LATVIJAS BANKA

EIROSISTĒMA

MACROECONOMIC DEVELOPMENTS REPORT

2019

JUNE

LATVIJAS BANKA
EIROSISTĒMA

ISSN 1691–5925

MACROECONOMIC DEVELOPMENTS REPORT
June 2019

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June 2019, No 29

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Abbreviations

APP – asset purchase programme
AS – joint stock company
CIF – cost, insurance and freight at the importer's border
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
EU28 – 28 countries of the EU
EURIBOR – Euro Interbank Offered Rate
Eurostat – statistical office of the European Union
FOB – free on board at the exporter's border
FOMC – FRS Federal Open Market Committee
FRS – US Federal Reserve System
GDP – gross domestic product
HICP – Harmonised Index of Consumer Prices
JSC – joint stock company
MFI – monetary financial institution
OFI – other financial intermediaries other than insurance corporations and pension funds
OPEC – Organization of Petroleum Exporting Countries
PIT – personal income tax
PMI – Purchasing Managers' Index
SEA – State Employment Agency
SIA – limited liability company
UIN – corporate income tax
UK – United Kingdom
UN – United Nations
US – United States of America
VAS – state joint stock company
VAT – value added tax

Introduction

Latvijas Banka's optimistic assessment with regard to Latvia's economic growth prospects has declined gradually: with the global economic cycle approaching slowdown and uncertainty in the external economic environment persisting, Latvia's economic growth also decelerated recording a slower-than-expected GDP growth rate in the first quarter of 2019. Export performance weakened already in the second half of 2018, and economic growth was expected to decelerate. Nevertheless, the unfavourable impact of external factors was projected to be largely offset by domestic factors in 2019. The data for the first quarter of 2019 point to continuously strong domestic demand; however, the growth rate tends to moderate. Therefore, Latvia's economic growth forecast for 2019 has been revised downwards. However, the ongoing sizeable investment projects and an increasing number of published new investment plans give reason to anticipate further investment activity. Overall, the outlook for the growth-driving factors in the near future has remained broadly the same, and the forecast for 2020 has been left unchanged.

The expected slowdown in the global economic growth and a decline in the economic sentiment indicators, inter alia, due to the moderation of the euro area economic growth, lead to downward adjustments in the growth forecasts for several Latvia's major trade partners. Therefore, in 2019 external demand is expected to expand at a much lower rate than in the previous year, representing one of the downward risks to the GDP forecasts. The adjustments were largely made on account of export indicators which deteriorated faster than expected.

Although the low interest rates stimulated by the ECB's accommodative monetary policy are supporting favourable financing conditions in Latvia, lending growth in Latvia has remained slow so far. Meanwhile, the situation prevailing in the labour market and income gains ensured a steady expansion of deposits. The adverse effects of the external environment have not yet passed through to the labour market. Moreover, labour demand still exceeds labour supply, and the unemployment rate continues to decline. Inflation hovered around 3%, close to the projected level, with energy prices reporting the highest rise on account of the growing oil prices. Meanwhile, the prices of services increased moderately, reflecting the rising labour costs. Latvijas Banka's inflation forecasts for 2019 and 2020 have remained unchanged, with the impact of higher oil prices balancing the moderation in the economic activity growth.

1. External Demand

Despite better-than-projected GDP data for the first quarter of 2019, the global economic growth is expected to decelerate overall this year primarily on account of a slowdown in the economic growth rate in the euro area and China. Euro area growth is significantly affected by weaker external demand, prolonged uncertainty and the ongoing impact of one-off factors, disruptions to the car production in Germany in particular. Against this background, the economic sentiment has continued on a downward path since the end of 2018 deteriorating to a low of more than two years in April. As a result, the world economic outlook, including growth forecasts for several Latvia's major trade partners, have been revised downwards. With new trade restrictions coming into force, the trade tensions between the US and China increased. Moreover, tensions also arose in the US-EU trade relations. The extension of the deadline for the UK's exit from the EU has not eliminated a no-deal Brexit, and uncertainty remains high. Therefore, in 2019 external demand growth is expected to be much more subdued than in 2018.

With continued uneven progress across regions and countries of various levels of economic development, global economic growth remained on a gradual downward trend in the first half of 2019. Although the first-quarter data in many countries pointed to a better performance than previously expected, leading indicators, including sentiment indicators, suggest that the first half of 2019 will record overall weaker results compared to the last six months of the previous year.

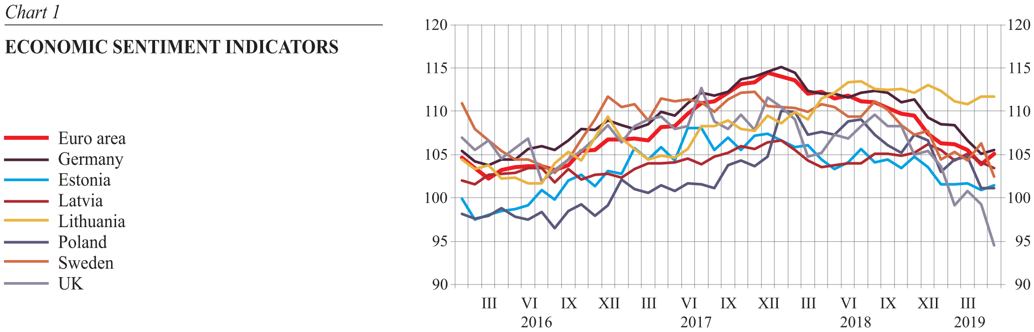
The forecasts revised by central banks at the beginning of the year suggest that the financing conditions in the world's leading economies have remained very favourable. The positions expressed in the latest committee and council meetings of the FRS, ECB, Bank of Japan and Bank of England strengthened the market participants' confidence that the monetary policy will remain accommodative also in the future. At the same time, GDP in the US increased by 3.2% in the first quarter as compared to a 3.0% rise in the previous quarter. Growth accelerated mainly on account of the economy's reorientation toward domestic supply owing to shrinking imports of goods and services as well as higher expenditure of certain US states and local governments. The strong economic growth has passed through to the labour market where the rate of unemployment has stood below 4% for a whole year. However, the very tight labour market conditions have not had a lasting impact on price increases. Consumer price inflation, reflecting annual changes in the personal consumption expenditure price index, stood at 1.5% in April, thus supporting the decision of the FRS to keep the target range for the federal funds rate unchanged. During the trade negotiations between the US and China, the US accused the government of China of not complying with previously agreed conditions. As a result, the US president raised trade tariffs on all goods imported from China, which were already subject to tariffs, from 10% to 25%. Meanwhile, the US president chose to postpone his decision to impose trade tariffs on vehicles exported from the EU to the US. In addition, the US-EU trade dispute filed in the World Trade Organisation regarding the unlawful state support to the aircraft manufacturing giant Airbus SE continues, with the US threatening to impose higher trade tariffs on aircraft parts. Trade tensions may also affect trade tariffs on food products.

Japan's economy remains fragile as it continuously grapples with the tightest labour market since 1974. Moreover, Japan's inflation is well below its target, and the central bank projections suggest that the inflation target will not be achieved until 2021. Therefore, the Bank of Japan has stated that the interest rates will not be changed at least until the spring of 2020, and it has also announced government bond purchases on the primary market. Meanwhile, with the Chinese government expanding the borrowing opportunities of municipal governments for investment in infrastructure projects, in the first quarter of 2019 the economic growth in China remained at the level of the previous quarter (6.4%). At the same time, China's trade tensions with the US have started to significantly weigh on its export growth, with the volume of China's exports remaining unchanged year-on-year in the first four months of 2019.

In January–March 2019, the euro area economy recorded 0.4% growth exceeding both the projections for the first quarter of 2019 (0.3%) and the figures recorded in the fourth quarter of 2018 (0.2%). With the initial date of the UK's exit from the EU approaching, stockpiling by its businesses intensified resulting in a temporary positive contribution to more dynamic economic growth in the euro area. At the same time, a more detailed breakdown of the euro area economy reveals significant imbalances between the manufacturing and services sectors. Euro area manufacturing has decreased every month since October. This development coincides with the signals from the manufacturing PMIs which have declined over a long period and have remained below the level of 50 points over the last three months. Meanwhile, the services and retail trade sectors continue to persistently facilitate economic growth. However, deteriorating consumer and services confidence indicators suggest that such support for the economic growth may not be long-lasting. Although the economy is experiencing the tightest labour market since 2008 and solid wage growth, the inflationary pressure is decreasing.

Chart 1

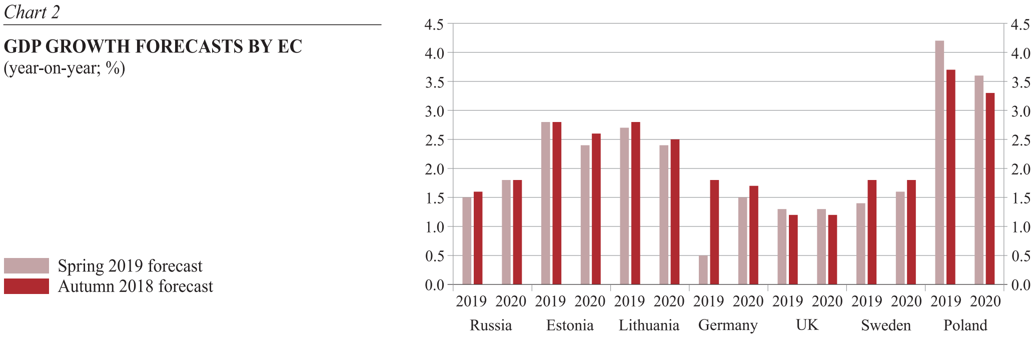
ECONOMIC SENTIMENT INDICATORS



With the German manufacturing reporting no improvements and external uncertainties persisting, in 2019 Latvia's major euro area trade partners are expected to record more subdued growth than previously projected. In its spring 2019 forecast, the EC lowered the real GDP growth projections for both the euro area (to 1.2% as compared to 1.9% in the autumn 2018 forecast) and Germany (to 0.5% as compared to 1.8% in the autumn 2018 forecast) on account of weak external environment. Unemployment remained low at the beginning of the year, and the minimum wage in Germany was raised as from 2019, facilitating consumption; however, manufacturing is facing ongoing problems. The car production sector has still not recovered after the production disruptions seen in 2018, and the sector has also suffered from weaker demand from the US and China. Moreover, declining industrial and consumer confidence may have a downward effect on private investment. In addition, Germany's export forecast was revised downwards and its export orders declined at the beginning of the year.

Chart 2

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



As already forecast in December, the growth momentum is also expected to decrease in Lithuania and Estonia in 2019, with export expansion decelerating on account of uncertainty in the external environment; meanwhile, the domestic economic activity is likely to remain resilient. Wages continue rising both in Lithuania and Estonia, thus promoting consumption. Moreover, ongoing inflows of EU funds are supporting investment growth. The EC kept Estonia's GDP growth forecast for 2019 unchanged at 2.8%: although exports were more resilient than could be expected due to weaker external environment, their expansion is expected to slow down. A similar growth rate of 2.7% is also projected for the Lithuanian economy (2.8% in the EC's autumn 2018 forecast), despite a rise in the minimum wage and strong labour demand which exerts pressure on remuneration and, thus, facilitates consumption. At the beginning of 2019, manufacturing growth decelerated but exports were still resilient. However, as in Estonia, Lithuania's export growth is also expected to decline in 2019.

Latvia's non-euro area trade partners are also experiencing slower economic growth. With the completion of several large investment projects at the end of 2018, Russia recorded unexpected expansion in the construction sector supporting rapid economic growth. However, the growth rate has declined in 2019. The EC revised Russia's GDP growth forecast downwards from 1.6% in its autumn 2018 forecast to 1.5%. Consumption grew moderately at the beginning of the year, partly on account of an increase in the VAT rate. Moreover, despite a rise in oil prices, the agreement between OPEC and other oil-exporting countries to cut oil production as well as the relatively warm winter constrained the increase in the volume of oil exports. Import growth was weaker than projected in 2018 and is unlikely to recover quickly in 2019 since it will be dampened by a slow rise in remuneration, inter alia, reducing demand for imported products.

With its volume of exports expanding, the economy of Sweden recorded positive trends at the end of 2018. However, owing to moderating domestic demand, Sweden's economic growth is expected to decelerate in 2019. The EC has revised Sweden's real GDP growth forecast downwards from 1.8% in its autumn 2018 forecast to 1.4% primarily on account of declining investment in housing. Moreover, with external uncertainties weighing on external demand, manufacturing growth moderated at the beginning of 2019. Unemployment remained low, and remuneration continued to rise at a moderate pace. Besides, the government has announced additional spending in the amount of 4.5 billion Swedish krona, thereby supporting consumption. At the same time, the exchange rate of the Swedish krona depreciated at the beginning of the year; therefore, a steep rise in imports is not expected.

In 2018, Poland recorded its strongest growth in the last 10 years. With its exports remaining resilient, Poland's GDP continued on an upward trend in the first quarter of 2019. The EC revised Poland's GDP growth forecast upwards from 3.7% in its autumn 2018 forecast to 4.2% due to the strong domestic demand and the higher base of 2018. At the beginning of 2019, investment expanded and manufacturing growth was more rapid than expected. Moreover, owing to higher social benefits and a reduced tax burden, remuneration continues to rise and is likely to support consumption also in the future. While investment has remained strong, the absorption of EU funding has moderated, and a slowdown in the trade partners' economic growth is likely to dampen the expansion of exports.

Meanwhile, with uncertainties surrounding Brexit persisting and, thus, constraining investment growth and negatively affecting consumer confidence, the economic growth in the UK is expected to remain at the level of the previous year. According to the EC forecasts, UK's GDP is expected to increase by 1.3% as compared to 1.2% in the autumn 2018 forecast. In the first quarter of 2019, GDP growth was stronger than expected; however, this was largely related to the increased stockpiling of inputs before the planned Brexit date on 29 March 2019. With the extension of the deadline, the above trend is expected to decline in the second quarter. While the UK government has announced the allocation of additional funds for health care, social guarantees and the easing of the tax burden, private consumption growth is hindered by uncertainty encouraging households to build up their savings. The postponement of Brexit until 31 October is expected to continue to weigh on investment inflows and hamper faster economic growth.

2. Financial Conditions

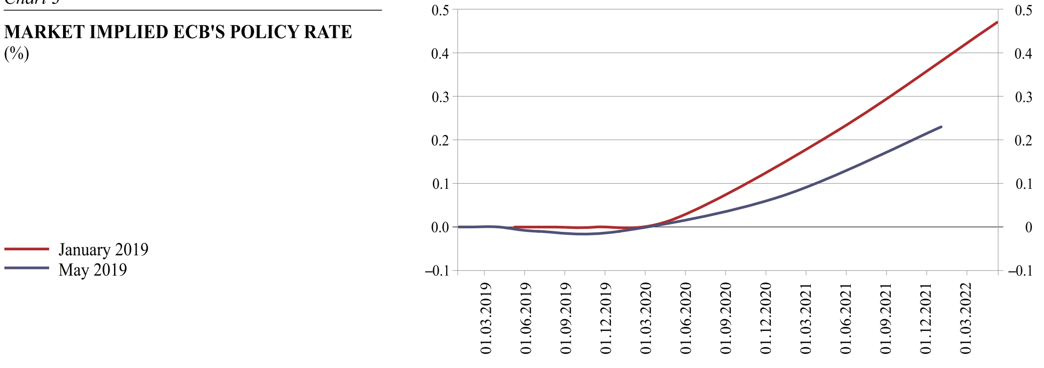
2.1 Decisions of the ECB and other major central banks

Major central banks have signalled potential easing of their monetary policies in response to the deteriorating economic outlook and prolonged uncertainty. At the end of January, the FOMC stated that in light of the global economic and financial developments and muted inflation pressures, the FOMC would be patient as it determines any future adjustments to the target range for the federal funds rate. In March, seeing that global growth continued to decelerate, the FOMC additionally announced that the balance sheet reduction programme would conclude at the end of September 2019. At the same time, the Governing Council of the ECB increased the degree of monetary accommodation, pointing out at its March meeting that the key ECB interest rates are expected to remain at their present levels at least through the end of 2019 and announcing the launch of a new series of quarterly targeted longer-term refinancing operations (TLTRO III) in order to preserve favourable bank lending conditions. With global headwinds continuing to weigh on the euro area outlook, in June the Governing Council of the ECB decided to keep the key ECB interest rates unchanged at their present levels at least through the first half of 2020.

Following the end of net asset purchases within the framework of the APP at the end of 2018, since the beginning of 2019 the ECB has signalled monetary easing and that can be explained by the weakening euro area economic growth. At the beginning of the year, it was believed that the deceleration of the euro area growth was mainly a result of some one-off factors like the slowdown in the German automotive industry and the "yellow vests" protests in France. At the time of preparing the March projections, however, it was already clear that the weakness was broader and could be more persistent than previously expected. Compared to the December 2018 projections, the economic growth for 2019 has been revised down notably and that for 2020 has been revised down slightly in the March 2019 ECB staff macroeconomic projections. The ECB also noted that the external environment remained to be affected by the uncertainties associated with Brexit and the US-China trade tensions. Therefore, the ECB assessed the risks surrounding the growth outlook as tilted to the downside. In light of a slower-than-expected economic growth, at its March meeting the Governing Council of the ECB announced the launch of a new series of quarterly targeted longer-term refinancing operations (TLTRO III) with a maturity of 2 years, starting in September 2019 and ending in March 2021. Fixed rate tender procedures will continue with full allotment. Like the previous TLTRO programme, TLTRO III will feature built-in incentives for credit conditions to remain favourable. In addition to that, the Governing Council of the ECB changed its forward guidance, confirming that the key ECB interest rates are expected to remain at their present levels at least through the end of 2019. Although no significant new decisions affecting the monetary policy were adopted at the April meeting, market participants viewed the press conference of the President of the ECB as a signal of monetary easing. At the press conference, the President of the ECB highlighted the weakening of the growth momentum

Chart 3

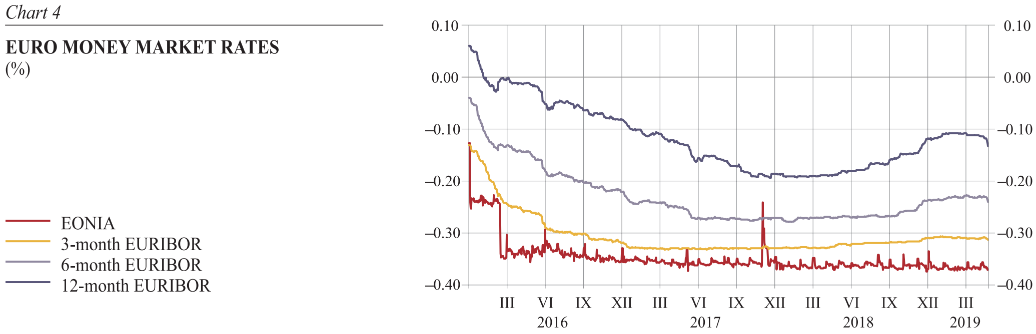
MARKET IMPLIED ECB'S POLICY RATE
(%)



and confirmed the ECB's readiness to adjust all of its monetary policy instruments to further economic growth. Financial markets do not expect any interest rate raises earlier than in 2021. With the risks surrounding the euro area growth outlook remaining tilted to the downside, the Governing Council of the ECB announced at the June meeting that it expects the key ECB interest rates to remain unchanged at least through the first half of 2020 and revealed the basic modalities of TLTRO III.

Chart 4

EURO MONEY MARKET RATES
(%)



Seeing that the global economy is decelerating, the FOMC changed its policy stance as of the beginning of the year, signalling the markets that they can expect no steep rises in the target range for the federal funds rate in the near term. In addition to that, it announced that the balance sheet runoff will conclude at the end of September. Contrary to market expectations, at the end of April the FRS gave no further hints of monetary easing. At the press conference, the Chair of the FRS Jerome Powell announced that there is no intention either to raise or to lower the target range for the federal funds rate in the nearest future, thus ending the speculations about any potential rate cut. Despite this announcement, as at the end of May, the financial markets put an 85% probability on lowering of the target range for the federal funds rate by the end of 2019.

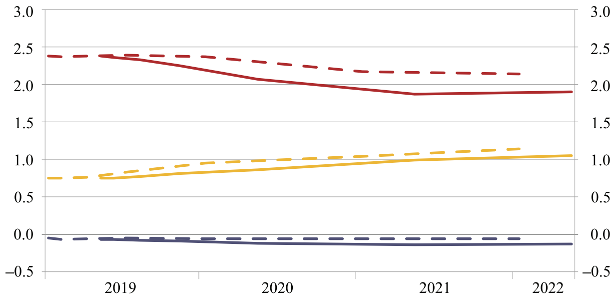
Like other major central banks, at the beginning of the year the Bank of England also viewed the probability of raising the Bank Rate during the year as very low and maintained an accommodative monetary policy stance. Over the first months of 2019, the Bank of England had to operate in the circumstances of particularly high uncertainty, considering the UK's commitment to exit the EU and the approaching initial date of departure which was subsequently pushed back. The UK's economy is the one to suffer most from the uncertainties and the negative economic impact of Brexit. Despite this high degree of uncertainty, the UK's economy has continued to grow and that has allowed the Monetary Policy Committee of the Bank of England to maintain a "wait and see" stance on interest rates. At the same time, it continues to hold that the future path of its monetary policy (and hence also the Bank Rate) is directly dependent on the eventual arrangements with the EU and that the response could be in either direction to achieve the 2% inflation target of the Bank of England.

The Bank of Japan continued with powerful monetary easing via an asset purchase programme and yield curve control. At its April meeting, the Policy Board of the Bank of Japan adjusted the economic growth forecast and announced its intention to maintain the current extremely low levels of short- and long-term interest rates at least until spring 2020, dispelling any rumours of an earlier rate increase in step with other major central banks, despite the failure to achieve the inflation target. Since the beginning of the year, the Bank of Japan mentions the following risks it its reports: the U.S. macroeconomic policies, rising protectionism, the UK's exit from the EU and the economic developments in emerging economies.

Chart 5

MARKET IMPLIED CENTRAL BANK POLICY RATES
(%)

US (January 2019)
US (May 2019)
UK (January 2019)
UK (May 2019)
Japan (January 2019)
Japan (May 2019)



2.2 Global financial market developments

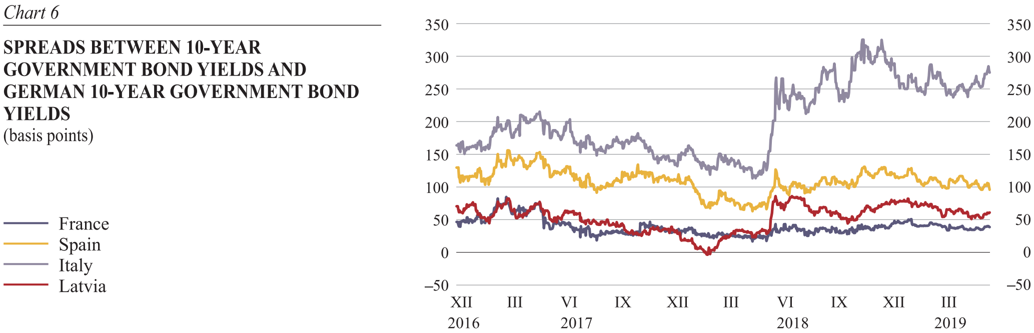
The year 2018 ended with a major stock sell-off, whereas in 2019 optimism was the prevailing sentiment on both stock and bond markets up until the beginning of May. After the re-intensification of the US-China trade tensions and the announcement of new tariffs, stocks fell in the second half of May. Stock price indices of the advanced economies have risen by nearly 10%. Moreover, as bond yields have contracted, the prices of debt securities have also increased. Although uncertainty has grown since the beginning of the year and the incoming macroeconomic data are worse than expected, this has not been fully priced in by financial markets. Partly this was because major central banks managed to time well their adjustments of monetary policy stances. Nevertheless, any further increases in stock prices are conditional on eliminating the factors causing the uncertainty.

Following the stock sell-off at the end of 2018, in the first quarter and at the beginning of the second quarter of 2019 financial markets were full of optimism, yet the latest news concerning the US-China trade talks worsened the situation in financial markets in the second half of May. The US-China trade talks are still ongoing and uncertainty remains high. Brexit developments over the period under review also did little to quench investors' activity. Most likely that, realising the negative implications of a no-deal Brexit on the UK itself and also the adverse short-term effects on its trade partners, financial market participants did not seriously believe that there was a chance that the UK government might allow it to happen. Even though financial market participants were optimistic about the outcome of geopolitical developments, the real economy data should have dampened their optimism. However, it turned out not to be the case. The impact of the adverse macroeconomic indicators was most likely mitigated by the major central banks: realising that the economic growth rate was starting to decelerate, they managed to time well the adjustments for their monetary policy stances, thereby reassuring financial market participants that support will follow. In addition, governments of some countries were also able to provide fiscal incentives or implied that such incentives will be provided in the future. This has also helped to offset the downward pressure of macroeconomic data on asset prices.

From early 2019 until the end of May, developed countries saw a decline in bond yields, even after the ECB terminated its net asset purchases at the end of 2018. The weighted average yield on the German 10-year government bonds declined by 44 basis points (to –0.20% as at 31 May), whereas the weighted average yield on the corresponding US Treasury bonds fell by 56 basis points (to 2.12% as at 31 May). The steep decline in the yields of government securities resulted from the central bank adjustments in their monetary policy stances as well as the growing investors' concerns about the impact of the US-China trade tensions on the global economy. Since the beginning of 2019, the weighted average yield on the French, Spanish and Portuguese government bonds also narrowed by 50, 70 and 91 basis points respectively. The Portuguese government bond yields shrank more rapidly as their credit rating was upgraded from BBB– to BBB by international credit rating agency S&P Global in mid-March. Meanwhile, the yield on the Greek 10-year government bonds recorded the steepest fall (by 149 basis points). On 5 April 2019, the euro area finance ministers approved the disbursement of a grant to Greece under the bailout programme, thereby confirming that Greece has met its reform commitments. At the same time, due to low yields on other euro area government debt securities, investors are more willing to purchase Greece's debt securities in search of higher yields. Meanwhile, yields on Italy's debt securities have remained broadly unchanged. The Italian government was unable to convince investors that it will implement sustainable fiscal policy, thus exerting an pressure on the yields of its debt securities. The weighted average yield on the UK 10-year government bonds contracted at a more moderate rate (by 39 basis points). Looking at the euro area countries, it is evident that spreads between the yields of the German government bonds and those of other euro area countries have narrowed, inter alia, due to adjustments in the monetary policy stances of central banks. Some countries, which are in need of a more accommodative monetary policy and in which interest rates are higher, experienced a more rapid fall in bond yields.

Chart 6

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



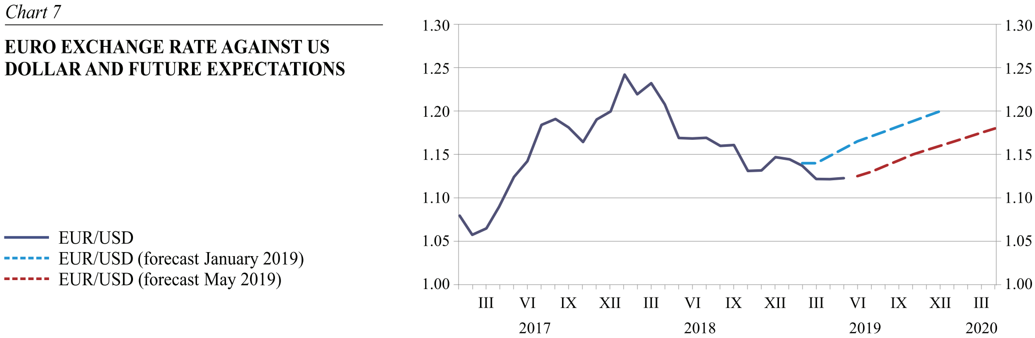
Since the beginning of 2019, optimism was the prevailing sentiment in stock markets. Following a steep drop at the end of 2018, stock price indices increased. At the beginning of May, stock price indices were close to their record highs calling for more caution with respect to future developments as the economic growth momentum has started to slow down and the uncertainty, which caused the stock sell-off at the end of 2018, continues to grow. So far, no solution has been reached in the US-China trade talks, and the UK withdrawal from the EU has only been postponed. Besides, uncertainty is also aggravated by the EU-US trade talks which are likely to be difficult. To ensure further growth of stock markets, the above issues should be solved as soon as possible and, preferably, according to the most optimistic scenario. The US stock market index S&P 500 has moved up by 9.8% since the beginning of the year. At the same time, the S&P 500 Banks index characterising the US banks and the Dow Jones Industrial Average index grew by 7.8% and 6.4% respectively.

Since the beginning of 2019, the European stock price indices have also risen. The European stock market index Euro Stoxx 50 increased by 9.3%, while the STOXX Europe 600 index characterising Europe's overall market picked up by 9.3%. Meanwhile, the Euro Stoxx Bank index characterising the banking sector decreased by 0.8% and was quite volatile in the period under review. The index is negatively affected by the movement of higher interest rate expectations to the more distant future, while TLTRO III has a positive impact on the index. At the same time, the UK stock market index FTSE 100 increased by 6.4%, and the banking sector index FTSE 350 Banks rose by 2.1%. Uncertainty related to the UK's exit from the EU continues to exert a downward pressure on asset prices in the UK.

Japan's stock market index Japan Nikkei 225 has grown by 2.9% since the beginning of 2019, whereas the emerging markets stock index MSCI Emerging Markets has moved up by 3.3%. Emerging market stock prices were positively affected by the FRS decision to delay the raising of the target range of federal funds rate, thus reducing capital outflows and the upward pressure on interest rates.

Chart 7

EURO EXCHANGE RATE AGAINST US DOLLAR AND FUTURE EXPECTATIONS



The exchange rate of the euro against the US dollar has decreased by 2.6% since the beginning of 2019 (to 1.117 US dollars per euro). Depreciation of the euro against the US dollar can be explained by a more rapid decline in the euro area economic growth rate. At the beginning of 2019, it was believed that the slowdown of the pace of the economic development will be temporary and transitory. However, according to the March projections, it could last longer. Taking account of the latest data, the ECB eased its monetary policy stance confirming investors' expectations that the interest rates are unlikely to increase in the near term. Since the end of January, the FRS has also adjusted its monetary policy stance, and no further changes to the target range for the federal funds rate are envisaged for the near future. Meanwhile, financial markets have started to price in the interest rate fall in the US leading to a slight decline in the spread between the German and the US 10-year government bonds; nevertheless, the spread remains wide. Due to higher interest rates, investors are more willing to make provisions and invest in the respective currency. Therefore, the US dollar is currently more advantageous for the above purposes. Despite the fact that the median forecasts made by surveyed experts have been erroneous for quite some time now, they still suggest that the euro is likely to appreciate vis-à-vis the US dollar in the medium term. A more significant increase in debt securities' interest rates in the US is prevented by the perception of investors that the US economy is already in the upswing of the business cycle, while the euro area is still at an earlier stage of the business cycle. It should be noted, however, that the market projections of the US economic growth have been exceeded several times over the past year. An upward pressure on the euro is also caused by the euro area current account surplus, whereas the US is running a deficit.

2.3 Conditions for financing the Latvian economy

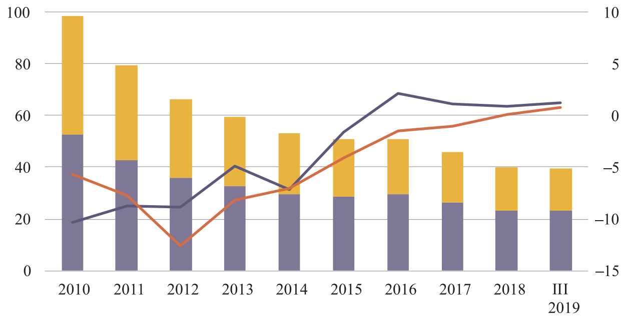
The decisions taken by the Governing Council of the ECB in March and June 2019 will contribute to favourable financing conditions in Latvia, providing attractive financing opportunities for the credit institutions intending to develop lending. Lending growth in Latvia remained slow, with a precautionary attitude prevailing both on the loan demand and supply sides. Although some sizeable loans made it necessary to revise upwards the forecast for an increase in total loans, the weakening of GDP growth and external demand did not contribute to an upturn in lending in the first quarter of 2019. Overall, the level of interest rates offered by credit institutions remained low and favourable for lending development. However, interest rates on loans from credit institutions are increasing in some lending sectors primarily on account of balance sheet constraints faced by credit institutions as well as due to changes in their risk perceptions and the structure of funding. The financial position of credit institutions and their ability to handle challenges linked to money laundering will affect interest rates on loans granted by credit institutions also in the future. The favourable situation prevailing in the labour market and income gains ensured a steady expansion of deposits. The decline in yields on Latvian government bonds improved financing conditions as well as provided an opportunity for Latvia to receive cheaper funding abroad.

With lending dynamics lagging behind accelerating economic growth rates over a long period, the ratio of the loan portfolio to GDP continued on a downward trend, i.e. in late 2018, loans to domestic non-financial corporations and households contracted to 40.2% of GDP (45.8% at the end of 2017). Thus, it was the firms' own funds that played an increasing role in economic development. This explained, to a certain extent, the relatively slow increase in deposits by non-financial corporations in previous years, while a slowdown in economic growth and all the more uncertain outlook support a steeper increase in savings by non-financial corporations in recent times.

Chart 8

DOMESTIC LOANS TO NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS

(% of GDP)
Non-financial corporations
Households
(annual rate of change; right-hand scale)
Non-financial corporations
Households

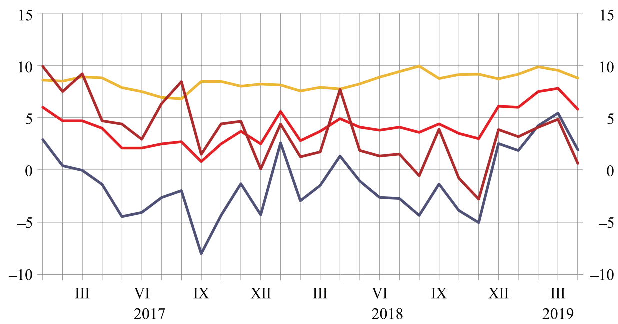


With government expenditure taking an upward trend, non-financial corporations closing the year and households receiving additional income, the last months of 2018 traditionally saw a sharp monthly rise in deposits. Moreover, domestic deposits recorded the steepest growth since the last month of 2013 when they were affected by the prospect of the introduction of the euro. Meanwhile, the first months of 2019 did not see a fall in foreign customer deposits, often a characteristic of the beginning of the year. The collection of deposits increased further, and the first four months of the year witnessed an increase in the aggregate domestic deposits (by 1.2%) as well as an expansion of deposits by non-financial corporations (by 1.6%) and households (by 0.9%). The annual growth rate of deposits reached 5.8% in April, with household deposits growing even faster. Since December, domestic deposits have already exceeded the loan portfolio, thus ensuring credit for credit institutions without using the assistance provided through the money market and foreign financing. This has enabled credit institutions to reduce their liabilities to foreign credit institutions (by 21.3% in January–April 2019). At the same time, the decline in foreign deposits, characteristic of the year 2018, decelerated, i.e. in the first four months of 2019, they fell by only 7.3% (the annual rate of decrease was 44.4% in April). The share of foreign deposits in total deposits contracted to 18.3% (29.8% in the same period of the previous year).

Chart 9

ANNUAL RATE OF CHANGE IN DOMESTIC DEPOSITS
(%)

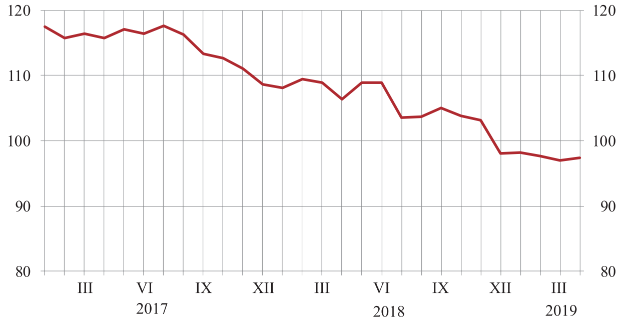
Total deposits by financial institutions, non-financial corporations and households
Deposits by financial institutions and non-financial corporations
Deposits by households
Deposits by non-financial corporations



Credit institutions have maintained very beneficial conditions for attracting funding in the domestic deposit market since late 2018. Interest rates on domestic deposits, representing the largest share in funding of credit institutions, were close to zero. The interest rate on euro deposits of domestic non-financial corporations and households was 0.1% in April 2019, the same as in October 2018. Meanwhile, the interest rate on new fixed-term euro deposits

Chart 10

DOMESTIC LOANS TO DEPOSITS RATIO
(%)

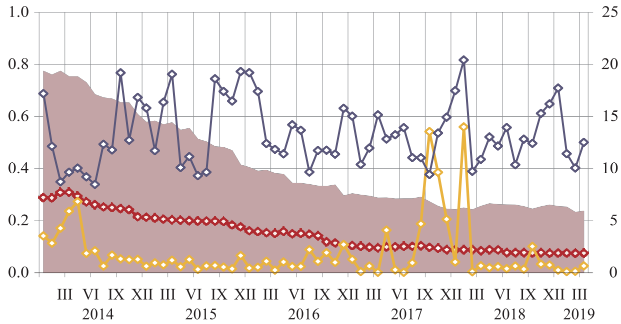


by non-financial corporations and households was 0.03% and 0.5%, respectively (0.1% and 05%, respectively, in October 2018). As a result of the monetary policy implemented by the ECB, deposit rates have reached the lowest level ever. It allows Latvian credit institutions to offer loans to domestic households and non-financial corporations on more favourable conditions. However, loans are also affected by other factors, e.g. lending policies and financial strength of credit institutions as well as borrowers' risk.

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
(%)

Weighted average interest rate on euro deposits
Weighted average interest rate on new euro fixed-term deposits by non-financial corporations
Weighted average interest rate on new euro fixed-term deposits by households
Share of euro fixed-term deposits in total deposits by domestic non-financial corporations and households (right-hand scale)



In November 2018–April 2019, loans to domestic non-financial corporations and households grew by 0.7% overall (in the first four months of 2019 – by 0.5%), and the annual growth rate of adjusted domestic loans stood at 2.4% in April (excluding the one-off effects triggered by the structural changes in the credit institution sector[1]). Moderate positive annual growth was recorded in all segments, i.e. in lending both to non-financial corporations (the adjusted annual growth rate was 3.2%) and to households (the adjusted annual growth rate was 1.0%), including also loans for house purchase 1.8%). The contribution provided by non-bank financial institutions, mainly leasing companies, to lending continued on an upward path. Their loan portfolio has already been expanding faster than that of credit institutions for several years (in 2018, loans to both non-financial corporations and households granted by leasing companies picked up by 6%–7%). By sector, the loan portfolio has expanded significantly during the last two quarters primarily in the fields of infrastructure, hotel and real estate development, i.e. by 11.4% in the energy sector, 1.7 times in the accommodation and catering sector, by 3.2% in the transport sector as well as by 4.9% in the real estate sector. At the same time, credit institutions' loan portfolio has contracted in the manufacturing, agricultural and trade sectors. However, financing provided by leasing companies has increased notably in the above sectors as well as in construction. The annual growth indicator of lending to households has been positive since late 2018. The upward trend has been driven by a steady rise in loans to households for house purchase brought about by the state support programme as well as by an increase in consumer lending.

[1] The effect of the cancellation of the ABLV Bank, AS credit institution's licence in July 2018 has been excluded.

Chart 12

ANNUAL RATE OF CHANGE IN DOMESTIC LOANS*
(%)

Total loans to financial institutions, non-financial corporations and households
Loans to households
Loans to non-financial corporations
Loans to non-financial corporations and households

* Excluding the effects of banking sector restructuring.

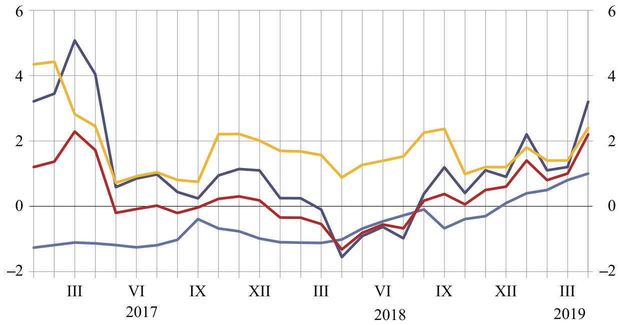
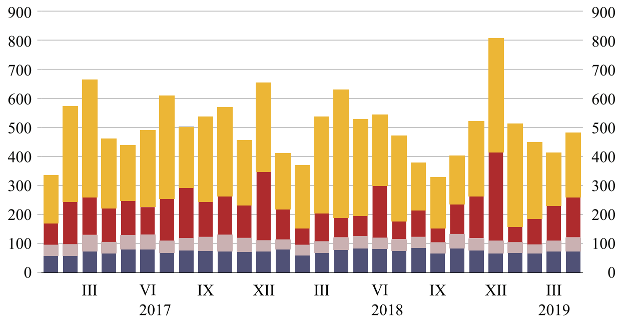


Chart 13

NEW LOANS
(millions of euro)

New contracts (households)
Renegotiated contracts (households)
New contracts (non-financial corporations)
Renegotiated contracts (non-financial corporations)

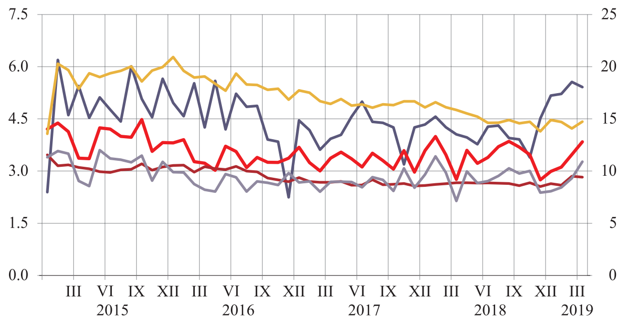


Loans to non-financial corporations became less available. At the same time, however, the demand by low-risk businesses substantially reduced loan financing costs. Some credit institutions reported tightening of credit standards as well as the terms and conditions applied to loans to non-financial corporations. The euro area bank lending survey revealed that the fourth quarter of 2018 and the first quarter of 2019 saw one of the four surveyed Latvian credit institutions tighten the credit standards for long-term loans to large enterprises and two credit institutions widen margins on average or riskier loans. Credit institutions reported that they had also somewhat tightened other credit terms and conditions for loans, including the amendments to loan agreements related to the prevention of money laundering. At the same time, several low-risk businesses made the general public aware of the fact that they had received sizeable long-term loans. For instance, AS Latvenergo announced in December 2018 that it would borrow 240 million euro for a period of 7–10 years from four credit institutions operating in Latvia to implement investment projects. As a result, the interest rate on new euro loans to non-financial corporations decreased to 2.4%. By the end of March, it returned to the levels seen before (2.9% in October 2018; 2.8% in March 2018), but April saw it rise to 3.3%. Some important transactions may lead to volatility of interest rates on loans to non-financial corporations in Latvia's lending market. However, the euro area bank lending survey suggests that greater balance sheet constraints and cost of funds faced by Latvian credit institutions, tighter credit institutions' risk assessment and less competition among credit institutions may play a more important role in the coming quarters. Therefore, financing conditions for non-financial corporations cannot reasonably

Chart 14

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

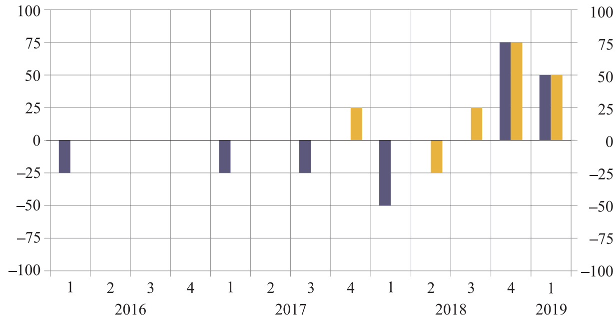
Loans to households for house purchase
Other loans to households
Loans to non-financial corporations
Total loans
Consumer credit (right-hand scale)



be expected to improve in the next half of the year. Overall, changes in funding conditions were less unfavourable for loans to non-financial corporations than to households in the first quarter of 2019.

Chart 15

CHANGES IN MARGINS ON LOANS TO HOUSEHOLDS FOR HOUSE PURCHASE
(net changes; Latvian credit institutions that took part in the bank lending survey; %)



Margins on average loans
Margins on riskier loans

Funding conditions for loans to households for house purchase deteriorated in the first quarter of 2019. Credit institutions tightened credit standards as well as widened margins on both average and riskier loans to households for house purchase. The euro area bank lending survey conducted in the fourth quarter of 2018 and in the first quarter of 2019 suggests that one and two of the four surveyed credit institutions, respectively, applied tighter credit standards for loans to households for house purchase. Meanwhile, three and two of the four surveyed credit institutions reported in the fourth quarter of 2018 and the first quarter of 2019, respectively, that they had widened margins on the respective loans. The changes in lending referred to by credit institutions were also reflected in interest rate statistics, i.e. in January–April 2019, interest rates on new euro loans to households for house purchase rose by 0.2 percentage point (to 2.8%). The increase in interest rates was primarily related to credit institutions' balance sheet constraints and cost of funds and to a lesser extent – to a credit institution's risk assessment and its risk tolerance.

The last months of 2018 and the first quarter of 2019 saw the cost of funds for consumer credit and other lending to households fluctuate, i.e. interest rates on consumer credit remained broadly unchanged and those on other lending to households were on the rise. Consumer credit and other lending to households became less available, and their interest rates varied primarily depending on borrowers' risk level. Based on the euro area bank lending survey data, one of the four surveyed credit institutions applied somewhat tighter credit standards for consumer credit and other lending to households in the fourth quarter of 2018 and two credit institutions – in the first quarter of 2019. Meanwhile, all surveyed Latvian credit institutions kept the terms and conditions for consumer credit and other lending to households unchanged in the first quarter of 2019. At the same time, the interest rates on new consumer credit in euro remained broadly unchanged (14.6% in October 2018; 14.7% in April 2019), but those on other lending to households climbed (3.9% in October 2018; 5.4% in April 2019). Given the changing structure of the loans granted and the increasing risk level of borrowers, the interest rate on other lending to households followed an upward trajectory. Consumer credit and other lending to households could become less available to riskier customers of credit institutions, thus contributing to a decline in the respective interest rate. Although the interest rates on the loans granted by credit institutions do not follow a downward path anymore, they are low enough to facilitate lending development.

Despite the fact that lending growth is somewhat faster than expected on account of particular major long-term transactions, lending dynamics, overall, will remain relatively moderate in 2019. External risks and their perception in a more critical manner by both credit institutions and consumers as well as the shadow economy-related structural factors will reduce both loan demand and supply.

The international credit rating agencies Fitch Ratings and S&P Global as well as Japanese credit rating agency R&I kept Latvia's credit rating unchanged (A, A and A–, respectively) with a stable outlook. The credit rating agencies appreciated Latvia's robust economic growth and balanced fiscal policy as well as highly appreciated the country's institutional stability and political structure ensured by EU and euro area membership. The credit rating agencies emphasised that Nordic banks will continue to play a major role in the country, and developments in the segment of credit institutions providing services to foreign customers will not have a material impact on the domestic credit institution sector.

The liquidity position of credit institutions remained high and broadly unchanged, i.e. excess liquidity was on average 4.4. billion euro in the first five months of 2019. Latvian credit institutions had plenty of available resources, which stimulated interest in investing in the government securities market.

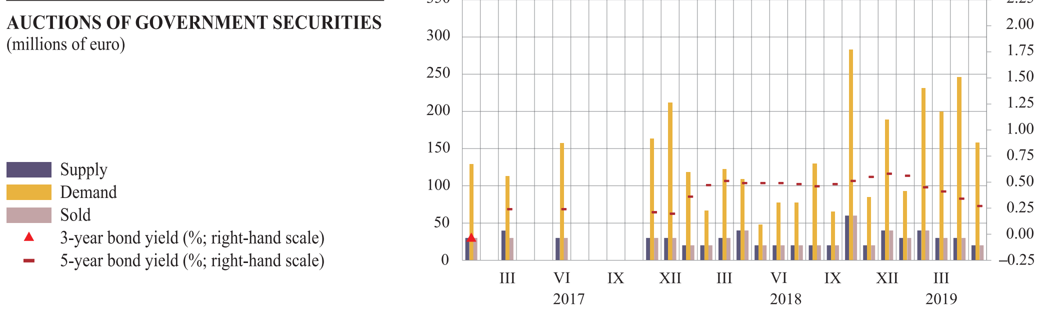
The Treasury issued 5-year bonds five times in the domestic securities market in January–May 2019. The supply totalled 150.0 million euro but the demand – 928.7 million euro (the supply coverage was 4.7 in the previous five months, but it reached 6.2 in January–May). The auction's average interest rate edged down from 0.56% in January to 0.27% in May. ECB monetary policy decisions supported demand for securities, i.e. the Governing Council of the ECB decided that the key ECB interest rates would remain unchanged in 2019. Consequently, the decision also affected medium and long-term interest rates. The domestic market saw Latvian bond yields follow a downward path. This decrease was, however, even sharper on external markets.

In February, the Latvian government issued 30-year eurobonds on external markets totalling 700 million euro with the average yield of 1.93%. The spread over the same maturity German government bonds was 120 basis points, but the spread over the 30-year swap rate stood at 68 basis points. It was in September 2018 that Latvia last issued 30-year bonds on external markets. The average interest rate was 1.86%, but the amount – 200 million euro. The spread over the same maturity German government bonds was 87 basis points, but that over the swap rate stood at 38 basis points. In May, the Latvian government issued the additional 30-year eurobonds in the amount of 300 million euro with the average yield of 1.76%. The spread over the same maturity German government bonds was 121 basis points, but the spread over the 30-year swap rate accounted for 74 basis points.

On the secondary market, the yields of the Latvian government bonds with the remaining maturity of nine years contracted from 1.02% in late December 2018 to 0.42% at the end of

Chart 16

AUCTIONS OF GOVERNMENT SECURITIES
(millions of euro)



May. The spread over the same maturity German government bonds narrowed from 91 basis points to 73 basis points. This meant that Latvia's risks vis-à-vis other euro area countries were mitigating since the majority of countries saw the yield spreads shrink at a more moderate rate.

At the end of May, Latvia's share price index OMXR was 13.1% higher than at the beginning of the year, while the Baltic share price index OMXBBGI grew by 8.8%. The most significant developments in leading pharmaceutical companies were as follows. The share price of AS GRINDEKS, the second largest publicly quoted Latvian company in terms of capitalisation, increased by 89.2% since early 2019 due to news in relation to shareholders' preparations for the mandatory share buyout offer to be made by 31 August. Meanwhile, the share price of AS Olainfarm, the third largest publicly quoted Latvian company in terms of capitalisation, fell by 5.1% as a result of shareholders' disputes concerning control of the company. The share price of the largest company in terms of capitalisation, AS Latvijas Gāze, rose by 2.0%. The highest turnover was recorded for the shares of AS GRINDEKS and AS Olainfarm as usual (6.5 million euro and 4.4 million euro, respectively). In May, AS Attīstības finanšu institūcija Altum issued bonds totalling 15 million euro (the first issue under the bond issue programme amounting to 70 million euro). Demand, primarily by Baltic investors, exceeded supply 13 times. The bond yield until the maturity date was 0.95% and the maturity – six years.

3. Sectoral Development[1]

With the global economic cycle approaching slowdown and high uncertainty persisting in the external economic environment, economic agents of Latvia have become more cautious, and it was already in the first quarter of 2019 that economic growth slowed down more than expected. The adverse effects of temporary domestic factors (e.g. the impact of weather conditions on agriculture and energy) also persist. Therefore, Latvia's GDP growth for 2019 has been revised downwards.

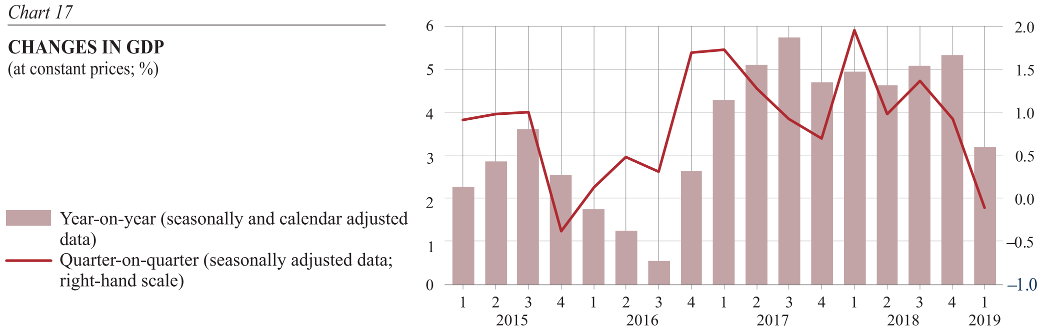
In 2018, when investment in the private and public sectors posted a sharp rise, GDP growth remained as strong as in 2017, i.e. 5.0%. A wide range of sectors experienced successful development, including the construction and information and communication services sectors whose annual growth exceeded 10%. The transport sector also recorded successful development due to the favourable situation lasting longer than expected, i.e. repairs at the port of Ust-Luga in Russia.

However, the second half of 2018 saw the export performance weakening. With uncertainty in the external economic environment increasing as well as the effects of the favourable one-off factors observed in 2018 (e.g. the transport sector development) fading, economic growth was expected to slow down gradually in 2019. However, according to the estimates made in December, the unfavourable impact of external factors was expected to be offset by domestic factors in the coming quarters, e.g. household income growth and still high investment activity. Retail growth, the volumes of the absorbed EU funding in January–March as well as the projects underway and the newly announced investment projects suggested ongoing robust development in the first quarter of 2019.

GDP data for the first quarter of 2019 show continuing strong domestic demand; however, the growth rate tends to decelerate. The effects of the temporary unfavourable factors prevailing in 2018 still persist, e.g. the impact of weather conditions on harvest and energy production. Thus, it is not only development of the external-market-oriented sectors that has been affected but also growth of the sectors primarily satisfying the domestic market needs.

Chart 17

CHANGES IN GDP
(at constant prices; %)



In the first quarter of 2019, Latvia's economic growth decelerated substantially, and such a deceleration (GDP growth –0.1% in quarter-on-quarter terms and only +3.2% in year-on-year terms) was not expected. Therefore, Latvijas Banka's real GDP growth forecast for 2019 has been revised downwards from 3.5% to 2.9%. Overall, vision for the future development remains the same. According to Latvijas Banka's assessment, the decline in GDP observed in the first quarter of 2019 will not be sustainable, and the forecast for 2020 remains unchanged at 3.1%.

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

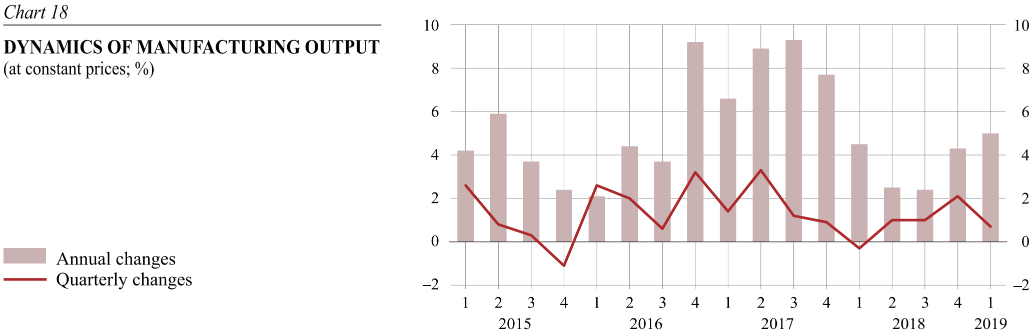
3.1 Manufacturing and energy

Despite the moderation in external demand, manufacturing growth remained relatively robust in the first quarter of 2019 and exceeded the projections (a constant level in quarter-on-quarter terms and a 4.5% increase in year-on-year terms). More dynamic manufacturing growth has been hampered by the insufficient capacity on the supply side (high level of capacity utilisation of the existing machinery and labour shortage) which was observed earlier and is still relevant in some sectors, limiting many producers' capacity to execute larger orders. Therefore, the declining activity of customers has not considerably affected the output. Moreover, new investment enables producers, whose products continue to enjoy a high demand, to expand their production.

However, the current situation will most likely not last for long, and the unfavourable developments in the external economic environment will also be reflected in manufacturing performance; recent producer surveys already show that the assessment of export orders has deteriorated. Moreover, the wood processing sector's performance is expected to weaken. The prices of wood recorded a sharp fall during the recent months. The contribution provided by the wood processing sector to manufacturing growth remained significant in the first quarter. However, it can be relatively reliably predicted that the sector's performance will weaken in the second half of the year, with only some segments, e.g. secondary processing (more processed) products, maintaining good performance. The final product prices will remain stable vis-à-vis the falling commodity prices. In 2018, the wood processing sector saw significant investment in machinery, including various automation processes, which could support the sector's growth and improve its competitiveness.

Chart 18

DYNAMICS OF MANUFACTURING OUTPUT
(at constant prices; %)



The technologically advanced sectors, i.e. the manufacture of electronic and electrical equipment and other machinery and equipment, remained significant contributors to manufacturing growth in the first quarter. The above sectors are characterised by relatively high performance, and their rapid growth over the past years has been an important pillar of the entire manufacturing sector. However, these are the sectors producing mainly for exports. Therefore, they are greatly exposed to changes in the external demand, and this suggests that growth of these sectors is expected to decelerate.

The first quarter of 2019 was particularly unfortunate for the mining, energy and water supply sectors with a significant drop in the volume of generated electricity. Like the situation in the agricultural sector, the failure was rooted in weather conditions, and in this particular case, inflows of water in hydroelectric plants were insufficient. The Nord Pool Spot data suggest that the electricity generation level remained low in Latvia also in April and May. However, the change of weather conditions might facilitate a gradual renewal of the volume of generated electricity later this year.

3.2 Construction and the real estate sector

The construction growth rate moderated somewhat compared to the very strong dynamics observed in 2018. In the first quarter of 2019, the value added in construction even decreased slightly (by 0.7%) quarter-on-quarter, but it continued a solid rise (7.7%) year-on-year. The decline seen in the first quarter was driven by the fall in construction of engineering structures (this segment posted a very robust growth during the previous two years due to investment from EU funds). The sharp increase in the volume of building construction and specialised construction works still persists. The segments of apartments, private houses and commercial real estate also experience positive dynamics.

In the first quarter of 2019, construction output picked up by 1.8% quarter-on-quarter and by 7.2% year-on-year. In year-on-year terms, the highest increase in the construction volume was observed in building construction and specialised construction works, i.e. demolition of buildings, site preparation, completion of works as well as electrical installation and pipeline installation. The reduction in construction of hydrotechnical projects and civil engineering structures, not elsewhere classified, affected the decline in construction output in civil engineering at the beginning of the year.

The level of construction costs continues on an upward path. In the first quarter of 2019, it moved up by 1.0% quarter-on-quarter and by 5.0% year-on-year, including the steepest rise in wages of employees by 8.2% and building material prices by 4.5%, but maintenance and operational costs of machinery and mechanical appliances – by 3.7%. According to the Eurostat data, Latvia experienced one of the highest increases in construction costs in Europe over the past two years, including the strongest rise in labour costs. One of the reasons behind the elevated labour costs is the reduction of the scale of the shadow economy in the construction sector, and this was primarily supported by a decreased incidence of the use of the so-called envelope wages for remuneration purposes in 2018. The share of the shadow economy in construction constituted 34.1% of GDP in 2018 (35.2% in 2017). The introduction of a collective agreement could contribute to boosting competitiveness in the construction sector and the reduction of the shadow economy in the medium term. The collective agreement of the construction sector will take effect on 3 November 2019. It provides that the minimum gross wage in construction shall be 780 euro, and that an employee may receive a 5% premium if he/she has acquired an appropriate education required for the profession, thus guaranteeing the minimum wage of 820 euro. To reach the long-term objectives of the construction sector, i.e. more efficient utilisation of resources and transparency of processes, the collective agreement should be combined with other control measures, e.g. electronic time sheets as well as control measures taken by the State Revenue Service and the State Labour Inspectorate.

The construction confidence indicator, following improvement in March, deteriorated further primarily on account of worse employment expectations and, to a lesser extent, owing to more negative order assessment, which remained at historically high levels. The issued building permits suggest that the construction sector is expected to grow further. The implementation of significant projects commenced in 2018 will continue in 2019, i.e. the reconstruction and expansion of the shopping centres Origo and Alfa, the expansion of the passenger service infrastructure and development of the cargo sector of VAS STARPTAUTISKĀ LIDOSTA "RĪGA", the construction of the Lidl Latvija SIA logistics centre in Ulbroka, the expansion of SIA RIMI LATVIA logistics centre in Riga, the construction of academic buildings of the University of Latvia, the first stage of works in the outlet village Via Jurmala Designer Outlet Village in Piņķi, the construction of residential building complexes, etc. The information about the construction of new large-scale projects, i.e. the potential construction of a wind power plant in Dobele and Tukums regional communities, the setting up of a bioethanol plant in Bauska, the construction of the new building of Pauls Stradiņš Clinical University Hospital, the construction of the Ice Hall in the Daugava Stadium, improvement of the canal side infrastructure and the public outdoor area of the Riga Central Market and the reconstruction of its underground basements, the construction of a new air filter production facility for SIA Dinair Filton, residential building complexes in Brīvības and Tallinas streets, etc. confirms sustainable development of the construction sector.

The availability of EU funding, information about development of various investment projects basically in all construction sectors, sentiment indicators, household purchasing power and the demand in the housing segment point to favourable conditions for construction development in 2019. The sector's key problems relate to a rise in construction costs due to the shortage of skilled labour and increased costs of building materials.

The real estate market saw a rebound in activity at the beginning of the year. In the first quarter of 2019, following the fall observed in 2018, the number of real estate purchases registered with the Land Register increased slightly. The largest increase in the number of purchases was in Riga. Development of the real estate market in the category of residential buildings is steady, the demand for new housing is rising and the data on the issued building permits also show an expected further growth of the real estate sector. Information published by real estate companies on transactions with standard apartments suggests that the rate of increase of prices reached 7.3% in the first quarter (the average price rise in 2018 was 6.3%).

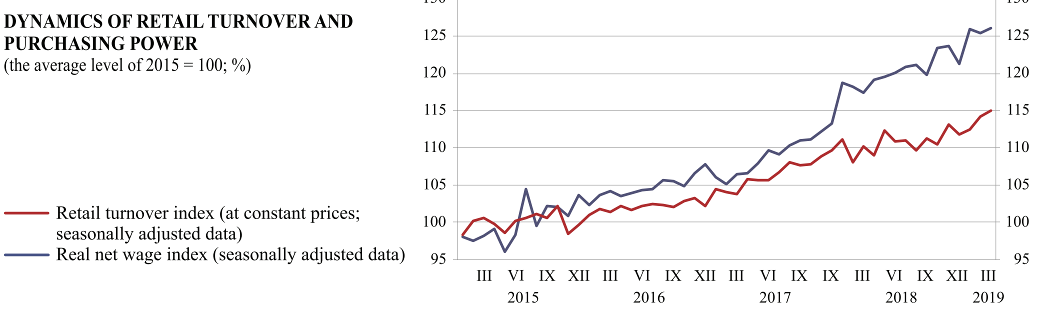
The number of real estate transactions and housing prices are expected to go up gradually also in 2019. The rise in real estate prices will be steady, and it will still be driven by rather strong household income growth. The average areas of the purchased residential properties followed a downward path in 2018, pointing to the global trend in demand for smaller apartments since the so-called millennial generation interested in well-designed and ergonomic housing is entering the housing market. The year 2018 witnessed the implementation of several sizeable residential building projects in Riga, Pieriga, Jūrmala and elsewhere in Latvia (Kalnciema Kvartāla Rezidences, Imantas Ozoli, Ezerparka nami, Skanstes Parks, Merks Gaiļezera nami in Riga, Tuvidi in Baloži, etc.). In response to the market demand, the construction of blocks of residential buildings in Riga is expected to continue also in the future.

3.3 Trade

The household income growth continues to provide favourable conditions for retail trade development. In the first quarter of 2019, the annual rise in retail trade turnover at constant prices (3.7%) was faster than a quarter ago and steeper than the overall economic growth. The contribution by non-specialised trade (retail sale in non-specialised stores selling primarily non-food goods) as well as retail sale of housing-related goods remains high. This suggests that household income and demand are rising steadily. The opening of new shopping centres or the expansion of the existing ones in Riga and its vicinity might initially trigger keen interest of consumers and further benefit retail trade in 2019 and 2020. At the same time, a slowdown in economic growth will likely lead to increased precaution and will contribute to a rise in household savings.

Chart 19

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



In the first quarter of 2019, the trade sector as a whole was one of the pillars of economic growth (the value added picked up by 2.1% quarter-on-quarter and by 4.6% year-on-year) despite the fact that the weak export data relating to the first two months of the year signalled a potential deceleration in wholesale growth. At the same time, it should be noted that temporary factors supported the increase in exports in March, thus leaving the vision for export and wholesale growth unchanged for the year as a whole.

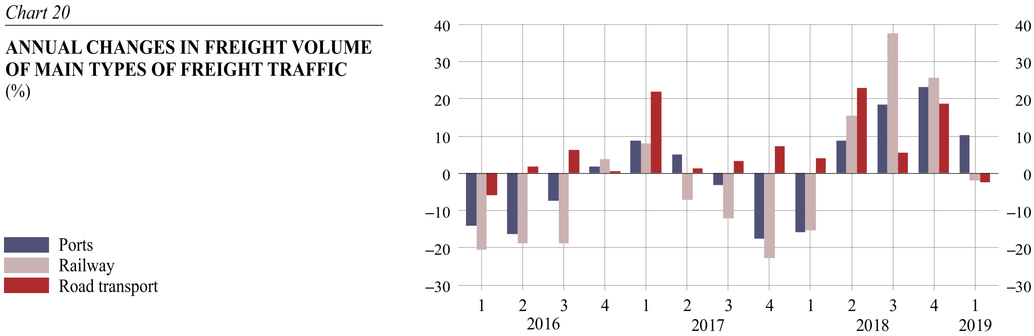
Although monthly data on the sale of motor vehicles are relatively volatile, the data provided by the Road Traffic Safety Department concerning vehicles (including cars) registered for the first time in the first four months of 2019 suggest a sustained upward trend that is consistent with the vision of sustainable private consumption.

3.4 Transport

Following the good performance in 2018, the transport sector's growth rate appears to be on a downward path in 2019 (as already forecast in December) due to decelerating growth in trade partners and a gradual disappearance of the beneficial effects of one-off factors prevailing in 2018, i.e. repairs at the port of Ust-Luga in Russia. The first quarter of 2019 saw the rail freight volume decreasing and also the cargo volume growth rate at ports contracting. The rise in exports of transportation services has also receded to a minimum. The forecast of weak further development of the transport sector has remained broadly unchanged.

Chart 20

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



Although cargo turnover at ports picked up by 10.4% in the first quarter in year-on-year terms, preliminary data for April show a decline. Moreover, the situation varies across Latvia's ports. In the first four months of 2019, the port of Riga experienced a contraction of freight volume, i.e. the volume of coal and oil product cargoes decreased, but the expansion of the volume of general cargoes was more moderate than in late 2018. The port of Liepāja also saw the cargo volume contracting in early 2019 when the volume of grain cargoes decreased. Meanwhile, the port of Ventspils witnessed a further sharp rise in cargo volumes at the beginning of the year, with the volume of bulk cargoes expanding in contrast to other ports, albeit the rate of increase is shrinking also at this port. Both new terminals of Krievu Island became operational in the first quarter, thus reaching the planned overall capacity of the Krievu Island project, i.e. 20 million tons of bulk cargoes per year. However, the current trends of coal cargo turnover suggest that the above capacity might not be fully utilised in the near future. Port deepening, costing 24.5 million euro, has begun in Liepāja. The work is scheduled to be completed before cargos of newly harvested cereals arrive, thus accelerating freight transhipment.

The volume of rail freight posted a decrease of 2% in the first quarter of 2019. VAS Latvijas dzelzceļš, whose performance in 2018 was the best over the past three years, intends to maintain a similar volume of cargoes also in 2019. However, taking account of the fact that the capacity of Russian ports is following an upward path and new investment in infrastructure is under way, the cargo volume will most likely continue to decline. Although the volume of Belarussian freight transit by in land transport has been expanding gradually, it is unlikely to be able to offset the contraction of the rail freight transit volume provided by Russia – Latvia's major partner of rail freight transit. There is evidence that Belarus has expressed interest in purchasing port infrastructure in the Baltic Sates and that it wants to increase the oil transit volume. However, this contribution is unlikely to be sufficient to prevent a decline in the volume of coal cargoes, taking account of Russia's desire to redirect cargoes to its domestic ports.

In 2018, a drop in international freight turnover resulted in a modest road freight transport growth, while domestic transportation experienced expansion. However, the first quarter of 2019 saw the international freight turnover pick up and at the same time the domestic cargo turnover take a downward path. Nevertheless, such development might not last long since the external demand is edging down. Moreover, the current political momentum at the EU level is unfavourable for Latvia's carriers transporting freight by road. The Mobility Package sets out tighter conditions for the road freight transport sector. Therefore, costs are expected to go up, reducing international competitiveness. The road transport sector is also still short of labour therefore its growth potential is declining.

Air transport is still witnessing positive development, with the number of air passengers handled increasing further, albeit at a more subdued rate than to date. In early 2019, the rise in the number of passengers edged down at VAS STARPTAUTISKĀ LIDOSTA "RĪGA", but remained sufficiently dynamic. Moreover, the preliminary data for April and May show an increase. At the end of 2018, the pickup in freight transportation followed a downward trend, and it continued to decline also in the first quarter of 2019. Air transport is expected to experience positive development. It has been planned to start the sixth stage of the airport extension in 2019 to build a new public area of the passenger terminal and the related infrastructure, thus stepping up passenger handling capacity of the airport. The construction of a new cargo platform will be commenced in parallel with the implementation of the sixth stage to increase the cargo volume handled at the airport.

Overall, the buoyant growth of the transport sector observed last year was short-lived, and the transport sector will no longer be able to deliver such a significant contribution to GDP growth in 2019. This is also confirmed by the sector's value added, which edged down by 1.3% in the first quarter in quarter-on-quarter terms (a 5.0% rise in year-on-year terms).

3.5 Information and communication services

The value added of information and communication services posted a 12.9% increase in 2018, representing the second steepest growth observed for the third consecutive year, outpaced only by the construction sector. The lack of specialists has already been constraining the sector's higher growth for a long time. Although enterprises seek to attract both part-time and full-time employees opting for teleworking, including those living abroad, and raise the relatively high wages (the average monthly wage in the sector is 1592 euro, including providers of computer services – 1891 euro, corresponding to 159% of the average wage in the economy), the labour demand still exceeds the labour supply. Therefore, against the background of weakening external demand growth, the sector's upstream dynamics could persist, and the export volume could continue to expand. This is also confirmed by the first quarter data revealing a 1.2% rise in quarter-on-quarter terms and a 10.8% increase in year-on-year terms.

4. GDP Analysis from the Demand Side[1]

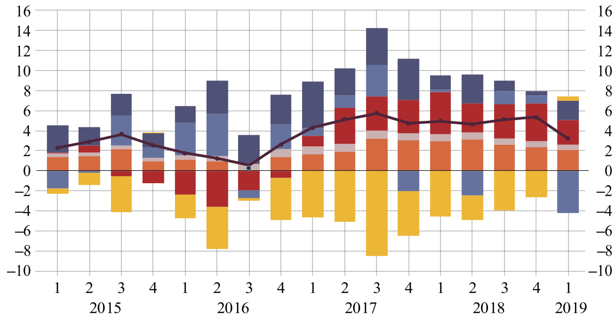
4.1 Domestic Demand

At the end of 2018, domestic demand growth remained stable and even stronger than projected. This was due to a rise in the household income and, hence, higher spending capacity as well as stronger-than-expected investment growth. However, with the weakening growth of external demand, the expansion of domestic demand is also expected to decelerate, and this may first manifest itself in reduced risk appetite among investors. Meanwhile, the ongoing sizeable investment projects and an increasing number of announced new investment plans give reason to anticipate that in 2019 the investment activity will remain overall relatively strong.

Chart 21

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 (%)



At the beginning of 2019, the private consumption continued on a stable upward trend, albeit at a gradually slower rate, posting increases of 0.6% and 3.3% quarter-on-quarter and year-on-year respectively. Growth is sustained by a rise in the average real net wage and an increase in the rate of employment. Consumer sentiment has remained within the usual fluctuation range and, thus, household consumption and saving habits are not expected to change significantly in the near term. In the short run, consumption is also expected to be driven by supply as the number of shopping centres in Latvia is constantly increasing (see the trade sector description).

Chart 22

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

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

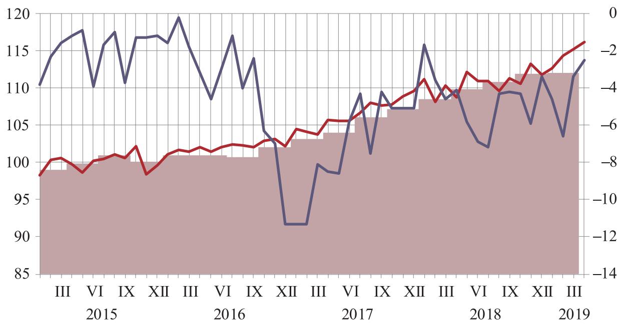
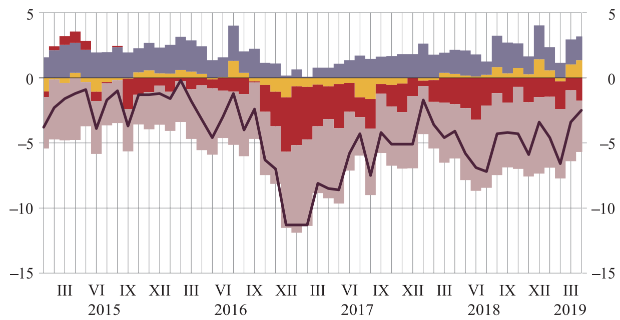


Chart 23

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



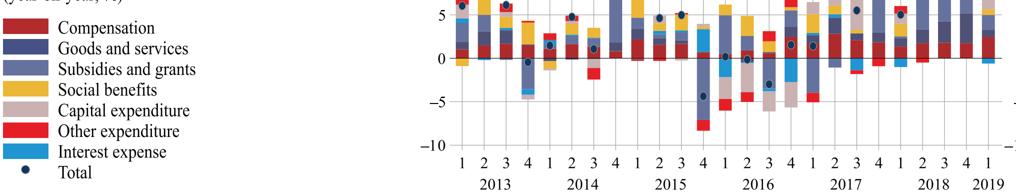
[1] This chapter analyses GDP and demand components at constant prices, using seasonally and calendar adjusted data (unless otherwise specified).

Among the components of domestic demand, it is investment that is facing the highest levels of uncertainty. On the one hand, moderation in external demand growth will reduce investors' risk appetite. Besides, in the circumstances of weak lending activity, credit institutions are cautious. Moreover, corporate profitability is expected to suffer, and stable financing is only ensured by the EU funding. On the other hand, growth exceeded the forecasts in 2018. Many sizeable investment projects, which might even raise the problem of construction capacity, have been launched and many are still in the planning stage. For instance, according to the published information, SIA GALLUSMAN is planning to construct a new site in Madliena for the production of eggs and egg products (over 85 million euro investment); the construction of a new industrial park, which is to become one of the largest logistics centres in the vicinity of Riga, has been launched in the Stopiņi municipality (45 million euro investment); AS Dobeles dzirnavnieks is planning to invest 18 million euro in the development of the largest organic grain full processing infrastructure in the Baltic States, etc. The government capital expenditure continues on a steep upward trend increasing by 34.4% year-on-year. The rise in capital expenditure is related to additional investment in the infrastructure of the National Armed Forces as well as higher spending on the projects co-financed by EU funds to be implemented at the level of local governments. Overall, in the first quarter of 2019 investment growth remained strong, albeit weaker than in the previous year, posting increases of 1.2% and 10.5% quarter-on-quarter and year-on-year respectively.

In the first quarter of 2019, government expenditure recorded a notable year-on-year rise primarily on account of the legal acts adopted in 2018 envisaging higher wages for those working in the health care sector, enforcing the Constitutional Court ruling on raising the wages of judges and prosecutors and stipulating a benefit to be paid to interior system officials every five years of service. Budget expenditure on compensation and on goods and services, both reflecting the overall government consumption expenditure, grew by 11.2% and 5.9% year-on-year respectively. While part of the allocated financing is to be provided also in the future, the rate of increase in the government expenditure is expected to decline somewhat. Meanwhile, the rise in compensation would be even higher if the financing allocated to the health sector was not reported under the subsidy and grant expenditure which posted a 5.9% year-on-year increase.

Chart 24

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



In the first quarter, overall, the government expenditure grew significantly by 9.1% year-on-year, primarily on account of increased financing for wages. It should be noted, however, that higher spending was recorded for all government budget expenditure items, except for the general and local government expenditure on interest payments for debt servicing which is expected to decline further. At the same time, the general government budget revenue picked up by 7.2% primarily due to an increase in the funds paid out by the European Commission for the implementation of EU co-financed projects in 2018. The tax revenue growth was more subdued (3.2%) on account of two main reasons. On the one hand, with both the number of the employed and the level of wages rising in the economy, the revenue from taxes on labour increased correspondingly: the revenue from the personal income tax picked up by 2.1%, whereas social security contributions grew by 15.9%. The expansion of the wage bill also lead to higher revenue from taxes on consumption, with revenue from VAT and excise tax posting increases of 13.% and 11.5% respectively. On the other hand, owing to previous legislative amendments, gross revenue from corporate income tax declined, whereas corporate income tax refunds increased. Overall, in the first quarter of 2019 corporate income tax revenue was negative, with refunds exceeding contributions by 11.1 million euro.

In 2019, the target of the general government budget deficit, approved in the State Budget by the Saeima of the Republic of Latvia in April, is 0.5% of GDP (according to the CSB data, the general government budget deficit amounted to 1.0% of GDP in 2018). According to the budget balance assessment carried out by Latvijas Banka in May, the budget deficit is projected to be 0.7% of GDP in 2019. Overall, in 2019 fiscal conditions will remain broadly unchanged and will continue to facilitate domestic economic growth.

4.2 Trade balance

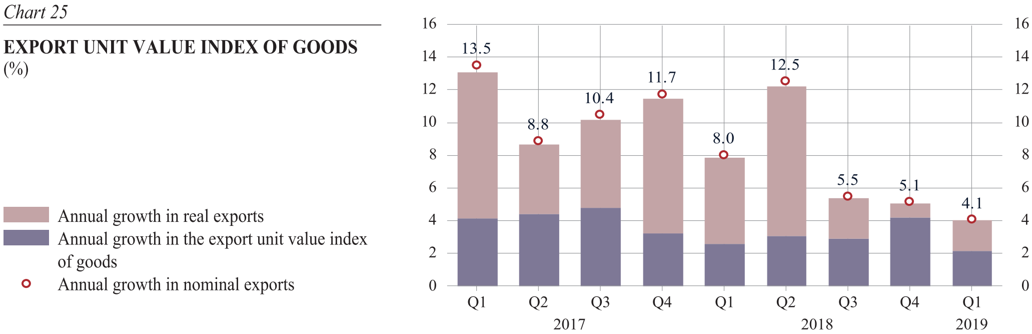
Moderation in external demand growth had a negative impact on the performance of exports. With export indicators deteriorating faster than expected, the projections were revised downwards. Although the euro area export markets saw some improvement in the past months and Latvia's exports were relatively resilient in the first quarter, the weakening external demand overall remains the main downward risk to the GDP forecast.

With the US-China trade tensions escalating and the deadline for the UK's exit from the EU extended, there is high uncertainty about the future growth. Therefore, Latvia's major trade partners have revised their forecasts for growth and imports. The degree of capacity utilisation in the exporting sectors remains high; however, the growth rate of exports is expected to moderate due to contracting external demand and other factors such as impact of prices and availability of labour force.

In January and February 2019, nominal exports of goods expanded only marginally by 0.2% year-on-year. While they were driven, inter alia, by one-off factors (e.g. aircraft turbine engines were exported for repair in 2018), exports of wood remained the key contributor and increased by 23.9% in annual terms. In March 2019, the annual growth rate of exports of goods recorded a steep 12.0% rise driven by a 61.9% increase in exports of agricultural products. However, one-off factors played a role in this as well (low base in March 2018), and the total export value was around the level of March 2016 and 2017 due to the poor harvest. Overall, in the first quarter the value of exports of goods recorded a 4.1% increase, with the export unit value and the volume of exports rising by 2.1% and 2.0% respectively. This development clearly reflected a downward trend in the momentum of export volume growth and, to a lesser extent, a slowdown in the rise of export prices.

Chart 25

EXPORT UNIT VALUE INDEX OF GOODS
(%)



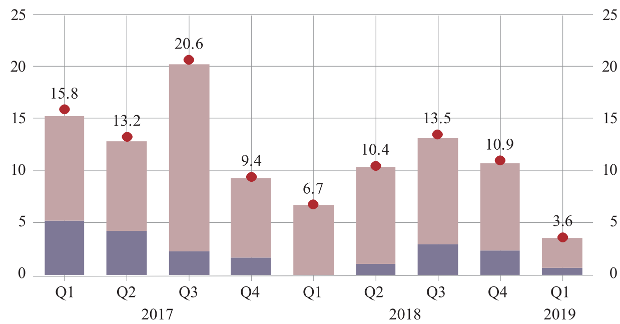
In the first quarter of 2019, exports of services expanded by 6.7% year-on-year, faster than exports of goods. This is particularly significant considering the notable 42.7% drop in the value of financial services exports. The growth rate of exports in other groups of services has remained close to the average level observed in 2018, with the exception of the transportation services. The positive contribution in this sector almost disappeared due to weaker growth of transportation services by rail and for the volume of freight transported at ports. The value of transportation services by air also contracted over the year; nevertheless, the overall projections have remained positive. Exports of transportation services by road expanded by 13.9% year-on-year; however, their projections are negatively affected by weaker trade growth in Europe, the main market, as well as tighter regulatory requirements for foreign service providers.

Overall, in the first quarter of 2019 real exports of goods and services grew by 1.3% and 3.1% quarter-on-quarter and year-on-year respectively. Meanwhile, imports of goods and services recorded the first annual decrease in the last four years declining by 0.7% year-on-year and 2.0% quarter-on-quarter.

Although domestic activity, i.e. consumption and investment, weakened somewhat, it is still expected to be the main contributor to a robust growth rate of imports, supported by a still relatively steep rise in wages and the availability of EU funding. In the first three months of 2019, imports of goods expanded largely on account of imports of transport vehicles, i.e. the base effect observed in February in relation to the aeroplanes imported in 2018 and the importing of two aeroplanes in March 2019. Consequently, the overall growth rate of imports of goods reached 3.6%, with import prices and the volume of imported goods rising by 0.7% and 2.8% respectively. In March 2019, imports of mineral products contracted year-on-year, and imports of mineral fuel from Russia recorded the most notable decline (–80.7% year-on-year). Imports of other groups of goods expanded overall by 2.8% over the year.

Chart 26

IMPORT UNIT VALUE INDEX OF GOODS
(%)



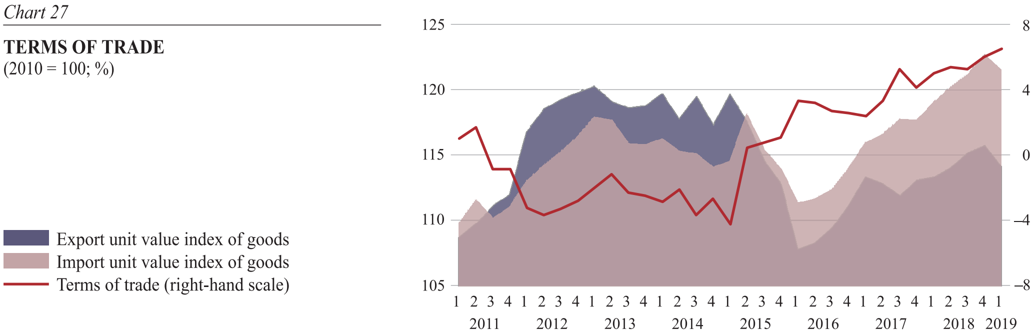
Annual growth in real imports
Annual growth in the import unit value index of goods
Annual growth in nominal imports

In the first quarter of 2019, imports of services increased by 8.3% year-on-year owing to rapid growth in imports of information and communication services and other business services. Similar to exports of services, the value of financial services imports also continued on a downward trend, contracting by 30.0% year-on-year. However, this could not offset the impact of the strong expansion of imports of information and communication services and other business services recording year-on-year increases of 38.4% and 22.4% respectively. The contribution of transportation services also contracted due to declining imports of transportation services by rail and those by sea. Meanwhile, the steep rise in income continues to support strong performance of imports in the travel services sector. At the same time, despite strong domestic demand in the construction sector, imports of construction services recorded a notable year-on-year decline of 11.7% in the first quarter of 2019.

Exports expanded at a stronger rate than imports leading to an improvement in trade balance in the first quarter of 2019. This was a result of several one-off effects (imports of aeroplanes, exports of agricultural products, etc.) on the goods side and a steeper drop in financial services exports than their imports on the services side. Indicators for the first quarter of the year point to stable export prices and gradually rising prices on imports suggesting that the terms of trade have remained favourable. Meanwhile, the price development forecast projects a decline in export prices (those of wood in particular) which, depending on import price developments, may affect the dynamics of the terms of trade in the future.

Chart 27

TERMS OF TRADE
(2010 = 100; %)



5. Labour Market, Costs and Prices

Although economic growth moderated due to external developments, the slowdown still had no impact on the labour market. With unemployment shrinking below its natural rate, labour demand in various sectors continues to exceed labour supply, and the rate of unemployment declines further. The latest information on the decisions taken in the area of remuneration, particularly in the public sector, has led to the upward revision of the wage growth forecast for 2019. Inflation was close to the projected level in the first four months of 2019, hovering around 3%. Energy prices reported the highest rise, reflecting an upward trend in oil prices. The pass-through of higher producer prices to consumer prices was weaker on account of falling import prices. The prices of services continued to increase moderately, reflecting the rising labour costs.

Latvia's unemployment rate decreased already for the ninth consecutive year, standing at 7.4% in 2018. The registered unemployment data suggest that the decline (to 6.3% in April of 2019) continues even reaching a rather low level in some regions (3.9% in Riga). Moreover, the number of employed persons in Latvia increased in 2018 not only on account of the decreasing unemployment rate, but also as a result of economically inactive people increasingly more entering the labour market. A rapid improvement in the economic activity in the age group of persons of pre-retirement age and pensioners (55 years and more) was observed.

Chart 28

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

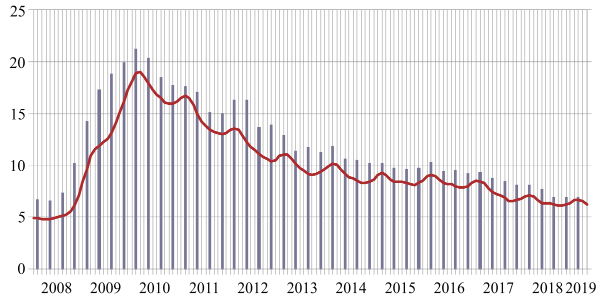
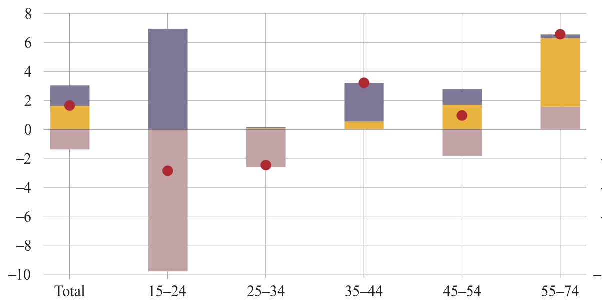


Chart 29

ANNUAL GROWTH RATE OF THE NUMBER OF EMPLOYED PERSONS BY COMPONENT
(average figure for 2018; percentage points)



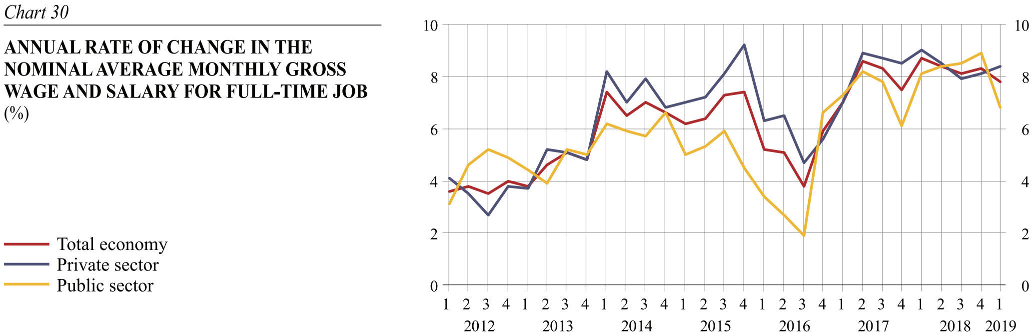
At the beginning of 2019, the number of vacancies registered with the SEA continued to rise rapidly, reaching a historical high of more than 34 thousand vacancies. However, the breakdown of vacancies also reveals the problems in the regional labour market: 80% of vacancies are registered in Riga and Pieriga, having the lowest rate of registered unemployment. At the same time, there is a shortage of vacancies in the regions where the rate of unemployment is much higher. Although labour mobility across regions is encouraged under the active employment policy, unemployed persons lack motivation to move to another region and seek a job there: this may be also explained by the fact that a large share of vacancies are recorded in occupational groups with a relatively low level of remuneration.

The unemployment forecast for 2019 has remained unchanged (7.0%). Although the economic growth rate is decelerating, labour demand remains high. This is evident from both the business survey data and the latest information on changes in the registered unemployment rate.

The average gross wage for full-time job grew by 8.4% in 2018, reaching 1004 euro in Latvia, and by 7.8% year-on-year in the first quarter of 2019. Although the rate of increase in wages decelerated at the beginning of 2019, the wage growth forecast for 2019 was raised to 7.1% mainly in the light of the latest information on the decisions granting additional funding for remuneration for those working in the health care sector, judges and prosecutors as well as for the disbursement of service pensions for officials having special ranks of service (once in five years); this affected remuneration already at the beginning of 2019. Wages in the private sector are also expected to grow due to the competition between the employed.

Chart 30

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



As regards other recent developments in the labour market, it is obvious that the conclusion of a collective agreement in the construction sector will have a minor impact on the wage growth in 2019: a large proportion of those working in the sector currently receive wages that are lower than the one stipulated in a collective agreement, but the agreement is to take effect only in November. Therefore, the impact will become more apparent only in the year to come. Plans for the conclusion of a collective agreement in other sectors are still in the phase of negotiation, and no other sector is expected to enter into a collective agreement in the near term.

In the first four months of 2019, energy prices reported the highest increase, reflecting an upward trend in oil prices. Energy costs recorded the most buoyant rise as compared to the previous year, and this fact is confirmed by several statistical data sources. For instance, the energy component is currently the only one consistently contributing to an increase in the import unit value. In the producer price survey, the highest rise in prices was recorded for the energy sector. Moreover, energy-related components (fuel, natural gas and electricity) are among those recording the most notable consumer price surges.

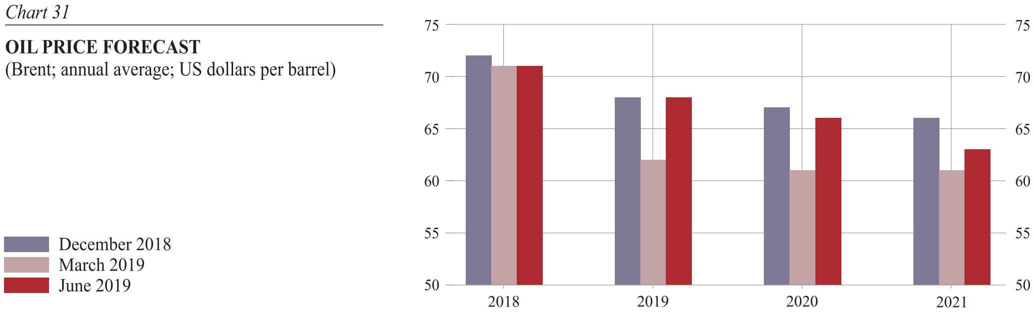
Energy costs went up on account of higher oil prices[1]. The ongoing political crisis in Venezuela, the expanding military activities in Libya as well as the non-extension of sanctions exemptions to countries importing oil from Iran are some of the factors that pushed up the oil price in spring. Thus, the oil price (Brent) offset the decline at the beginning of 2019, standing at 70 US dollars per barrel. However, most investors anticipate that the oil price will decrease in the medium term, with the US oil producers ramping up oil production and exports as well as with concerns prevailing regarding the slower than previously expected global economic growth.

Therefore, Latvijas Banka's forecast for the oil price is similar to the forecast published in the Macroeconomic Developments Report of December 2018.

[1] With the exception of higher electricity prices, reflecting electricity price hikes at the Nord Pool Spot Exchange in the second half of 2018.

Chart 31

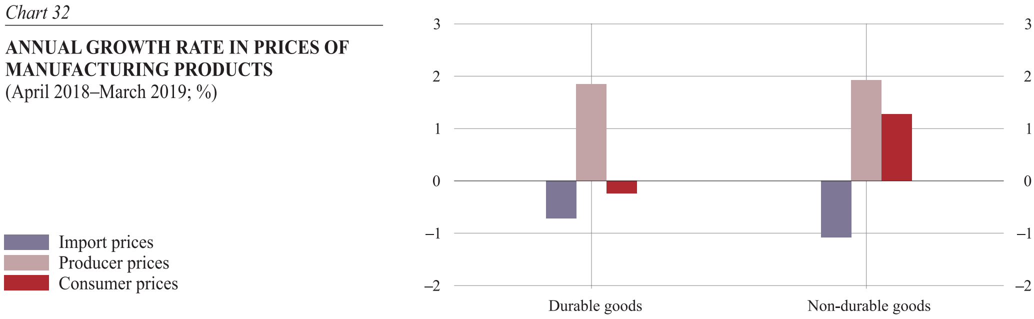
OIL PRICE FORECAST
(Brent; annual average; US dollars per barrel)



Low import prices weaken the pass-through of growing producer prices to consumer prices. The prices of imported fabricated products followed a downward trend in the last months. If the expectations of the analysts polled by Reuters concerning appreciation of the euro against the US dollar are met, this may further bring down prices of the products imported from the non-euro area countries. At the same time, the prices of manufacturing products produced in Latvia and sold in the domestic market are on a moderate upward trend: the impact of the growing labour costs is partly offset by the broadly unchanged price of the imported capital goods and intermediate goods.

Chart 32

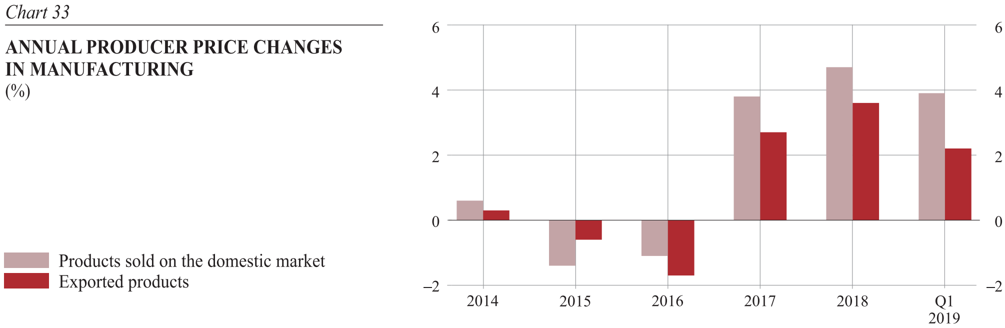
ANNUAL GROWTH RATE IN PRICES OF MANUFACTURING PRODUCTS
(April 2018–March 2019; %)



Producer prices in manufacturing for domestically sold products have been rising somewhat faster than for exported goods for the third consecutive year. This development, characteristic of the economic expansion period, reflects two processes. First, the rising domestic labour costs increase production and prompt businesses to look for opportunities to raise prices. Second, businesses have more room for manoeuvre to raise prices in the domestic market than abroad (the purchasing power of Latvian households increases notably and the domestic demand elasticity in the domestic market is in all likelihood lower than that of imports in terms of price). However, the current situation cannot last long as Latvian producers may face a reduction of their market share in the domestic market, with purchasers refocusing to cheaper import analogues.

Chart 33

ANNUAL PRODUCER PRICE CHANGES IN MANUFACTURING
(%)

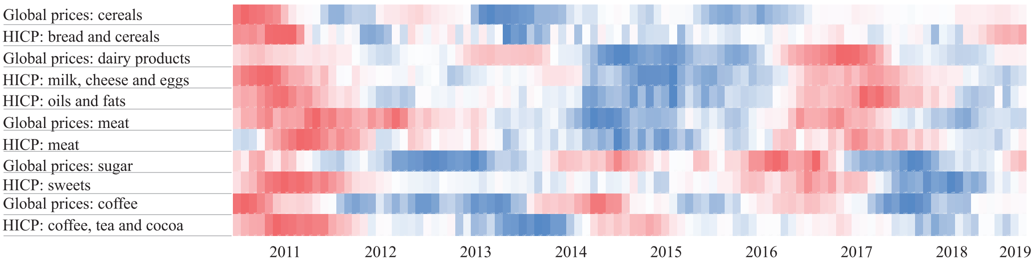


Food consumer prices reflect the global food price fluctuations with a few months' lag. The global food price indices did not follow a uniform trend in the last months. For instance, the outbreak of swine fever in China pushed up global pork prices, while the price of wheat is going down as a record high harvest is expected in 2019. At the same time, the price hikes of dairy products are mainly related to the decreasing supply in Oceania, and this has relatively small effects on the European region. The price dynamics of both imported food products and those produced in Latvia and sold in the domestic market is stable.

The increase in the prices of services fluctuates around 3%, thus reflecting sustainable income convergence and economic growth slightly above its potential. Moreover, the rise in the prices of transportation and tourism services was driven by an escalation of fuel prices on account of higher oil prices, while the increase in the prices of catering services was determined by moderately growing food prices.

Chart 34

GLOBAL AND CONSUMER PRICES OF FOOD PRODUCTS
(annual changes)



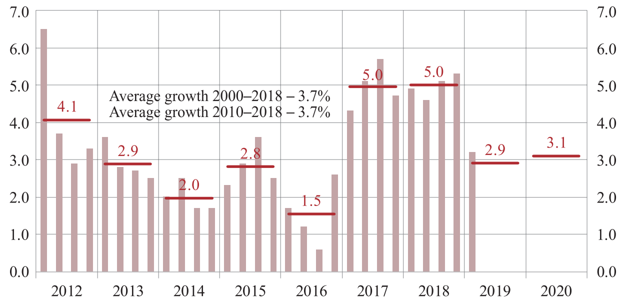
Notes. Red colour denotes inflation above the long-term trend. Blue colour denotes inflation below the long-term trend. The brighter the colour, the sharper is the inflation deviation from the long-term trend. Annual changes in HICP and global food prices are normalised by subtracting the long-term average and dividing by the standard deviation.

6. Conclusions and Forecasts

Latvijas Banka has revised its GDP growth forecast for 2019 downwards from 3.5% to 2.9%, leaving the forecast for 2020 unchanged at 3.1%. The unexpectedly slow growth in the first quarter suggests that domestic consumers have become more cautious and investors' risk appetite has declined: this calls for a downward revision of the GDP forecast. At the same time, the overall outlook for the development of the growth drivers in the near future has remained broadly unchanged, therefore the forecast for 2020 remains the same.

Chart 35

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

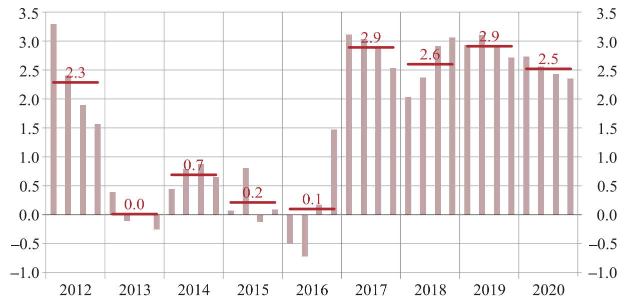


Although the overall economic sentiment indicator has slightly deteriorated in Latvia since the beginning of the year, this has not been caused by any strong driving factor and the sentiment changes registered in a few sectors were observed in the usual fluctuation range.

Latvijas Banka's inflation forecast has remained unchanged, i.e. 2.9% for 2019 and 2.5% for 2020. In the first four months of 2019, inflation stood at 2.9%; compared to December 2018, the impact of the key factors on the inflation forecast remained broadly unchanged.

Chart 36

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



In spring, oil prices rose mostly on account of temporary factors; investors are expecting oil prices to fall in the medium term. Along with a slightly slower rise in labour costs, this will result in a gradual decline in inflation over the medium term. Nevertheless, on account of the income convergence process, inflation in Latvia is most likely to exceed the euro area average also in the years to come.

Table

FORECASTS OF MACROECONOMIC INDICATORS
(annual increase; %, unless otherwise indicated)

Indicator	**2019**	**2020**
ECONOMIC ACTIVITY (annual change at constant prices; seasonally and calendar adjusted data)		
GDP	2.9	3.1
Private consumption	3.2	3.3
Government consumption	2.4	2.1
Investment	6.9	4.0
Exports	1.3	3.1
Imports	1.6	3.4
INFLATION (annual HICP)	2.9	2.5
LABOUR MARKET		
Unemployment (% of the economically active population)	7.0	6.9
Nominal gross wage (annual change)	7.1	5.9
CURRENT ACCOUNT BALANCE (% of GDP)	–1.1	–1.3
FISCAL SECTOR (% of GDP)		
General government debt	35.9	36.1
General government budget surplus/deficit (–)	–0.7	–0.7

7. Formulating a Balanced Budget. Analysis of Scenarios

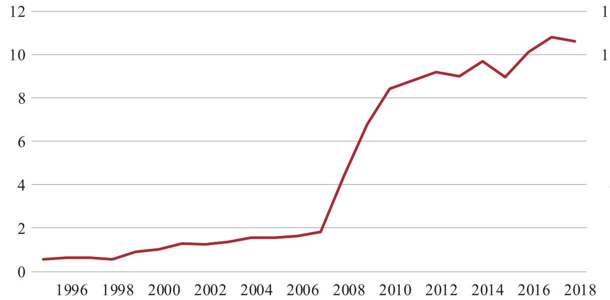
Motivation

In recent years, Latvia's economy has seen relatively fast growth or the cyclical upswing. At this stage, an economy should accumulate funds for the time when the economic growth might be slower or a recession might start. Respecting the fiscal discipline is one of the basic principles of fiscal policy as an economy's ability to balance revenue and expenditure within a business cycle enables it to ensure economic stability.

Nevertheless, since the last economic crisis the Latvian government budget expenditure has exceeded its revenue almost every year except 2016 when it had a balanced budget. As a result, the government has increased its debt burden even in a period of relatively accelerated economic growth.

Chart 37

GENERAL GOVERNMENT DEBT
(billions of euro)



This means that during the next economic downturn the government will have less space for economic stimulus measures to support the economy.

According to the Ministry of Finance of the Republic of Latvia, the government is also planning a budget deficit for the next three years. With relatively favourable economic development persisting, in economic policy discussions one can hear encouragements to consider planning a balanced budget for 2020 by cutting the prospective amount of the general government expenditure. Latvijas Banka has assessed the impact of the potential expenditure reduction on the Latvian economy using the DSGE model for Latvia, supplemented by a detailed modelling of the fiscal sector.[1]

Simulation

The budget balance forecast by both the Ministry of Finance of the Republic of Latvia and Latvijas Banka (with the projected government deficit standing at 0.3% of GDP[2] and 0.7% of GDP respectively) has been used as a reference for the purpose of formulating a balanced budget for 2020, and two scenarios of government expenditure reduction have been considered:
1) reducing government consumption;
2) cutting expenditure for government investment.

The estimates assume that the government does not offset the improvement in the 2020 budget balance with deterioration in the budget balance in the coming years (expenditure cuts are sustainable). It is also assumed that public attitude towards the government's

[1] For information on the DSGE model for Latvia, see Bušs, Ginters. *Wage Formation, Unemployment and Business Cycle in Latvia*. Riga: Latvijas Banka, Working Paper No. 1, 2017. 69 pp.; this model has been supplemented with a detailed modelling of the fiscal sector in the assessment by Latvijas Banka.

[2] "Latvia's Stability Programme for 2019–2022" estimates the general government deficit in 2020 at 0.4% of GDP (taking into account the minimum fiscal security reserve of 0.1% of GDP laid down in the Fiscal Discipline Law). The maximum allowable general government deficit has been estimated at 0.3% of GDP. Available at https://ec.europa.eu/info/sites/info/files/2019-european-semester-stability-programme-latvia_en.pdf [viewed on 27 May 2019].

announcements of the reduction in government deficit is neutral, and the public does not change its behaviour proactively in anticipation of such a move by the government. Thus, the simulation estimates are conservative, and they are not based on positive public expectations concerning the improvement in budget balance in the future.

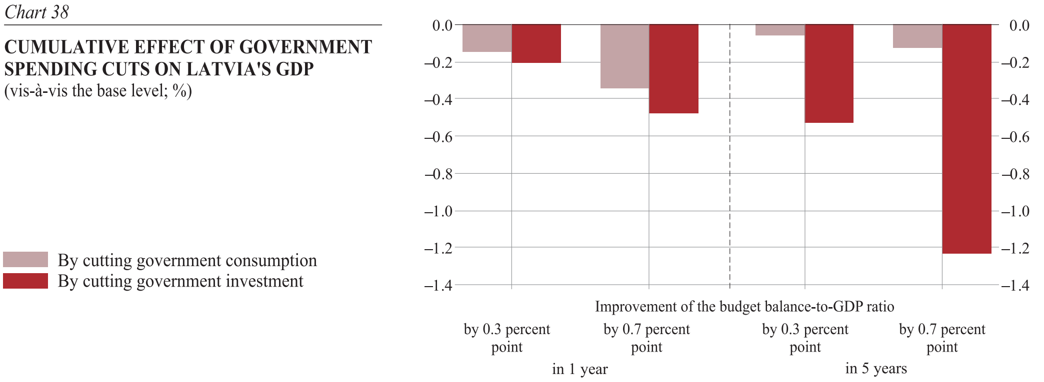
The simulation has been performed by employing the DSGE model for Latvia supplemented with a detailed modelling of the fiscal sector. This model makes a distinction between government intermediate consumption, spending on public sector compensation, investment expenditure, government expenditure for unemployment benefits and other transfers of funds asymmetrically divided between households that optimise funds and those restricted by liquidity conditions as well as the government's debt service costs and other expenses. Part of government consumption and investment is imported. Government expenditure consists of the consumption tax, labour income tax, social security contributions by employees and employers and the income tax on capital gains. The estimation has been performed by employing 26 macroeconomic time series, including eight fiscal ones.

Scenario 1. In this scenario, government consumption is reduced, and the decrease is apportioned between intermediate consumption and government spending on public sector compensation. The expansion of the total and private consumption as well as the pressure on wages and inflation follow a downward trend in this scenario. The shrinking domestic demand results in the decline in GDP. However, competitiveness on the domestic and foreign markets improves due to lower inflation. Thus, the growth rate of exports picks up and that of imports decelerates. If the ratio of the budget balance to GDP is improved by 0.3 percentage point and 0.7 percentage point, respectively, during the first year of budgetary fiscal consolidation, GDP would decrease by 0.15% and 0.34%, respectively, as compared with a case where budgetary fiscal consolidation is not performed. However, due to competitiveness improvements, the cumulative decrease in Latvia's GDP over five years following the budgetary fiscal consolidation compared with the baseline level (if no budgetary consolidation is performed) would roughly amount to merely 0.1%.

According to such a scenario, the government debt-to-GDP ratio would edge down by 1.8 percentage points (employing the government deficit projection by the Ministry of Finance of the Republic of Latvia) and by 4.2 percentage points (using the government deficit projection by Latvijas Banka), respectively, over a five-year period.

Chart 38

CUMULATIVE EFFECT OF GOVERNMENT SPENDING CUTS ON LATVIA'S GDP
(vis-à-vis the base level; %)



Scenario 2. Expenditure for government investment is cut in this scenario. The total demand shrinks owing to a decline in government investment. The private sector seeks to partially replace public sector investment with that of the private sector; however, the total investment value is lower. Moreover, a decrease in the contribution provided by the public sector to the total capital of the economy reduces the potential economic growth. In the longer term, such budgetary fiscal consolidation leads to a more negative impact on GDP than that of a reduction in government consumption. If the ratio of the budget balance to GDP is improved by 0.3 percentage point and 0.7 percentage point, respectively, during the first year of

budgetary fiscal consolidation, GDP would be by 0.2% and 0.5% smaller, respectively, as compared with a case where budgetary fiscal consolidation is not performed. Meanwhile, a decline in GDP vis-à-vis the baseline level would be 0.5% and 1.2%, respectively, during five years.

In the case of reduced investment expenditure, the government debt-to-GDP ratio would edge down by 1.5 percentage points (employing the government deficit projection by the Ministry of Finance of the Republic of Latvia) and by 3.6 percentage points (using the government deficit projection by Latvijas Banka), respectively, over a five-year period.

Conclusions

In a period of relatively buoyant economic growth, anti-cyclical fiscal policy should be pursued, thus reducing government debt and making savings to be used during a period of slower economic growth. The scenarios deal with the situation which might arise if the government ensures a balanced budget in 2020 and commits itself to not spending the saved resources in the coming years.

Overall, the simulation results suggest that the scenario providing the formulation of a balanced budget via reducing government consumption would be more favourable for the Latvian economy. The adverse effect of such a budgetary fiscal consolidation on economic development would be less pronounced and shorter-term. Moreover, the formulation of a balanced budget would decrease the government debt-to-GDP ratio, with positive consequences for sustainability of public finances. Meanwhile, the budgetary fiscal consolidation via government investment would be undesirable since it would have an adverse effect on the potential economic growth.

The above results encourage to place more emphasis on greater centralisation of administrative functions, on reinforced assessment and planning of current expenditure by clearly defining the objective to be pursued and on the assessment of the result achieved when carrying out budgetary fiscal consolidation, while reducing expenditure for government investment as little as possible.

Additional Information

General notes

The cut-off date for the information used in the publication *Macroeconomic Developments Report* (June 2019, No. 29) is 6 June 2019.

The *Macroeconomic Developments Report* (June 2019, No. 29) 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, 22 and 23), Bloomberg (Charts 3–6, 9 and 31), Reuters (Chart 7), the Treasury (Charts 16, 24 and 37), Latvijas Banka (Charts 8–15, 28, 29, 31, 34–36 and 38), the CSB (Charts 8, 17–22, 25–30, 32, 33, 35 and 36) and the SEA (Chart 28).

Data sources for Statistics tables are Latvijas Banka (Tables 1, 3, 4, 6–24, 26, 27 and 35–38), AS Nasdaq Riga (Table 1), the Treasury (Tables 1, 2ab and 28), Euribor-EBF (Table 1), the CSB (Tables 2.ab and 29–34) and ECB (Tables 5 and 25).

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) assets and liabilities of Latvijas Banka (Table 6), expanding the range of reported financial instruments;

2) 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 7);

3) monetary aggregates and counterparts (Table 4) 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 3) are also published comprising the national contribution to the euro area monetary base and the counterparts, as well as a monetary survey of Latvia's MFIs (excluding Latvijas Banka; Table 10).

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 8). 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) aggregated balance sheet of Latvia's MFIs (excluding Latvijas Banka) which is the sum of the harmonised balance sheets (Tables 9ab);

3) information characterising foreign assets and foreign liabilities of MFIs (excluding Latvijas Banka; Tables 11ab), including selected items in the monthly financial position report of MFIs (excluding Latvijas Banka) by group of countries (Table 12);

4) information characterising the maturity profile and types of deposits (including repo agreements) of Latvia's financial institutions, non-financial corporations and households with MFIs (excluding Latvijas Banka; Tables 13 and 14abc) as well as government and non-resident deposits (Table 14d). Deposits redeemable at notice have been grouped by period of notice. Long-term deposits include deposits with the original maturity of over 1 year. The breakdown of MFI (excluding Latvijas Banka) deposits by currency is provided in Tables 19ab;

5) information characterising the maturity profile and types of MFI (excluding Latvijas Banka) loans to Latvia's financial institutions, non-financial corporations and households (Tables 15, 16ab, 17, 18, 35 and 36) as well as government and non-resident loans (Table 16c). The breakdown of MFI (excluding Latvijas Banka) loans by currency is provided in Tables 19cd;

6) information characterising MFI (excluding Latvijas Banka) securities holdings (Tables 18ab and 19ef);

7) information characterising debt securities issued by MFIs (excluding Latvijas Banka; Table 19g).

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 (Table 20). 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 22) 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 23) 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 24) comprise non-cash transactions performed by credit institutions and branches of foreign credit institutions, reported by major currency.

The euro reference rates published by the ECB (Table 25) are reported as monthly mathematical averages. Weighted average exchange rates (cash transactions; Table 27) are reported based on the information provided by credit institutions and branches of foreign credit institutions as well as currency exchange bureaus.