

Latvian Macro Monitor

June 2017

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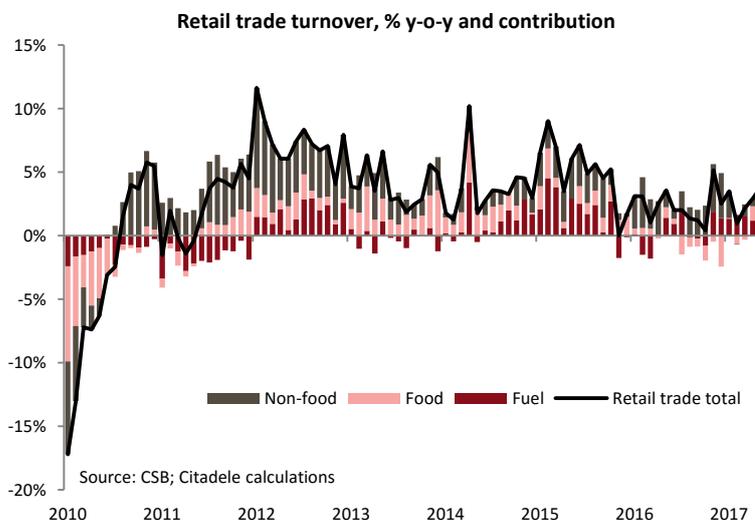
Summary

- **Moderate acceleration in retail trade continued in May as annual retail trade growth reached 6 month high and sales grew by 3.8% y-o-y.**
- **Latvian manufacturers continue to benefit from positive developments in the global economy as well as from growing demand in the domestic market and as a result manufacturing output in May expanded by 9.4% compared to previous year.**
- **In May headline inflation in Latvia declined for the first time since the summer of 2016 as consumer prices inflation slowed to 2.8% compared to previous year down from 3.4% in April. Deceleration in inflation in May was mainly caused by external factors.**
- **As spending on EU financed projects begins to speed up, public expenditure in May rose by 9.6% compared to previous month, however weak spending growth in previous months means that in the first five months of 2017 public expenditure in Latvia increased only by 2.2%.**
- **After several months of promising recovery credit growth again became negative in May as stock of outstanding loans to domestic non-financial companies and households declined by 0.3% compared to previous year after growing on average by 1.5% in the first four months of 2017.**
- **After several months of very rapid growth exports came almost to a standstill in April, as exports of goods grew by only 1.0% compared to previous year while imports in April grew by only 0.2%.**

Retail trade

Moderate acceleration in retail trade continued in May as annual retail trade growth reached 6 month high and sales grew by 3.8% y-o-y. Faster growth was driven by gradual improvements in consumer confidence and recovery in food sales which grew by 2.3% in May.

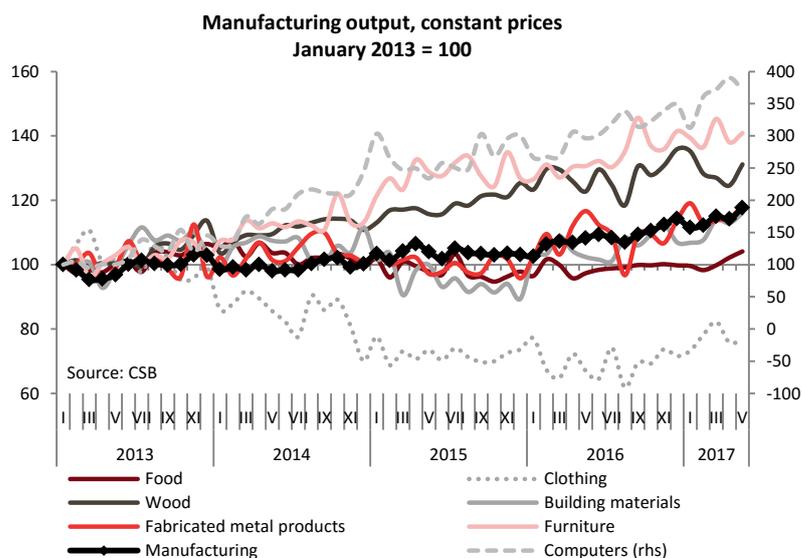
In addition retail trade was boosted by strong growth in sales of non-food items (excluding fuel) which in May grew by 5.8% y-o-y up from 0.7% in April. But at the same time fuel sales remained volatile and growth there slowed to 1.2% in May down from 7.3%.



Rapid growth in the sales of non-food items was caused by recovery in the sales of IT equipment and household appliances which grew by 34.4% y-o-y and 20.4% respectively. At the same time rise in food inflation has put pressure on budget constrained households and as a result sale of pharmacy and second hand goods as well as sales in markets declined by 2.0%, 7.3% and 7.9% respectively.

Manufacturing

Latvian manufacturers continue to benefit from positive developments in the global economy as well as from growing demand in the domestic market and as a result manufacturing output in May expanded by 9.4% compared to previous year. This is at least twice the rate of overall GDP growth. Exports remain the main driver of growth in manufacturing as turnover outside Latvia grew by 12.4%. At the same time domestic demand is also beginning to pick up as turnover in domestic market (+6.1% y-o-y) grew at the fastest pace in more than two years.



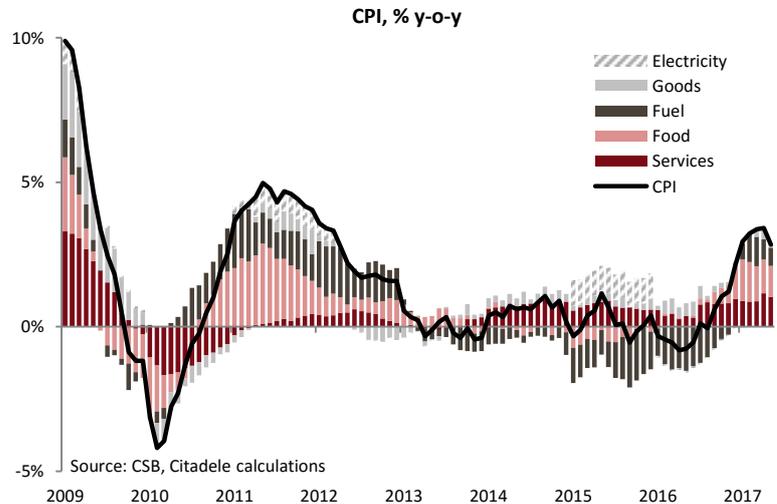
Manufacturing growth in May was led by manufacture of electrical equipment (+51.1% y-o-y), cars and car parts (+18.3%) as well as machinery and equipment (+26.5%). These sectors collectively made up almost 1/3 of overall manufacturing growth in May. May also saw positive trends in wood sector where following several months of negative growth output there expanded by 6.8%. At the same time food manufacturing had second month in a row with very strong growth as output in this sector grew by 7.5%. Meanwhile the only sector in May where output declined was in repair and installation of machinery and equipment (-16.7%), however output in this sector historically has been very volatile.

Also in May manufacture of non-metallic minerals which are mainly made up from building material grew by 11.4% y-o-y. This is a positive signal for construction sector since in April and May turnover in domestic market in this sector grew by 14.4% after growing only by 1% in Q1 and declining by 13% in 2016. This suggest that construction output could accelerate even further in Q2.

Inflation

In May headline inflation in Latvia declined for the first time since the summer of 2016 as consumer prices inflation slowed to 2.8% compared to previous year down from 3.4% in April. Deceleration in inflation in May was mainly caused by external factors.

As last year's surge in world oil prices begins to drop out from headline inflation, fuel price inflation in Latvia in May slowed to 8.7% y-o-y, down from 11.6% March. At the same time food prices remained relatively stable and only rose by 0.3% compared to previous month due to seasonal factors. May also saw rather unusual seasonal pattern in apparel and footwear where prices declined by 3.7% y-o-y. This could be due to significant discounts at closing sales at major retail chain "Prisma" which decided to leave Latvian and Lithuanian market. As a result clothing prices could rebound in June.



At the same time domestic inflation remains strong as service prices grew by 3.6% and wage growth continues to exceed gains in productivity. In addition service prices are also affected by sine sector specific factors, for example, insurance where prices rose again in May by 5.8% compared to previous month as insurers try to offset impact from low interest rates.

Fiscal sector

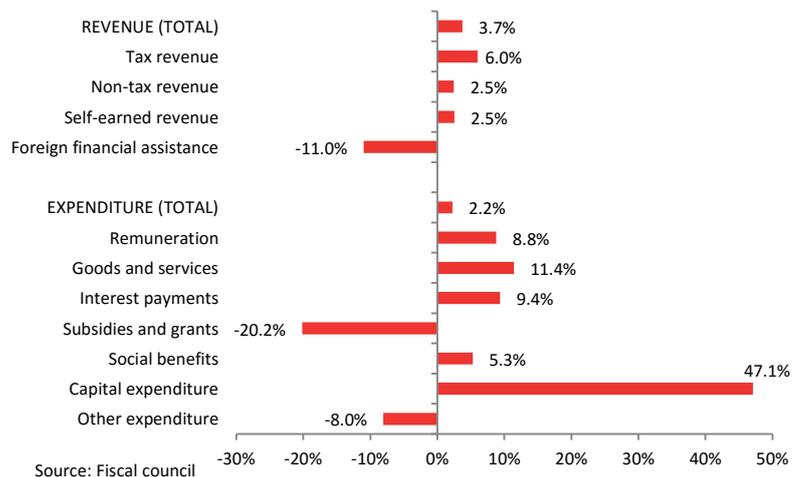
As spending on EU financed projects begins to speed up, public expenditure in May rose by 9.6% compared to previous month, however weak spending growth in previous months means that in the first five months of 2017 public expenditure in Latvia increased only by 2.2%.

During this period capital expenditure rose by 47.1% compared to the first five months of previous year, but this was offset by drop in subsidies (-20.2%) and other expenditure (-8.0%).

Meanwhile spending on remuneration as well as goods and services rose by 8.8% and 11.4% respectively. According to state budget public expenditure in 2017 is set to increase by 7.5% which would mean significant surge in public expenditure in the second half of the year.

At the same time budget revenue rose by 3.7% in the first five months of 2017 as significant increase in tax revenues (+6.0%) was offset by 11% drop in foreign financial assistance. In the first five months of 2017 labour tax revenues rose by almost 10% while corporate income tax revenues dropped by 6.7% which reflects shrinking corporate profits as weak economic growth combined with strong wage growth over the past two years have put significant pressure on profit margins.

General government revenue and expenditure, I-V 2017/ I-V 2016



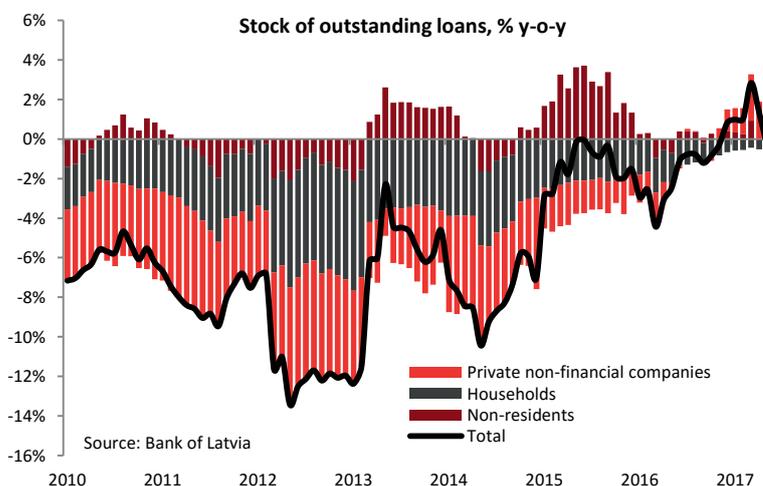
Banking sector

After several months of promising recovery credit growth again became negative in May as stock of outstanding loans to domestic non-financial companies and households declined by 0.3% compared to previous year after growing on average by 1.5% in the first four months of 2017.

Slowdown in credit growth was mainly caused by weaker lending to non-financial companies as credit to domestic firms grew by only 0.6% y-o-y in May after growing by 4.4% in April. At the same time credit to domestic households declined by 1.2% as consumer loans grew by 4.5% while mortgage lending declined by 1.6%.

Overall lending to domestic economy continues to lag behind Lithuania and Estonia despite significant growth in household income and pick up in investment in Q1.

At the same time domestic deposits continue to grow rapidly as domestic household deposits in May increased by 7.9% y-o-y while deposits of non-financial corporations grew by 5.7%. As a result domestic loan to deposit ratio in May stood at 113.9%.



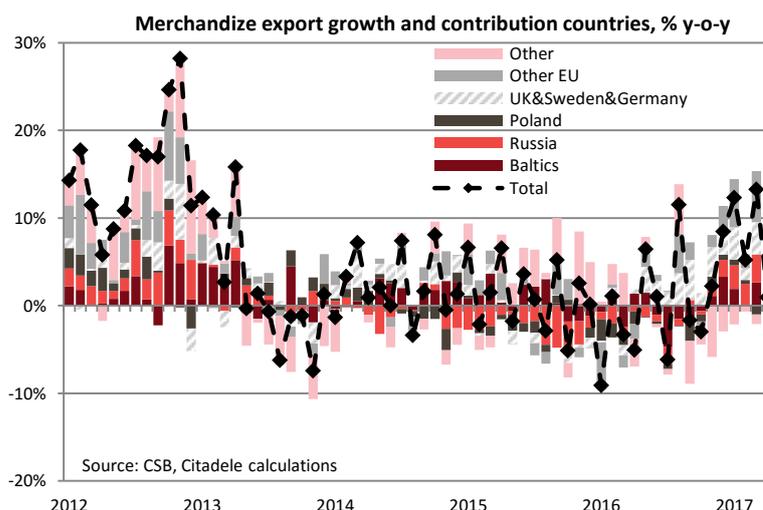
External trade

After several months of very rapid growth exports came almost to a standstill in April, as exports of goods grew by only 1.0% compared to previous year while imports in April grew by only 0.2%. However, this is likely to be only temporary slowdown as manufacturing continued to grow rapidly in April and May while international trade remains buoyant and grew by 6.5% April.

Unexpected drop in exports of wood products (-6.1% y-o-y) had the most significant impact on Latvian exports in April.

In addition exports in April exports of machinery (-20.2%), oil products (-7.3%) and vehicles (-5.1%) also declined but this was mainly due to lower level of re-exports and does not reflect performance of Latvian manufacturing sector.

At the same time exports of chemical products (+162.2%), milk products (21.4%), drinks (+15.5%), as well as iron and steel (+140.7%) rose in April although iron and steel exports were also mainly driven by re-exports.





In April exports to other Baltic countries declined by 5.5% y-o-y while exports to Poland dropped by 7.0%. Meanwhile exports to Russia rose by 1.9% in April while exports to Sweden and Turkey rose by 21% and 224% latter driven mainly by sharp increase in export of iron and steel.

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