

Latvian Macro Monitor

February 2017

2A, Republikas Square, Riga LV-1010, Latvia
Tel. +371 67010827, Fax +371 67010191;

www.citadele.lv

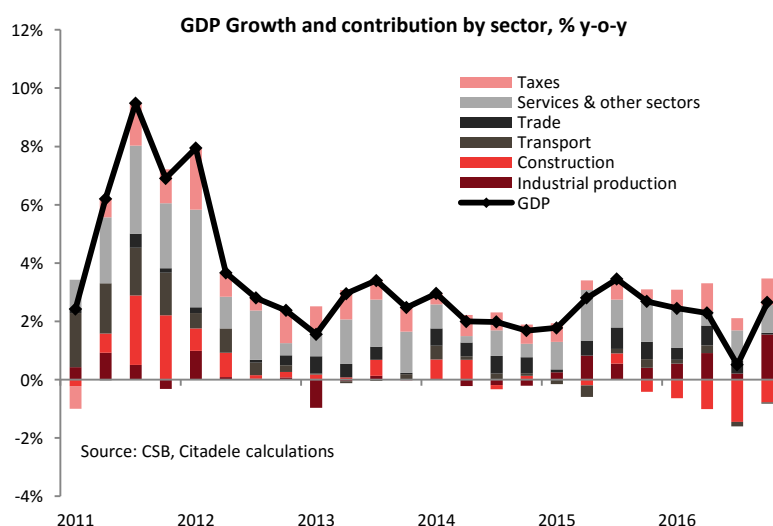
Martins Abolins
Economist
Treasury
Martins.Abolins@citadele.lv

Summary

- Latvian economy ended 2016 on a positive note as GDP growth in Q4 rebounded to 2.6% y-o-y following only 0.5% growth in Q3. In 2016 overall GDP in Latvia grew by 2.0% however growth in many sectors in 2016 exceeded 3-4% and only delays with EU funds, declining cargo volumes in transit sector as well as unfavourable conditions in agriculture sector dragged down overall GDP growth.
- Retail trade in Latvia continues to recover from minor slump in the middle of 2016 as retail sales in January grew by 3.7% y-o-y despite pick-up in inflation in recent months.
- In Q4 construction fell by 11.9% compared to Q4 of 2015 which nevertheless was the best quarter for construction in the last year since in 2016 as a whole construction declined by 18.2%.
- Inflation in Latvia continued to accelerate in January as consumer prices rose by 2.9% compared to January 2016 as inflation in Latvia has now reached its highest level since 2012 broadly reflecting trends in other Euro area countries.
- Rapid increase in budget expenditures at the end of the year was a major reason behind sharp rebound in wage growth in Q4 as average wages grew by 5.9% y-o-y. However weaker wage growth in previous quarters meant that in 2016 overall average wage in Latvia grew by 5.0% which is the slowest rate of wage growth in recent years.
- Latvian exporters ended 2016 with a strong performance as export of goods in December rose by 7.6% y-o-y thus largely reflecting strong growth in manufacturing in the final months of 2016. At the same time in December imports rose by 11.4% which resulted in slight deterioration in trade balance.

GDP

Latvian economy ended 2016 on a positive note as GDP growth in Q4 rebounded to 2.6% y-o-y following only 0.5% growth in Q3, while compared to previous quarter GDP increased by 1.1%. Q4 data shows that GDP growth has begun to pick up despite ongoing delays in the use of EU funds under the new programming period and Q4 was the best quarter for Latvian economy in the whole of 2016.



In 2016 overall GDP in Latvia grew by 2.0% however growth in many sectors in 2016 exceeded 3-4% and only delays with EU funds, declining cargo volumes in transit sector as well as unfavourable conditions in agriculture sector dragged down overall GDP growth. Compared to 2015 output in construction in 2016 dropped by 17.9%, while in transport sector and agriculture in increased only by 0.5% and 1.5% respectively.

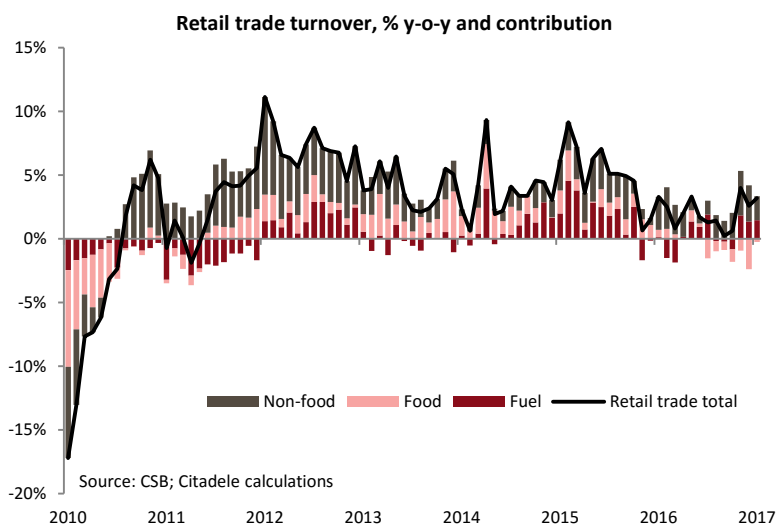
In Q4 fastest growing sectors in Latvian economy were manufacturing (+10.2%), hotels and restaurants (+10.8%) and public administration (+5.8%), while output declined in construction (-11.8%) and real estate sector (-0.8%).

Retail trade

Retail trade in Latvia continues to recover from minor slump in the middle of 2016 as retail sales in January grew by 3.7% y-o-y despite pick-up in inflation in recent months. Retail trade growth in January was again led by fuel (+8.7%) and non-food items (+4.6%) while food sales (-0.1%) continued to stagnate although this is significant improvement compared to December when food sales dropped by 6.1%.

Buoyed by rising inflation, retail trade turnover in current prices rose by 7.4% in January which is the fastest rate of growth in almost three years. However higher inflation has had a somewhat negative impact consumer confidence in recent months.

In January fastest growing segments of retail trade were IT devices (+10.3% y-o-y), clothing (+12.3%), household appliances (+9.9%) and jewellery (+8.1%). In addition online shopping (+11.5%) continued to grow strongly in January; however this was the slowest rate of growth in almost a year. But at the same time retail sales of construction items (+6.9%) grew at the fastest rate in almost two years pointing to an increasing activity in the construction sector.



Construction

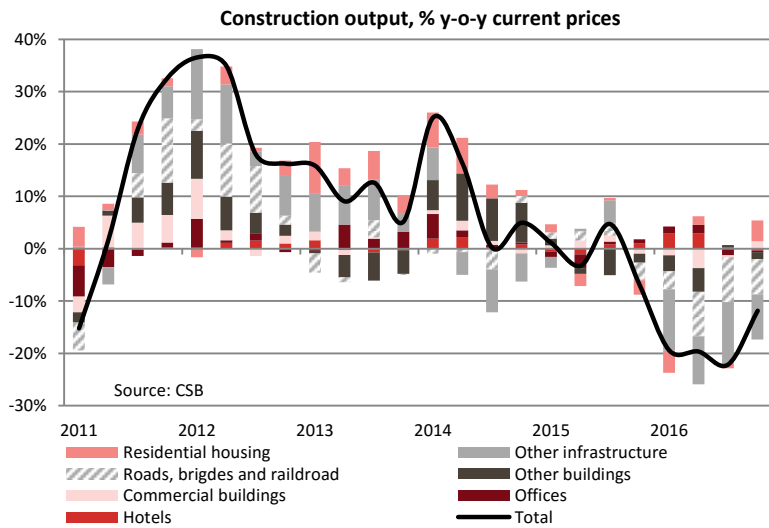
In Q4 construction fell by 11.9% compared to Q4 of 2015 which nevertheless was the best quarter for construction in the last year since in 2016 as a whole construction declined by 18.2%. Continued delays in the use of EU funds under the new programming period were again the main reason behind sharp fall in construction.

In Q4 infrastructure construction declined by 29.2% y-o-y which is a slight improvement compared to previous quarters when in decline in infrastructure construction exceeded 35%, however infrastructure construction is set to rebound in 2017 as EU spending finally begins picks up. Between the beginning and December of 2016 amount of EU funds already allocated to specific projects increased from 8.8% to 32% of total planned over the period 2014-2020. In addition investment expenditure by general government rose by 11.3% y-o-y in January following 27.9% decline in 2016.

At the same time private sector construction also seems to be picking up as construction of residential housing and industrial premises in Q4 rose by 40% and 43.1% y-o-y respectively.

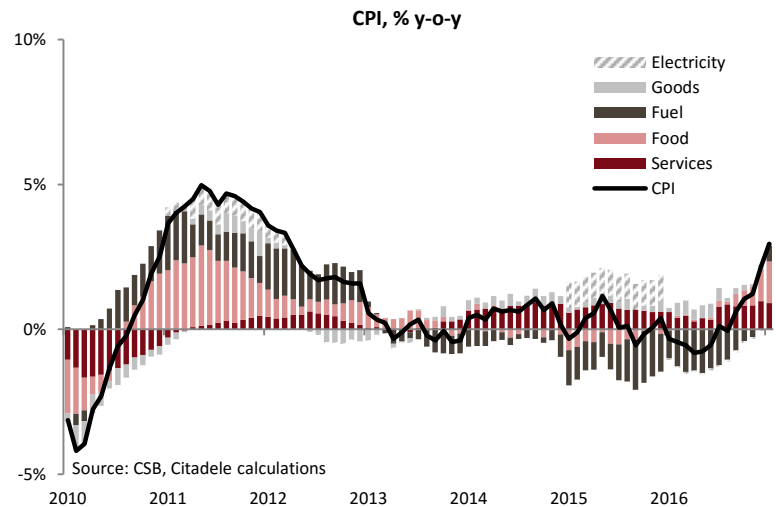
However construction of hotels declined by 11.6% despite growing by more than 100% at the start of the year and data on construction permits points a mixed picture going forward. In Q4 floor area for which the building permits are issued declined by 2.6% y-o-y, although

floor area for retail, residential and office building increased strongly while for permits for public and residential buildings as well as for hotels have declined.



Inflation

Inflation in Latvia continued to accelerate in January as consumer prices rose by 2.9% compared to January 2016 as inflation in Latvia has now reached its highest level since 2012 broadly reflecting trends in other Euro area countries. However, significant acceleration in headline inflation in January (up from 2.2% in December) was mainly due to very low oil and food prices at the start of 2016 since in January compared to December consumer prices increased only by 0.1%.

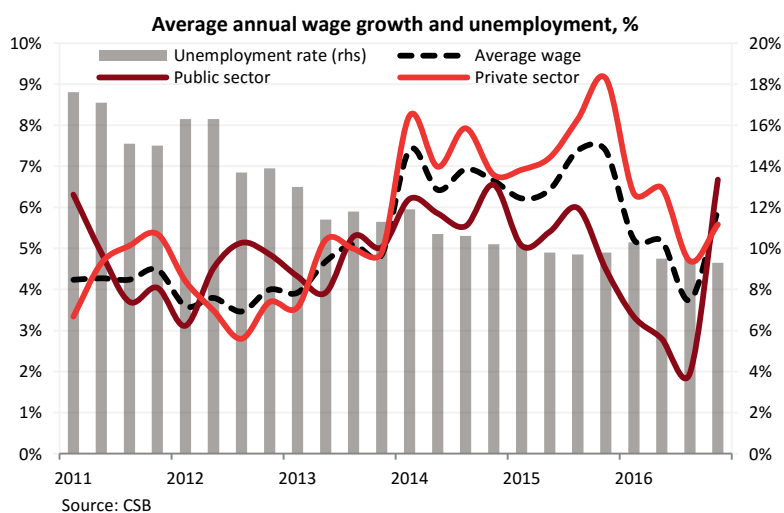


Inflation trends in Latvia continue to be driven by external factors as food price inflation has reached 6.8% y-o-y as prices of vegetable, dairy products and sweets rose by 14%, 10.5% and 11.1% respectively. In addition to food, inflation in January was also boosted by 14.9% increase in fuel prices. All these developments reflects surge in world food and energy prices in recent months.

At the same time in January somewhat unexpectedly service prices declined by 0.5% compared to previous month as annual service price inflation dropped to 3.1%. This was mainly related to cheaper airline fares which declined by 17.3% following 15.1% increase in December and as a result domestic inflation remains broadly unchanged since the middle of 2016. However increase in headline inflation in recent months has also led to rising inflation expectations both among consumers retailers and this could lead to higher domestic inflation pressures in the future.

Labour market

Rapid increase in budget expenditures at the end of the year was a major reason behind sharp rebound in wage growth in Q4 as average wages grew by 5.9% y-o-y. However weaker wage growth in previous quarters meant that in 2016 overall average wage in Latvia grew by 5.0% which is the slowest rate of wage growth in recent years. At the same time unemployment in Latvia in Q4 declined to 9.3% compared to 9.5% in previous quarter and 9.8% in Q4 of 2015, but this was mainly due to shrinking labour force since employment in Q4 fell by 1.1% y-o-y.



In Q4 strong increase in public expenditure resulted in faster public sector wage growth as wages there grew by 6.7% y-o-y despite increasing by only 2.7% in the first three quarters of 2016. This jump is mainly due to reforms education system which has led to higher salaries for teachers and as a result average wage in education sector in Q4 increased by 10%. At the same time this was not the only factor behind faster wage growth in public sector as wages in central state administration increased also by 10.8%

In 2016 as a whole public sector wages grew by 3.7% while in private sector wage growth remained relatively stable at 5.8%. Overall wage growth in 2016 was somewhat suppressed by the same factors that also had negative impact on overall economic growth – low levels of EU funded investment and resulting decline in output in construction, problems in transport sectors, as well as outflow of non-resident deposits from banking sector. As a result wages in transport sector in Q4 remained unchanged compared to previous year while in finance and construction wages increased by 1.9% and 2.9% respectively.

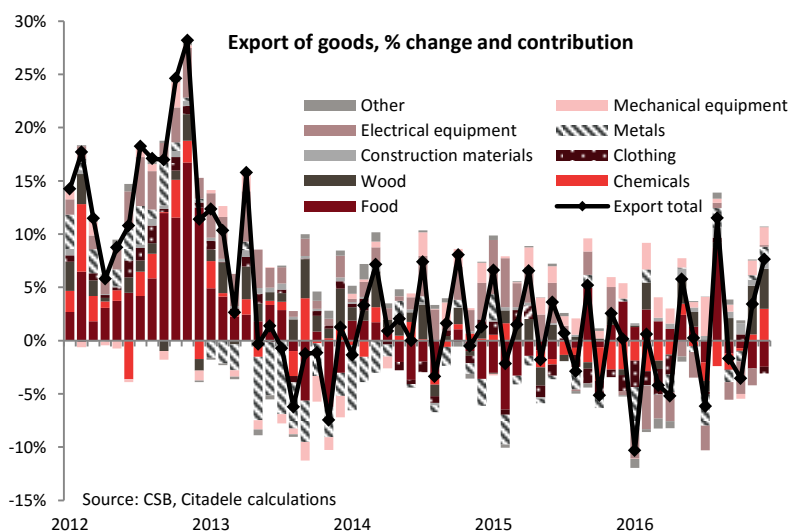
External trade

Latvian exporters ended 2016 with a strong performance as export of goods in December rose by 7.6% y-o-y thus largely reflecting strong growth in manufacturing in the final months of 2016. At the same time in December imports rose by 11.4% which resulted in slight deterioration in trade balance, however strong import growth seems to be related to new aircraft purchases by national airline Airbaltic.

In December fastest growing export categories were wood products (+19.4%), fabricated metal products (+20%) and cement products (+58.9%) which helped to offset sharp decline in the export of grains (-71.8%) as drop in agriculture exports once again reflected.

Strong improvement in manufacturing and export performance in recent months most likely is reflecting positive developments in external environment. Business and consumer confidence in US and Euro area have risen to highest levels in recent years signalling strong growth in advanced economies. In addition Russian economy is showing signs of stabilization following recession in last two years as manufacturing PMI in Russia has

moved strongly in to expansionary territory and in January reached 54.7 points which highest level in more than 5 years. As a result demand for Latvian exports is picking up and exports to CIS countries in December already rose by 16.7% y-o-y.



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2a Republikas square, Riga,
Latvia, LV-1010
Tel. +371 67010827
Fax +371 67010191
www.citadele.lv
Regulator – FCMC, www.fktk.lv