LATVIJAS BANKA
EIROSISTĒMA

Macroeconomic Projections Report

2024 | October

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October 2024, No 2

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Additional information

The cut-off date for the information used in the Macroeconomic Projections Report (October 2024, No 2) and in the forecast is 30 September 2024.

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Key points in brief[1]

While inflation has declined on a global scale, substantial challenges for further economic development persist as global uncertainty remains high and geopolitical tensions have continued to rise over recent months.

Global energy commodity prices remain volatile due to geopolitical tensions, with price trends reversing since spring: the price of natural gas has gradually risen, while the price of oil has fallen.

While the world's leading central banks are keeping to their tight monetary policies, they have also started to lower the degree of monetary policy restriction.

Global growth continues to be moderate, with Latvia's foreign demand recovering slowly, consistent with earlier forecasts. The economies of Latvia's primary trade partners have shown varied developments. Manufacturing is experiencing an overall downward trend both in the euro area and globally, while consumer caution remains prevalent in many regions.

[1] Economic developments and indicator forecast revisions have been compared with the previous forecasts published in June 2024.

A shift in euro area monetary policy has occurred, as the Governing Council of the ECB has begun a gradual easing of its restrictive monetary policy, resulting in more favourable financial conditions.

Both lending activity and government securities market activity saw a slight increase, while interest rates exhibited a downward trend.

The budget deficit is currently estimated to be above 3% of GDP (with the upcoming tax reform having minimal economic impact and being fiscally neutral for the budget). The deficit would be reduced if additional funds were raised outside the government budget for investment projects, including the construction of Rail Baltica. Slower economic growth will lead to a higher budget deficit and, with a growing need for borrowing, the government debt level will approach 50% of GDP.

GDP growth is still projected to be sluggish, and the outlook for future growth has become increasingly pessimistic. The ongoing decline in competitiveness, coupled with already weak external demand, will hamper export recovery. This, in turn, is likely to reduce revenues for both consumers and investors, who remain cautious amid persistent geopolitical uncertainties.

After last year's modest economic growth, this year's growth is expected to be lower than previously projected. In the short term, weak external demand is constraining manufacturing sector development, while consumer tendencies to build up savings are slowing trade growth. Over the medium term, weakening competitiveness is likely to impede the expansion of export sectors. Additionally, delays in implementing EU co-financed projects as well as the Rail Baltica project, coupled with a more pessimistic outlook for the Scandinavian market, are limiting growth opportunities in the construction sector.

Under conditions of weak economic activity, unemployment rose to 7%. The recovery of economic growth, which is not expected to be as strong as previously estimated, does not allow unemployment to approach the 6% level projected in June for the medium term; this figure has been revised slightly upwards for the entire projection horizon.

After this year's robust wage growth, the government's decision to cap the increase in the public sector wage bill, combined with weaker-than-expected economic growth, is anticipated to suppress wage growth next year. Meanwhile, the constrained labour supply and the rise in the minimum wage are expected to continue driving wage growth at a pace that exceeds productivity.

Inflation in Latvia is currently low, with forecasts revised downwards in light of declining global resource prices, particularly for oil and food. However, an increase in prices for services in Latvia persists.

Projections in figures

Table 1

Macroeconomic fundamentals: Latvijas Banka's forecasts

	2024	2025	2026
Economic activity (annual changes; %; at constant prices; seasonally adjusted data)			
GDP	0.6	2.6	3.0
Private consumption	0.2	2.4	3.0
Government consumption	11.3	1.2	0.9
Investment	–4.2	3.4	4.9
Exports	–2.1	1.2	2.8
Imports	–2.5	3.0	3.2
HICP inflation (annual changes; %)			
Inflation	1.3	1.5	1.6
Core inflation (excluding food and energy prices)	3.8	2.6	2.6
Labour market			
Unemployment (% of the economically active population; seasonally adjusted data)	7.1	6.8	6.5
Nominal gross wage (annual changes; %)	9.7	6.7	7.3
External sector			
Current account balance (% of GDP)	–2.9	–4.5	–4.8
Government finances (% of GDP)			
General government debt	47.0	48.4	49.0
Budget surplus/deficit	–3.1	–3.3	–3.2

Projections in brief

GDP

2024 **0.6%**

GDP growth is expected to be more modest

The revival of GDP growth is held back by cautious spending from consumers and businesses. The medium-term outlook for GDP growth has become more pessimistic due to a decline in competitiveness.

Projection

2025	2026
2.6%	3.0%

INFLATION

2024 **1.3%**

Inflation in Latvia remains low

Inflation in Latvia is low; however, growth in services prices remains resilient.

Projection

2025	2026
1.5%	1.6%

BUDGET DEFICIT

2024 **3.1%**

Budget deficit may breach the 3% threshold

Tax policy changes will not strengthen competitiveness, and their impact on GDP can be regarded as minor. Meanwhile, the government budget deficit is being offset at the expense of the pension system sustainability.

Projection

2025	2026
3.3%	3.2%

Global environment

While inflation has declined on a global scale, substantial challenges for further economic development persist as global uncertainty remains high and recent developments suggest that geopolitical tensions have continued to rise over recent months.

Ukraine's prolonged war has entered a new phase, with the warfare now extending onto Russian soil. The armed conflict between Israel and the terrorist groups Hamas and Hezbollah continues in the Middle East. The failure of the parties to agree on a ceasefire continues to pose the risk of a broader regional conflict. Maritime traffic remains disrupted in the Red Sea. At the same time, as the US presidential elections approach, protectionist rhetoric is intensifying and risks of escalating trade tensions between leading global economies are increasing, as are other uncertainties that hold back investment.

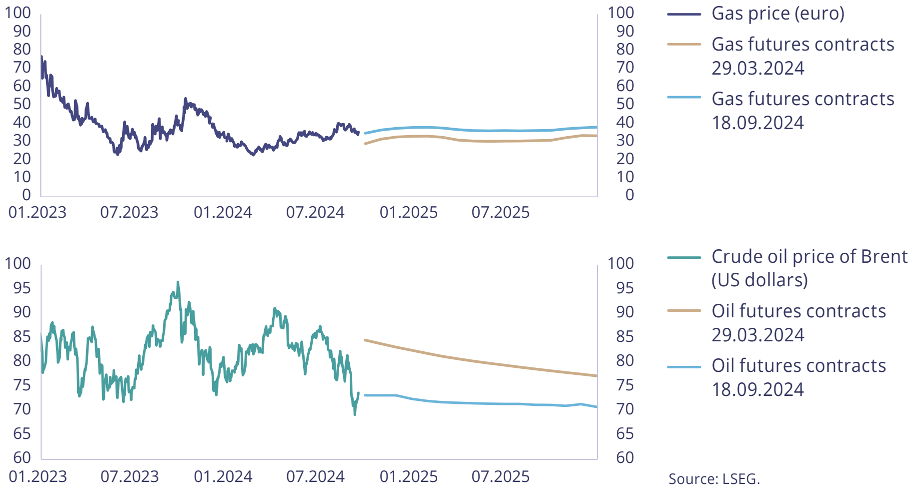
Global prices of goods

Global energy commodity prices remain volatile due to geopolitical tensions, with price trends reversing since spring: the price of natural gas has gradually risen, while the price of oil has fallen.

Although Europe's natural gas storage facilities are filling rapidly and nearing full capacity, concerns about an earlier cutoff of Russian natural gas supplies through Ukraine to Austria, Slovakia, and Hungary are driving prices upwards. The Ukrainian government has previously indicated that it does not intend to sign a new transit agreement when the current one with Russia expires at the end of this year. Additionally, a sharp spike in natural gas prices occurred following Ukraine's actions in the Kursk region, a key transit hub for Russian natural gas passing through Ukraine. Other factors that have until now affected natural gas prices include extreme weather conditions, which have either hampered the supply of liquefied natural gas globally or led to a greater need for electricity during heat waves. Futures contracts show that the price of natural gas could slightly increase as the heating season approaches.

Oil prices have recently fallen. Concerns when it comes to global demand are an important factor behind the decline in prices. Meanwhile, in early summer, OPEC+ countries also announced plans to gradually restore limited production. However, no real action has been taken yet, as the anticipated production increase set for October has been postponed. However, looking ahead, it will become increasingly difficult for OPEC+ to refrain from increasing production as non-OPEC+ oil-producing countries continue to expand their market share. The risks of wider warfare in the Middle East cannot be overlooked, despite the oil markets currently assigning a lower probability to this risk. Futures contracts suggest that the crude oil price of Brent is likely to remain at its current level for an extended period of time.

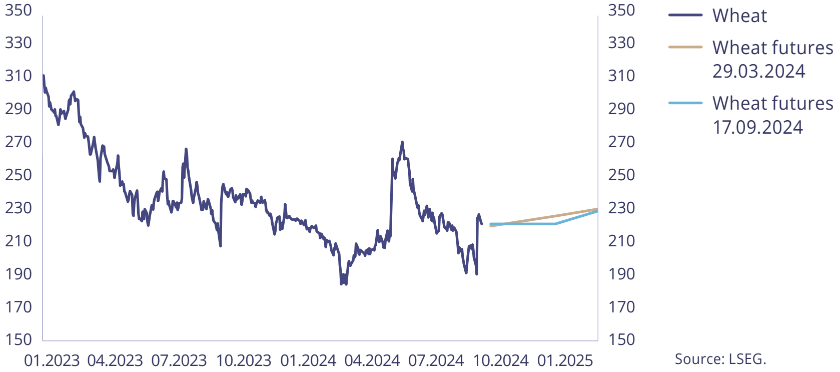
Chart 1. **Natural gas prices on the Dutch TTF trading point and Brent crude oil actual and future prices** (euro/MWh; US dollars/barrel)



Source: LSEG.

Wheat prices increased slightly in mid-September in response to reports of poor harvests in France and across the European Union. At the same time, strong Russian wheat exports have kept global prices at levels similar to those in spring. Futures contracts indicate that wheat prices could rise slightly during the winter months.

Chart 2. **Wheat prices on the Euronext exchange** (euro/t)



Source: LSEG.

Monetary policy at the leading central banks across the world

While the world's leading central banks are keeping to their tight monetary policies, they have also started to lower the degree of monetary policy restriction. At its September meeting, the Fed decided to reduce the target level of interest rates by 50 basis points to between 4.75 and 5.00%. The Fed notes that economic activity in the United States continues to expand at a consistent pace. Job creation has slowed, while the unemployment rate has increased, but remains low. Inflation has moved closer to its target, but is still elevated. Jerome H. Powell, Chair of the Fed, states that the shift in the monetary policy stance in September will help to maintain a robust economy and labour market, while also guiding inflation towards the target at a time when the Fed is starting to adopt a more neutral monetary policy stance. Financial markets are pricing in a further reduction of 70 basis points in the target interest rate by the end of this year, with a decrease of 175 basis points expected by the June meeting next year.

The Bank of England has also started to reduce its base interest rates. At its August meeting, its Monetary Policy Committee lowered the base rate by 25 basis points to 5.00%. During its September meeting, while opting to keep the rate unchanged, the Committee signalled that a decline in interest rates could follow at its November meeting. The Governor of the Bank of England states the Bank should be able to gradually reduce the base interest rate if inflation continues to align with the Bank's forecasts. However, he stresses that inflation must remain low, urging the Bank of England to exercise caution against making any premature interest rate cuts. Financial markets are pricing in a reduction of 44 basis points in the base interest rate by the end of this year, with a decrease of 125 basis points expected by the June meeting next year.

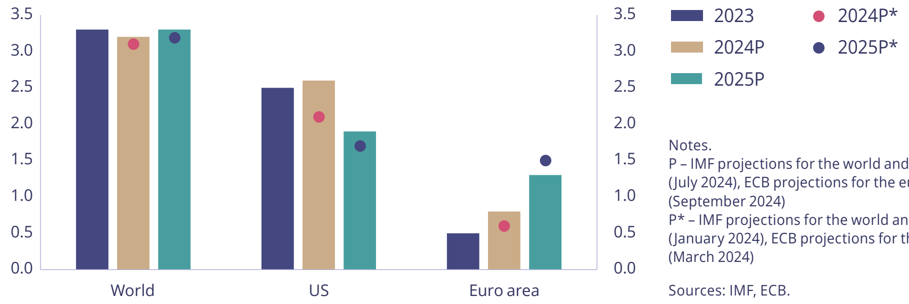
Unlike other leading global central banks, the Bank of Japan took action, deciding at its end-July meeting to raise the base interest rate from 0.00–0.10% to approximately 0.25%. Kazuo Ueda, Governor of the Bank of Japan, justified the decision by stating that inflation was moving in line with the bank's forecasts. Financial markets are pricing in another increase of 25 basis points in the base interest rate closer to the summer of next year.

External demand

Global growth continues to be moderate, with Latvia's foreign demand recovering slowly, consistent with earlier forecasts. The economies of Latvia's primary trade partners have shown varied developments. Manufacturing is experiencing an overall downward trend both in the euro area and globally, while consumer caution remains prevalent in many regions.

Overall, global economic growth remains weak, yet resilient. According to IMF projections announced in July 2024, global growth is expected to reach 3.2% in 2024 and 3.3% in 2025. While growth forecasts have slightly improved compared to the estimates made at the beginning of the year, the path to recovery remains fraught with challenges. Geopolitical and trade tensions continue to escalate, while a historically high number of elections worldwide contribute to significant uncertainty about the future economic outlook in the US and other nations. Additionally, financial market volatility has increased. Global growth varies by country and sector, with performance in manufacturing lagging and growth being primarily driven by the dynamics of the services sector. In the US, a weakening labour market has raised concerns about the effects of high interest rates, including their potential impact on the global economy; however, the so-called soft landing remains the baseline scenario.

Chart 3. **Projections for the world, US and euro area economic growth** (annual changes; %)

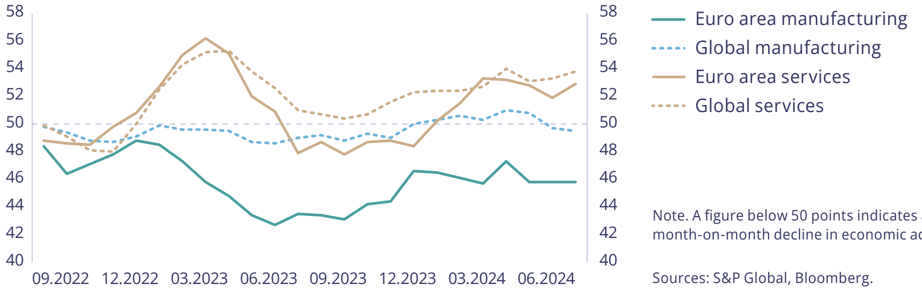


Notes.
P – IMF projections for the world and the US (July 2024), ECB projections for the euro area (September 2024)
P* – IMF projections for the world and the US (January 2024), ECB projections for the euro area (March 2024)

Sources: IMF, ECB.

Growth in the euro area showed some recovery in 2024, but it remains sluggish, and the outlook on future developments has somewhat deteriorated. Consumers continue to exercise caution, leading to lower-than-expected consumption growth. Similarly, investment activity is weaker than expected. The manufacturing sector is experiencing a downturn, underscoring the structural competitiveness issues in the euro area. According to the latest forecasts from the ECB, euro area GDP is projected to grow by a mere 0.8% in 2024 and by 1.3% in 2025.

Chart 4. **Purchasing Managers' Index (PMI) for the euro area and the world**



Note. A figure below 50 points indicates a month-on-month decline in economic activity

Sources: S&P Global, Bloomberg.

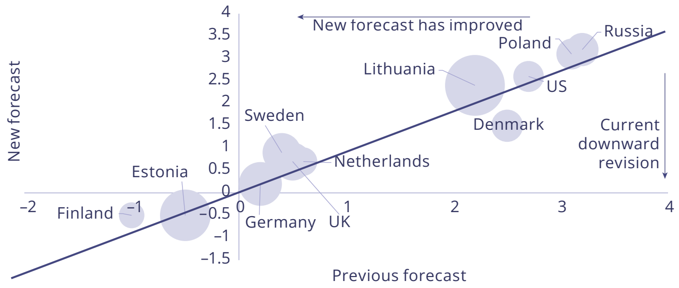
The outlook on external demand has remained largely unchanged in recent months. Latvia's main trade partners are experiencing uneven growth – some economies are expanding faster than previously expected, while others are lagging behind. Key factors hindering stronger recovery in external demand include the long-anticipated but yet unseen rise in consumer spending and a weak performance in the manufacturing sector.

The German manufacturing sector continues to struggle, with declining investment in new machinery, equipment, and buildings, as well as industrial confidence indicators having worsened in recent months. Export order valuations in German manufacturing have dropped more sharply than in other euro area countries, negatively impacting Germany's economic performance, which contracted by 0.1% in the second quarter, falling short of Deutsche Bundesbank's expectations. Structural issues within Germany's manufacturing sector remain a concern, underscored by Volkswagen Group's plans to close two factories. This slowdown in Germany's growth could weaken demand for Latvian exports, particularly in sectors such as mechanical engineering, electronics, and the manufacture of wood.

Unlike Germany, Lithuania has shown much stronger growth rates. It is one of Latvia's few major trade partners to have experienced stable economic expansion in both the first and second quarters of this year. Lietuvos bankas revised its 2024 GDP growth forecast upwards from 1.9% in June to 2.2% in September. However, this does not significantly alter the broader outlook, as forecasts for the coming years remain unchanged. Lithuania's economic growth has been driven by private consumption, which sets it apart from other countries, including Latvia, where consumer caution and increased saving have delayed consumption recovery. Overall, Lithuania stands out with positive indicators for both consumer and industrial sentiment, suggesting that growth is likely to continue in Lithuania. Consumption is expected to rise further, with increased investment supported by interest rate cuts and EU funding.

Over the course of the year, forecasts for Estonia's economic performance have become increasingly pessimistic, with private consumption – a key driver of stable growth for Lithuania – proving to be a stumbling block for Estonia. Since the second quarter of 2022, its contribution to GDP growth has been either negative or neutral. Moreover, increases in VAT and PIT could further hinder the recovery of consumption. However, it is worth noting that Estonia's economy stopped contracting in the second quarter of this year, marking the end of the economic downturn that had lasted for over two years. Economic sentiment indicators also suggest that the Estonian economy may now be on the path to recovery.

Chart 5. **2024 GDP forecasts for major export partners** (annual changes; %)



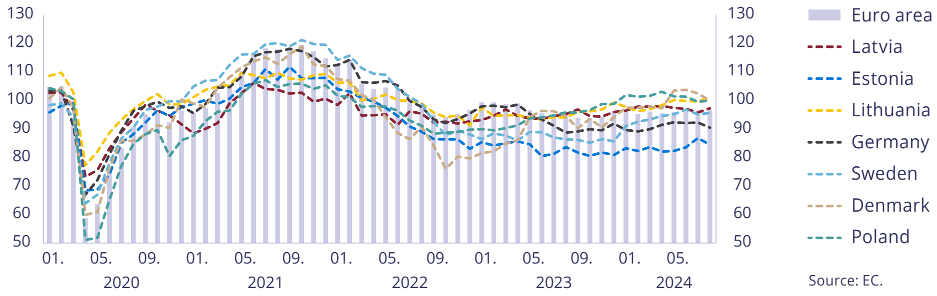
Nordea Economic Outlook for the Nordic economies
(the new forecast – September 2024, the previous forecast – April 2024).

IMF forecasts for other countries
(the new forecast – July 2024, the previous forecast – May 2024)

Sources: IMF and Nordea.

Positive news came from the UK, where the economy grew by 0.6% in the second quarter of 2024 and by 0.7% in the first quarter. In its August report, the Bank of England highlights increased consumption in the second quarter and expresses optimism that growth will continue throughout the year. In early August, the Bank of England cut its interest rates – a move previously anticipated for the end of the year – offering additional relief to households and boosting investment in the economy. This could lead to faster economic growth in the UK and, consequently, increase demand for Latvian goods and services.

Chart 6. **Economic sentiment indicator** (long-term average = 100)



Source: EC.

Sveriges Riksbank has similarly lowered interest rates, projecting that they could be reduced two to three more times this year – one time more than had been previously anticipated. While household optimism regarding both personal finances and the broader Swedish economy is growing, consumption data still point to weak performance. The economy contracted in the second quarter, contrary to Sveriges Riksbank's forecasts. Corporate sentiment indicators also suggest that growth will remain sluggish in the third quarter. The number of building permits issued remains less than half of 2021 levels, indicating that demand for Latvian imports in this sector has yet to recover. Additionally, real estate prices have been on a downward trend since the second quarter of 2022, improving real estate affordability. Looking forward, growth in this sector is expected to moderate, as past projections for population growth were greatly overestimated, having stood at just 0.3% in 2023, Sweden's lowest rate in 20 years.

Monetary policy in the euro area

A shift in euro area monetary policy has occurred, as the Governing Council of the ECB has begun a gradual easing of its restrictive monetary policy, resulting in more favourable financial conditions.

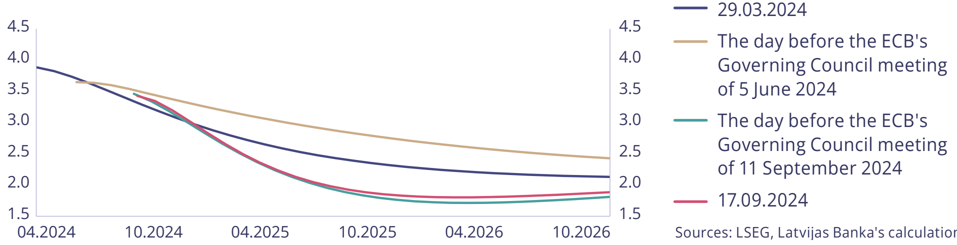
ECB monetary policy

At its June and September meetings, the Governing Council of the ECB decided to lower its main monetary policy rate, which is currently the deposit facility rate, by 25 basis points to 3.50%. The ECB based its decision on inflation dynamics indicating a steady return to the target level over the medium term.

- ***The ECB's September inflation forecasts reaffirmed those made in June, projecting a return to the target level in the second half of 2025.*** However, the Governing Council of the ECB cautions that inflation may see a slight uptick towards the end of this year as sharp declines in energy prices are no longer reflected in the annual inflation. Additionally, the Governing Council of the ECB notes that domestic inflation remains elevated. While wages continue to rise at an accelerated pace, labour cost pressures are moderating. Furthermore, data on the profit per unit of output indicate that the ability of companies to raise prices is diminishing, which partially limits the inflationary impact of higher wages.

Economic growth remains subdued. This is primarily due to weak private consumption and low levels of investment. While growth is projected to pick up over the next two years, the economic growth outlook carries downside risks. With regard to future interest rates, Christine Lagarde, President of the ECB, stated that the ECB will continue to follow a data-dependent and meeting-by-meeting approach in its future decisions. Financial markets anticipate that the deposit facility rate will decrease to 2.25% by early next summer.

Chart 7. **One-month €STR OIS forward rates** (%)



Sources: LSEG, Latvijas Banka's calculations.

Financial conditions in the euro area

Financial conditions in the euro area continued to improve, largely due to the interest rate cut cycle initiated by the ECB and financial market participants' expectations of further reductions. Declines in key interest rates echoed in the falling government bond yields, which subsequently influenced the corporate debt yields. The dynamics of government bond yields in France differed notably, as unexpected extraordinary elections led to an increase in the spread between the French and German government bond yields for comparable maturities.

Concerns regarding the sustainability of US economic growth emerged in the second half of the summer, triggering negative risk sentiment across global stock markets. Although stock prices experienced a sharp decline, this downturn proved to be temporary. The heightened uncertainty adversely affected financial conditions in the euro area. Concerns about slowing economic growth in both the US and the euro area were reflected in a slight widening of the spread on the euro area corporate debt securities above the risk-free rate, which limited companies' ability to benefit from overall interest rate cuts. Despite the increase in spreads, non-financial corporations successfully raised the necessary funding in capital markets.

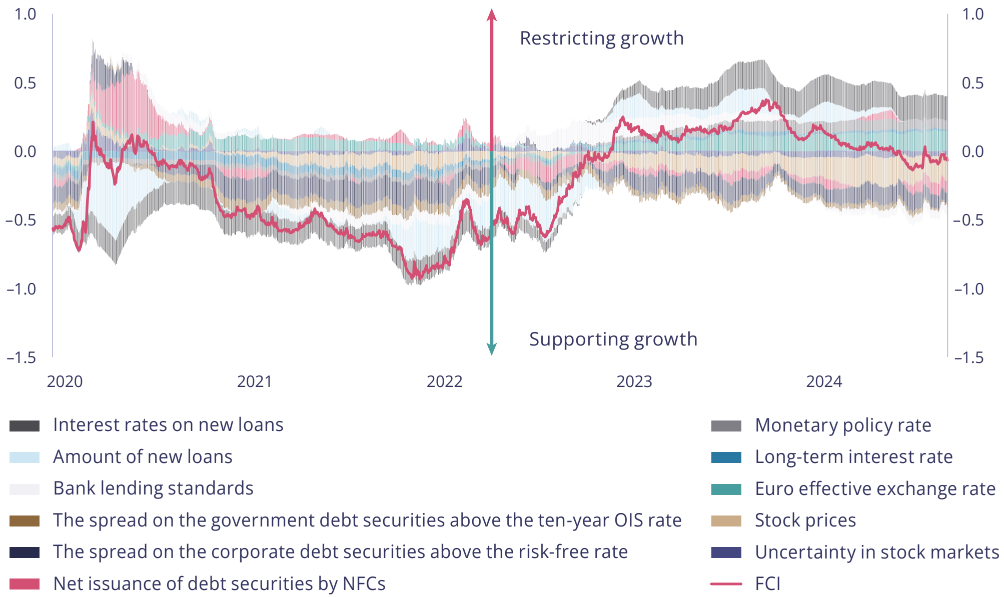
The AI technology sector, which has been resilient until now, is starting to show signs of weakness as investors increasingly scrutinise the returns on AI investments, particularly for highly valued companies.

The results of the euro area bank lending survey indicate that demand for loans among non-financial corporations continued to decline in the first half of 2024, primarily due to high lending rates. Concurrently, tighter credit standards were enforced because of lower risk tolerance. However, household demand for loans for house purchase increased in the second quarter, reflecting improved prospects in the housing market. Euro area credit institutions eased their lending standards for loans for house purchase due to heightened competition among banks. Looking ahead, credit institutions anticipate a recovery in demand for bank loans from both non-financial corporations and households, although the supply of loans to non-financial corporations may continue to contract.

With the onset of a new monetary policy cycle marked by key interest rate cuts and growing expectations of further reductions, interest rates on new loans are experiencing slight declines across the euro area and its largest countries. This, along with bank expectations of a stabilisation in loan demand, suggests a potential normalisation of lending growth and a further recovery. However, there is a risk that, amid slower economic growth, the euro area banks can resume the tightening of lending standards, thus restricting credit supply.

Provided there are no new economic shocks, the interest rate cut cycle initiated by the ECB is anticipated to further enhance financial conditions in the euro area and bolster economic growth.

Chart 8. **Euro area Financial Conditions Index of Latvijas Banka** (FCI; standard deviations from the long-term average)



Sources: LSEG, Bloomberg, ECB, and Latvijas Banka's assessment.

Notes. In the Financial Conditions Index, each factor is assigned a weight based on its impact on GDP growth. This impact is assessed using a vector autoregression (VAR) model, which helps determine how GDP responds to unexpected changes in factors or shocks. The significance of each factor is calculated using impulse response functions, as the 12-month cumulative impact following a shock. The index is expressed in standard deviations from the long-term average level. The higher the index value, the more restrictive the financial conditions.

Financial conditions in Latvia

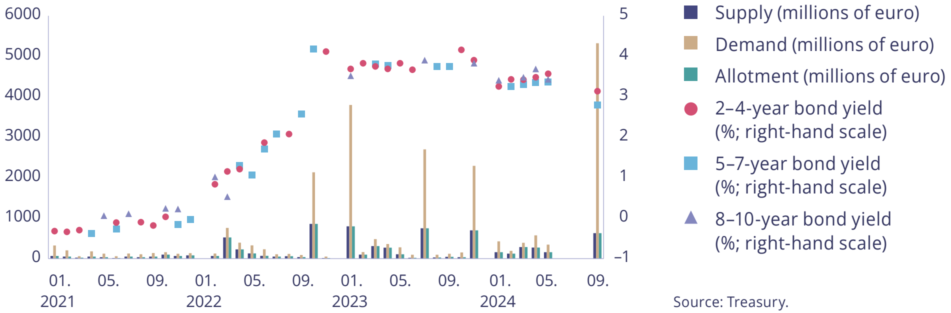
Both lending activity and government securities market activity saw a slight increase, while interest rates exhibited a downward trend.

Latvian capital market

The financial conditions in the securities market were similar to those of the previous period. At the same time, share capitalisation decreased significantly due to AS Latvijas Gāze ceasing to list its shares on the stock exchange, which had a considerable impact on total capitalisation. One credit rating agency, which had previously rated Latvia higher than others, downgraded its credit rating by one notch from A+ to A. Meanwhile, the other two major credit rating agencies maintained their ratings at the A– level, with one of them keeping a positive outlook for the future.

During the February–August period, the trajectory for reducing the ECB's key interest rates was reassessed, with financial markets projecting higher ECB key interest rates over the long term. As a result, yields on government securities across the euro area rose, while the yield on Latvia's 10-year government bonds declined from 3.51% at the end of January to 3.29% at the end of August. This indicates an improvement in Latvia's risk perception, which boosted demand for Latvian bond issues in international markets compared to the securities auctions of other euro area countries.

Chart 9. **Issues of euro-denominated Latvian government securities**



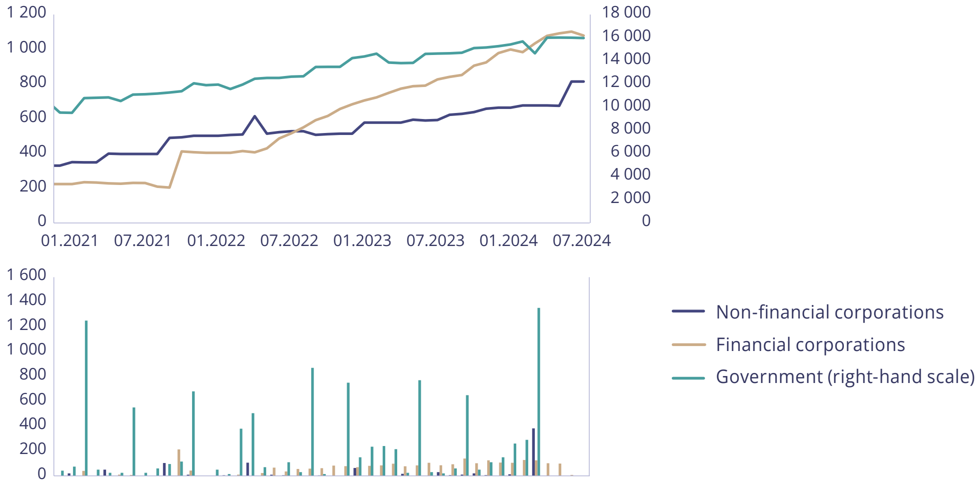
Source: Treasury.

In May, the government issued US dollar-denominated bonds worth 1.25 billion US dollars in international markets, while the demand exceeded 4.9 billion US dollars. Meanwhile, in September, the government issued 7-year euro-denominated bonds worth 600 million euro in international markets, with demand exceeding 5.2 billion euro. The yields on these issuances were 5.252% and 3.14%, respectively, with the spread over the reference rate standing at approximately 80 basis points. To fully eliminate currency risk, the issuance of US dollar bonds is accompanied by a currency swap, converting the sovereign debt into euro. Consequently, the effective post-swap interest rate on the US dollar-denominated bonds was lower than the borrowing cost for a comparable maturity in euro.

In September, the Treasury stated that the country will need to borrow at least 3 billion euro annually over the next four years to refinance a series of previously issued Eurobonds, as well as to finance budget deficits and loans to local governments.

Debt securities of non-financial corporations continued to grow, with Air Baltic Corporation AS issuing bonds worth 340 million euro in the international market. Meanwhile, in August, the shares of AS Latvijas Gāze were delisted from the stock exchange following a decision made by the company.

Chart 10. **Outstanding debt securities of Latvia's issuers and new issues by issuer group** (millions of euro)

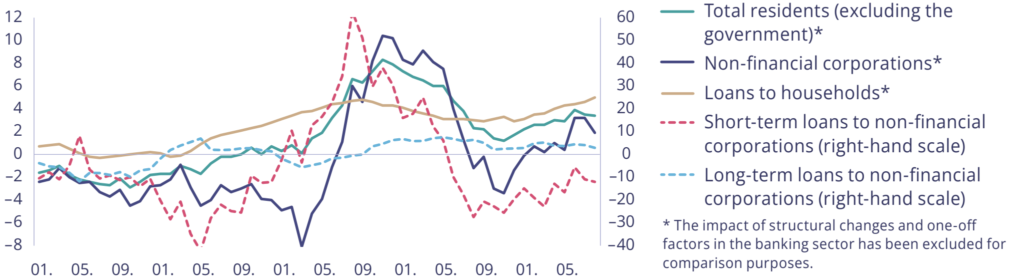


Source: ECB.

Banking sector

With interest rates gradually declining and economic sentiment stabilising, lending started to grow in the first three quarters of 2024. The growth in the total loan portfolio was primarily driven by increased lending to households for the purchase of both housing and consumer goods. Lending to non-financial corporations, which was nearly zero at the beginning of the year, increased during the summer as the normalisation of repayments of short-term loans issued during the 2022 heating season continued. Despite a moderate increase in the loan portfolio, its size remains relatively small in the context of the overall economic landscape, fluctuating around 27% of GDP.

Chart 11. **Domestic loans** (outstanding amount; annual changes; %)



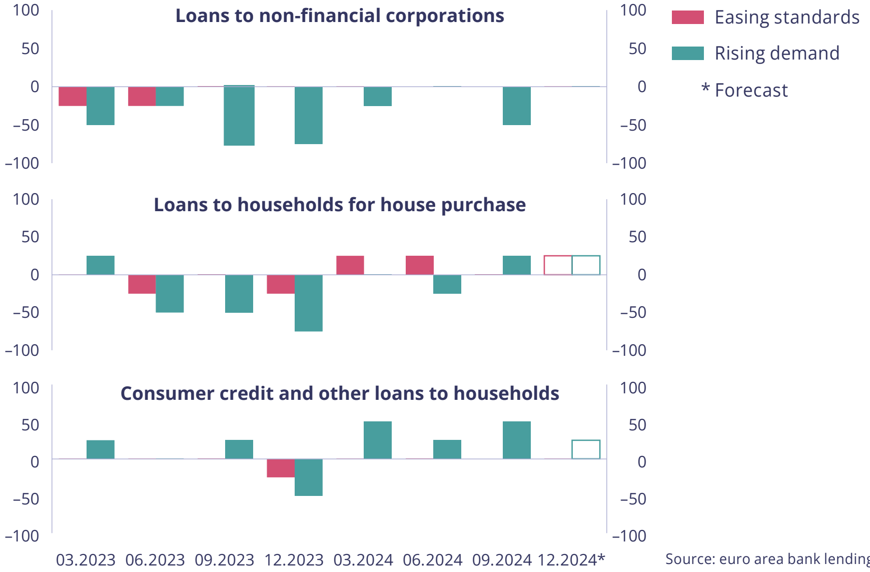
* The impact of structural changes and one-off factors in the banking sector has been excluded for comparison purposes.

Source: Latvijas Banka.

The bank lending survey shows a prevailing sense of pessimism in the non-financial corporate sector. Demand for credit remained stable in the second quarter of 2024, with expectations for improvement. However, it declined again in the third quarter, and credit institutions do not anticipate a change in financing needs for the fourth quarter. Modest investment plans remained the primary factor dampening demand, while general interest rates no longer had an impact on credit demand.

In contrast, the outlook for lending to households is optimistic. In the first half of the year, credit institutions facilitated loan availability for house purchase and construction by easing their standards. In contrast, household demand for housing loans rose in the third quarter, fuelled by increased consumer confidence and a more optimistic outlook for the housing market. Rising demand has accelerated the pace of lending, aligning with the growth of new housing loans. In addition to expectations of easing credit standards and a rebound in credit demand, there is potential for further growth in housing lending. With strengthening consumer confidence and the need to finance durable goods, consumer credit also remains robust.

Chart 12. **Changes in lending standards and loan demand** (net; %)

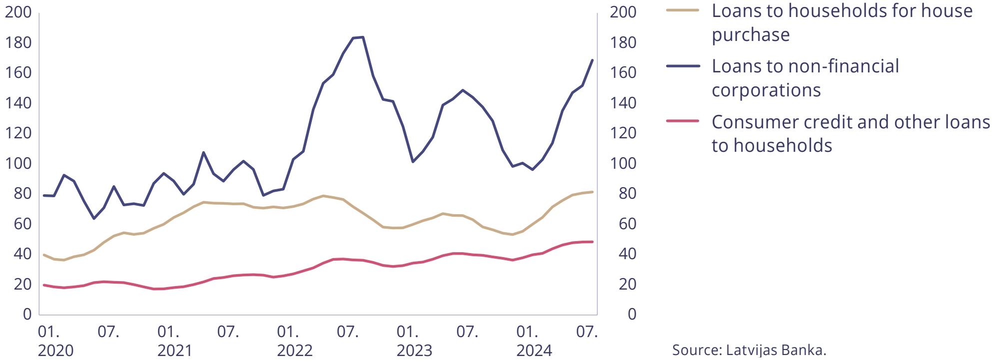


Source: euro area bank lending survey.

The decline in the ECB's key interest rates is gradually leading to lower interest rates on loans. Interest rates on loans to non-financial corporations remained broadly unchanged in the first half of 2024. However, they gradually declined over the summer following the initial decision of the Governing Council of the ECB to lower its key interest rates[1]. A decline in interest rates on new short-term loans was observed, while interest rates on long-term loans continued to fluctuate around 6.5%, indicating the caution of credit institutions regarding the economic situation of non-financial companies.

1 The decrease in interest rates on loans to non-financial corporations observed in August can be attributed to the issuance of a separate large loan under significantly better terms than other loans.

Chart 13. **Volumes of new euro-denominated domestic loans**
(millions of euro; 6-month average)

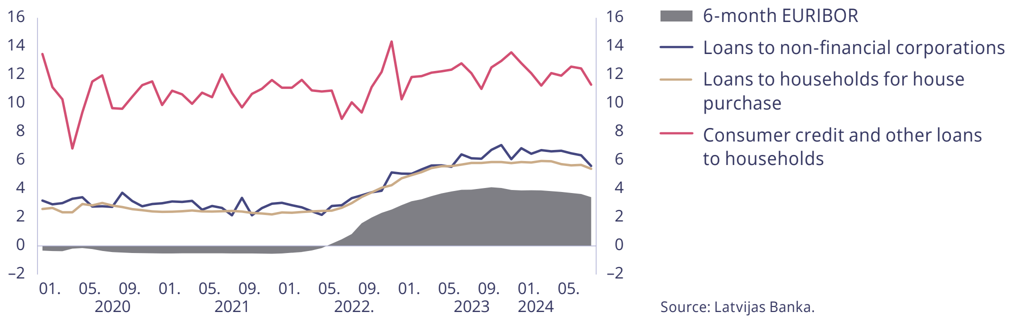


Source: Latvijas Banka.

A sharper decrease in lending costs was observed for new loans to households for house purchase and construction. Changes in the overall interest rate were influenced by fluctuations in the structure of transactions between unsecured housing loans (such as loans for repairs or "small housing" loans) and secured (mortgage) housing loans. At the beginning of the year, some market participants started to issue unsecured housing loans with fixed, and consequently higher, interest rates. As a result, the decline in financial market reference rates was only partly reflected in the overall interest rate on housing loans. At the same time, mortgage lending rates have gradually decreased since November of last year. This trend was further supported by the decline in markups (see more in the report Financing of the Economy 2024).

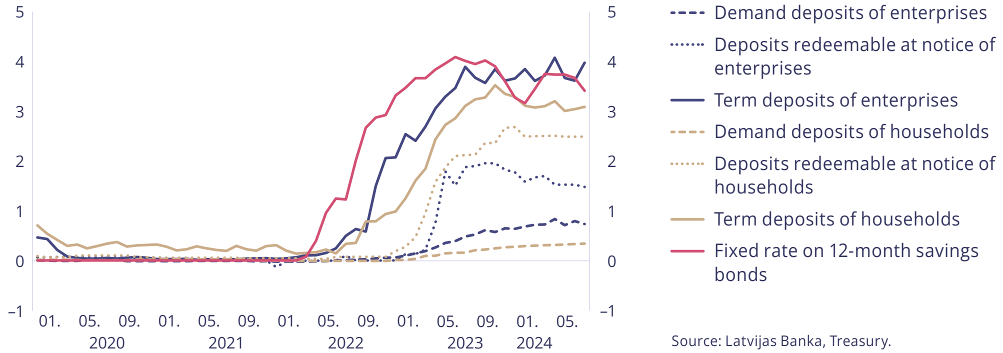
Changes in lending rates reflect developments in financial markets, including expectations for future movements of base interest rates. Therefore, the recent reduction in base interest rates during the September meeting of the ECB's Governing Council, coupled with increasing expectations for further cuts, will continue to support credit availability at lower borrowing costs.

Chart 14. **Interest rates on new euro-denominated domestic loans and the 6-month EURIBOR** (%)



Source: Latvijas Banka.

Chart 15. **Interest rates on new euro-denominated domestic deposits and the 12-month savings bonds** (%)



Source: Latvijas Banka, Treasury.

Growth in real wages, positive real interest rates, and weak confidence continue to drive the increase in deposits. During a period of low inflation, households are actively redirecting their real wage growth into savings. As a result, the growth rate of household deposits has been steadily increasing since the beginning of the year, standing above 5% during the summer. By contrast, the growth of deposits by non-financial corporations fluctuated in the first half of 2024, with a decline in June driven by their annual dividend contributions to the state budget. However, such growth remains strong.

The relatively high interest rates on deposits also continue to bolster deposit growth. In the first half of 2024, households continued to direct funds into term deposits whose share of the total household deposit portfolio remained unchanged,despite a decline in interest rates that stayed well above inflation. Household investment in savings bonds also rose, surpassing 300 million euro in July. However, as the return on deposits decreases, the pace of fund reallocation is slowing. Already during the summer, non-financial corporations significantly reduced their term deposits, with the invested funds staying in current accounts.

Upon reaching its peak, the gradual decline in interest rates on deposits will further diminish their attractiveness and hinder deposit growth. Low inflation and rising consumer confidence will reduce the need for precautionary savings. Given these factors, coupled with rising real wages, household funds might not be directed toward savings but rather toward consumption. This will, on one hand, reduce household deposits, while on the other hand, it will increase the account balances of non-financial corporations.

Fiscal policy in Latvia

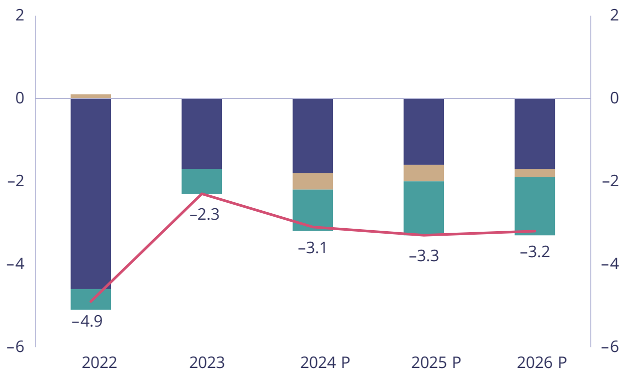
The budget deficit is currently estimated to be above 3% of GDP (with the upcoming tax reform having minimal economic impact and being fiscally neutral for the budget). The deficit would be reduced if additional funds were raised outside the government budget for investment projects, including the construction of Rail Baltica. The forecasts, however, include weaker public investment and slower absorption of EU funds, which is not favourable for growth and, consequently, for tax revenues. Slower economic growth will lead to a higher budget deficit and, with a growing need for borrowing, the government debt level will approach 50% of GDP.

Projections	2024		2025		2026	
	June	**October**	June	**October**	June	**October**
Budget surplus/deficit (% of GDP)	–3.8	**–3.1**	–3.5	**–3.3**	–2.8	**–3.2**
General government debt (% of GDP)	44.5	**47.0**	45.5	**48.4**	46.0	**49.0**

The general government budget deficit is expected to be lower this year and next, driven by stronger revenues and reduced public investment. However, the deficit is still projected to be above 3% of GDP. This year, the improvement in tax revenues is related to the rapid rise in wages. Accordingly, a faster increase in labour tax revenues is expected. In practice, other revenues are set to benefit from dividends paid into the budget of state-owned enterprises, while interest income from loans and deposits will also be higher than had been projected. It should be noted that these forecast changes are having a significant impact on revenue for 2024, but this impact will be much lower next year. At the same time, the outlook for weaker economic growth in the medium term will negatively affect tax revenues, resulting in a more negative budget balance by the end of the projection horizon compared to the previous forecast.

The projected level of total expenditure for this year and over the medium term is expected to be higher than previously projected, mainly due to adjustments to historical data. This year, expenditure in some categories is expected to increase, while other categories have been revised downwards. For example, expenditure on wages has been increased, as the growth rate of expenditure remains strong, particularly in local government budgets. Next year's forecast incorporates the government's decision to cap the growth of the wage bill, resulting in a reduced expected rate of expenditure change. In the latest assessment, expenditures for certain social benefits (e.g. illness benefit) have been increased due to a higher number of recipients; furthermore, faster wage growth this year has led to a rise in the average benefit amount. Despite substantial investments aimed at enhancing the country's internal and external security, overall capital expenditure, including those for EU-funded projects and the Rail Baltica project, have been reduced throughout the projection horizon. Part of the medium-term planned absorption of EU funds is shifted to 2027, and such a change in plans points to the need for increased efforts in steering projects to ensure their timely implementation. The current state of the Rail Baltica project and uncertainties surrounding the availability of funding have also led to a reduction in project expenditure throughout the projection horizon. While the outlook for the public investment dynamics has become more pessimistic over the projection horizon, the revision of historical data has resulted in a significant increase in public investment within the economy.

Chart 16. **General government budget* balance** (% of GDP)

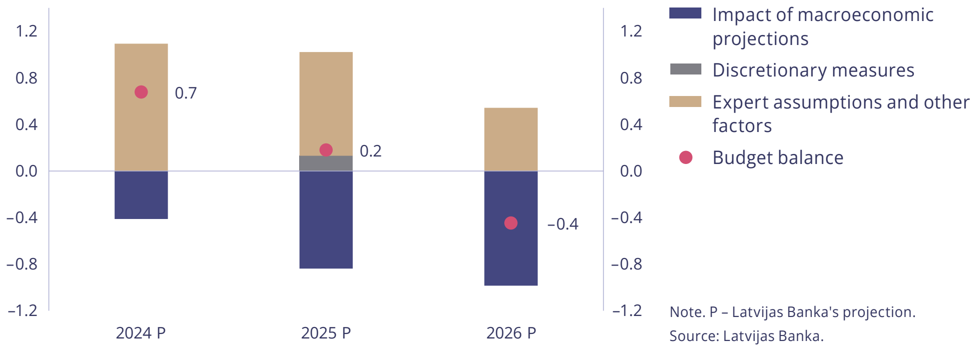


* The cyclical component has been calculated as the difference between the primary balance and the cyclically adjusted primary balance. The cyclically adjusted primary balance has been assessed using the ECB methodology, and is based on the revenue and expenditure elasticity to the GDP output gap over the past three years.

Sources: CSB, Latvijas Banka. The figures for 2022 and 2023 are based on the revised GDP data from the CSB.

Compared to the June 2024 forecast, the budget balance has improved for both this and next year due to higher labour taxes and other revenues. The government's decision to cap the growth of the public sector wage bill also contributes modestly to reducing next year's budget deficit. Additionally, the reduction in public investment over the medium term plays a significant role in improving the budget balance. Economic growth is projected to be much slower throughout the projection horizon. This will negatively affect the budget balance and significantly increase the deficit, assuming no changes in other assumptions (e.g. non-tax revenues and investment). This negative impact will accumulate every year, and the budget balance will deteriorate in 2026 compared to the previous forecast.

Chart 17. **Changes in the budget balance forecast relative to the previous forecast and the factors affecting it** (percentage points)

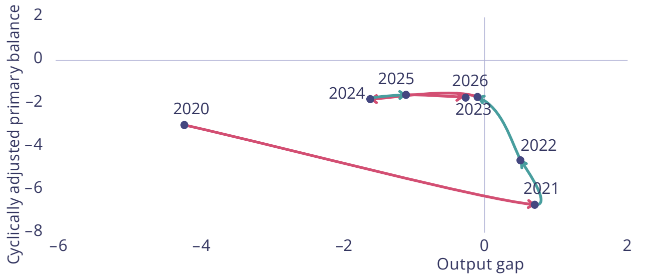


Note. P – Latvijas Banka's projection.
Source: Latvijas Banka.

The country's medium-term fiscal policy remains supportive, with the cyclically adjusted primary deficit holding steady at around 1.6% of potential GDP without significant changes.

Box 1. Labour tax wedge in the Baltic States and impact of potential changes

Chart 18. **Cyclically adjusted primary balance* and GDP output gap** (% of potential GDP)

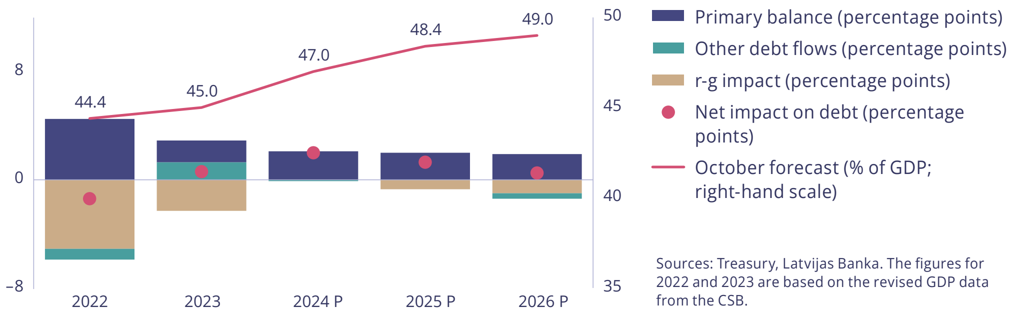


* The cyclically adjusted primary balance has been assessed using the ECB methodology and is based on the revenue and expenditure elasticity to the GDP output gap over the past three years.

Source: Latvijas Banka.

The upward trend of government debt will remain unchanged over the upcoming years, while the pace of increase in the debt will be faster than in June 2024 projections. The slower economic recovery continues to reduce the ratio of interest expenditure to growth, causing the government debt to rise more quickly than previously projected. The primary balance deficit will improve more moderately than expected over the medium term and, with a growing need for borrowing, the government debt level will approach 50% of GDP.

Chart 19. **Trend of government debt and the underlying factors**
(% of GDP; contribution; percentage points)



Sources: Treasury, Latvijas Banka. The figures for 2022 and 2023 are based on the revised GDP data from the CSB.

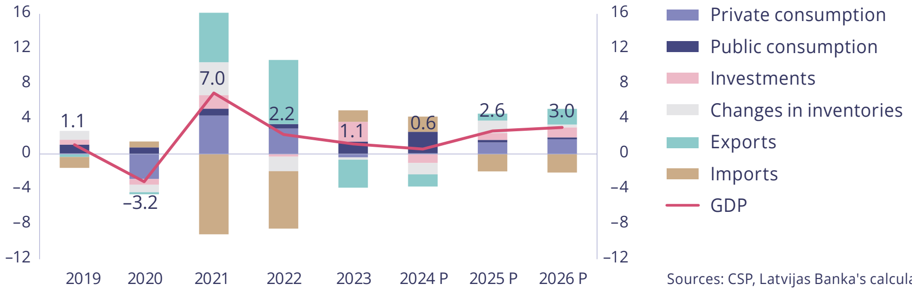
Gross domestic product – demand

GDP growth is still projected to be sluggish, and the outlook for future growth has become increasingly pessimistic. The ongoing decline in competitiveness, coupled with already weak external demand, will hamper export recovery. This, in turn, is likely to reduce revenues for both consumers and investors, who remain cautious amid persistent geopolitical uncertainties.

Projections	2024		2025		2026	
	June	**October**	June	**October**	June	**October**
GDP (annual changes; %; at constant prices; seasonally adjusted data)	1.8	**0.6**	3.3	**2.6**	3.8	**3.0**

Weakening competitiveness necessitates a more cautious outlook on medium-term economic growth. Latvia's previously stable competitiveness had been a key factor in maintaining a more optimistic future outlook, even in the face of weak performance by its trade partners and, consequently, subdued external demand. The upbeat sentiment in the manufacturing sector in the spring and the unexpectedly strong GDP growth in the first quarter (which was revised by the CSB downwards to a mere 0.1% on 30 September) had also raised hopes for much faster growth. However, the deterioration of competitiveness indicators is likely to have a significant long-term impact, impeding the recovery of exports and lowering earlier optimistic projections for disposable income available for consumption and investment. Furthermore, a slower implementation of investment projects – evident in the sluggish absorption of EU funds and setbacks in the Rail Baltica project – are also dampening domestic demand.

Chart 20. **GDP** (annual growth; %; seasonally adjusted data),**expenditure components and Latvijas Banka's projections** (contribution; percentage points)

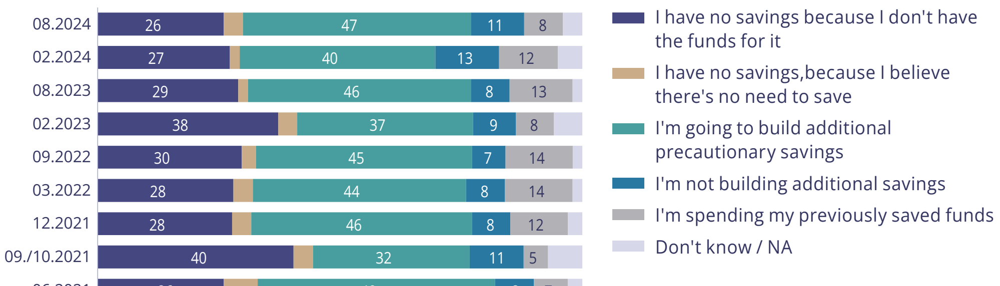


Sources: CSP, Latvijas Banka's calculations.

Projections for private consumption have been revised downwards across the entire projection horizon, driven by lower disposable income and increased precautionary savings. A population survey conducted in August revealed a stronger intent among respondents to build precautionary savings, indicating that caution is once again a significant factor in household decision-making. Additionally, past high inflation has eroded savings as a safety cushion, which may further motivate households to remain frugal for some time. These are likely the main factors behind the delayed recovery of private consumption, despite the improvement in purchasing power. Meanwhile, consumer sentiment has generally improved this year compared to the end of last year, with more optimistic assessments of both current and future household finances. This indicates the potential for faster private consumption growth, dependent only on when this heightened caution begins to subside.

Despite rising purchasing power, consumer caution is evident also in household bank accounts, with their deposits growing steadily and surpassing a 5% annual growth rate in July –the first time since 2022. This increase occurred even as the yield on household term deposits fell from 3.5% to 3.0% over the past six months. At the same time, resident investment in government savings bonds has also risen, with yields slightly higher than bank deposits (3.20% for the most popular 12-month bonds). This offers positive real returns, which may deter spending on larger purchases. Looking ahead, interest rates are expected to decline, potentially reducing the incentive to accumulate savings.

Chart 21. **Population survey data on the question "What is the current status of your savings?"** (share of responses; %)



Sources: SIA Latvijas Fakti, Latvijas Banka.

Investment is projected to gradually become the fastest-growing component of total demand, but at a pace significantly slower than previously anticipated. Delays in the implementation of current investment plans, coupled with heightened geopolitical risks, continue to disrupt the plans of private investors. However, new projects are on the horizon. Notably, Estonian investor Fibenol plans to invest up to 700 million euro in the construction of a new biorefinery plant in Valmiera. Although the production is projected to begin only in 2030, this project could start driving investment growth as early as 2025.

Private investment continues to benefit from access to EU funds and companies' own financing, with some positive trends emerging in lending. The reduction in loan interest rates is providing an initial boost to lending activity. However, geopolitical risks continue to exert a strong negative influence, and the decline in interest rates alone will not be enough to drive significant investment growth. As a result, public investment will remain a crucial factor.

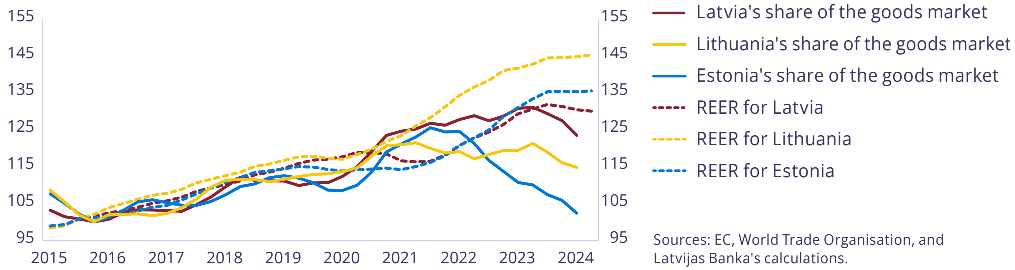
Growth in public investment in the coming years will be driven by investments aimed at enhancing both internal and external security, as well as the execution of EU-funded projects and the Rail Baltica project. However, the outlook on public investment volume has been significantly downgraded from earlier forecasts due to the continued sluggish pace of project implementation. Delays in implementing EU-funded projects have pushed part of the expenditure into 2027, leaving project completion to the last minute. Additionally, uncertainty surrounding the framework and funding of the Rail Baltica project has resulted in spending cuts throughout the projection horizon. At the same time, investments in strengthening national defence and security will be fairly substantial. Military facility construction will continue, and the supply of significant amounts of military equipment will contribute notably to public investment, which is expected to rise significantly from 2026 onwards. In terms of overall public investment dynamics, the revision of historical data has notably increased the reported levels, especially for 2023. As a result, the embedded reduction in capital expenditure due to delays is not directly visible in public sector data for the projection period.

While the outlook on external demand remains largely unchanged, Latvia's export performance may weaken in the coming years due to competitiveness challenges. Additionally, the EU as a whole is experiencing slower growth, trailing slightly behind both the US and China.

Exports performed well at the start of the year but slowed in the second quarter, as growth among trade partners remained sluggish and monetary policy stayed restrictive. However, exports of wood products, for instance, saw a slight increase in the second quarter, suggesting that the worst may be behind us. Looking ahead, expected interest rate cuts could further boost export growth. Grain prices are relatively low, presenting challenges for Latvian farmers. While the harvest volumes are robust and the strong storms in July had a rather minimal impact, the quality of the grain is subpar, and this will limit export income. Conversely, demand for various electronic products remains fairly stable, suggesting no significant changes in their export levels. Additionally, exports of Latvian pharmaceutical products are on the rise, as the Russian market is gradually being replaced by other countries, with exports to these new markets expanding at an even faster pace.

Significant changes in services exports may arise from implementing the future strategy of the Air Baltic Corporation AS. Recently, air transport services have been one of the fastest-growing segments, with ambitious plans for expansion ahead. Meanwhile, exports of railway services are gradually declining due to the diminishing transit flows with Russia; however, these services have long constituted a small share of total services exports, accounting for 1% in the second quarter of this year. Tourist activity is also experiencing slight growth; however, the gap compared to the pre-pandemic levels is narrowing only gradually, as tourists from other countries increasingly replace Russian visitors. With a less restrictive monetary policy, a rebound in construction services exports is anticipated, particularly to Scandinavian countries. This rebound is expected to also bolster exports of wood products and other construction materials. Notably, interest rate cuts in Scandinavia, especially in Sweden, are occurring slightly faster than expected, raising hopes for a quicker recovery in exports from these sectors. However, it is important to consider that, due to slower population growth, the overall demand for construction goods and services will likely grow more slowly in the long term compared to previous years.

Chart 22. **Real effective exchange rate (REER) and the market shares of the Baltic States in global imports** (2015 = 100)

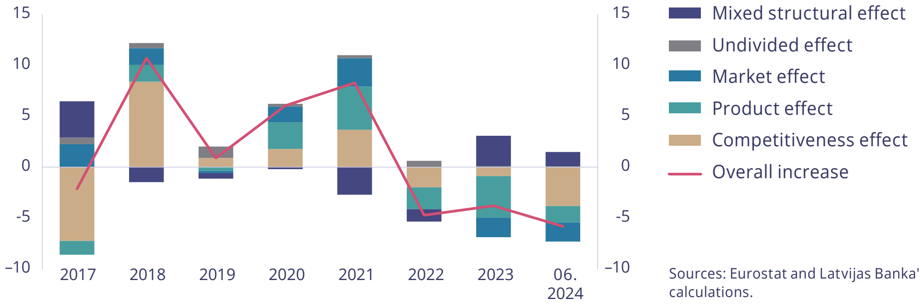


Sources: EC, World Trade Organisation, and Latvijas Banka's calculations.

Previous warnings about the risk of declining competitiveness are beginning to materialise. To foster export growth, reviving foreign demand alone will not suffice; the competitiveness of Latvian manufactured goods and services is equally crucial. Several indicators this year more clearly demonstrate a decline in competitiveness, as Latvia's export market shares in both global and European markets continue to shrink. In Latvia, labour costs continue to rise rapidly, driven by significant wage growth, while productivity remains flat, and this increase in labour costs is occurring at a pace much faster than the euro area average. Although wage growth is slightly slower than in Lithuania and Estonia, our Baltic neighbours cannot currently be viewed as positive examples, as they too are losing ground in the global market. Although the growth of relative prices (real effective exchange rate) has moderated somewhat, they have surged in recent years, negatively impacting the cost competitiveness of the Baltic States in foreign markets. Additionally, it is important to note that the economic development of EU countries is currently lagging in certain areas. For example, the US and China are outperforming the

EU in electric vehicle production, prompting the EU to implement additional import tariffs on Chinese electric cars.

Chart 23. **Difference in the growth rate of Latvian goods exports compared to global imports** (12-month moving average compared to the previous 12 months; %; contributions; percentage points)



Sources: Eurostat and Latvijas Banka's calculations.

Trade has also been significantly impacted by sanctions against Russia and Belarus; however, Latvia's exports to Russia remain robust and have not changed significantly in recent years. The factors contributing to the resilience of Latvia's exports to Russia are explored in greater detail in Box 2.

Box 2. **Impact of sanctions against Russia**

Economic sectors

After last year's modest economic growth, this year's growth is expected to be lower than previously projected. In the short term, weak external demand is constraining manufacturing sector development, while consumer tendencies to build up savings are slowing trade growth. Over the medium term, weakening competitiveness is likely to impede the expansion of export sectors. Additionally, delays in implementing EU-funded projects, as well as the Rail Baltica project, and a more pessimistic outlook for the Scandinavian market are limiting growth opportunities in the construction sector.

Along with the prolonged sluggish economic development of trade partners, which limits expectations for stronger short-term growth in the Latvian economy, there is little reason to foresee a rapid improvement in competitiveness, and so the success of Latvia's export sectors is likely to be less ambitious in the medium term than previously estimated. As unit labour costs rise relatively more rapidly, coupled with investment delays that hinder adaptation to global market needs, Latvian exporting companies may find it increasingly difficult to respond to changes in both the EU and global markets, once activity resumes after the period of high interest rates. Certain sectors are currently being hindered by local factors, and they are expected to continue facing these challenges. In a low-inflation environment, sluggish consumer spending may be accompanied by a shift in shopping habits, with an increase in online purchases from abroad. Furthermore, delays in the execution of major infrastructure projects and their postponement to the distant future are creating an unfavourable environment for construction, which is further exacerbated by current demographic trend estimates and the resulting construction needs in the Scandinavian market. The poor performance of the transport sector is likely to persist due to modest growth in the export sectors, coupled with significant uncertainty surrounding the future development plans of the national airline.

Manufacturing is still anticipated to rebound gradually, though at a slower pace than previously projected. The previously optimistic sentiment in manufacturing has deteriorated since April, and a decline in competitiveness indicators has been noted, offering little hope for a mere temporary weakness in manufacturing. Sluggish activity in the construction segment, which is particularly vital for manufacturers, continues to impact both Latvia and international markets for wood materials, metal constructions, and construction materials. While significant investment plans have been implemented and announced in the wood processing segment after several years of strong profitability, many of these plans primarily focus on capacity expansion. This, along with plans to expand areas designated for the protection and conservation of biodiversity – affecting the availability of forested areas for economic use – intensifies concerns regarding the adequacy of wood resources and the high uncertainty due to ongoing geopolitical tensions. At the same time, the decisions regarding protected areas are intended to promote more sustainable management practices and may encourage the forestry sector to transition toward higher value-added production and more efficient use of land and wood. However, the uncertainty is impacting new investment plans as well as future production volumes and export potential. Additionally, the decline in Latvia's competitiveness will hinder exporters' success, even if trade partners experience stronger growth.

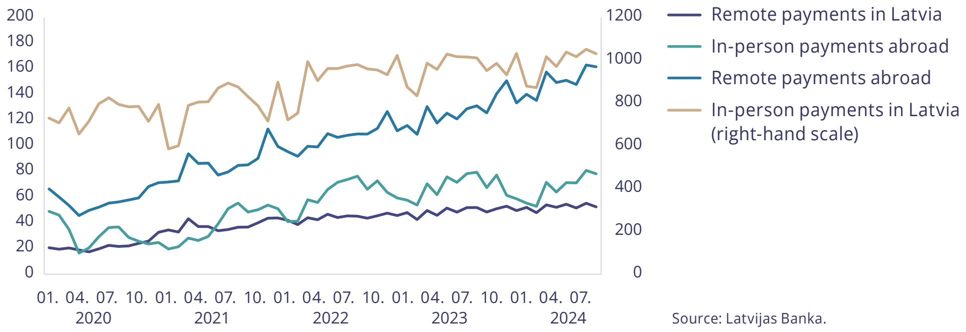
Construction activity this year is projected to be weaker than expected, with a more pessimistic outlook on growth in the coming years primarily attributed to the sluggish implementation of public and EU-funded projects. While growth in the construction sector has fallen short of expectations, activity levels vary significantly across different segments. The decline in demand has predominantly affected the volume of construction works for both residential and non-residential buildings. While the costs of construction materials have stabilised and are no longer on the rise, overall construction costs remain high, which is slowing down the volume of new orders.

Despite a decline in construction contractors' sentiment, the outlook is comparatively more positive in the civil engineering and specialised construction segments, where the volume of construction works has not seen significant reductions, and sharp declines in activity are not anticipated. Conversely, entrepreneurs expect a further drop in orders for the construction of buildings, which is likely to negatively impact construction activity as the year draws to a close.

Delays in the absorption of EU funds and a weaker-than-expected implementation of public investments indicate a diminishing growth capacity in the construction sector for the coming years. Furthermore, private investors remain cautious about initiating new projects due to the sluggish economic recovery and significant geopolitical uncertainty.

A rapid rebound in the trade sector is unlikely, as consumers build up their savings and adjust their purchasing habits. Short-term data on retail trade turnover and card payments, along with the results of an Omnibus survey conducted in collaboration with SIA Latvijas Fakti in August, indicate that Latvian residents are spending relatively cautiously in a low inflation environment. They are also attempting to rebuild their desired savings levels, which may have decreased during the period of rising prices due to expenditures on durable goods and energy bills. Furthermore, card payments to foreign accounts are rising at a faster rate than domestic payments, including in trade. Although foreign payments still make up a smaller share of total card transactions, their increase highlights a growing trend of remote shopping abroad.

Chart 24. **Submitted card-based payment transactions** (millions of euro)



Source: Latvijas Banka.

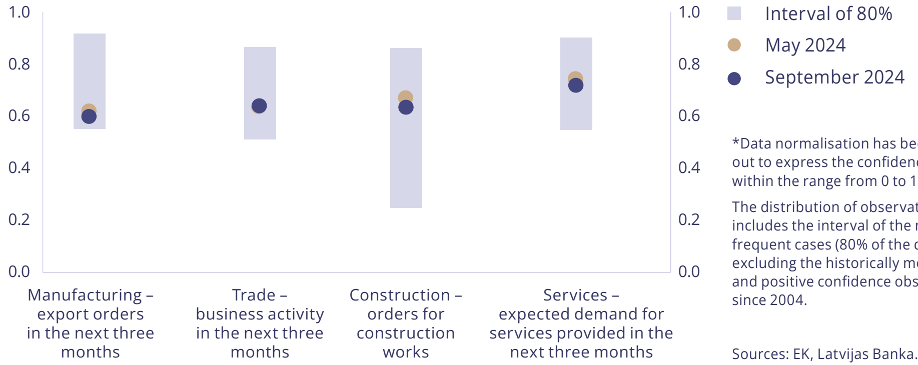
Weak economic growth is also curbing the purchase and registration of non-essential goods, such as new cars, in Latvia, as indicated by CSDD data, which shows slower growth in new car registrations. The competitive position of European car manufacturers – specifically, their ability to offer attractive prices compared to global competitors – is unlikely to see significant improvement over the projection horizon. This is evidenced by plans to close certain factories in Europe and the EU's Memorandums of Understanding with non-EU countries for sourcing critical materials (e.g., lithium), which may only come into effect after the current projection horizon. Anticipated changes in minimum wage dynamics could positively impact the trade sector.

While transport sector activity is gradually improving, geopolitical factors continue to reinforce expectations of only modest growth in the near future. Activity in the transport sector remained sluggish in the first half of the year, though business sentiment is slowly improving. Rising demand in specific transport activities suggests that the lowest point is now behind us, although the transport sector continues to face challenges, and a swift recovery in growth is not anticipated this year.

The activity of Latvian road carriers in foreign markets has rebounded sooner than projected, with a more positive trend in export and import freight transport anticipated by the end of the year. However, the transit sector remains under significant strain. Rail freight volumes continue to be negatively affected by geopolitical tensions, while cargo volumes trans-shipped through ports are gradually stabilising. The share of transit cargoes varies considerably across Latvia's major ports, and any further declines in transit are likely to worsen conditions, particularly in the port of Ventspils.

Air transport has outperformed other segments within the sector. Passenger numbers at Riga Airport continue to rise, and transit passenger traffic is increasing. However, the sentiment in the sector is growing more pessimistic as passenger volumes have yet to return to pre-pandemic levels, and growth is slowing. Additionally, the airBaltic announcement of plans to attract a strategic investor and prepare for an initial public offering (IPO) has heightened uncertainty about the future trajectory of the sector, raising concerns about the airline's impact on the sector's development.

Chart 25. **Assessment by businesses of future business growth*** (coefficient, 3-month moving average)



*Data normalisation has been carried out to express the confidence indicators within the range from 0 to 1.

The distribution of observations includes the interval of the most frequent cases (80% of the distribution), excluding the historically most negative and positive confidence observations since 2004.

Sources: EK, Latvijas Banka.

Labour market – unemployment

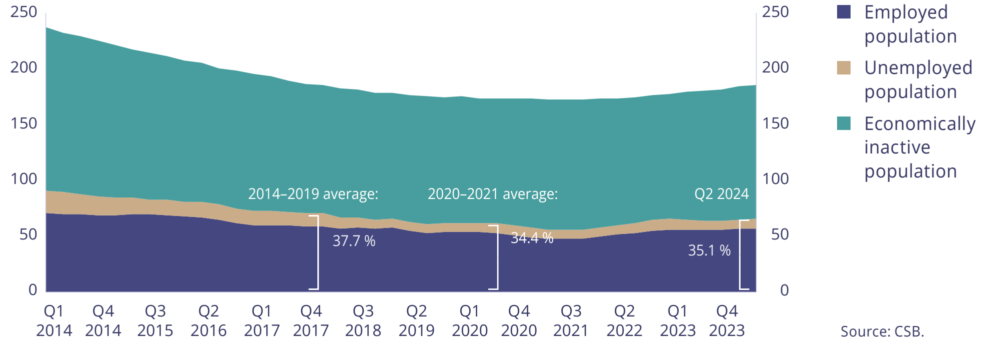
Under conditions of weak economic activity, unemployment rose to 7%. The recovery of economic growth, which is not expected to be as strong as previously estimated, does not allow unemployment to approach the 6% level projected in June for the medium term; this figure has been revised slightly upwards for the entire projection horizon.

Projections	2024		2025		2026	
	June	**October**	June	**October**	June	**October**
Unemployment (% of the economically active population; seasonally adjusted data)	6.7	**7.1**	6.4	**6.8**	6.1	**6.5**

The labour market is adjusting to the economic situation with a lag. The economic weakness observed in the second quarter, combined with employment expectations remaining below the average level in the third quarter and a rising trend in registered unemployment, necessitates an upward revision of the short-term unemployment forecast. Higher unemployment throughout the projection horizon reflects weaker prospects for economic growth; however, the slight increase in unemployment does not change the overall outlook on the labour market situation.

Over the projection horizon, the available labour force will slowly decline due to the age structure. More people will exit the labour market upon reaching retirement age than will enter it, despite a slight increase in the age group of young people. Different economic activity levels are observed across age groups – trends indicate an increasing number of young people choosing to remain economically inactive while studying, and so the available labour force that can be engaged in the labour market is declining. Furthermore, although the migration balance in Latvia is approaching zero, it remains negative in the young people age group.

Chart 26. **Labour market structure for the age group 15–24** (four-quarter average; in thousands)



Source: CSB.

As the economy gradually recovers, no increase in labour demand is expected this year. Private sector employers will continue to feel the pressure of labour costs. This is indirectly indicated by the fact that fewer entrepreneurs view labour shortages as the main production limiting factor. Due to the deterioration of competitiveness, companies will have fewer opportunities to increase the number of jobs. Although employment in the public sector, particularly in healthcare, continued to rise, this trend will be limited by constraints in the state budget.

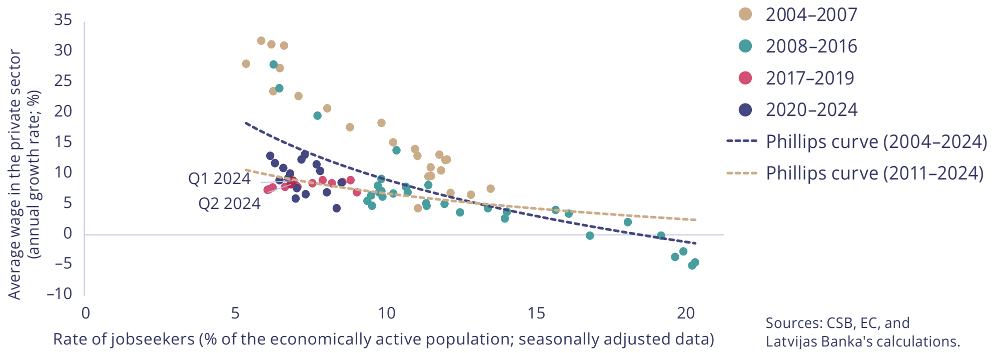
Labour market – wages

After this year's robust wage growth, the government's decision to cap the increase in the public sector wage bill, combined with weaker-than-expected economic growth, is anticipated to suppress wage growth next year. Meanwhile, the constrained labour supply and the rise in the minimum wage are expected to continue driving wage growth at a pace that exceeds productivity.

Projections	2024		2025		2026	
	June	**October**	June	**October**	June	**October**
Nominal gross wage (annual changes; %)	7.9	**9.7**	7.8	**6.7**	7.6	**7.3**

Wage growth is likely to be tempered by slower-than-expected economic growth. However, in the context of a tight labour supply, any relief from wage growth pressures is anticipated to be temporary, and assessments of labour market tensions have remained largely unchanged. Moreover, if wage growth continues to outpace productivity gains, it will undermine business competitiveness as the burden of labour costs increases. This, in turn, could result in fewer job opportunities in the future.

Chart 27. **Phillips curve** (2004–2024)



Sources: CSB, EC, and Latvijas Banka's calculations.

Wage growth projections for the upcoming years are also shaped by government decisions. A decision to limit the increase in the public sector wage bill in 2025 is expected to dampen wage growth. Conversely, adjustments to the minimum wage will contribute to wage growth in the coming years. A new methodology for calculating the minimum wage will be implemented in 2025, allowing for regular revisions of the minimum wage based on changes in the average or median wage. Although the decision has yet to be approved by the Saeima, the government's latest assumptions suggest a minimum wage of 740 euro in 2025 and 780 euro in 2026.

Box 3. **What income replacement level can be expected from Latvia's future old-age pension?**

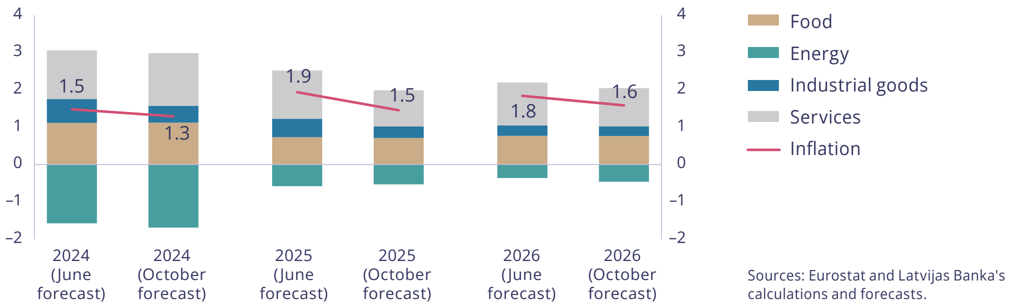
Inflation

Inflation in Latvia is currently low, with forecasts revised downwards in light of declining global resource prices, particularly for oil and food. However, an increase in prices for services in Latvia persists.

Projections	2024		2025		2026	
	June	**October**	June	**October**	June	**October**
Inflation	1.5	**1.3**	2.1	**1.5**	1.8	**1.6**

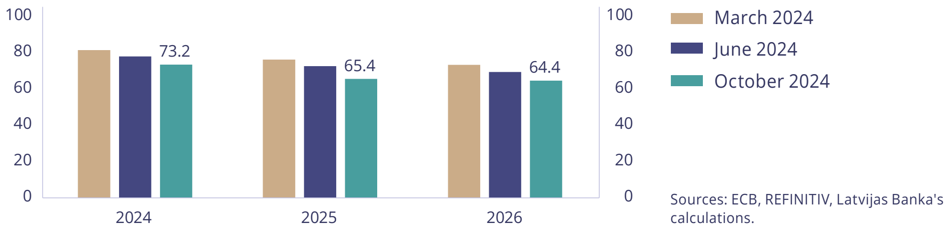
Latvia's inflation forecast has been downgraded for the projection period, primarily due to global oil prices and recent data indicating a slower-than-expected rise in prices within the country.

Chart 28. **Latvia HICP inflation and contributions, forecast revisions**
(annual changes; percentage points)



Sources: Eurostat and Latvijas Banka's calculations and forecasts.

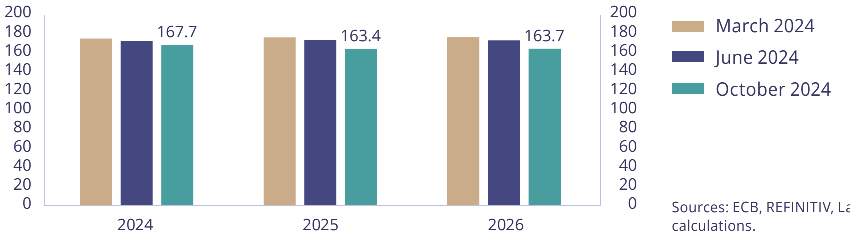
Chart 29. **Oil price forecast** (euro)



Sources: ECB, REFINITIV, Latvijas Banka's calculations.

HICP inflation in Latvia was among the lowest in the euro area, recorded at 0.9% in August. According to the September flash estimate, inflation rose to 1.6%. In the short term, price increases were influenced by both global price trends and, as is typically the case, price fluctuations of specific groups of goods due to various promotions. The incoming monthly inflation figures were lower than had been expected in the June forecast, predominantly due to a decline in energy and food prices. Furthermore, in certain months, the prices of industrial goods have risen less than previously projected. These processes were influenced by a decline in prices for oil and certain food products in the global resources market. While natural gas prices have experienced slight increases during this period, their impact on Latvian energy prices is less significant than the effect from the declines in oil prices. Furthermore, expectations of lower futures prices for oil and food have also contributed to a more subdued inflation outlook for the coming years.

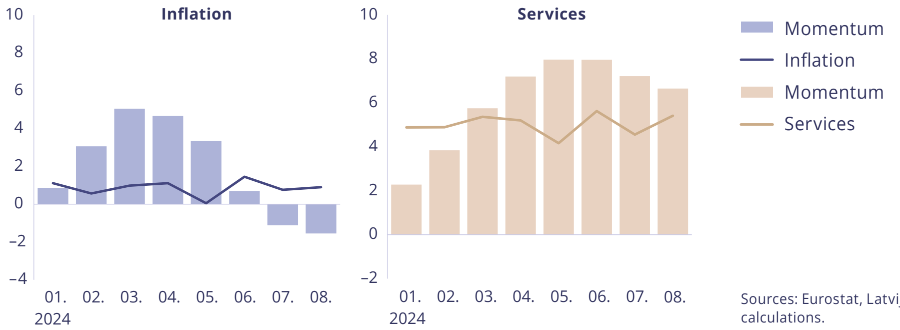
Chart 30. **Agricultural product prices** (index; 2005 = 100)



Sources: ECB, REFINITIV, Latvijas Banka's calculations.

In recent months, the rise in prices for services has significantly diverged from trends in other product groups. Prices for services increased more rapidly than projected in June, maintaining a robust year-on-year growth rate of 5.0% over the first eight months of this year. The robust momentum driving the service price dynamics also indicates a significant upward trend, with sharp rises observed for various services, including cultural, medical, and care-related services. While some services, such as air transport, exhibit volatility in pricing – fluctuating dramatically during promotions – others, like catering, show more consistent price increases. Overall, the rise in services prices is primarily driven by labour costs and demand dynamics. In 2025, wage growth is expected to be lower than projected in June, and the upward pressures on services prices will moderate, but remain high.

Chart 31. **Inflation and services prices** (annual changes; % and annualised three-month changes compared to the previous three months)



Sources: Eurostat, Latvijas Banka's calculations.

Over the medium term, global resource prices – particularly oil prices – and domestic wage trends will remain the primary drivers of inflation dynamics. Currently, these factors are exerting opposing influences: while global prices suggest a forecast of low inflation, robust wage growth keeps the price increase of certain product categories, especially services, above the average inflation rate.

Box 4. Have heat energy prices in Latvia outpaced international energy prices?

Scenario analysis

Macroeconomic impact of the proposed tax changes[1]

Motivation

On 19 September 2024, the government reviewed the informative report prepared by the Ministry of Finance and conceptually approved the tax policy changes.[2] Several tax changes are set to be introduced in 2025, with the most significant including:

- replacing the differentiated non-taxable minimum with a fixed non-taxable minimum, regardless of the wage level (510 euro per month in 2025, 550 euro per month in 2026, and 570 per month in 2027);
- increasing the PIT rate to 25.5% for income up to 105 300 euro per year and to 33% for income exceeding that amount;
- increasing the non-taxable minimum for pensions (NTMP) from 500 to 1000 euro per month;
- increasing various consumption-related taxes (excise duty, vehicle operation tax, etc.);
- Transfer of 1 percentage point from the funded pension scheme (second-pillar pension scheme) to the first-pillar pension scheme.

[1] Prepared by Ginters Bušs and Kārlis Vilerts, economists at Latvijas Banka.

[2] Informative report "On the Review of the State Budget Revenue and Tax Policy in 2025–2027". State Chancellery, 19 September 2024 [Last viewed on 23 September 2024]

Latvijas Banka has assessed the potential impact of the tax changes on the Latvian economy using the DSGE model for Latvia.[3]

Simulation

The scenario identifies the following key channels of macroeconomic impact.

- **Easing the PIT burden.** The shift to a fixed non-taxable minimum reduces the PIT burden, positively impacting employees' net wages. However, this effect is largely offset by higher PIT rates, resulting in a marginal increase in the disposable income of households, estimated at 0.19% of GDP in 2025, 0.30% of GDP in 2026, and 0.36% of GDP in 2027.
- **PIT rotation.** The impact of changes in the non-taxable minimum and PIT rates varies across wage levels. Disposable income increases the most for lower-wage workers, while it decreases for the highest earners. Since lower-wage earners tend to spend a larger portion of their additional income, this PIT adjustment is expected to boost overall private consumption. Given that these tax changes will also increase disposable income for those earning relatively high wages (even those earning over 4000 euro per month), the scenario calibrates this PIT adjustment to 25% of the full PIT redistribution scenario;[4]
- **Increase in the NTMP.** An increase in the NTMP generally leads to a rise in pensioners' disposable income, estimated at around 0.32% of GDP.
- **Increase in consumption taxes.** Increasing other taxes, primarily the excise duty and vehicle operation tax, is modelled as an increase in the consumption tax burden by approximately 0.14% of GDP in 2025, 0.22% of GDP in 2026, and 0.18% of GDP in 2027.

[3] Ginters Bušs & Patrick Grüning (2023) Fiscal DSGE model for Latvia, Baltic Journal of Economics, 23:1, DOI: 10.1080/1406099X.2023.2173915.

[4] Based on the full redistribution scenario, the non-taxable minimum would be increased only for financially restricted households, while the PIT rate increase would apply solely to financially unrestricted households.

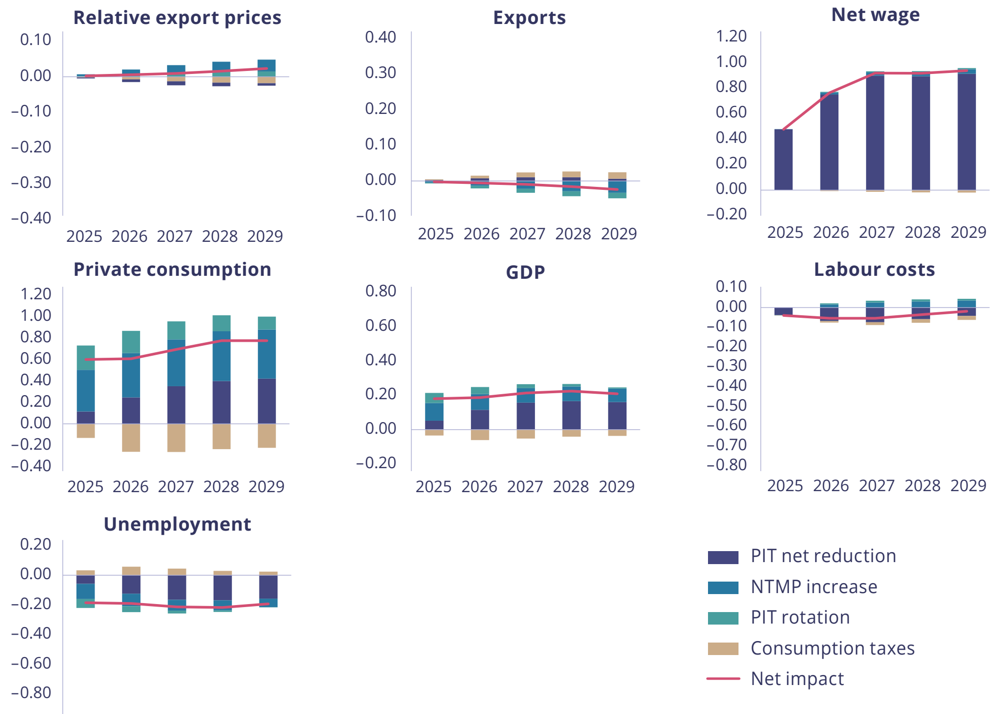
Tax revenue offsetting measures do not compensate for the budget shortfall resulting from tax cuts. In practice, this shortfall is expected to be addressed through a 1 percentage point transfer from the funded pension scheme to the first pillar pension scheme[5], adjustments to the proceeds from the sale of confiscated criminal assets, and other measures modelled as government borrowing with no significant impact on the economy.

Results

The results of the scenario analysis are presented in Chart 1.

A lower PIT burden results in a higher net wage for most workers, which in turn boosts private consumption. Likewise, the increase in disposable income for pensioners also enhances private consumption. Furthermore, as net wages rise most significantly for lower-wage earners who tend to have a higher propensity to consume, the PIT adjustment serves to further stimulate private consumption. The positive impact on private consumption is only partially diminished by higher consumption taxes. Since the proposed tax changes impact labour costs only indirectly, and to a limited extent, the export competitiveness (relative export prices) and exports of Latvian companies remain largely unaffected. Thus, private consumption remains the primary driving force of the economy. However, its contribution to GDP is somewhat diminished by the rising prices of goods and services. As a result, GDP is expected to grow by approximately 0.2% over a four-year period.

Chart 1. **Macroeconomic impact of the tax change scenario reviewed by the government**
(cumulative change; %; unemployment – percentage points)



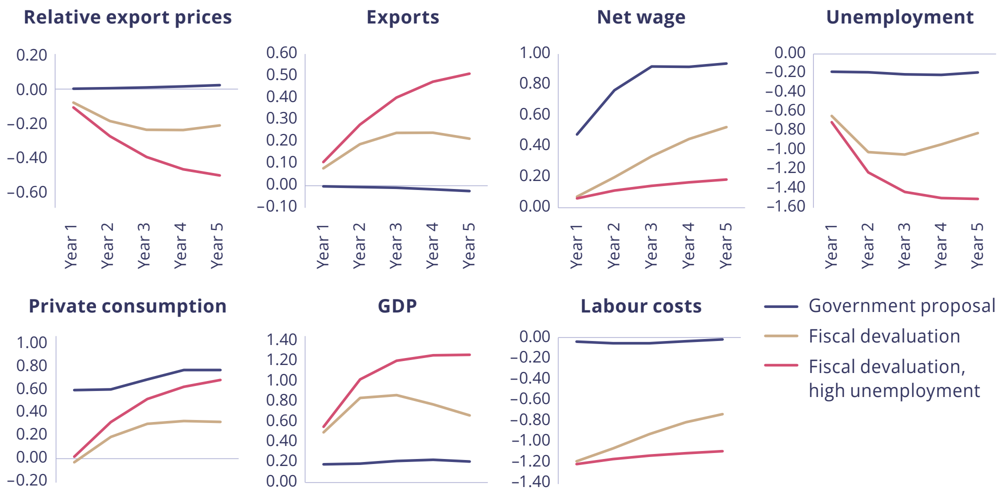
Source: Latvijas Banka's calculations based on the DSGE model for Latvia (Bušs & Grüning, 2023).

While the tax changes proposed by the government have a positive impact on GDP, this effect is less pronounced than it would be if the tax burden were shifted from labour to consumption through a reduction in employers' obligatory state social security contributions (SSC), particularly in the context of high unemployment. Chart 2 illustrates a scenario in which the

[5] Although the 1 percentage point transfer from the funded pension scheme (second pillar) to the first pillar pension scheme does not have a direct macroeconomic impact, it sets an undesirable precedent for financing current budgetary expenditures at the expense of the sustainability of the pension system.

employers' SSC is reduced by a similar amount (0.6% of the initial GDP), with this reduction initially fully offset by an increase in consumption taxes.

Chart 2. **Macroeconomic impact of the scenario reviewed by the government and the alternative scenario (fiscal devaluation)** (cumulative change; %; unemployment – percentage points)



Source: Latvijas Banka's calculations based on the DSGE model for Latvia (Bušs & Grüning, 2023).

By reducing the tax burden on labour through a decrease in the employers' SSC, labour costs decrease by significantly more. This improves the price competitiveness of Latvian companies. As a result, with Latvian products becoming more attractive in both domestic and export markets, the exports of domestic companies and their market share at home grow. As exports expand and labour costs decrease, employment levels also increase, resulting in a decline in unemployment. With rising employment, private consumption grows, only partially offset by higher consumption taxes. Therefore, in the fiscal devaluation scenario, the economy is driven by improved external competitiveness of domestic companies and rising employment. In this scenario, the estimated impact on GDP is two to four times larger than that of the government's scenario. Additionally, in this scenario, reducing the second-pillar pension savings would be unnecessary.

Furthermore, if such fiscal devaluation is implemented in an environment of high unemployment, where employers can attract new employees without exerting excessive upward pressure on wages, the impact on external trade and employment becomes even greater and more sustainable. This could increase GDP levels by up to six times more than in the scenario approved by the government. Consequently, such fiscal devaluation is particularly beneficial during periods when the economy is entering a recession and unemployment is rising rapidly.

Conclusions

The economic impact of the tax change scenario approved by the government is positive. However, it is primarily driven by growth in private consumption resulting from increases in net wages. Moreover, these net wage increases are expected to be partially financed by compromising the sustainability of the pension system.

Alternatively, the government could opt to lower the employers' SSC while fully offsetting the resulting budget shortfalls with higher consumption taxes. It is important to note that such a reform would necessitate a review and potential reallocation of certain expenditures from the social budget to the basic budget. Nevertheless, shifting the tax burden from labour to consumption enhances the price competitiveness of domestic companies, boosts employment, and contributes to higher GDP levels. The maximum positive and sustained impact of such fiscal devaluation is achieved when implemented in a context of high unemployment.

Scenario analysis

The impact of the carbon tax on Latvia's economy depending on revenue use[1]

Motivation

Growing evidence in the scientific literature suggests that taxing greenhouse gas (GHG) emissions is the most economically efficient way to reduce these emissions. Recent studies indicate that while existing carbon tax schemes have shown effectiveness, the carbon price (the cost of emitting one t CO_2-eq[2]) implied by them is generally set too low and covers too narrow a range of products. As a result, the achieved reduction in GHG emissions is insufficient.[3]

In its March 2024 Macroeconomic Projections Report, Latvijas Banka analysed the potential impact of increasing the carbon tax on Latvia's economy, exploring three different scenarios. While the analysis offered detailed insights into the overall economic effects and the impact on the output and prices of specific products, it was incomplete as it did not account for the further use of the carbon tax revenues.

By targeting emission-intensive activities and raising their costs, the carbon tax negatively affects producers. Moreover, as producers may partly pass some of the cost increases onto consumers by raising the prices of the final goods and services, the carbon tax makes consumers worse off as well. Therefore, economically justified approaches for utilising carbon tax revenues include offering new support to businesses and households, reducing other taxes, and investing these funds in green transformation initiatives. Increasing investment in green technologies can help manufacturers lower the cost of adopting new technologies, enabling higher economic growth with reduced GHG emissions.

To understand how an increase in the carbon tax impacts the Latvian economy depending on the use of its revenues, Latvijas Banka conducted a scenario analysis utilising both the CGE-EUROMOD model[4] and the DSGE model[5] for Latvia.

Simulation

Four potential approaches for utilising carbon tax revenues have been compared (Table 1).

Table 1. **Scenarios for utilising carbon tax revenues**

Title	Approaches for utilising additional budget revenues
Public consumption	An increase in public consumption by 150 million euro annually

[1] Prepared by Ginters Bušs, Dzintars Jaunzems, and Oļegs Matvejevs, economists at Latvijas Banka.

[2] Tonne of carbon dioxide equivalent.

[3] See, for instance, Errendal, S., J. Ellis and S. Jeudy-Hugo (2023) "The role of carbon pricing in transforming pathways to reach net zero emissions: Insights from current experiences and potential application to food systems", *OECD Environment Working Papers*, No. 220, OECD Publishing, Paris, https://doi.org/10.1787/5cefdf8c-en.

[4] CGE-EUROMOD is a model developed by Latvijas Banka and BICEPS, combining the general equilibrium macroeconomic model, which is based on Latvia's cost and output database, with EUROMOD, a tax-benefit microsimulation model; see here. The CGE-EUROMOD model has been employed to simulate the effects of a carbon tax on demand for green investment goods across various sectors, along with their intersectoral interactions.

[5] Ginters Bušs & Patrick Grüning (2023) Fiscal DSGE model for Latvia, Baltic Journal of Economics, 23:1, DOI: 10.1080/1406099X.2023.2173915. The DSGE model is used to measure the medium-term impact of fiscal measures on the economy.

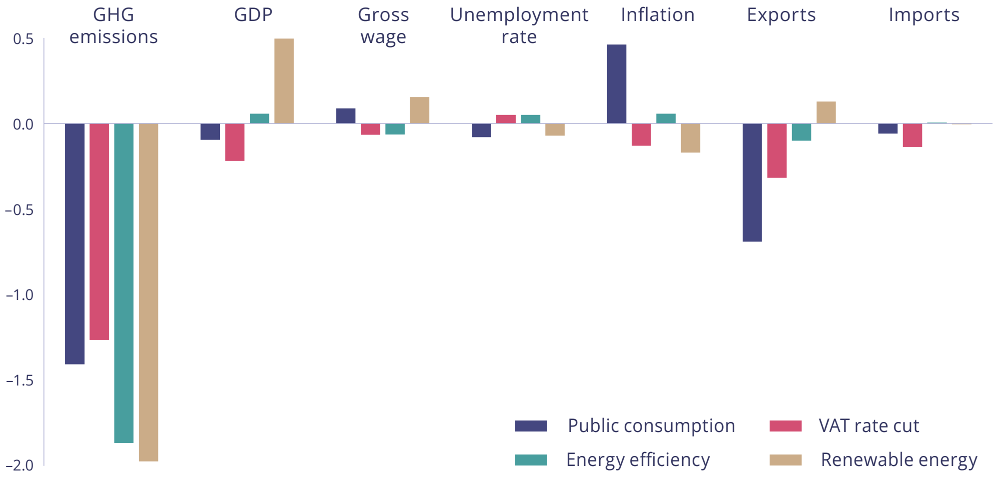
VAT rate cut	A VAT rate cut of 0.7 percentage points (which reduces the budget revenue by 150 million euro annually, hence the policy is fiscally neutral)
Investment in energy efficiency in manufacturing	An increase in public investment by 150 million euro annually to finance the reduction of energy consumption and emissions in the manufacturing sector
Investment in renewable energy	An increase in public investment by 150 million euro annually to finance the transition to renewable energy sources

In each scenario, the fiscal impact has been set at 150 million euro annually, reflecting the expected revenue from increasing the carbon tax to a level sufficient to meet Latvia's nationally determined contribution (NDC) for GHG emission reductions[6]. Over the coming years, the reduction of GHG emissions needs to be accelerated, and to achieve this, the carbon price would have to rise to 102 euro/t CO_2-eq[7] across all sectors, including manufacturing and all services sectors. However, if these additional tax revenues are not reinvested into the economy, raising the tax could lead to a 0.4 percentage point decline in economic activity.

Results

The results of the scenario analysis presented in Chart 1 illustrate changes in key economic indicators three years following the introduction of the proposed carbon tax. They indicate that using the carbon tax revenues to boost public consumption, reduce VAT or to invest in energy efficiency improvements in manufacturing substantially mitigates the adverse impact of the tax on the economy. In particular, these scenarios reduce, but do not always fully offset, the negative impact of a carbon tax on personal income and GDP. Conversely, investing the proceeds of the carbon tax in developing renewable energy completely offsets the tax's negative impact in the medium term and even stimulates economic activity.

Chart 1. **The medium-term macroeconomic impact of the carbon tax depending on the use of the additional revenues** (% change compared to the current policy)



Recycling the carbon tax revenue by investing it in renewable energy generates more jobs and boosts economic activity by 0.5% in the medium term compared to the baseline scenario without the carbon tax. As a result of the increased renewable energy generation capacity, energy prices would decrease, thus reducing production costs across all sectors of the economy and improving competitiveness of Latvia's products on the domestic and international markets. Such investment also facilitates the most rapid reduction in GHG

6 In line with the increase in the ambition of the EU climate policy, whereby the EU has pledged to reduce its GHG emissions by 55% from the 1990 level by 2030, Latvia has revised its GHG emissions reduction target from 6% to 17% by 2030.

7 As outlined in the previous Macroeconomic Projections Report, this will not result in higher current taxes across all sectors. Currently, the natural resources tax, payments for EU ETS emission allowances, and various fuel excise duties already impose a carbon price ranging from 2 to 117 euro/t CO_2-eq, depending on the sector.

emissions, whereas cutting VAT and increasing public consumption reduce the decrease in GHG emissions achievable by the carbon tax.

In turn, utilising the carbon tax revenue for improving energy efficiency in manufacturing allows us to achieve almost the same GHG emissions reduction as other forms of green investment and boosts economic activity by 0.05% in the medium term, although the average gross wage becomes by 0.06% lower. However, improving energy efficiency is a crucial step of the green transformation because it reduces the amount of investment required for the transition to renewable energy sources. Therefore, the economic benefits of energy efficiency improvements are greater over a longer time horizon.

Conclusions

The analysis indicates that, in the medium term, raising the carbon price not only contributes to reducing GHG emissions and enhancing environmental quality but also positively affects economic activity when additional tax revenue is allocated to green investment. If the extra tax revenue is used to finance transition to renewable energy, such policy significantly boosts the incomes and improves welfare of the Latvian population. Moreover, the positive impact of all forms of green investment would remain in the future even if carbon tax revenues were to be redirected for other purposes.

However, it is essential to recognise that the positive effects of green investment only fully materialise in the medium term, while the negative impact is felt immediately. Therefore, policies should designate a portion of the additional budget revenue to support households and companies most affected by these changes. This approach will help mitigate the short-term adverse economic impact while facilitating a fair and inclusive green transition.

Box 1. Labour tax wedge[1] in the Baltic States and impact of potential changes[2]

The government has developed a proposal for tax reform which envisages changes to the personal income tax (PIT) system. The existing differentiated non-taxable minimum will be replaced by a uniform non-taxable minimum, increasing it from the current maximum applicable 500 euro to a fixed minimum of 550 euro for all wages in 2026. To offset the fall in tax revenue for the general government, PIT rates will be changed. The current three-stage progressivity will be replaced by two rates, increasing the two lower PIT rates from 20% and 23% to a uniform 25.5% rate.

This box will explore the current labour tax wedge in Latvia compared to the rest of the Baltic States and the changes to be brought about by the planned tax reforms.

The OECD assessment[3] indicates that the tax wedge on the average gross wage in the Baltic States was lower than the average in other EU countries in 2023. At the same time, Latvia had the lowest hourly labour costs in the Baltic States[4].

However, it is essential to remember that tax systems are complex, and variations in tax treatment across countries make direct comparisons of the tax wedge challenging. This OECD indicator provides only a general, but not detailed, view in this regard. First, since 2023, for which the latest data are available, several changes have taken place: in 2024, as the average wage, including in Latvia grew faster than the progressivity thresholds, the tax wedge on the respective wage scale shifted accordingly. In addition, changes in non-compulsory tax contributions, mainly in the second

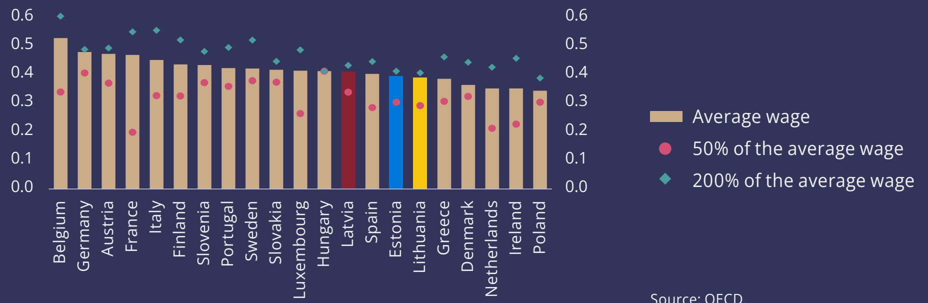
[1] For the purposes of this report, the tax wedge is defined as the ratio of all labour taxes (social security contributions and income tax) to total labour costs.

[2] Prepared by Baiba Brusbārde, economist at Latvijas Banka.

[3] The OECD estimates do not include non-compulsory tax contributions.

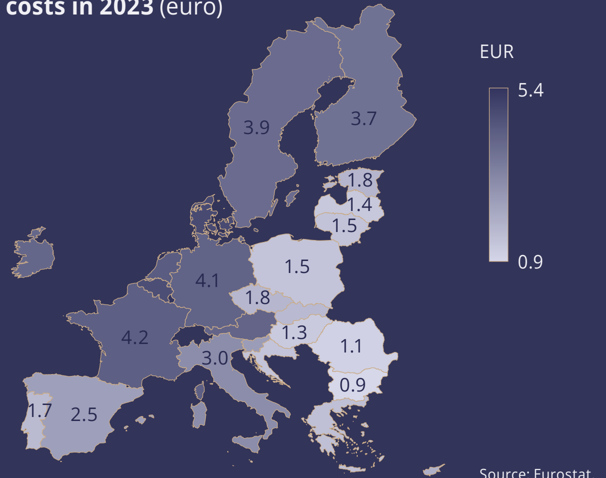
[4] Including compensation to employees, social security contributions, and employment taxes, net of subsidies received, but excluding vocational training costs or other expenses such as expenditure on work clothing.

Chart 1.1. **Tax wedge for employees without dependants in 2023** (share of total labour costs)



Source: OECD.

Chart 1.2. **Hourly labour costs in 2023** (euro)



Source: Eurostat.

pillar pension scheme, need to be considered. Notable differences also exist regarding tax relief for dependants, which no longer applies in neighbouring countries. In light of these aspects, the Latvian labour tax system is already, in essence, the most competitive in the Baltic States for employees with at least one dependant (the average number of children per woman in the country over the last 24 years has been 1.48[5]).

The announced tax reform in Latvia, pending approval by the Saeima, will enable most residents to reduce their labour tax wedge, despite the rising PIT rate. However, for people earning lower gross wages, such as 1000 euro per month, the actual benefit will be smaller compared to those with a gross wage of 2000 euro. This is a result of the latter being eligible for non-taxable income in the future, which had not been the case previously. Consequently, the tax wedge will essentially remain unchanged for lower-income earners, while those with an average wage will see a reduced tax wedge. Latvijas Banka has previously noted that the lowest wage earners would benefit most from reduced social security contributions on the employee's side[6]. Meanwhile, due to the upcoming reform, the tax wedge of employees earning a gross wage above 4200 euro per month is set to increase next year.

In the Baltic context, the tax reform will continue to preserve Latvia's competitive advantage. In Lithuania, changes will only be discussed after the elections in October, as tax reform is among the reforms planned under the Recovery and Resilience Facility (RRF). This means that Lithuania is likely to maintain its existing system in 2025. Reforms[7] for 2025 (an increase in the PIT rate and the introduction of a fixed non-taxable minimum) have currently been announced in Estonia. Additionally, the new government had originally initiated further increases in both the PIT and the non-taxable minimum for 2026. However, considerable uncertainty remains. In view of Estonia's commitment to reduce its budget deficit, the introduction of the fixed non-taxable minimum may be postponed, as it is a fiscally costly measure. Thus, even if Latvia were to implement all the initially envisaged reforms, the labour tax wedge in 2026 could still be lower for the majority of the population compared to Lithuania, and lower for employees with dependants compared to Estonia.

Chart 1.3. **Tax wedge in the Baltic States in Q2 2024** (relative to total labour costs)

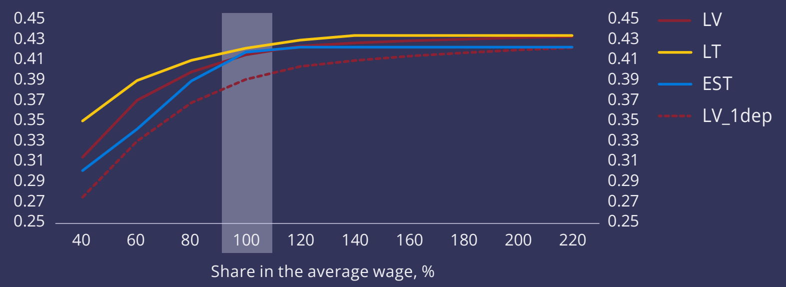
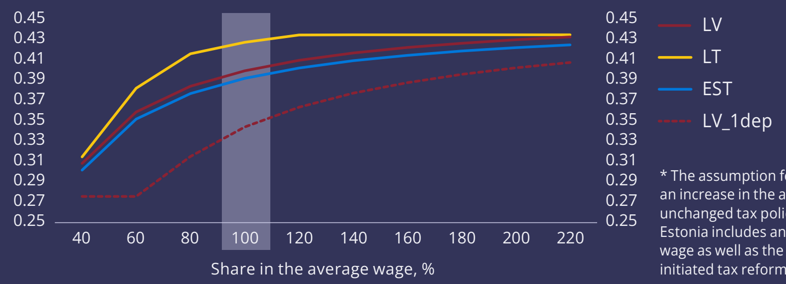


Chart 1.4. **Tax wedge in the Baltic States in 2026** (relative to total labour costs)*****



* The assumption for Lithuania includes an increase in the average wage under the unchanged tax policy. The assumption in Estonia includes an increase in the average wage as well as the announced and initiated tax reforms.

Sources: for the average wage forecast – the Ministry of Finance of Latvia (July 2024), the Ministry of Finance of Estonia (September 2024), the Ministry of Finance of Lithuania (June 2024); Latvijas Banka's calculations.

[5] 1.36 in 2023. Source: Total fertility rate (stat.gov.lv)

[6] For more information, see the Macroeconomic Developments Report. September 2023.

[7] For more information, see the website of the Ministry of Finance of Estonia: Amendments to tax legislation in 2024 and 2025 | Estonian Tax and Customs Board (emta.ee)

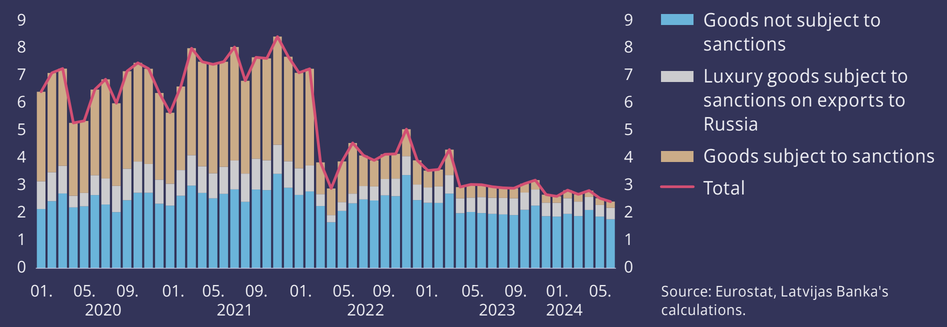
Box 2. Impact of sanctions against Russia[1]

Following Russia's full-scale invasion of Ukraine, the EU has adopted 14 packages of sanctions to date, most of which target trade with Russia. Despite these measures, exports to Russia persist, with Latvia maintaining relatively high export volumes to the country. Although a wide array of goods, ranging from military equipment to luxury items, are subject to various prohibitions, EU countries still export goods worth over 2 billion euro to Russia each month. While exports to Russia represent only 1.2% of the EU's total global exports, Russia remains among the EU's top 20 trade partners.

Over time, the impact of sanctions has been substantial, both immediately after the start of the war and later, as other sanctions packages were implemented. However, as shown in Chart 2.1, the impact of the latest rounds of sanctions has been relatively modest, with exports to Russia expected to decline by only about 10%. The chart includes all sanctioned goods, some of which may be subject to exceptions or have transitional periods before the export ban takes effect. Exports of luxury goods, pharmaceuticals, other chemical products, various types of equipment, cocoa, and other items have remained resilient. It is important to note that luxury goods are only sanctioned if their unit value exceeds a certain threshold – typically 300 euro. For other categories of goods, the thresholds vary, such as 750 euro for household appliances and 50 000 euro for vehicles.

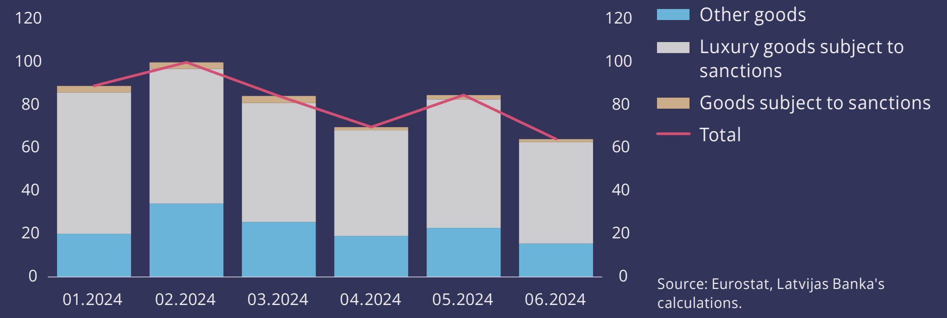
In Latvia's case, exports to Russia have unfortunately remained relatively stable, with goods worth an average of 90 million euro still being exported to Russia each month. The vast majority of these exports consist of various luxury items, including spirits, clothing, and cosmetics. However, it is likely that these are mostly re-exports, as many of those goods are not domestically produced.

Chart 2.1. **EU exports of goods to Russia** (billions of euro)



Source: Eurostat, Latvijas Banka's calculations.

Chart 2.2. **Latvia exports of goods to Russia** (millions of euro)



Source: Eurostat, Latvijas Banka's calculations.

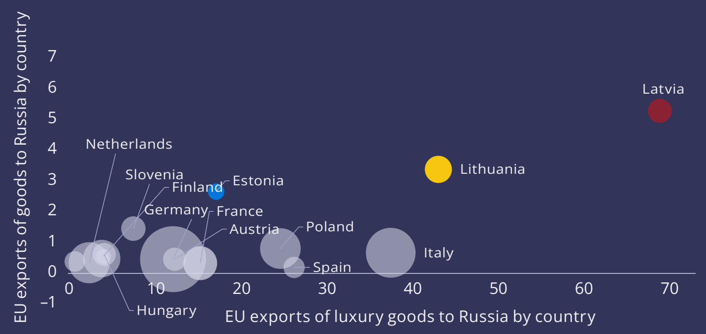
[1] Prepared by Matīss Mirošņikovs, economist at Latvijas Banka.

Indeed, Latvia stands out compared to other countries, as Russia regrettably remains a relatively important trade partner. Notably, the largest share of exports consists of luxury goods, most of which are likely re-exports. The significance of Russia as a trade partner for all the Baltic States is primarily driven by their geographical location on the EU's external border with Russia. Along with Lithuania, Latvia exports proportionally more luxury goods than countries like Italy, which is typically more associated with the production of such items.

When examining the specific goods exported from Latvia (or through Latvia) to Russia, it is evident that nearly all vermouth exported from the EU to Russia passes through Latvia. Additionally, a total of 60% of all spirits are exported to Russia from Latvia, accounting for one quarter of Latvia's total exports to the country. Furthermore, apparel and clothing accessories makes up one fifth of these exports, while exports of footwear, wine, bags, and leather contribute approximately 10% each. Notably, Latvia's exports of bags and leather represent about one quarter of the EU's total exports of these goods to Russia.

Latvia's exports of goods to Russia remain relatively stable, primarily driven by luxury goods, which face less stringent export restrictions, allowing for the potential manipulation of their value.

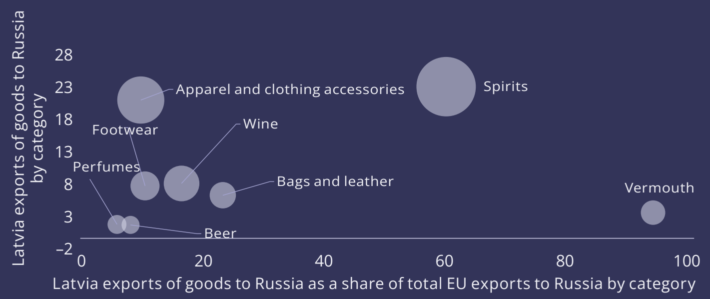
Chart 2.3. **EU exports of goods to Russia by country** (%)



X axis: EU exports of luxury goods to Russia by country (%);
Y axis: EU exports of goods to Russia by country (%);
the size of the circle represents the value of goods exported to Russia.

Source: Eurostat, Latvijas Banka's calculations.

Chart 2.4. **Latvia exports of luxury goods to Russia** (%)



X axis: Latvia exports of goods to Russia as a share of total EU exports to Russia by category (%);
Y axis: Latvia exports of goods to Russia by category (%);
the size of the circle represents the value of goods exported to Russia.

Source: Eurostat, Latvijas Banka's calculations.

Box 3. What income replacement level can be expected from Latvia's future old-age pension?[1]

Latvia implemented a three-pillar pension system in July 2001.

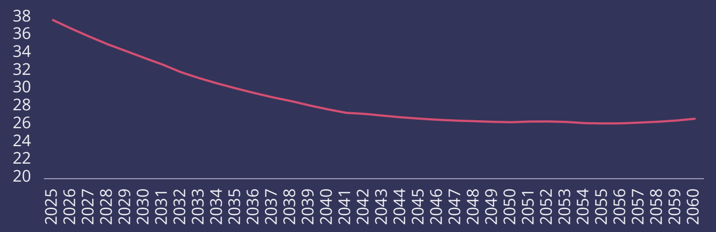
The first pillar is the obligatory state non-funded pension scheme, where each employee contributes 14% of their wage. These contributions fund the State's social budget, which provides pensions to current pensioners. Each member also has a virtual account where these contributions are registered, thereby building their pension capital. To prevent this registered capital from losing its value, it is adjusted annually based on changes in the total wages subject to insurance contributions in the country. In other words, an index is applied that reflects the growth rate of the wage fund for employees in Latvia.

The second pillar is the state funded pension scheme, which accounts for 6% of labour income. These funds are accumulated in a fund selected by the participant and are not used to cover current expenses. Consequently, the capital in the second pillar is adjusted based on developments in the international securities market. As the prices of securities in the global financial market rise, the capital accumulated in the second pillar also grows. This structure diversifies the old-age pension accumulation strategy: the first pillar is linked to the Latvian economy, while the second pillar is influenced by global economic developments.

Finally, the third pillar is a private pension scheme with purely voluntary contributions. Employees can make contributions themselves, thereby benefiting from personal income tax (PIT) advantages, or employers can contribute on behalf of their employees.

When retiring, one can currently expect an average old-age pension of about 40% of the country's average gross wage. However, due to the country's demographic situation and trends, the replacement rate is projected to decline to around 25% by 2060 (Chart 3.1). This decline is primarily because the pension capital accrued in the first pillar is adjusted annually based on the growth rate of the wage fund, which is influenced by changes in average remuneration and the number of employees. According to forecasts by the European Commission, Latvia's population will continue to decrease steadily, leading to a gradual decline in the number of employees. Consequently, the capital accumulated in the first pillar will grow at a slower pace than the average wage. While the increase in the second pillar pension capital will partially offset this trend, it receives contributions of only 6% of the wage, making it insufficient to fully compensate for the expected decrease in the replacement rate of the old-age pension system.

Chart 3.1. **Income replacement rate of the old-age pension system**
(% of the average gross wage)



Source: Latvijas Banka's projection.

Recently, a decision was made to reduce the tax burden on labour, partly financed by reallocating contributions from the second pillar to the first. Starting from 2025, these contributions will be adjusted to 15% and 5%, respectively. Consequently, instead of strengthening the pension system and improving pension substitutability, these legislative changes will slightly further reduce the level of substitutability. By shifting contributions to the first pillar, the state also assumes greater liabilities for future pensions, leading to an increase in pension-related expenditures from the state budget.

[1] Prepared by Oļegs Tkačevs, economist at Latvijas Banka.

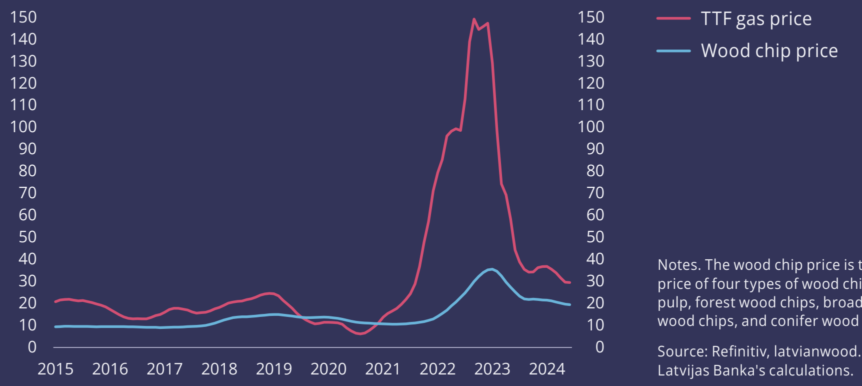
Box 4. Have heat energy prices in Latvia outpaced international energy prices?[1]

Russia's invasion of Ukraine led to surging energy prices in 2022 and 2023. The price of natural gas – important source of heat energy in Europe and Latvia – rose several times. Dramatic increase in natural gas prices motivated producers of heat energy to shift to alternative energy sources, thereby leading to a significant increase in other energy prices, including wood chips, which are crucial for Latvia (Chart 4.1). Thus, elevated energy prices triggered a substantial rise in heat energy prices (Chart 4.2).

Recently, inflation in Latvia has dropped significantly, primarily driven by lower energy (including heat energy) prices year on year. Nevertheless, heat energy prices remain elevated compared to pre-energy crisis levels. In the first half of 2024, the average heat energy price in Latvia was 79 euro/MWh (excluding VAT), 60% higher than the average for 2017–2019. While the increase in heat energy prices in Latvia mirrored, on average, the rise in natural gas and wood chip prices (Chart 4.3), there were quite notable disparities between the largest cities of Latvia.

The sharpest rise was observed in Riga, while Jēkabpils experienced the smallest increase (Chart 4.4). This raises questions as to what extent the current heat energy tariffs are justified by global energy prices and whether the historical correlation between energy prices and heat energy tariffs in Latvia has changed over time.

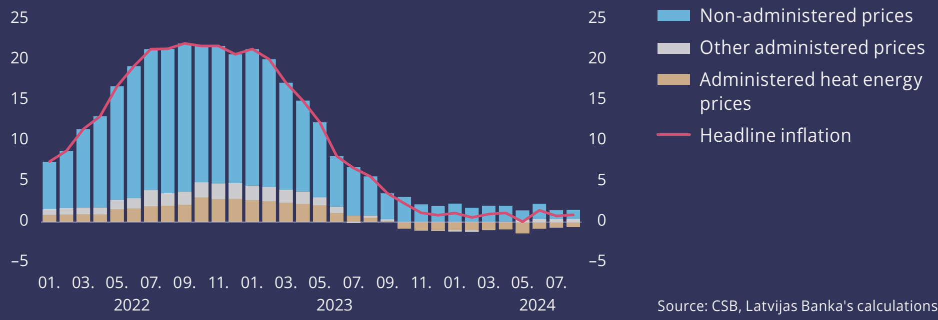
Chart 4.1. **Title Transfer Facility (TTF) natural gas prices and wood chip prices**
(euro/MWh, 6-month moving average)



Notes. The wood chip price is the average price of four types of wood chips (wood pulp, forest wood chips, broad-leaved wood chips, and conifer wood chips).

Source: Refinitiv, latvianwood.lv, Latvijas Banka's calculations.

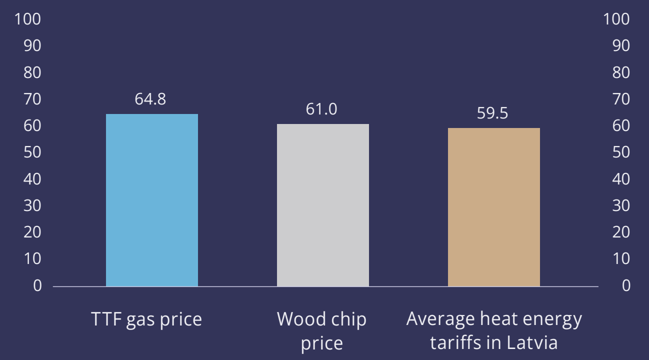
Chart 4.2. **Administered and non-administered price inflation**
(year on year; % and contributions)



Source: CSB, Latvijas Banka's calculations.

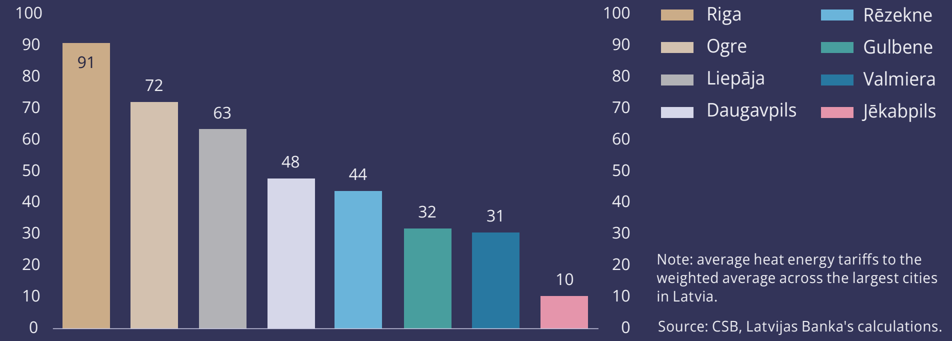
[1] Prepared by Andrejs Bessonovs and Ieva Opmane, economists at Latvijas Banka.

Chart 4.3. **Energy prices** (January–June 2024 relative to 2017–2019 average; %)



Source: CSB, Refinitiv, latvianwood.lv, Latvijas Banka's calculations.

Chart 4.4. **Heat energy prices in Latvia's cities** (January–June 2024 relative to 2017–2019 average; %)

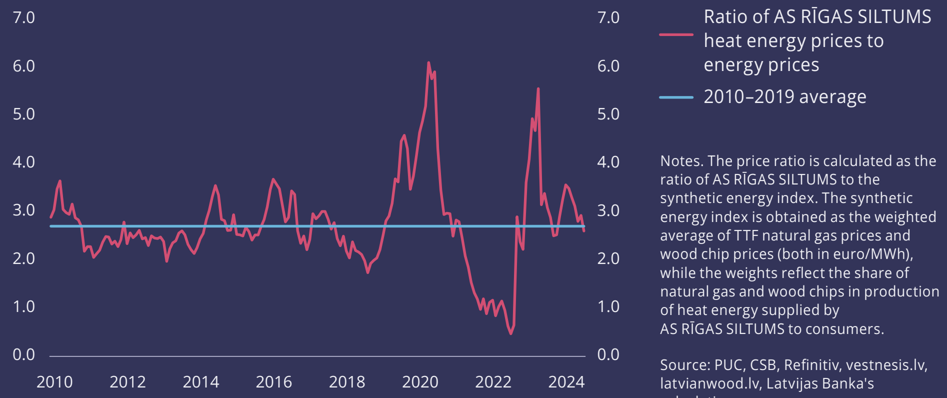


Note: average heat energy tariffs to the weighted average across the largest cities in Latvia.

Source: CSB, Latvijas Banka's calculations.

There are several factors that could explain the varying pass-through of changes in global prices to heat energy tariffs in individual cities, inter alia: 1) the use of various fuels to produce heat energy; 2) a delay from changes in energy prices to changes in tariffs. The fact that the adjustment of costs of energy and heat energy tariffs is approaching its final stage in Riga could be seen by the ratio of tariffs of AS RĪGAS SILTUMS to energy prices (Chart 4.5). Heat energy tariffs have rapidly decreased over the last year and correspond to the historical relationship between the actual heat energy tariffs and energy prices. While global energy prices already have stabilised, the heat energy tariffs of AS RĪGAS SILTUMS are set to continue decreasing for the upcoming heating season (Chart 4.6).

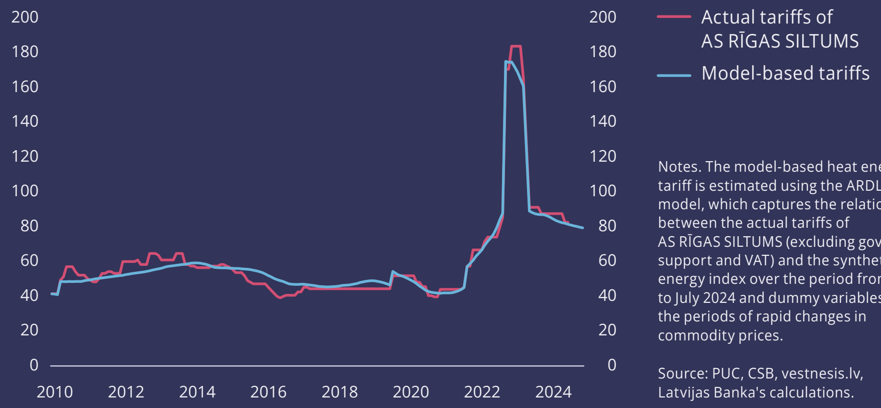
Chart 4.5. **Ratio of AS RĪGAS SILTUMS heat energy prices to energy prices**



Notes. The price ratio is calculated as the ratio of AS RĪGAS SILTUMS to the synthetic energy index. The synthetic energy index is obtained as the weighted average of TTF natural gas prices and wood chip prices (both in euro/MWh), while the weights reflect the share of natural gas and wood chips in production of heat energy supplied by AS RĪGAS SILTUMS to consumers.

Source: PUC, CSB, Refinitiv, vestnesis.lv, latvianwood.lv, Latvijas Banka's calculations.

Chart 4.6. **Actual and modelled heat energy tariffs of AS RĪGAS SILTUMS**
(euro/MWh)



Notes. The model-based heat energy tariff is estimated using the ARDL(1,0) model, which captures the relationship between the actual tariffs of AS RĪGAS SILTUMS (excluding government support and VAT) and the synthetic energy index over the period from 2010 to July 2024 and dummy variables during the periods of rapid changes in commodity prices.

Source: PUC, CSB, vestnesis.lv, Latvijas Banka's calculations.

Abbreviations

€STR – euro short-term rate

AS – joint stock company

CSB – Central Statistical Bureau of Latvia

EC – European Commission

ECB – European Central Bank

EU – European Union

EURIBOR – Euro Interbank Offered Rate

Fed – US Federal Reserve System

GDP – gross domestic product

HICP – Harmonised Index of Consumer Prices

IMF – International Monetary Fund

ISIN – International Securities Identification Number

OIS – Overnight Index Swap

OPEC – Organisation of the Petroleum Exporting Countries

OPEC+ – OPEC Member States and the Russian Federation, the Republic of Azerbaijan, the Kingdom of Bahrain, Brunei Darussalam, the Republic of South Sudan, the Republic of Kazakhstan, Malaysia, the United Mexican States, the Sultanate of Oman and the Republic of Sudan

PIT – personal income tax

PUC – Public Utilities Commission

UK – United Kingdom

US – United States of America

VAT – value added tax