted time series do not include one-off decreases in the loan portfolio that emerged as a result of structural changes (the establishment of Luminor Bank AS in October 2017 and the cancellation of the ABLV Bank, AS credit institution's licence in July 2018). It is assumed that changes in loans in the respective quarter correspond to the average of the previous and next quarters.

After the adjustment of the time series of Latvia (and also Estonia) made to exclude the declines caused by one-off factors in 2017 and 2018, loans granted to non-financial corporations in Latvia are currently lagging behind those of the Baltic neighbouring countries by approximately 14%.

It should be noted that such developments of lending to non-financial corporations were seen during a period when the demand of non-financial corporations for loans in Latvia had grown much faster than in the neighbouring countries (see Chart 36).

Chart 36

ASSESSMENT OF CREDIT INSTITUTIONS REGARDING CHANGES IN THE NON-FINANCIAL CORPORATIONS' DEMAND FOR LOANS ON AVERAGE PER QUARTER SINCE THE FIRST QUARTER OF 2016
(% of the credit institutions having participated in the lending survey)



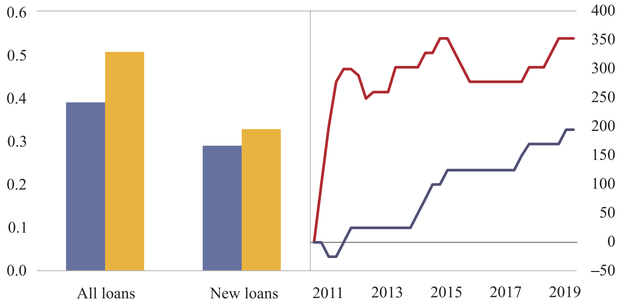
Differences in lending activity were affected by tighter credit standards set by Latvia's credit institutions. Interest rates on loans to non-financial corporations in Latvia have been approximately 0.3–0.5 percentage point higher than those in Lithuania and Estonia since the beginning of 2016 (see the left-hand panel of Chart 37). The credit standards in Latvia were also considerably tighter (see the right-hand panel of Chart 37).

Taking account of the role of lending in investment funding, weak lending activity could have had a negative impact on Latvia's economic growth. Therefore, Latvijas Banka, using the DSGE model for Latvia[1], has assessed the potential impact of the sluggish lending activity on Latvia's economy.

Chart 37

SPREAD BETWEEN INTEREST RATES ON LOANS TO NON-FINANCIAL CORPORATIONS IN LATVIA AS COMPARED TO THE NEIGHBOURING COUNTRIES AND CUMULATIVE CHANGES IN CREDIT STANDARDS
(percentage points)

Spread between interest rates on loans to non-financial corporations in Latvia as compared to Estonia
Spread between interest rates on loans to non-financial corporations in Latvia as compared to Lithuania
Cumulative changes in credit standards in Latvia (right-hand scale)
Cumulative changes in credit standards in Estonia (right-hand scale)



Note. Credit standard data for Lithuania are available starting only from 2015.

Simulation

The scenario assesses the impact of two factors on Latvia's economy:

a) a slower increase in loans to non-financial corporations; therefore, the volume of the loan portfolio is 14% lower than in the baseline scenario;

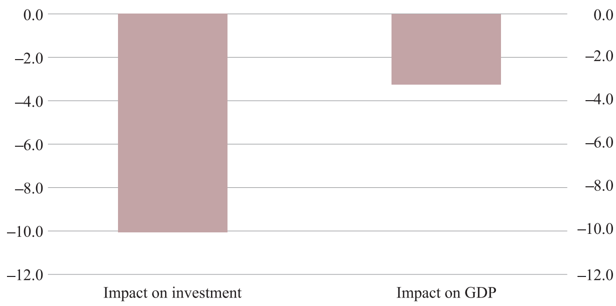
b) the interest rate on loans is 0.35 percentage point higher than in the baseline scenario.

More sluggish lending directly affects business investment. At the same time, higher interest rates on loans leading to higher borrowing costs reduce the appetite for borrowing of non-financial corporations and households. Slower lending to non-financial corporations has been gradually introduced in the simulation, reaching the difference of 14% within four years. Higher interest rates on loans are applied immediately and on a continuous basis.

Overall, the simulation results suggest that investment growth is also more subdued due to lower lending activity. Moreover, following the failure of non-financial corporations to step up production, their demand for labour is lower than if lending activity recovered faster. Thus, GDP growth is likewise lower. The effect of the lending amount significantly offsets the negative impact of relatively higher interest rates. The total unrealised GDP growth reaches 3.2% or 0.8% per annum on average in four years (see Chart 38).

Chart 38

IMPACT OF WEAKER LENDING AND HIGHER INTEREST RATES ON INVESTMENT AND GDP
(cumulative changes; %)



Conclusions

The relatively buoyant economic growth rate notwithstanding, lending to non-financial corporations has been weak in Latvia. At the same time, lending growth in Lithuania and Estonia has been robust. As lending represents one of the sources of investment funding, sluggish lending activity in Latvia could have had a significant negative impact on Latvia's potential growth over these years.

[1] Bušs, Ginters. *Wage Formation, Unemployment and Business Cycle in Latvia.* Latvijas Banka Working Paper, No. 1/2017. 69 p.

Latvijas Banka's calculations suggest that due to more subdued lending activity, business investment has been notably lower than if lending activity had followed the trends observed in the neighbouring countries for the last four years. Thus, economic growth has also been slower.

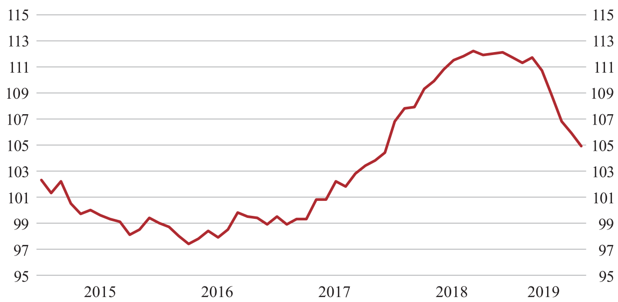
7.2 The impact of a further drop in wood prices on Latvia's economy

Motivation

The prices of wood started to rise in mid-2017. This was underpinned by several factors, but the main one was a shortage of raw materials for logging activities caused by unfavourable weather conditions and restrictions on imports of wood in the rough from Belarus. These factors came to the forefront not only in Latvia, but also throughout Europe; thus, prices rose globally leading to improved terms of trade in Latvia due to the significant share of exports. In 2018, a steep rise in wood prices was driven by significant changes in weather conditions, with the prices of some types of wood (e.g. pulpwood) increasing nearly twice in comparison with the average prices recorded in 2016. Under weather conditions favourable for logging, many owners of forests wanted to harvest timber from previously unprofitable and inaccessible felling sites, and the industry faced supply side restrictions, namely a lack of logging equipment and shortages of labour. The demand from the UK (for stockpiling for Brexit) and the Scandinavian countries (mainly for pulpwood for wood pulp industry) was also rising. Many owners of forests turned to producing pulpwood, the price of which had soared rapidly, causing a shortage of raw materials and also an increase in prices in other wood producing segments. Overall, higher prices boosted the profitability of logging and wood industry companies, thus also strengthening new investment in machinery. An increase in total value added was supported by favourable terms of trade, export growth and investment to boost capacity and productivity. However, sector representatives expected the rise in wood prices to be temporary. Overall, by the end of 2018 the unit value index of exports of wood increased by 13.7% from the average level of 2016, peaking in December, but 2019 already saw falling prices (see Chart 39).

Chart 39

UNIT VALUE INDEX OF EXPORTS OF WOOD, PRODUCTS OF WOOD AND CORK (EXCEPT FURNITURE), ARTICLES OF STRAW AND PLAITING MATERIALS
(2015 = 100)



At the beginning of 2019, most of the above factors captured different trends – the demand from the Scandinavian countries weakened and the stockpiling for Brexit was replaced by declining demand. Furthermore, investment caused overproduction in some wood industry segments (e.g. overproduction of fibreboard). The fall in wood prices is also amplified by the damage from insect infestation in forests in Europe necessitating logging. As a result, the supply of wood surged. Therefore, this might possibly bring the risk of a further decline in prices in the future.

Simulation

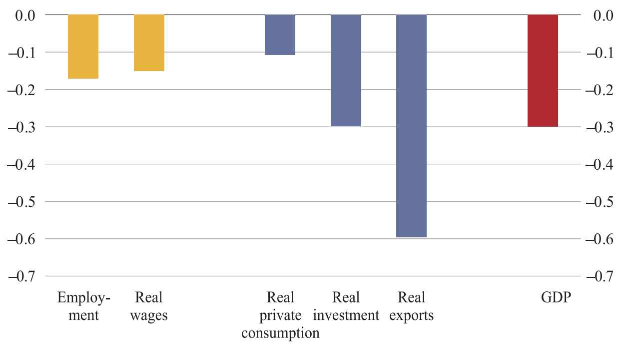
The scenario where the prices of wood would decrease to the average level observed in 2016 (a further decline of 6.4%), offsetting the previous increase in the export prices of wood is dealt with.

The simulation has been performed by employing the computable general equilibrium (CGE) model[1], which leads to drawing detailed and in-depth conclusions about the effect of some shocks on Latvia's economy, both in aggregate and by sector.

The results (see Chart 40) suggest that the volume of the products manufactured by sectoral businesses and also exports decrease as a result of regional overproduction in an environment of low prices. Thus, the growth in the rate of employment and real wages are on a downward trend. This, in turn, has a negative effect on private consumption. Moreover, with the economic activity and future outlook deteriorating, businesses reduce investment. Consequently, real GDP is 0.3% lower, as compared with a case where prices stabilise at their current levels. By sector (excluding logging and wood industry), a downturn in the economic activity is likely to have a negative effect also on the transport services sector.

Chart 40

ESTIMATED IMPACT OF LOWER WOOD PRICES ON LATVIA'S ECONOMY
(%)



The real impact on GDP would most probably be lower than estimated by the CGE model since businesses could absorb lower prices by reducing profit margins rather than by dampening the wage and employment growth.

Conclusions

The results suggest that the adjustment of the export unit value of wood may negatively affect not only the wood industry, but also Latvia's economy as a whole. Decreasing prices of wood will also lead to lower profitability of logging and wood businesses, inflows of new investment and harvesting of timber from new felling sites respectively. This, overall, will worsen the expansion of the sector and thus the economic growth. It may be partly offset by a positive situation in some wood industry segments capable of keeping the price of finished goods at the current level, while raw materials, for instance, in the manufacture of furniture will become cheaper. However, these individual segments will fail to offset the overall negative impact of the diminishing export unit value of wood on GDP.

[1] For further information, see Beņkovskis, Konstantīns, Goluzins, Eduards, Tkačevs, Oļegs. *CGE Model with Fiscal Sector for Latvia*. Latvijas Banka Working Paper, No. 1/2016. 62 p.

Additional Information

General notes

The cut-off date for the information used in the publication Macroeconomic Developments Report (December 2019, No. 30) is 10 October 2019.

The Macroeconomic Developments Report (December 2019, No. 30) published by Latvijas Banka is based on data provided by the CSB, ECB, Treasury, AS Nasdaq Riga, Euribor-EBF and Latvijas Banka.

Data sources for charts are the EC (Charts 1, 2, 24, 25 and 30), Bloomberg (Charts 3–6 and 32), Reuters (Chart 7), Latvijas Banka (Charts 8–12, 14, 15, 26, 27, 29, 30, 32–34, 38 and 40), the CSB (Charts 8, 17–21, 23, 24, 26–31, 33, 34 and 39), the ECB (Charts 13 and 35–37), the Treasury (Charts 16 and 22), and the SEA (Chart 27).

Beginning with this issue of December 2019, the only data source for Statistics tables is Latvijas Banka.

Details may not add because of rounding-off.

FOB value is the price of a commodity on the border of the exporting country, including the transportation and insurance costs only up to the border.

CIF value is the price of a commodity on the border of the importing country, including the transportation and insurance costs only up to the border.

"–" – no transactions in the period; "x" – no data available, no computation of indicators possible or insufficient number of respondents to publish information.

Money and banking sector

Calculation of monetary aggregates includes the balance sheet data of Latvijas Banka and information from the financial position reports of other MFIs, prepared using methodology of Latvijas Banka (see Latvijas Banka Regulation No. 132 "Regulation for Compiling the 'Monthly Financial Position Report' of Monetary Financial Institutions" of 16 May 2014).

In the publication, the following terms have been used:

MFIs – financial institutions forming the money-issuing sector. In Latvia, MFIs include Latvijas Banka, credit institutions and other MFIs in compliance with the List of Monetary Financial Institutions of the Republic of Latvia compiled by Latvijas Banka. In the EU, MFIs include the ECB, the national central banks of the euro area, credit institutions and other MFIs (money market funds) in compliance with the original List of MFIs published by the ECB.

Non-MFIs – entities other than MFIs.

Financial institutions – other financial intermediaries, excluding insurance corporations and pension funds, (hereinafter, OFIs), financial auxiliaries, insurance corporations and pension funds.

OFIs – financial corporations that are primarily engaged in financial intermediation by incurring liabilities in forms other than currency, deposits and close substitutes for deposits from their customers other than MFIs, or insurance technical reserves. OFIs are corporations engaged in lending (e.g. financial leasing companies, factoring companies, export/import financing companies), investment funds, investment brokerage companies, financial vehicle corporations, financial holding corporations, and venture capital corporations. OFIs data include also financial auxiliaries' data.

Financial auxiliaries – financial corporations that are primarily engaged in auxiliary financial activities, i.e. activities that are closely related to financial intermediation but are not financial intermediation themselves, e.g. investment brokers who do not engage in financial intermediation services on their own behalf, corporations that provide infrastructure for financial markets, central supervisory institutions of financial institutions and the financial market provided that they are separate institutional units. In Latvia, the FCMC and the AS Nasdaq Riga shall also be regarded as financial auxiliaries. Financial auxiliaries' data are included in OFIs data.

Non-financial corporations – economic entities producing goods or providing non-financial services with the aim of gaining profit or other yield.

Households – natural persons or groups of natural persons whose principal activity is consumption and who produce goods and services exclusively for their own consumption, as well as non-profit institutions serving households. The following are also regarded as households in the Republic of Latvia: persons engaged in individual entrepreneurship provided that they have not registered their activity with the Commercial Register of the Enterprise Register of the Republic of Latvia.

Holdings of securities other than shares – financial assets, which are instruments of the holder, usually negotiable and traded or compensated on secondary markets and which do not grant the holder any ownership rights over the issuing institutional unit.

The following information is published in accordance with the ECB methodology:

1) aggregated balance sheet of MFIs (excluding Latvijas Banka), i.e. the sum of the harmonised balance sheets of Latvia's MFIs, excluding Latvijas Banka (Table 3);

2) monetary aggregates and counterparts (Table 2) reflect Latvia's contributions to the euro area M3 and counterparts to M3. These are obtained from the consolidated balance sheet of MFIs. Latvia's contributions to the following monetary aggregates are calculated and published:
– overnight deposits in all currencies held with MFIs;
– deposits redeemable at a period of notice of up to and including 3 months (i.e. short-term savings deposits) made in all currencies and deposits with an agreed maturity of up to and including 2 years (i.e. short-term time deposits) in all currencies held with MFIs;
– repurchase agreements, debt securities with a maturity of up to and including 2 years issued by MFIs, and money market fund shares and units.

Analytical accounts of Latvijas Banka (Table 1) are also published comprising the national contribution to the euro area monetary base and the counterparts.

In view of the fact that Latvijas Banka collects more comprehensive information, the following is also published:

1) consolidated balance sheet of MFIs obtained by netting out inter-MFI positions in the aggregated balance sheet of Latvia's MFIs (Table 4). Due to slight accounting methodology differences, the sum of the inter-MFI positions is not always zero; therefore, the balance is reported under the item Excess of inter-MFI liabilities;

2) selected items in the monthly financial position report of MFIs (excluding Latvijas Banka) by group of countries (Table 5);

3) information characterising the maturity profile and types of deposits (including repurchase agreements) of Latvia's financial institutions, non-financial corporations and households with MFIs (excluding Latvijas Banka; Tables 6 and 7abc), as well as government and non-resident deposits (Table 7d);

4) information characterising the maturity profile and types of MFI (excluding Latvijas Banka) loans to Latvia's financial institutions, non-financial corporations and households (Tables 8, 9ab and 10), as well as government and non-resident loans (Table 9c);

5) information characterising MFI (excluding Latvijas Banka) securities holdings (Table 11).

Interest rates

The interest rates calculation includes information from MFI reports prepared in compliance with Latvijas Banka Regulation No. 133 "Regulation for Compiling Interest Rate Reports of Monetary Financial Institutions" of 16 May 2014. Based on the methodology laid out in the above Regulation, credit institutions, branches of foreign credit institutions and particular credit unions registered in the Republic of Latvia have to provide information on interest rates on deposits and loans applied in transactions with resident non-financial corporations and households.

Information on interest rates on deposits and loans applied in transactions with non-financial corporations and households provided by credit institutions, branches of foreign credit institutions and credit unions registered in the Republic of Latvia is collected (Tables 12ab). Interest rate statistics is collected on new business and outstanding amounts. All rates included in the interest rate statistics are weighted average rates. When preparing the interest rate statistics, credit institutions use annualised agreed rates (AAR) or narrowly defined effective rates (NDER) and annual percentage rate of charge (APRC). Credit institutions have to select the calculation of the AAR or the NDER based on the terms and conditions of the agreement. The NDER can be calculated on any deposit or loan. In addition to the AAR or the NDER, the APRC is reported for loans to households for house purchase and consumer credits.

The interest rates on new business with overnight deposits and deposits redeemable at notice and on their outstanding amounts coincide.

Interest rates on new loans are reported on the basis of the initial rate fixation period set in the agreement, whereas overdraft interest rates are reported on loan balances.

When reporting the interest rates on consumer credit and other credit to households with the maturity of up to 1 year and loans to non-financial corporations with the maturity of up to 1 year, interest rates on overdraft are included.

Interbank market lending interest rates (Table 14) are reported as weighted average interest rates on new business, aggregating the information submitted by credit institutions, prepared based on the methodology of Latvijas Banka (see Latvijas Banka Regulation No. 102 "Regulation for Compiling the 'Report on Monetary Market Transactions'" of 16 May 2013).

Foreign exchange and exchange rates

Information characterising the foreign currency selling and buying transactions is reported based on the methodology of Latvijas Banka (see Latvijas Banka Regulation No. 36 "Regulation for Purchasing and Selling Cash Foreign Currency" of 13 May 2009 and Latvijas Banka Regulation No. 101 "Regulation for Compiling Reports on Foreign Currency Purchases and Sales" of 16 May 2013). The principal foreign exchange transactions (Table 16) comprise the cash and non-cash transactions conducted by credit institutions and branches of foreign credit institutions, reported by transaction type and counterparty, and currency. Non-cash foreign exchange transactions (Table 17) comprise non-cash transactions performed by credit institutions and branches of foreign credit institutions, reported by major currency.

Weighted average exchange rates (cash transactions; Table 18) are reported based on the information provided by credit institutions and branches of foreign credit institutions as well as currency exchange bureaus.