

# Latvian Macro Monitor

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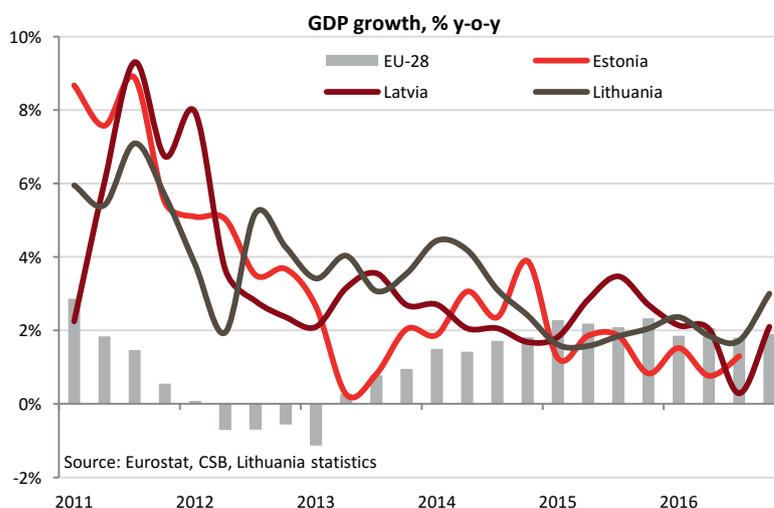
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## Summary

- Following very weak GDP growth in Q3 when Latvian economy almost came to a standstill, in Q4 GDP returned to moderate. According to first estimate GDP growth in Q4 was 2.1% y-o-y and as a result GDP in Latvia in 2016 grew by 1.6%.
- Moderate growth in retail trade continued also in December as retail sales increased by 2.4% compared to December of 2016 while in 2016 as a whole retail trade grew on average by 2.0%.
- Strong growth in industrial production in Latvia continued also in December as industrial output increased by 11.5% y-o-y and in recent months manufacturing has seen the fastest growth since 2012. In 2016 as a whole industrial production grew almost three times as fast as GDP as a whole as industrial output expanded by 4.9% compared to 2015.
- In December inflation in Latvia continued to accelerate and reached 3 year high as consumer prices increased by 2.2% compared to December 2015 while compared to November prices rose by 0.6%.
- As a result of continued delays in the EU financed investment, fiscal policy provided significant drag on the economic growth in Latvia in 2016 as public investment in declined by 27.9% compared to 2015 while total expenditure excluding interest payments grew by only 1.2%.
- In November export of goods from Latvia increased by 3.4% y-o-y following two months of decline as export growth has remained near zero for most of the year and in the first 11 months of 2016 overall export of goods declined by 1.1%.

## GDP

Following very weak GDP growth in Q3 when Latvian economy almost came to a standstill, in Q4 GDP returned to moderate growth even before new EU financed investments have begun to flow into the economy. According to first estimate GDP growth in Q4 was 2.1% y-o-y and as a result GDP in Latvia in 2016 grew by 1.6%, however growth should accelerate in the next few quarters as EU financed construction and investment will begin to pick up from current low levels.



At the same time economic growth in Latvia will continue to depend on external developments where on the one hand business confidence indicators point to a broad based pick-up in economic activity in

advanced economies in recent months, but on the other hand various political risks remain high. Nonetheless in its most recent January 2017 forecasts IMF projects that global economic growth will increase from 3.1% in 2016 to 3.4% in 2017 and 3.6% in 2018, which will support economic growth also in Latvia.

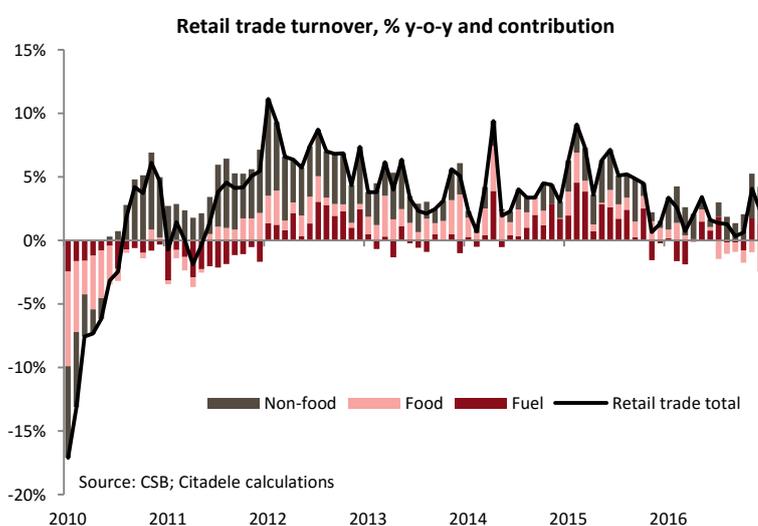
In Q4 GDP growth was in large part driven by industrial production which grew by 10% y-o-y while construction output declined by 13% compared to more than 20% in previous quarters. Somewhat surprising was only 1% growth in services despite strong growth in export orientated services sectors in previous quarters.

## Retail trade

Moderate growth in retail trade continued also in December as retail sales increased by 2.4% compared to December of 2016 while in 2016 as a whole retail trade grew on average by 2.0%. Although retail trade in December grew faster than in the year as a whole, retail trade growth in Latvia continues to lag behind Lithuania and Estonia where retail trade growth throughout 2017 has been in the range of 4-7%.

Somewhat surprisingly food sales in December declined by 6.3% y-o-y which cannot be explained only by declining population and weak food sales is one of the main reasons why retail trade growth in Latvia has lagged behind Estonia and Lithuania. At the same time non-food sales in December grew by 7.2% which is broadly in line with trends in other Baltic States as well as labour market developments. In addition fuel sales also grew by 10.6% in December although such a strong growth partly reflects also weak fuel sales in December 2015.

Rapid growth in non-food sales in December was driven mainly by clothing (+10.8 y-o-y), jewellery (+13.3%), electric goods (+8.4%) and IT devices (+11.1%) as well as pharmacy (+6.1%), while sales of used good declined by 5.7%. In addition in December online sales grew by 34.6% y-o-y.



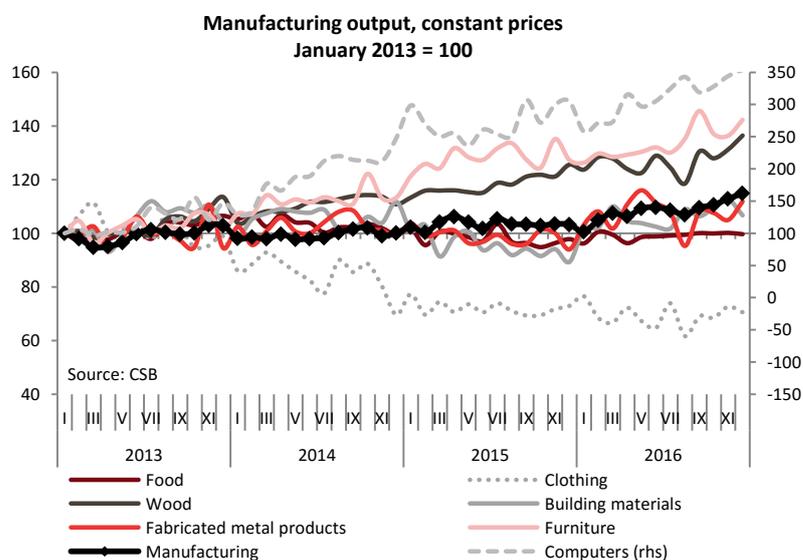
## Manufacturing

Strong growth in industrial production in Latvia continued also in December as industrial output increased by 11.5% y-o-y and in recent months manufacturing has seen the fastest growth since 2012. In 2016 as a whole industrial production grew almost three times as fast as GDP as a whole as industrial output expanded by 4.9% compared to 2015.

In December output grew in almost all subsectors of manufacturing except textiles and clothing where output has been on a long term declining trend.

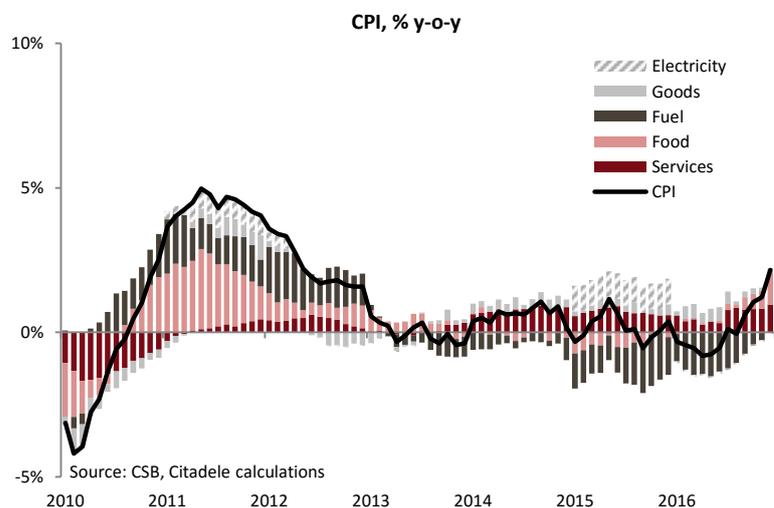
In December growth in manufacturing was again supported by strong growth in wood products (+8.6% y-o-y), fabricated metal products (+19.0%), computers and optical equipment (+16.2%), construction materials (+19.4%), electrical equipment (+33.9%) and car parts (+32%). In addition food production also grew by 1.9%

which is already fifth month in a row of expanding output. This suggests that although only gradually, but food sector is finally starting to overcome impact from Russian sanctions. Overall very strong and broad based growth in manufacturing in final months of 2016 has been mainly export driven which probably reflects also positive external economic developments in recent months.



## Inflation

In December inflation in Latvia continued to accelerate and reached 3 year high as consumer prices increased by 2.2% compared to December 2015 while compared to November prices rose by 0.6%. Rapid acceleration in inflation from 0% in August to 2.2% in December was in large part driven by increase in global energy and food prices as well as by changes in EUR/USD exchange rate. As a result on an annual basis energy prices in Latvia are no longer declining and fuel prices have already begun to increase. In December fuel prices in Latvia rose by 2.3% compared to November while compared to December 2015 fuel prices increased by 6.6%. In addition in December heating prices increased by 2.6%.



Besides energy prices, food prices have also started to increase in recent months as food price inflation in Latvia reached highest level since 2012. In December food prices in Latvia rose by 4.7% compared to December 2015 as prices of vegetables (+17.3%), vegetable oils (+9.7%), sugar and sweets (+8.1%) as well as dairy products (+6.6%) increased the most. These increases broadly reflect trends in global food prices.

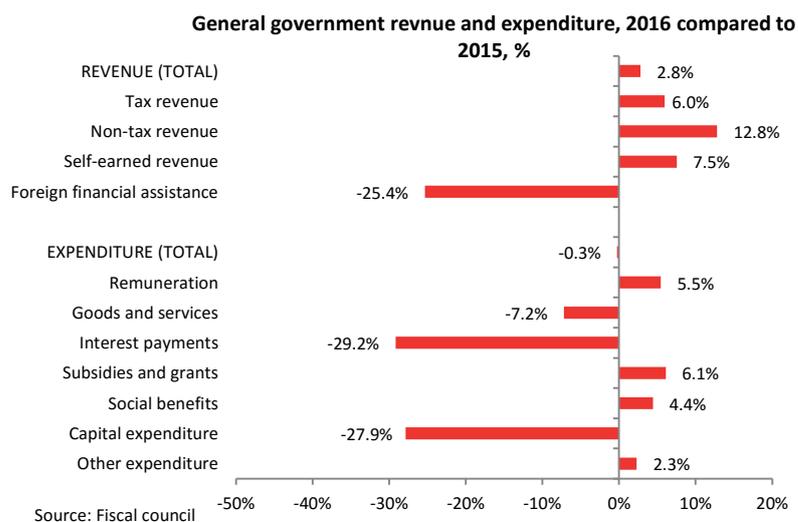
Due to seasonal factors in December clothing prices declined by 3.3% compared to previous month. At the same time prices of services rose by 0.8% in December as service price inflation reached 3.4%. Such a strong increase however partly reflects also increase in fuel prices as prices of aviation services increased by 15.1% compared to November.

## Fiscal sector

As a result of continued delays in the EU financed investment, fiscal policy provided significant drag on the economic growth in Latvia in 2016 as public investment in declined by 27.9% compared to 2015 while total expenditure excluding interest payments grew by only 1.2%.

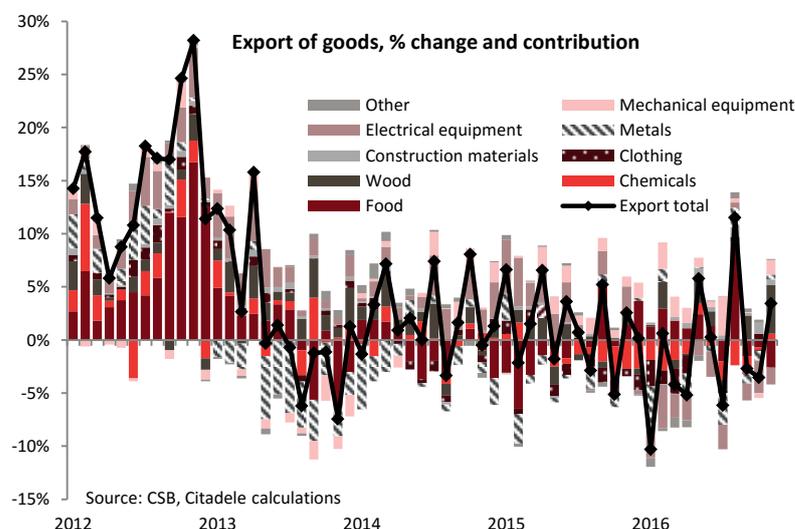
At the same time general government revenue in 2016 grew by 2.8% and according to preliminary estimate from Ministry of Finance in 2016 general government budget was in surplus for the first time since 1998.

In 2016 tax revenue grew by 6% despite overall economic growth of 1.6% and near zero inflation for most of the year, thus reflecting ongoing improvement in tax collection and reduction in shadow economy. In addition tax revenues were also boosted by increase in excise tax rates and scrapping of reduced VAT rate on housing maintenance services. In 2016 VAT revenues grew by 6.1% while personal income tax and social security contributions revenues increased by 5.7% and 7.4% respectively.



## External trade

In November export of goods from Latvia increased by 3.4% y-o-y following two months of decline as export growth has remained near zero for most of the year and in the first 11 months of 2016 overall export of goods declined by 1.1%. In November export growth was negatively affected by declining export of grain as well as by lower re-export of oil products and electrical equipment. However in November this was offset by rapid growth in the export of wood products.



In November export of wood products and furniture grew by 22.4% and 46.2% y-o-y respectively. Apart from wood products in November export growth was also supported by transport equipment (+13.7% y-o-y) and pharmaceutical products (+22.9%), although both of these sectors are dominated by re-exports as imports of both products also increased. In November imports of transport equipment and pharmaceutical products grew by 15.1% and 3.0% respectively while export of oil products declined by 10.7% and as a result overall exports grew by 3.2%.

Following more than two year decline export to Russia has started to increase again as in November exports to Russia grew by 13.2% y-o-y. This is as a result of both stronger ruble and stabilization in the Russian economy as business confidence indicators in Russia have improved significantly in recent months pointing to a pick-up in GDP growth. Apart from Russia exports in November grew also to Baltic and European countries while declining to countries outside EU, mainly due to lower grain exports to African and Middle Eastern countries.

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