LATVIJAS BANKA
EIROSISTĒMA

Macroeconomic Projections Report

2025 | December

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December 2025, No 4

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Additional information

The cut-off date for the information used in the Macroeconomic Projections Report (December 2025, No 4) and in the forecast is 3 December 2025 (26 November for the information used in some technical assumptions). The cut-off date for the information used in the Section "Monetary policy in the euro area" is 12 December 2025.

Contents

Key points in brief

Global uncertainty remains high but has declined since mid-2025. By negotiating new trade agreements with many of the world's major economies, the US has reduced the import tariff rates announced on 2 April. The trade war with China has also eased slightly, whereas, from a geopolitical perspective, active global conflicts persist, albeit with signs of change. A fragile peace has been reached in the Middle East, while calls for an end to active warfare in Ukraine have intensified.

Overall, global and euro area economic growth is expected to be moderate in the coming years, constrained by high uncertainty and weaker consumption. Euro area inflation is projected to continue fluctuating around the ECB's target. External demand will gradually increase, largely owing to rising demand from partner countries of importance to Latvia, such as Lithuania, Estonia, and Sweden.

With interest rates set by the Governing Council of the ECB at neutral levels, financing conditions remained favourable, resulting in continued high demand for financing by firms and households. However, as the interest rate cut cycle approaches its end or comes to a close, no further rapid improvements in financing conditions are expected, particularly as government debt growth accelerates and interest rates on government debt securities rise.

The decline in interest rates was driven both by the ECB's monetary policy decisions and by the refinancing of household loans, supported by increased competition among banks. This has contributed to growth in lending to both households and non-financial corporations.

The budget deficit assessment for this year has improved, while a rapid increase in defence spending, especially in 2026, will raise the deficit level, which is projected to exceed 3% of GDP in the medium term. The budget deficit will lead to higher borrowing needs, with the government debt level exceeding 50% of GDP over the medium term.

With global uncertainty declining and both external demand and domestic activity intensifying, economic growth is gradually gaining strength.

As trade policy uncertainty eases, growth in manufacturing – where substantial investments have previously been made – is set to accelerate. Additional investment in strengthening defence capacity is also improving the sentiment of economic agents and will continue to support consumption and investment decisions in both the short and long term, thereby reinforcing retail, construction, and industrial development.

Unemployment is on the decline and, as previously projected, is approaching 6% in the medium term. Labour demand remains resilient, as also suggested by business expectations for employment.

Wage growth will remain strong throughout the projection horizon. This is driven by persistent labour shortages. Moreover, the forecast for wage growth has been revised upwards in light of higher labour demand in the private sector.

The inflation forecast has been revised upwards for the entire projection horizon and remains in a range of 3–4%. Stronger wage growth puts pressure on both the demand and the cost sides, while being the main driver of inflation over the projection horizon

Projections in figures*

Table 1

Macroeconomic fundamentals: Latvijas Banka's forecasts

	2025	2026	2027	2028
Economic activity (annual changes; %; at constant prices; seasonally adjusted data)				
GDP	1.7	2.8	2.9	3.2
Private consumption	0.6	3.0	3.1	3.1
Government consumption	2.0	0.2	1.2	1.7
Investment	9.9	4.0	2.2	6.2
Exports	1.2	4.0	2.8	2.8
Imports	5.7	3.1	2.2	3.3
HICP inflation (annual changes; %)				
Inflation	3.9	3.2	2.9	3.6
Core inflation (excluding food and energy prices)	3.5	4.0	3.3	3.5
Labour market				
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	6.6	6.4	6.2
Nominal gross wage (annual changes; %)	8.0	7.6	7.6	7.9
External sector				
Current account balance (% of GDP)	–3.2	–3.5	–3.2	–3.5
Government finances (% of GDP)				
Budget surplus/deficit	–2.7	–3.5	–3.5	–3.1
General government debt	48.4	49.4	50.8	50.8

* The cut-off date for the information used in the forecast is 3 December (26 November for the information used in some technical assumptions).

Projections in brief

GDP

Investment in strengthening security, EU funds, and lending are bolstering GDP growth

2026 **2.8%**

Projection

2027 **2.9%**

2028 **3.2%**

INFLATION

Wage growth is fuelling demand and raising business costs, emerging as the main driver of inflation

2026 **3.2%**

Projection

2027 **2.9%**

2028 **3.6%**

GROSS WAGE

Low unemployment and difficulties in finding suitable workers are pushing businesses to offer higher wages

2026 **7.6%**

Projection

2027 **7.6%**

2028 **7.9%**

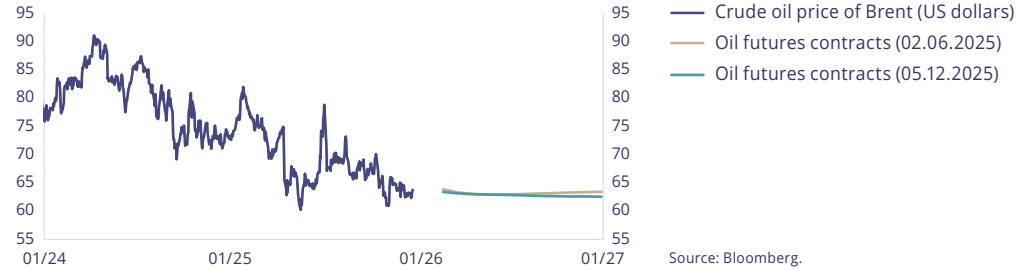
Global environment

Global uncertainty remains high but has declined since mid-2025. By negotiating new trade agreements with many of the world's major economies, the US has reduced the import tariff rates announced on 2 April. The trade war with China has also eased slightly, whereas, from a geopolitical perspective, active global conflicts persist, albeit with signs of change. A fragile peace has been reached in the Middle East, while calls for an end to active warfare in Ukraine have intensified.

Global prices of goods

Global oil prices remain relatively low. The crude oil price of Brent ranges between USD 60 and 65 per barrel. The low oil prices are largely due to the decision made by the OPEC+ countries to gradually restore higher oil production. Looking ahead, analysts are concerned that oil supply will continue to significantly exceed demand and, as a result, oil prices may continue to decrease. Yet uncertainty remains about the impact of US sanctions on Russia's largest oil companies. At their final meeting of the year, the OPEC+ countries decided to halt further increases in oil production in the first quarter of next year.

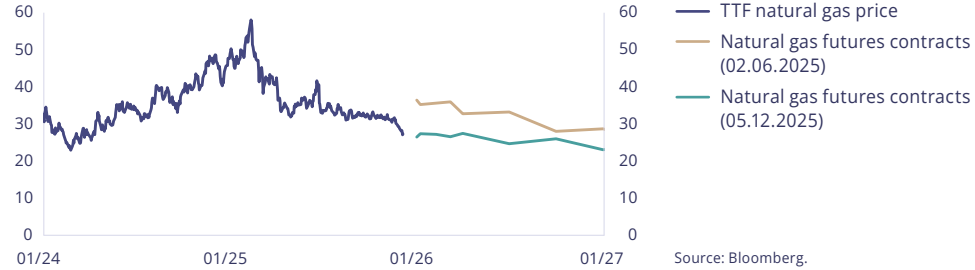
Chart 1. **Brent crude oil actual and future prices** (US dollars/barrel)



Source: Bloomberg.

Natural gas prices in the European market also continue to fall. The drop in prices can be explained by the improved availability of liquefied natural gas in the global market. Looking ahead, some analysts suggest that the supply-demand balance remains fairly tight and unexpected infrastructure-related events or a colder-than-expected winter may exert upward pressure on prices. However, this is not the market's baseline scenario, and futures are not currently predicting price increases in the European market.

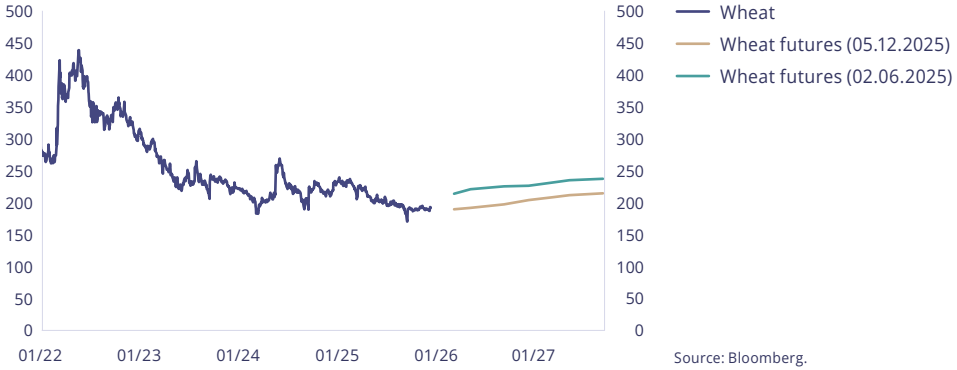
Chart 2. **Dutch TTF natural gas trading point and futures prices** (euro/MWh)



Source: Bloomberg.

Global grain prices, similarly to energy prices, ***have decreased.*** Low grain prices, which are causing concern for European farmers, are due to strong harvests in parts of South America, Australia, and Russia. This year has been particularly painful for European grain farmers, who faced poor harvests and low prices. Futures in financial markets suggest that prices should increase in the long run.

Chart 3. **Wheat prices on the Euronext exchange** (euro/t)



Source: Bloomberg.

Monetary policy at the leading central banks across the world

Central banks	Changes in interest rates since mid-2025	Main policy rate (%)	Market expectations of future interest rate developments	Considerations
Fed	–75 basis points	3.50–3.75	Interest rates will decrease	Labour market concerns, but inflation remains relatively high
Bank of England	–25 basis points	4.00	Interest rates will decrease	High inflation discourages faster interest rate cuts
Bank of Japan	–	0.50	Interest rates will increase	Concerns about the persistence of inflation have so far deterred a more rapid rise in interest rates

Leading central banks, such as the Fed and the Bank of England, have continued to reduce interest rates since mid-2025 and to move gradually from restrictive to neutral monetary policy. According to the Fed, the US economy continues to grow at a moderate pace, but, while unemployment remains low, job creation has slowed. Assessing the risks to the Fed's dual mandate objectives of price stability and maximum employment, it decided to ease its restrictive monetary policy. According to the Bank of England, if the process of reducing inflation in the UK continues as projected, the Bank of England will also be able to continue its interest rate cuts. Its projections expect inflation to return to the target level in 2027. In turn, the Bank of Japan continues to gradually move towards a more restrictive monetary policy in order to bring inflation back to target levels and prevent a further weakening of the Japanese yen.

External demand

Overall, global and euro area economic growth is expected to be moderate in the coming years, constrained by high uncertainty and weaker consumption. Euro area inflation is expected to continue fluctuating around the ECB's target. External demand will gradually increase, largely owing to rising demand from partner countries of importance to Latvia, such as Lithuania, Estonia, and Sweden.

The global and euro area economy

Global economic growth is still considered weak. This is driven by high geopolitical uncertainty and persistent risks of protectionism and economic fragmentation. They are holding back a more assertive recovery in global activity and continue to hamper international trade. While the latest IMF autumn forecast raises global GDP growth to 3.2% for 2025 and maintains it at 3.1% for 2026 (summer forecast: 3.0% and 3.1% respectively), these rates remain well below the pre-pandemic average growth. Global trade is projected to grow slowly and unevenly in 2025–2026. Additional risks stem from the high level of public debt and relatively loose fiscal policies in a number of major economies. Some pressure is also exerted by threats to the independence of central banks, in particular the US Fed, which may have a negative impact on the quality of monetary policy decisions. Global inflation is projected to decline further, supported by falling commodity prices and the further normalisation of global supply chains.

Economic activity in the euro area is slowly picking up, but overall momentum remains moderate. The ECB autumn forecasts reflect a more optimistic outlook: GDP growth is projected at 1.2% in 2025 (summer forecast: 0.9%), 1.0% in 2026, and 1.3% in 2027. This year's growth acceleration is largely supported by stronger exports, particularly in the largest euro area countries, though this driver remains associated with elevated uncertainty.

Rapid immigration into Spain, in particular from Latin America, has also had an additional positive impact. It has boosted labour force growth and helped to bring unemployment down to historically low levels, a trend also observed in the euro area as a whole. However, private consumption remains weak, as household cautiousness is still high and consumer sentiment indicators are low. Delays in the supply of rare earth metals from China have an additional negative impact on the region's industry.

Headline inflation in the euro area is projected to average 2.1% in 2025, fall to 1.7% in 2026, and rise to 1.9% in 2027. The easing of pressure will be driven by slower wage growth, more moderate increases in service prices, the appreciation of the euro, as well as stronger competition in the imported goods segment, in particular for Chinese goods.

Latvia's major trade partners

External demand has been more favourable than previously projected, and a moderate increase in demand is expected to continue. Although uncertainty has receded, the external environment continues to be marked by prominent news about import tariffs imposed by US President Donald Trump and debates over their legitimacy, as well as by political instability

in European countries. These signals have held back investment and consumption in trading partner countries; nevertheless, overall external demand in 2025 is projected to be slightly higher in light of newly available data. External demand for 2026 is supported by somewhat "clearer rules of the game" regarding US tariffs, as well as by the impact of the reform of Lithuania's 2nd pension pillar.

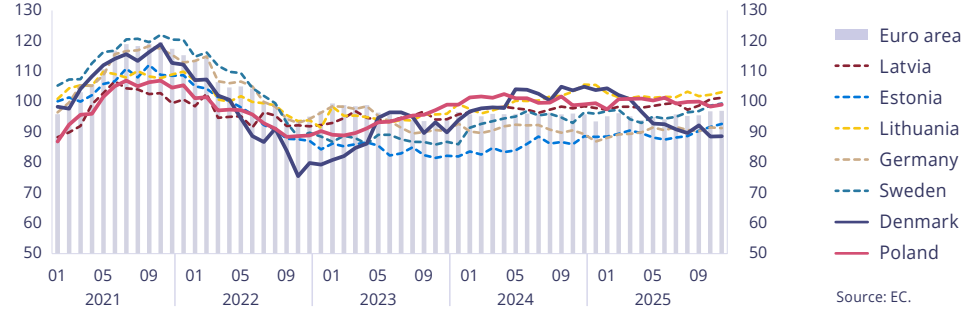
This reform, which will enter into force in early 2026, will increase private consumption next year. As this will only lead to a short-term increase, the outlook for private consumption growth in 2027 has been revised significantly downwards. This, in turn, has prompted a downward revision to the overall external demand forecast for 2027. Lithuania is one of the few EU countries that have shown a strong growth trend over the past year, which is, in turn, positive news for Latvia.

Tax increases introduced in Estonia this year have fuelled inflation, eroded the population's purchasing power, and are currently weighing on demand for Latvian goods and services. In contrast, Eesti Pank expects stronger growth in 2026 and 2027, with an increase in real wages and thus purchasing power, and the economic sentiment is already on a positive trend, providing a more positive outlook for the future.

In Germany, one of the countries where the US import tariffs have caused the greatest difficulties, the economy is still stagnant. At the same time, stronger exports to the US ahead of the introduction of tariffs pushed growth in the first quarter above previous expectations. A more positive outlook for the end of the year also suggests higher overall GDP growth in 2025, although Deutsche Bundesbank expects future private consumption growth to remain weak due to subdued industrial performance.

In Sweden, the unemployment rate has increased this year, but Sveriges Riksbank has revised its forecast for both private consumption and economic growth upwards for the next two years, as the economic recovery started earlier than previously expected. In Sweden, a downward revision of the inflation forecast is expected to bolster the overall purchasing power of the population and thereby support demand for Latvian products.

Chart 4. **Economic sentiment indicator** (long-term average = 100)



Source: EC.

Monetary policy in the euro area

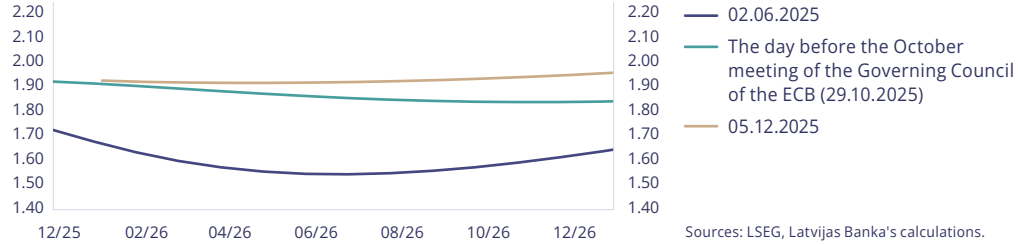
With interest rates set by the Governing Council of the ECB at neutral levels, financing conditions remained favourable, resulting in continued high demand for financing by firms and households. However, as the interest rate cut cycle approaches its end or comes to a close, no further rapid improvements in financing conditions are expected, particularly as government debt growth accelerates and interest rates on government debt securities rise.

ECB monetary policy

With inflation gradually stabilising at around the medium-term target, the ECB has suspended interest rate cuts following a reduction in June and maintains a data-driven and meeting-by-meeting approach to determining the monetary policy stance. Inflation is close to the 2% medium-term target, and economic growth continues despite the challenging global environment. The strong labour market, private sector balance sheets, and previous decisions by the Governing Council of the ECB to cut interest rates will continue to provide an important basis for economic resilience. At the same time, the economic outlook remains uncertain amid global trade disputes and geopolitical tensions, requiring a data-driven approach and precluding forward guidance on monetary policy. In addition, the Governing Council of the ECB underlines that we are currently in a "good position" in terms of interest rates and inflation dynamics and that keeping inflation close to target will be the main task moving forward.

Financial markets view the interest rate cut cycle as having ended and expect interest rates to remain at their current levels throughout the coming year. At the same time, some analysts have suggested that financial markets may be underestimating the likelihood of a further, albeit modest, decline in interest rates.

Chart 5. **One-month €STR OIS forward rates** (%)



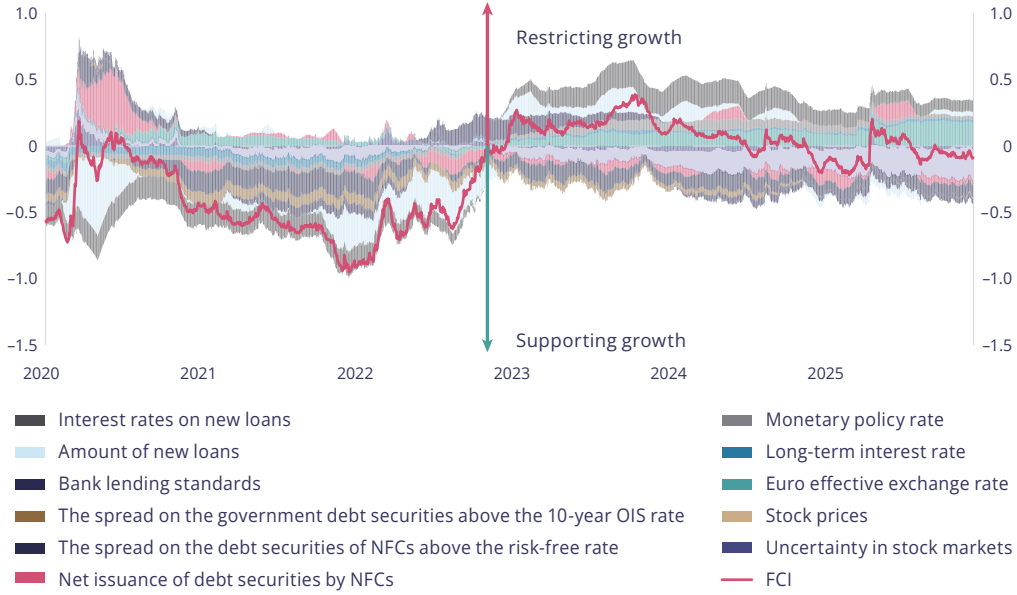
Sources: LSEG, Latvijas Banka's calculations.

Financial conditions in the euro area

Financial conditions in the euro area continued to gradually improve. Greater clarity regarding trade tariff conditions improved financial market sentiment, supporting stock market gains and reducing expectations of stock price volatility. While base interest rates have remained unchanged since their last decline in early June, the yield on 10-year government bonds increased. This reflects market concerns about the sustainability of government debt,

particularly in France. Spreads over the risk-free rate narrowed in the corporate debt securities segment. Non-financial corporations leveraged this situation to raise financing in the capital markets.

Chart 6. **Euro area Financial Conditions Index of Latvijas Banka** (FCI, standard deviations from the long-term average)



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

The euro area bank lending survey suggests that lending standards for non-financial corporations tightened somewhat further in the third quarter of 2025. Concerns about economic development contributed to this. However, demand for loans increased, driven by low lending rates and the need to refinance existing loans. At the same time, the drop in lending rates, driven by declining money market rates and sustained by lower bank margins for an extended period of time, has slowed significantly.

In the housing lending segment, the upward impact of the risk assessment and the downward effect of the increased competition offset each other, thus keeping lending standards unchanged. Demand was still high, supported by low interest rates and expectations of rising housing prices. Similarly to firms, the decline in lending rates to households has come to an end, with some countries even showing some increases.

In the near future, developments in financial conditions will be determined by financial market sentiment and the ECB's further actions. At present, financial conditions have improved due to financial market optimism, yet high uncertainty and a cautious economic growth outlook remain a source of pressure on lending conditions. If, in line with market expectations, the ECB's interest rate cut cycle has come to an end, further improvements in financial conditions are unlikely.

Financial conditions in Latvia

The decline in interest rates was driven both by the ECB's monetary policy decisions and by the refinancing of household loans, supported by increased competition among banks. This has contributed to growth in lending to both households and non-financial corporations.

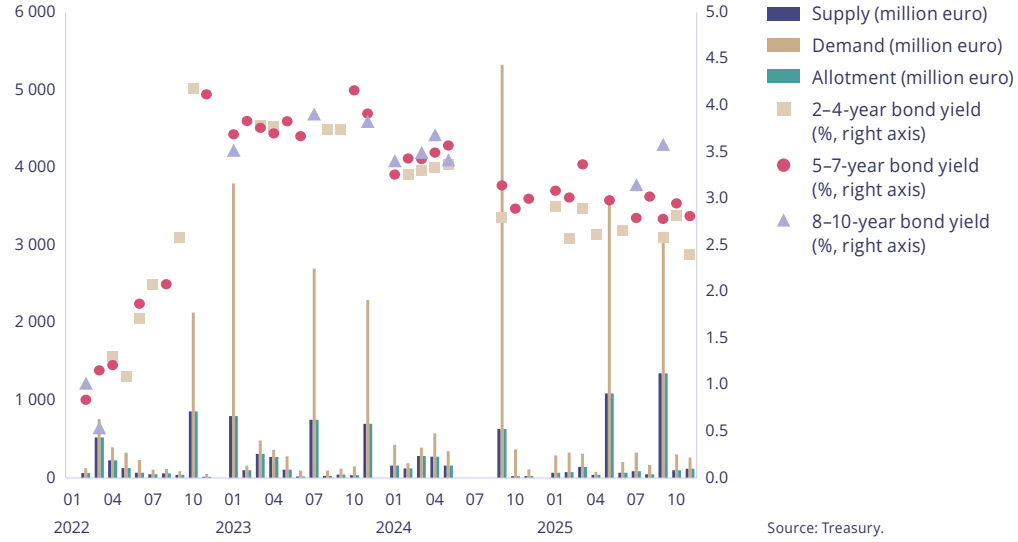
Latvian capital market

Activity in the primary market of government securities remained high. At the same time, the borrowing rate increased and a further rise in the government debt-to-GDP ratio is expected, resulting in heavier dependence on interest rate fluctuations. From June to November 2025, the three leading credit rating agencies maintained their current credit rating of Latvia, i.e. in the A group, as well as a stable future outlook.

In June-November, ***the yield on Latvian 10-year government bonds increased*** from 3.46% to 3.62%. Though the ECB cut its base rate in June, this rate rose in most euro area countries. Investors in the government bonds market demanded higher returns, as they observed one of the following factors: higher inflation, economic fluctuations, higher fiscal policy risk, or the risk of greater debt burden. The Treasury announced that domestic investors may choose two new maturity periods for savings bonds: 3 months and 2 years.

In September, the government issued 10-year euro-denominated bonds worth EUR 1.25 billion in international markets. Demand significantly exceeded supply, reaching EUR 2.5 billion, while the issue yield was 3.583%.

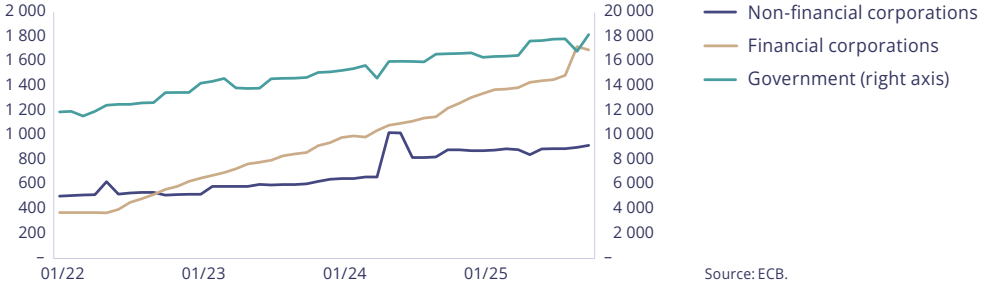
Chart 7. **Latvian government securities auctions**



Source: Treasury.

In the private debt securities market, there was one larger issue, i.e. in September AS Citadele banka issued the highest priority unsecured bonds totalling EUR 300 million. These funds will be used to meet current and future MREL requirements (minimum requirements for own funds and eligible liabilities), as well as for general business purposes.

Chart 8. **Outstanding debt securities of Latvian issuers, by issuer group** (million euro)

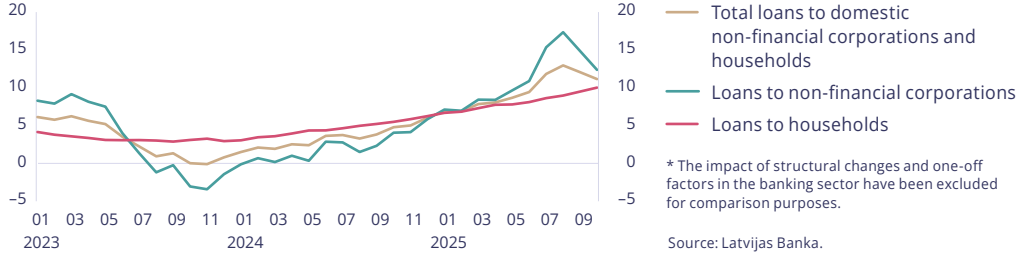


Source: ECB.

Banking sector

Lending has accelerated, and the loan portfolio of Latvia's non-financial private sector is one of the three fastest growing in the euro area. Though interest rates did not continue to decline, in general, lower rates coupled with greater competition among banks and, most likely, the positive effect of the solidarity framework have contributed to the growth in lending both to households and to non-financial corporations. In general, the loan portfolio continues to grow much faster than the economy, reaching 30.9% of GDP in the third quarter (30.2% in the second quarter).

Chart 9. **Annual changes in domestic loans*** (outstanding, %)

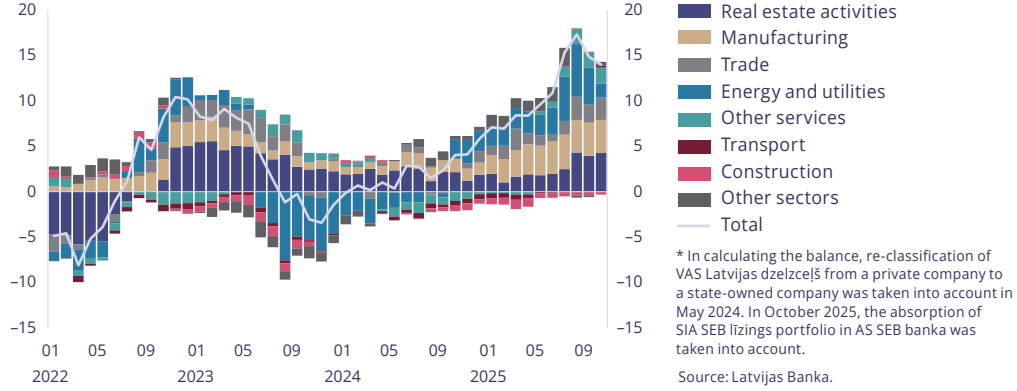


* The impact of structural changes and one-off factors in the banking sector have been excluded for comparison purposes.

Source: Latvijas Banka.

Loans to non-financial corporations grew sharply (by 14% in October year-on-year): corporate investment needs were on the rise, and the ratio of outstanding loans significantly increased in a wide range of sectors. Notable growth was observed in the loan portfolios of manufacturing, trade, real estate, and energy companies alongside a significant increase in various outstanding long-term loans. In the future, these developments could mean more investment and expected returns, potentially accelerating economic growth. Furthermore, outstanding loans to households continued to increase (by 9.8% in October year-on-year) – both mortgage and consumer credit portfolios rapidly increased (by 9.3% and 12.7% respectively), with a portion of new consumer loans specifically related to house purchases.

Chart 10. **Annual growth rate of outstanding loans to non-financial corporations, by sector*** (%)

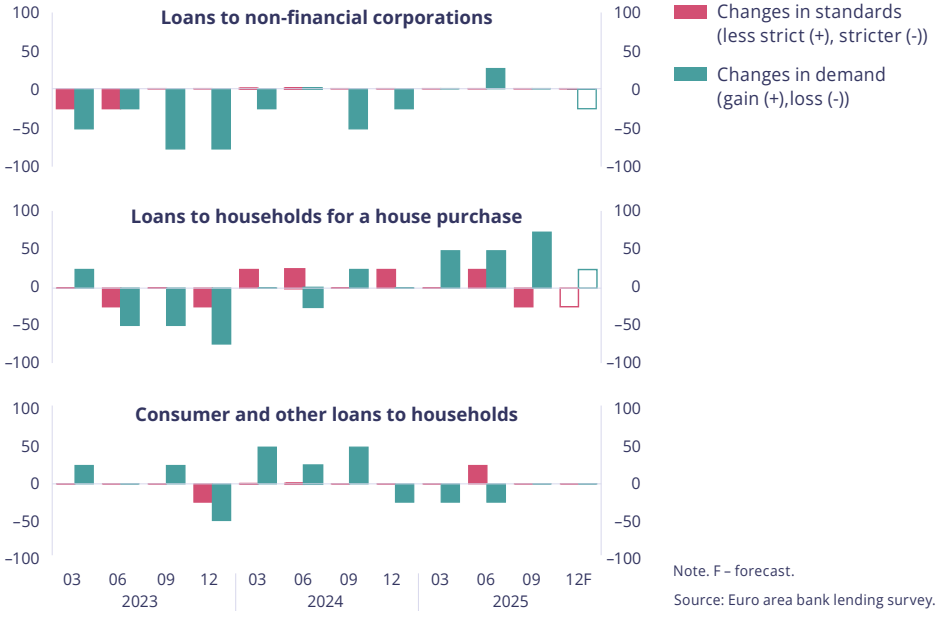


* In calculating the balance, re-classification of VAS Latvijas dzelzceļš from a private company to a state-owned company was taken into account in May 2024. In October 2025, the absorption of SIA SEB līzings portfolio in AS SEB banka was taken into account.

Source: Latvijas Banka.

The euro area bank lending survey suggests that the demand of non-financial companies increased only slightly, contrasting with the notable growth of the loan portfolio. However, in the household sector, the situation seems to be much more optimistic, as banks have suggested that demand has significantly grown and is still on the rise, in particular, in housing loans.

Chart 11. **Changes in lending standards and loan demand** (net, %)

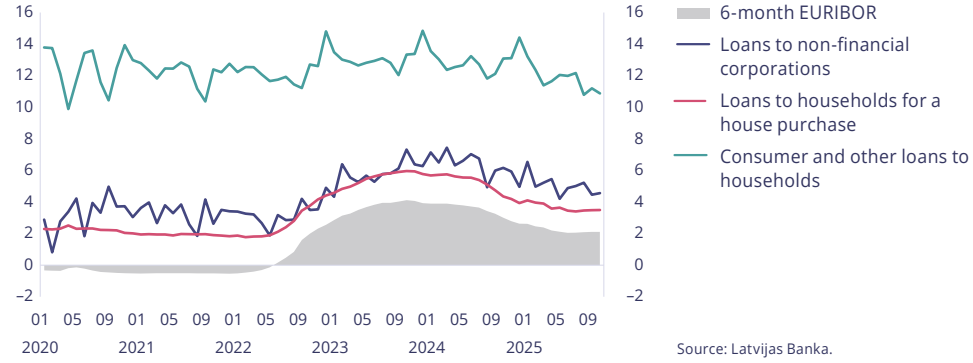


Note. F – forecast.

Source: Euro area bank lending survey.

Interest rates of new loans have stabilised. This is a result of both the stabilisation of ECB base rates and insignificant EURIBOR changes (since the first quarter of 2025). In general, the interest rates of loans issued to non-financial corporations were approximately 4.5% until October, significantly lower than the previous year (above 6%) or at the beginning of the year (5–6%). Similar developments can be observed in household housing loans, as the interest rates of new loans have fallen below 4%. This results not only from a lower EURIBOR, but also from lower bank markups, as the competition among banks increases. In particular, given the very high activity in refinancing mortgage loans, markups applied to current or other lenders have decreased by more than 15% of the entire value of the mortgage loan portfolio, while the markups have decreased by 0.5 percentage points on average. Changes in lending rates are aligned with financial markets and reflect market expectations regarding future base rate developments. Thus, the fact that the monetary policy has currently remained relatively stable has driven the stabilisation in lending rates.

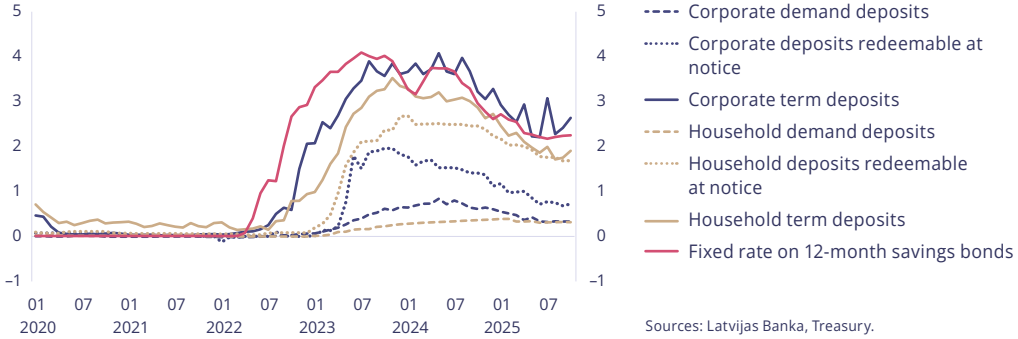
Chart 12. **Interest rates on new euro-denominated domestic loans and the 6-month EURIBOR** (%)



Source: Latvijas Banka.

As household income increased, deposits continued to grow, though some spending caution remained. Deposits of households and non-financial corporations continued to increase – rising by 6.5% in October 2025 year-on-year. Households have remained cautious, maintaining liquid funds despite growing real wages. This could be explained by considerable uncertainty and efforts to rebuild savings. However, deposits of non-financial corporations have been more volatile, and growth has generally slowed (increased by 1.3% in October 2025 year-on-year). All in all, this could be explained by more active investing and less attractive deposit interest rates. Deposits are still a profitable source of financing for banks, with the loan-to-deposit ratio of the private non-financial sector reaching 70% in October.

Chart 13. **Interest rates on new euro-denominated domestic deposits and the 12-month savings bonds** (%)



Sources: Latvijas Banka, Treasury.

As interest rates decreased and inflation increased, real deposit rates are currently clearly negative. This drives the decision of households to use term deposits on fewer occasions. During the last few months, there has been increased interest in channelling funds into Treasury savings bonds, as their fixed yield rates are currently more favourable. In the future, negative real deposit rates could undercut deposit growth; however, so far, prudence has prevailed along a desire to rebuild savings. Lower inflation and strong wage growth could contribute to more active consumption rather than savings. Due to this, household deposits could decline in the coming years.

Box 1. Impact of credit institutions' solidarity contributions on lending

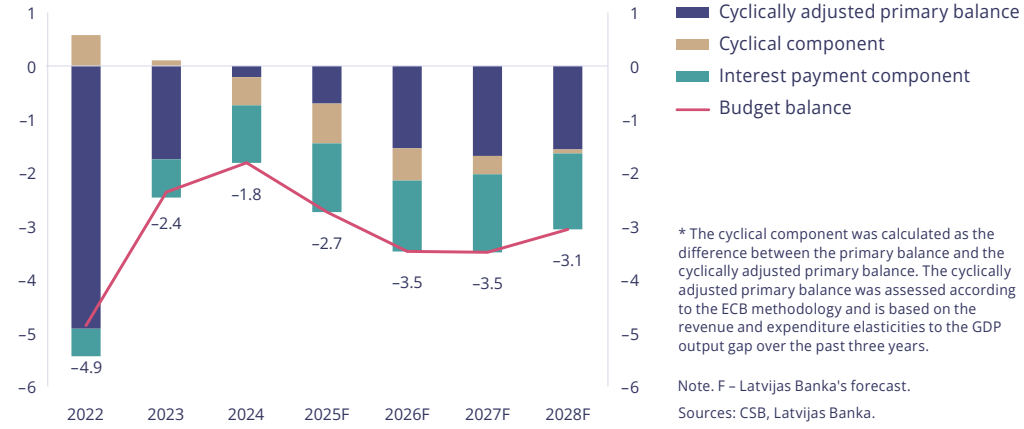
Fiscal policy in Latvia

The budget deficit assessment for this year has improved, while a rapid increase in defence spending, especially in 2026, will raise the deficit level, which is projected to exceed 3% of GDP in the medium term. The budget deficit will lead to higher borrowing needs, with the government debt level exceeding 50% of GDP over the medium term.

Projections	2024	2025		2026		2027		2028
	Actual	June	**Dec.**	June	**Dec.**	June	**Dec.**	**Dec.**
Budget surplus/deficit (% of GDP)	–1.8	–3.2	**–2.7**	–2.8	**–3.5**	–2.9	–3.5	**–3.1**
General government debt (% of GDP)	46.6	47.9	**48.4**	48.2	**49.4**	49.9	**50.8**	**50.8**

The budget deficit of general government will rise in the medium term, as it will be significantly affected by growing defence spending. This year, due to the implemented personal income tax reform, the deficit increase will be driven by more rapid growth in expenditure than in revenue, while the growth of other revenues will be slower or even reverse. For example, this year interest income will be smaller than during the previous years. In 2026, the deficit will be driven upwards by a steeper rise in defence spending, while in 2027, it will remain stable and the deficit will not significantly change. Currently, it is expected that in 2028, the deficit will slightly decrease as the spending hike will flatten out, assuming that defence spending will essentially remain the same.

Chart 14. **General government budget* balance** (% of GDP)



* The cyclical component was calculated as the difference between the primary balance and the cyclically adjusted primary balance. The cyclically adjusted primary balance was assessed according to the ECB methodology and is based on the revenue and expenditure elasticities to the GDP output gap over the past three years.

Note. F – Latvijas Banka's forecast.

Sources: CSB, Latvijas Banka.

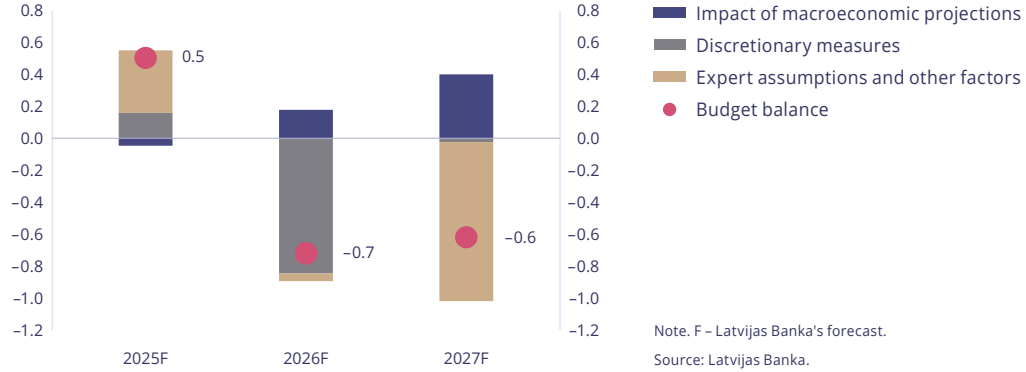
The revenue hike will slow down this year, and future fluctuations will be determined by income from the implementation of EU funded projects. However, tax revenue will grow at the same pace as this year. In 2025, changes in tax revenue were largely driven by developments in the labour market and a relatively steep rise in wages, as well as VAT revenue during the

second semester. In the coming years, a more favourable situation in the labour market is expected, improving the tax base. Tax policy changes, conceptually approved by Parliament, will also contribute to the pace of growth of tax revenue. The excise rate will increase faster than planned, and the gambling tax will rise as early as 2026 – one year earlier than planned. While in 2027, the natural resource tax rate will be increased for some categories, and a tax for unprocessed timber will be introduced. The planned increase in the dividend share of state-owned enterprises, from 70% to 90%, will also contribute to revenue. At the same time, as of 1 July 2026 the VAT rate for some food groups will be decreased from 21% to 12% for one year.

In the medium term, spending will be increased by the approved budgetary priorities, in particular, higher defence spending to be financed by increasing the deficit and using the permitted deviation from the expenditure growth path set previously. The EU Council has approved the request of Latvia to apply the national escape clause allowing it to raise defence spending faster than previously planned, reaching close to 5% of GDP already in 2026 and maintaining a high level thereafter. These changes will increase expenditure on government consumption and public investment. Furthermore, the latest spending forecast includes medium-term budget financing for demography and education priorities, including more social benefits and financing for teacher wages, as well as support to farmers. A part of the financing needed for these measures was found by savings on remuneration, goods and services costs, as well as smaller savings amounts in other budget lines. Larger spending is also planned for social benefits, e.g. old-age pensions. It will generally be impacted by a faster increase in average pensions along a more rapid rise in wages. More resources will also be needed to service government debt.

The forecasted budget deficit for future years has been increased. In comparison to the June 2025 forecast, the improved budget balance for this year is ensured by updated assumptions on tax and other revenue collections based on the current revenue and spending dynamics. Next year, the deterioration of the budget balance will be mostly driven by the decisions made, including additional financing for defence, demography, education, and farmer support that will only be partially offset by revenue-increasing measures and savings from the expenditure review. At the same time, the effects of higher spending on social benefits and interest rate payments will be more than offset by changes in assumptions on the transfer of military equipment deliveries to later years. While in 2027, the deterioration of the balance will be affected by higher interest rates, larger military equipment deliveries, and more expenditure for EU funded projects.

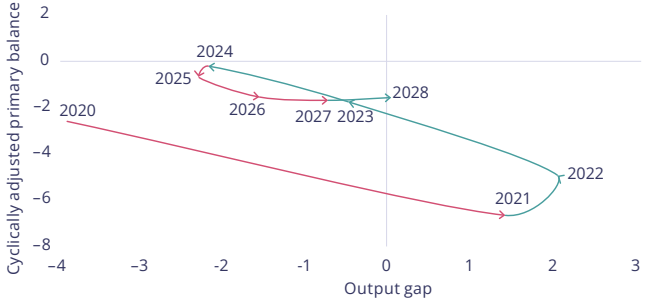
Chart 15. **Changes in the budget balance forecast versus the previous forecast and underlying factors** (in percentage points)



Note. F – Latvijas Banka's forecast.
Source: Latvijas Banka.

In the medium term, the fiscal policy will remain expansionary, next year reaching the largest fiscal impulse in the entire forecasting period. Thereafter, the effect of the expansionary fiscal impulse will gradually diminish and become restrictive in 2028. The cyclically adjusted primary deficit is projected to increase in 2026 and will remain around 1.6% of potential GDP over the medium term.

Chart 16. **Cyclically adjusted primary balance* and GDP output gap** (% of potential GDP)

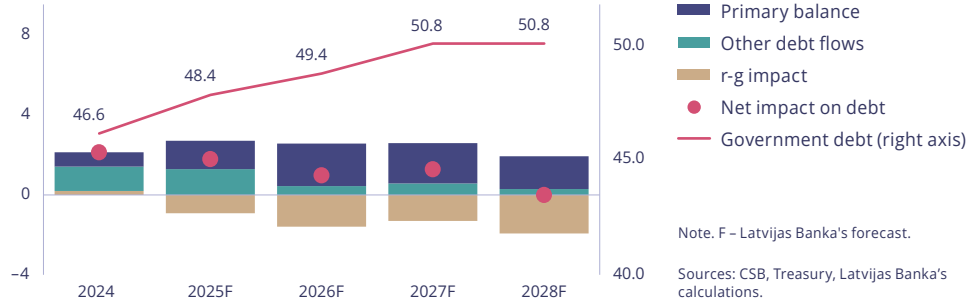


* The cyclically adjusted primary balance was assessed according to the ECB methodology and is based on the revenue and expenditure elasticity to the GDP output gap over the past three years.

Source: Latvijas Banka.

Due to higher budget spending, government debt will maintain an upward trend in the coming years. Government debt will increase faster than previously projected, and the increase will be driven by the budget priorities approved in the autumn, in particular, higher defence spending. This will increase the need for more external financing than previously expected. Debt sustainability risks have not increased due to the macroeconomic effects, while the interest rate to growth ratio has improved due to higher inflation than expected.

Chart 17. **Government debt** (% of GDP) **and underlying factors** (contribution, in percentage points)



Note. F – Latvijas Banka's forecast.

Sources: CSB, Treasury, Latvijas Banka's calculations.

Box 2. Member States' debt and defence expenditure dynamics

Scenario 1. Possible impact of fiscal consolidation on the Latvian economy

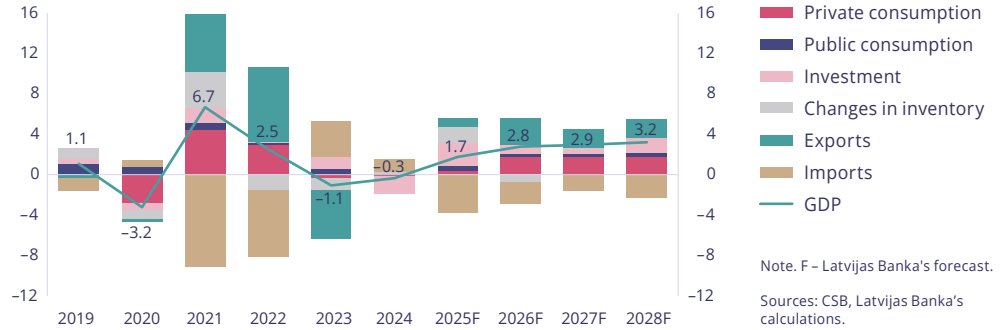
Gross domestic product – demand

With global uncertainty declining and both external demand and domestic activity intensifying, economic growth is gradually gaining strength.

Projections	2024	2025		2026		2027		2028
	Actual	June	**Dec.**	June	**Dec.**	June	**Dec.**	**Dec.**
GDP (annual changes, %; at constant prices; seasonally adjusted data)	–0.3	1.2	**1.7**	2.8	**2.8**	3.2	**2.9**	**3.2**

Externalities are becoming more positive and support more optimistic forecasts on domestic developments. The US import duties review cycle resulted in clearer rules for exporters and importers in the autumn of 2025. Moreover, interest rate cuts in many countries, including important trading partners of Latvia, have supported the first signs of reinforcement in the construction sector, also echoing in a more reliable business environment in Latvia and improved consumer confidence. This supports a more hopeful outlook regarding a rebound in private consumption, as well as export performance and investors' desire to develop new projects. Although these processes gradually strengthen over the projection horizon, the scope of planned large investment projects is significant enough to result in fluctuations of general GDP forecasts as a result of information on their successful implementation or any changes in plans. As a result, a part of the higher growth forecast for 2027 had to be moved to 2028.

Chart 18. **GDP** (annual changes, %; seasonally adjusted data)**, expenditure components, and Latvijas Banka's projections** (contribution, in percentage points)



Note. F – Latvijas Banka's forecast.

Sources: CSB, Latvijas Banka's calculations.

The autumn of 2025 has favourable conditions for a more rapid growth in private consumption; however, concerns about the sustainability of consumer optimism cannot be fully excluded. The real purchasing power of consumers has been improving since 2024. However, they have been reluctant to increase their spending, setting aside income for savings. In October–November, consumer sentiment improved significantly, including the assessment of the financial situation of households – after an extended period of time, it has finally reached the "optimism zone", namely, the responses have become positive (above 0). Consumers are

also more positive in terms of large purchases. However, trust in the general economic growth outlook has not yet been restored. It will be hard to achieve, considering the current increase in the activity of politicians, eager to solve political arguments publicly ahead of the upcoming parliamentary elections.

Although inflation has not significantly impeded the growth in real income, it has undermined the favourability of deposits – real deposit rates are clearly negative. However, caution and the desire to rebuild savings have contributed to higher deposits – they continued to increase throughout the year, including towards the end of the year. In October, household deposits had risen by 10% year-on-year.

The higher investment level observed in 2025 will remain stable. In the long term, it may even be reinforced by the implementation of the expected large public and private investment projects. The investment environment became more active this year by relying on own and EU financing, as well as due to rapid growth in lending. Throughout the year, this has allowed a high level of public and private investment to be maintained. In general, the short-term outlook for the investment environment has not significantly changed, but the implementation outlook of some large investment projects, including Rail Baltica, has been slightly revised by delaying the higher projected growth from 2027 to 2028. At the same time, significant positive risks are related to the growth in private investment, as during the last few months, several new large scale private investment plans have been put forward. For example, the leading German defence corporation Rheinmetall AG will start constructing a new ammunition plant (the planned investment amounts to EUR 275 million)[1], the leading Danish wind energy developer Eurowind Energy and the German company Neue Energien plan to construct five wind farms (by 2032, planned investment EUR 600 million)[2], etc. These projects, along with projects already planned (for example, the construction of the Fibenol biorefinery plant in Valmiera with a total planned investment of EUR 700 million), support a positive outlook for investment prospects.

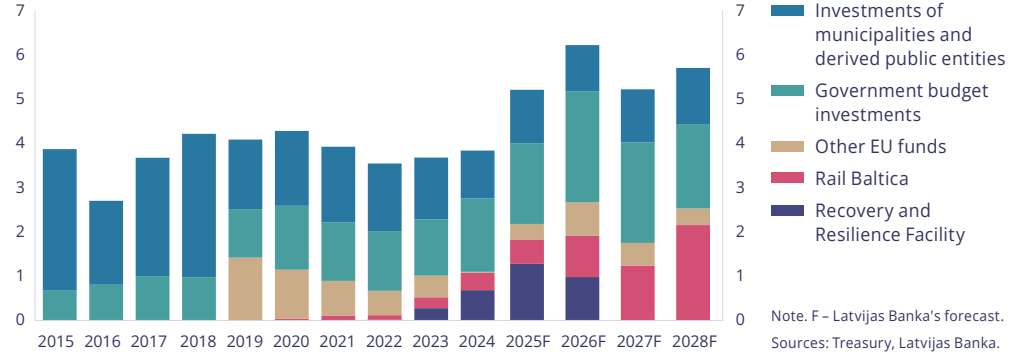
[1] Latvia will develop an artillery ammunition plant together with Rheinmetall, sargs.lv, 25.09.2025.

[2] Largest Danish wind farm developer has ambitious plans in Latvia – will invest EUR 600 million, jauns.lv, 28.08.2025.

Scenario 2. Macroeconomic impact of lending growth

Over the entire projection horizon, public investment will remain unusually high. The expected investments do not significantly differ from the previous forecast, and the implementation of the Recovery and Resilience Facility projects has been progressing successfully. In 2026, a more rapid rise in investments than projected is expected considering the decision of the government to significantly increase defence spending to reach almost 5% of GDP according to the NATO defence spending accounting approach. This will considerably drive up investment to reinforce internal and external security. The construction of military infrastructure will continue, and deliveries of military equipment larger than in the previous years are expected. In 2026, the last year of the Recovery and Resilience Facility, a sizeable expenditure is expected to fully absorb the financing. In the medium term, investments will be complemented by the implementation of EU funded projects and the development of the Rail Baltica project.

Chart 19. **Public investment** (cash flow, % of GDP)



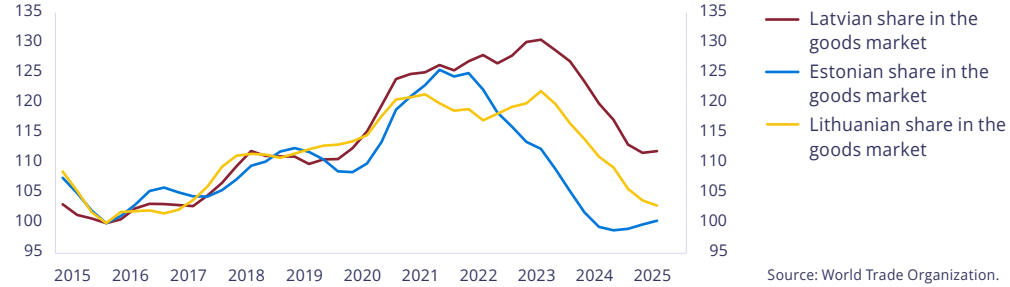
Note. F – Latvijas Banka's forecast.
Sources: Treasury, Latvijas Banka.

As construction activity and defence spending increase in trade partner countries and the underlying uncertainty decreases in international trade, opportunities for exporters will improve. This allows to forecast stronger export activities. However, due to the weak performance in the first half of the year, the overall annual estimate for exports has been downgraded. Furthermore, previous sizeable investments in manufacturing, in particular, in developing new products and in automation, will help to strengthen further economic growth, gradually leading to production gains. Additionally, higher defence spending and more construction activity in external trading partner countries offer Latvian exporters additional opportunities, for example, Rheinmetall AG plans to construct an ammunition plant not only in Latvia, but also in Lithuania. As a result, this construction can contribute to the domestic sales and export of construction supplies and services produced in Latvia. The ability of increased production capacity to find suitable export markets could be challenged by competitiveness issues. However, the first positive news has been received from this sector.

After a long downturn, the share of Latvian exports in global imports has stabilised and somewhat increased. Market shares are currently on the rise in Estonia and the Netherlands, while stabilising in Germany and Lithuania. By commodity group, the market share has increased for milk, vehicles, and mineral products related to re-exports, and has stabilised in several product groups – timber, pharmaceuticals, machines, and electronics. In the category of electronic goods, in particular, the segment of electric control devices, the more favourable development is mostly driven by the rapidly increasing exports to Sweden, on the rise despite the weak export dynamic to this market. Competitiveness of products is still limited by a rapid increase in labour costs, higher than the EU average, but on par with the neighbouring countries.

The value of the export unit has slightly decreased this year. Prices of agricultural goods have decreased, more along lines with prices in the global market. Moreover, lower cereal prices also reflect the low quality of the 2025 harvest in Latvia. However, the price of timber products has increased. In general, the price of the most important products has remained stable.

Chart 20. **Market shares of the Baltic States in global imports** (2015 average = 100)



Source: World Trade Organization.

In 2025, the development of Latvian exports has been uneven, but generally stable. Both goods and services exports have continued to grow. Concerning import tariffs, the global situation has become clearer, and an agreement has been reached on most published US tariffs, mitigating imminent risks. However, despite this, global economic uncertainty remains high: earlier notifications on tariffs and rapid political shifts have undermined investment and consumption activities in many countries, reducing the demand for goods made in Latvia.

During the second half of the year, Latvian exports have gradually rebounded after the slump that started in March. This increase was observed in several product groups. Despite unfavourable weather conditions, agricultural exports, in particular cereal exports to the EU, especially Spain, grew more rapidly. Moderate growth was observed in the main categories, namely, electronic equipment and timber products. In the traditional markets, in particular Estonia, exports stabilised as exports in pharmaceuticals and timber products increased. The export market is gradually becoming more diversified in turn reducing dependence on the US, which has introduced import tariffs, and Sweden, where construction is recovering slowly. At the same time, trade with the UK and Italy rose.

Goods imports stagnated, mitigating the decline in the trade balance. Most declines were observed in imports of mineral fuels from Finland and electric goods from China, while imports of these goods reverted to the long-term average level.

Services exports continued to grow, reaching new historic peaks. An increase in travel services was observed – stimulated by higher tourism activity, the organisation of international events, and favourable weather. Rapid growth in exports of information and communications technologies, as well as professional and other economic services continue. At the same time, exports of air carrier services have decreased mainly due to SmartLynx Airlines, which announced the cessation of its economic activities. Furthermore, the activity of port and railway services remain low.

When it comes to services imports, construction services have continued to rapidly expand, supported by the development of large projects and upgrading the energy infrastructure. Imports of information and communications technologies and other professional services are also on the rise. This reflects higher demand for such services. Travel imports have also exhibited a positive trend, suggesting the growth in travel by Latvian consumers.

Economic sectors

As trade policy uncertainty eases, growth in manufacturing – where substantial investments have previously been made – is set to accelerate. Additional investment in strengthening defence capacity is also improving the sentiment of economic agents and will continue to support consumption and investment decisions in both the short and long term, thereby reinforcing retail, construction, and industrial development.

As a result of a more optimistic outlook for external demand and the increased production capacity stemming from substantial investments in previous years, manufacturing is projected to continue growing. Moreover, already this year, growth is broad-based across a wide range of subsectors. The previously persistently stagnating segment of food processing is growing, while the segment of construction goods (wood, non-metallic mineral products, and metal structures) has started to recover. Following last year's slowdown, faster growth has also resumed in the high-tech segment, including electronics and the manufacture of electrical engineering and other equipment. Company information suggests that further growth is expected across all these segments. In addition, investments in new production facilities have expanded the product portfolios of these sectors, which also enables the diversification of export markets. Among other actions taken, Latvian entrepreneurs have responded rapidly to opportunities arising from increased countries' defence expenditures by also offering their services and products to this market, as well as by ensuring the conditions for producing such goods, including obtaining the necessary production quality certifications.

At the same time, the potential for expanding export markets may be limited in product categories that must compete with low-priced, sanctioned Russian goods. For instance, exports of wood industry products to countries such as Turkey, the United Arab Emirates, the CIS countries, and Vietnam – where cheap plywood, sawn timber, and similar goods imported from Russia are preferred – are declining.

The future growth of the construction sector will be supported by a more active implementation of construction projects in both the public and private sectors. While construction activity is recovering this year, growth across different segments, however, remains uneven. Building construction volumes are increasing, particularly in the segment of residential buildings, as household demand gradually recovers, supported by lower interest rates and rising mortgage lending. Construction volumes for industrial and commercial buildings remain stable, reflecting sustained investment activity and ongoing business development plans. However, the main pillar of growth in the sector remains civil engineering, supported by the implementation of infrastructure projects in road construction and municipal infrastructure development.

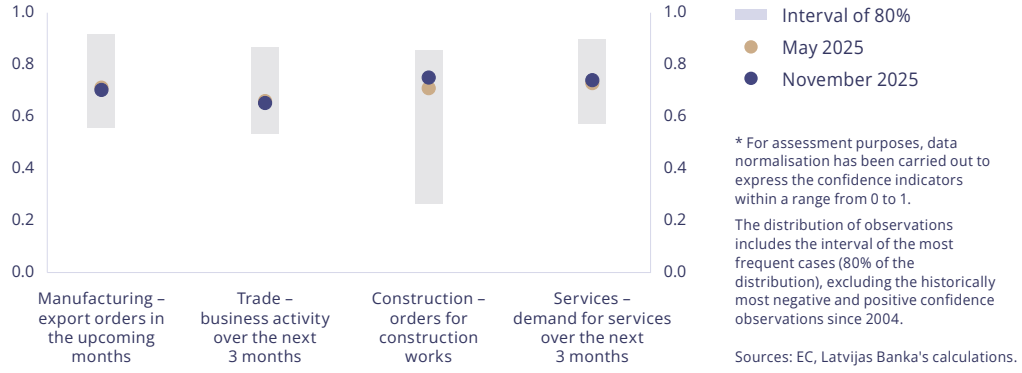
Construction costs remain stable. This ensures predictable implementation and profitability of projects for construction contractors who remain optimistic about future cost stability and order volumes. At the same time, investment dynamics remain highly cautious, particularly regarding new residential projects, where investment inflows remain weak.

Improving consumer sentiment, reduced uncertainty, and stronger projected income growth will support retail sales growth. Retail turnover growth accelerated as early as the third quarter of 2025 and was observed across most broad product groups such as housing-related goods, various non-food goods, as well as food and fuel retail. Domestic retail of information and communication technology goods faces competitiveness challenges, as evidenced by card-based payment data, which have for some time already shown a sharp rise in remotely initiated payments made abroad, while domestic non-remotely initiated payments for this group of goods are stagnating. Mortgage lending growth reflects not only the maintenance of more favourable lending conditions but also, to some extent, improved consumer sentiment, i.e. a preference for long-term investment. Income is rising faster than previously projected, as the labour market remains relatively tight. Income growth could provide an additional positive contribution to sales of goods for house improvements in the medium term.

Growth in the transport sector will recover later than expected, as the performance of the sector is constrained by a sluggish recovery in international trade activity and persistently high trade uncertainty. Activity in the road transport sector is gradually increasing; however, growth is expected to recover later than previously projected. As economic activity and demand recover, domestic and export freight transportation is gradually expanding, while freight turnover in international transport has been weaker than expected. The persistently cautious outlook of transport companies regarding the future development of demand suggests that activity in foreign markets will remain moderate for longer, particularly in European countries where Latvian road carriers have previously strengthened their market shares.

The performance of the aviation sector has been weaker than expected. Passenger flows at Riga Airport have been affected by adjustments to airBaltic's routes and cost optimisation measures, while SmartLynx Airlines has announced the cessation of its economic activity. In the medium term, the sector's growth prospects will be driven by a gradual increase in domestic demand and lower fuel price forecasts, as global oil production volumes rise. At the same time, the limited supply of sustainable aviation fuel (SAF) is expected to persist, increasing carbon-related costs in aviation. Uncertainty regarding the future development of airBaltic remains high. The company's planned initial public offering (IPO) has yet to be implemented, and scenarios for the sector's future growth remain uncertain.

Chart 21. **Assessment of future business growth by economic sectors** (coefficient, 3-month moving average)



* For assessment purposes, data normalisation has been carried out to express the confidence indicators within a 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: EC, Latvijas Banka's calculations.

Labour market – unemployment

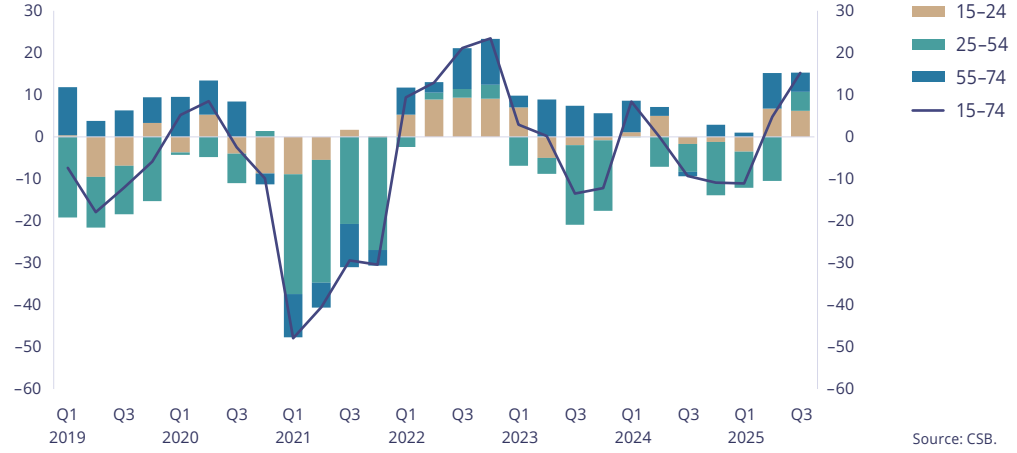
Unemployment is on the decline and, as previously projected, is approaching 6% in the medium term. Labour demand remains resilient, as also suggested by business expectations for employment.

Projections	2024	2025		2026		2027		2028
	Actual	June	**Dec.**	June	**Dec.**	June	**Dec.**	**Dec.**
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	6.9	6.9	6.7	**6.6**	6.5	**6.4**	**6.2**

Employment will remain resilient as private sector activity picks up. The increase in business activity will raise labour demand, further tightening labour resources in the labour market. The private sector is taking the lead in boosting employment, and business expectations for the end of 2025 suggest that this trend is most likely to continue in the short term. In addition, large investment projects are expected to be implemented in the medium term, generating additional demand in the labour market.

In the short term, the number of economically active people is expected to grow. This will be supported by increased private sector activity and a wider range of job opportunities, which may also attract previously inactive individuals who were not seeking employment. Growth will continue across the 15–24 and 55–74 age groups. This will be reinforced by the possibility of part-time work in the private sector, as students and pensioners may not be subject to minimum social contributions. In the medium term, however, the demographic structure will gradually change, weighing on the level of economic activity in the labour market. The number of young people of working age entering the labour market, as well as the number of middle-aged workers, will start to decline, while the labour market will gradually become dominated by older individuals, who traditionally exhibit lower economic activity. Although an increasing share of the population will choose to continue working, at least partially, after reaching retirement age, their production capacity will be limited in the future due to health constraints.

Chart 22. **Changes in the economically active population by age group** (annual changes, thousands)



Source: CSB.

The forecast for the unemployment rate has remained almost unchanged. Although the number of economically active people has grown, labour demand in the economy will remain resilient and will therefore absorb the free labour force that has recently entered the labour market. Moreover, as the demographic situation deteriorates, labour supply will decline and the average age of employees will rise. This, in turn, will exacerbate labour shortages, as a higher average age of the population, constrained by health limitations, reduces not only its activity rate but also its capacity to work full-time.

Labour market – wages

Wage growth will remain strong throughout the projection horizon. This is driven by persistent labour shortages. Moreover, the forecast for wage growth has been revised upwards in light of higher labour demand in the private sector.

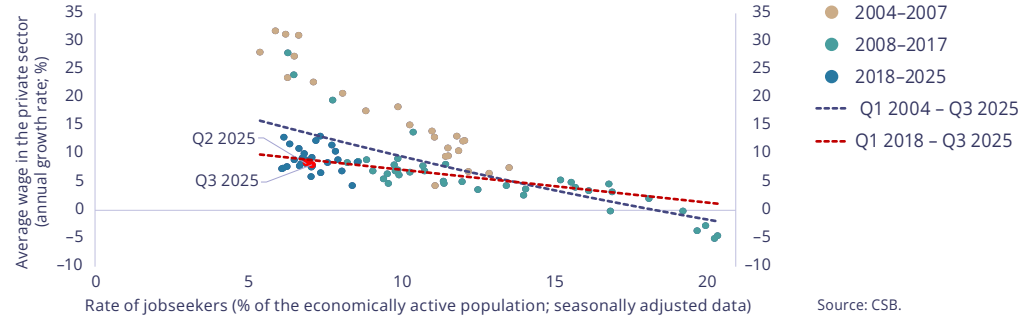
Projections	2024	2025		2026		2027		2028
	Actual	June	**Dec.**	June	**Dec.**	June	**Dec.**	**Dec.**
Nominal gross wage (annual changes; %)	9.7	6.0	**8.0**	6.3	**7.6**	6.3	**7.6**	**7.9**

The private sector will be the main driver of wages in the medium term. The improvement in the economic situation and the depletion of labour resources will continue to support wage growth. As private sector activity picks up, stronger competition for labour is expected in the coming years, reinforcing the increase in the average wage. Meanwhile, the wage growth forecast for 2025 has been revised upwards, mainly due to higher public sector wages. This was due to a lower-than-expected impact of a cap on the growth of the public sector compensation fund.

Amendments to the wage legislation are also underway, with their impact on wages expected to be upward rather than downward. The changes will ensure income growth for lower wage earners and help maintain their purchasing power. Amendments to the minimum wage regulation are expected. In line with the current methodology for calculating the minimum wage, it will be increased to 780 euro[3], while the minimum wage in the construction sector will also rise to 1050 euro [4]. There is an active discussion on reducing the minimum overtime allowance from 100% to 50% by 2026, which could slow the rise in the average wage next year.

Investment projects planned by companies to introduce new technologies and automation will increase productivity and may reduce the need for labour. However, labour shortages in the economy will persist overall throughout the projection horizon, with wage growth projected to outpace productivity growth.

Chart 23. **Phillips curve** (2004–2025)



Source: CSB.

[3] On the amount of the minimum monthly wage in 2026, the Ministry of Welfare, NTSP, 19.09.2025.

[4] The minimum wage in 2026, the Trade Union of the Latvian construction sector, 15.09.2025.

Inflation

The inflation forecast has been revised upwards for the entire projection horizon and remains in a range of 3–4%. Stronger wage growth puts pressure on both the demand and the cost sides, while being the main driver of inflation over the projection horizon.

Projections	2024	2025		2026		2027		2028
	Actual	June	**Dec.**	June	**Dec.**	June	**Dec.**	**Dec.**
Inflation (HICP; annual changes; %)	1.3	3.4	**3.9**	2.1	**3.2**	2.8	**2.9**	**3.6**

The assumptions for global oil, natural gas, and agricultural product prices have not changed significantly. Although no additional pressure from external price developments has been observed since June, inflation in Latvia has exceeded the June forecasts. This can be partly explained by higher-than-expected wage increases; however, price developments have also been influenced by other factors. For example, energy prices have risen faster than expected (mainly due to higher regulated heating tariffs in Riga).

Chart 24. **Oil price** (euro per barrel)

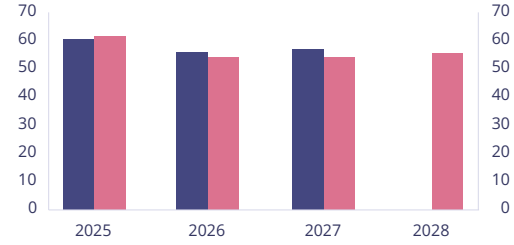


Chart 25. **Natural gas price** (euro/MWh)

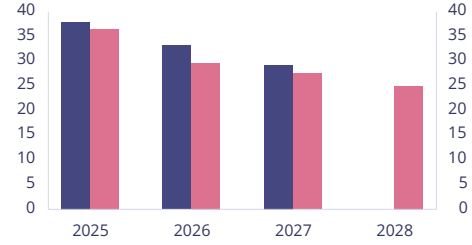
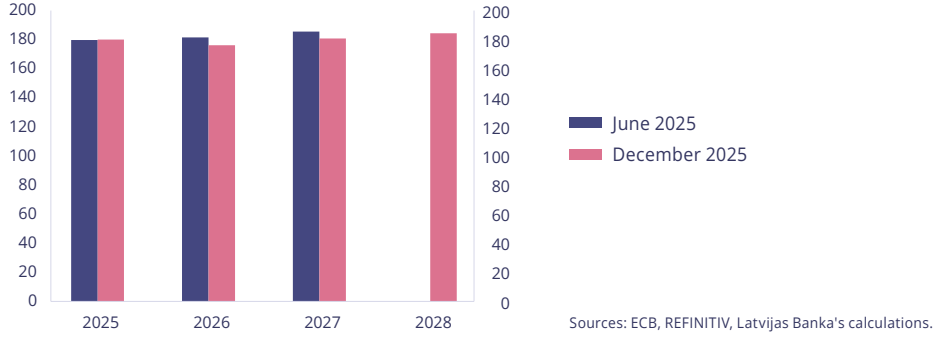


Chart 26. **Price of agricultural products** (index, 2015=100)

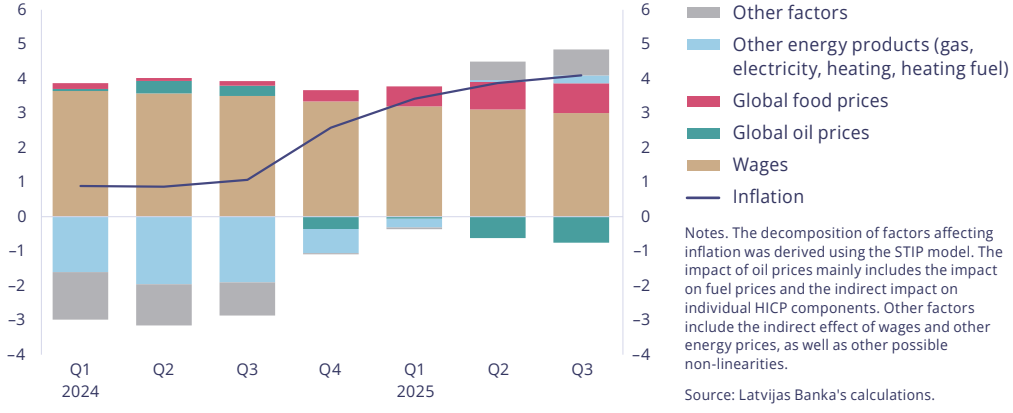


Sources: ECB, REFINITIV, Latvijas Banka's calculations.

As a result of higher projected wage growth, the inflation forecast has been revised upwards. In line with the correlations of the short-term inflation projection model (STIP) used by Latvijas Banka, the wage forecast that has been significantly revised upwards since June implies increased pressure on price growth. As a result of wage growth, the inflation forecast has been raised by 0.5 percentage points in both 2026 and 2027. An increase in the minimum wage in 2026 has also been confirmed. Higher projected wage growth in 2028 also indicates

that inflation – particularly core inflation related to changes in the prices of labour-intensive services – is expected to remain resilient throughout the entire projection horizon in Latvia.

Chart 27. **Decomposition of factors affecting inflation** (annual changes and contributions, % and percentage points)



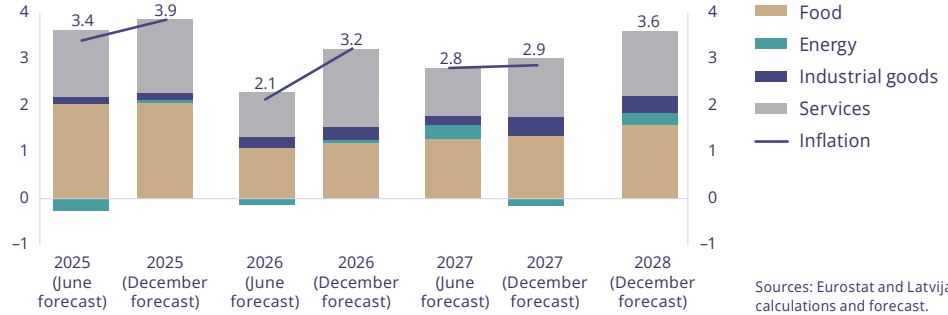
Notes. The decomposition of factors affecting inflation was derived using the STIP model. The impact of oil prices mainly includes the impact on fuel prices and the indirect impact on individual HICP components. Other factors include the indirect effect of wages and other energy prices, as well as other possible non-linearities.

Source: Latvijas Banka's calculations.

The upward revision of the inflation forecast is also driven by new incoming data showing higher indicator values and expert judgement on the dynamics of the indicators. Administratively regulated prices are expected to rise in the coming months (including higher regional public transport fares from January 2026 and increases in water service and waste management tariffs in some cities, etc.). Moreover, given that changes in administratively regulated tariffs tend to follow developments in the prices of other goods and services, the increase in administratively regulated prices is projected to be sustained in 2026. In addition, higher consumer price index data in the second half of 2025 also raise the level of this indicator for the following year. Moreover, due to recent forecasting model errors, an upward expert judgement has been added to the forecast, particularly for 2026 but also throughout the entire projection horizon, as various consumer surveys and incoming inflation data suggest that the impact of a period of rapid wage growth on price growth is stronger than implied by the forecasting model's long-term data correlations.

A number of tax changes are planned over the projection horizon. Excise duty rates will be adjusted for a number of products, and VAT will be increased for the press and books not issued in the national language (or in the official language of an EU country, an OECD member state, or a candidate country). However, in 2026, the most significant impact on inflation will come from the planned reduction in VAT for certain food products (milk, bread, eggs, and chicken), from 21% to 12%, effective from July 2026. These changes will help to somewhat delay the increase in food prices. If the VAT reduction is fully reflected in retail food prices[5], the impact on inflation in 2026 will be –0.2 percentage points. If the VAT rate for these products is increased again in 2027 as planned, the impact on inflation in that year will be zero (as the first half of the year is expected to be subject to the lowest rate, while the second half is expected to be subject to the highest rate), and inflation in 2028 will be 0.2 percentage points higher accordingly.

Chart 28. **Harmonised consumer price inflation in Latvia and contributions, changes in the forecast** (annual changes, percentage points)



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

[5] However, it should be noted that the pass-through to consumer prices is usually incomplete (see, for example, O. Krasnopjorovs, "Year with reduced VAT rate for fruit and vegetables: First results" (available in Latvian), macroeconomics.lv, 07.01.2019).

Assumptions about the introduction of ETS2 have changed since June (see Box 3). As the introduction of the common ETS2 is most likely to take place one year later (in 2028) than previously planned, its strongest impact on Latvian consumer prices will occur in 2028 rather than in 2027 (increasing inflation in 2028 by 0.3 percentage points respectively).

Box 3. What is ETS2 and how does it affect prices in Latvia?

Scenario 3. Macroeconomic impact of various ETS2 revenue recycling options in the euro area and Latvia

Scenario analysis: Scenario 1

Possible impact of fiscal consolidation on the Latvian economy[1]

Motivation

According to the budget framework for 2026-2028, the government debt level will have reached 55% of GDP in 2028 and the budget deficit will exceed 3% of GDP throughout the period. Meanwhile, in 2029, a number of temporary conditions and derogations that had previously allowed fiscal policy to remain accommodative will expire. This will increase the need for fiscal consolidation. This scenario models possible budgetary consolidation paths and their economic impact.

In its communication of 19 March 2025 on accommodating increased defence expenditure within the Stability and Growth Pact[2], the EC invited EU Member States to make use of the flexibility offered by the national escape clause (NEC) to facilitate, as much as possible, the transition to a consistently higher level of defence expenditure. The activation of the NEC allowed Member States to temporarily (until 2028) deviate from the fiscal policy constraints approved by the Council of the EU. Latvia applied for the activation of the NEC and additionally allocated around 2.6% of GDP to security needs over a three-year period[3]. However, the derogation will no longer be in force in 2029, applying only to military supplies contracted during the period of the NEC's validity. This means that exceeding 3% of GDP deficit for other reasons will no longer be feasible without risking the triggering of the excessive deficit procedure. For Latvia, this may imply a consolidation of around 0.4% of GDP over a one-year period.

In 2029, the reallocation of 1 percentage point of state social security contributions from the 2nd to the 1st pension pillar will end. This will require additional fiscal consolidation of approximately 0.3% of GDP.

Furthermore, the construction of the Rail Baltica project will remain on the agenda, with commitments to build the main line, connecting Tallinn and Vilnius, by 2030. This means that, alongside potentially available external funds, substantial co-financing will also need to be secured from the state budget, which could require additional funding of at least 0.5% of GDP in 2029.

The EU funds programming period for 2021–2027 will also gradually draw to a close. Experience shows that the transition between programming periods in Latvia is not smooth and involves large fluctuations in financing, which reduces the amount of public procurement in the short term. The national envelope proposed for Latvia under the EU Multiannual Financial Framework for 2028–2034 is broadly comparable to the level of the current programming period. However, in view of price developments, the total investment in the economy is expected to be lower.

The National Armed Forces (NAF) aim to significantly expand peacetime personnel by 2029. The introduction of the national defence service will result in a temporary withdrawal of labour

[1] Prepared by Baiba Brusbārde, Ginters Bušs, and Kārlis Vilerts, economists of Latvijas Banka.

[2] Accommodating increased defence expenditure within the Stability and Growth Pact, European Commission, 19.03.2025.

[3] Explanatory notes to Draft Law 25-TA-2441 "On the State Budget for 2026 and the Budget Framework for 2026, 2027, and 2028" (14.10.2025) (Table 2.13 of Chapter 2 ("Fiscal Policy"): the fiscal impact of the national escape clause amounts to 0.48% of GDP in 2026, 1.10% of GDP in 2027, and 1.00% of GDP in 2028), totalling 2.6% of GDP over the period.

from the labour market, given that full-time service lasts 11 months. Overall, the expansion of the NAF personnel and the introduction of regular training [4] may constrain the availability of the total labour force in the wider economy.

Due to this set of circumstances, Latvia's economy and fiscal policy will face a number of challenges in 2029, which are likely to require significant budgetary consolidation to ease the pressure on a further increase in government debt. If government debt exceeds 60% of GDP, the EC has the right to intervene in national fiscal policymaking, as a lack of effective action may lead to penalties.

Taking into account **the NEC (0.4% of GDP)** and **the end of the redistribution of national social security contributions (0.3% of GDP)** as well as the national co-financing required for the construction of the **Rail Baltica project (0.5% of GDP)**, this scenario models a b**udgetary consolidation of 1.2% of GDP in 2029**.

Simulation

In order to assess the impact of fiscal consolidation on Latvia's economy, Latvijas Banka has carried out an analysis using the DSGE model for Latvia [5].

Five scenarios are modelled as part of the simulation, and all scenarios aim at a consolidation amounting to 1.2% of GDP.

Scenario 1 envisages a reduction in expenditure (excluding expenditure that cannot be reduced, such as debt servicing) ***in proportion to its budgetary share***, while maintaining public employment at its current level.

Scenario 2 envisages expenditure cuts of 0.9 % of GDP in proportion to its budgetary share, additionally ***reducing public employment*** by approximately 4%, thus bringing the public employment rate closer to that of Estonia [6]. It is assumed that the volume of services provided by the public sector remains broadly unchanged, while the laid-off employees do not take up employment in the private sector. The reduction in the wage bill is modelled as a decrease in government consumption by 0.3% of GDP.

Scenario 3 is analogous to Scenario 2 but assumes that half of the laid-off employees (around 0.5% of the labour force) enter the private sector labour market within six months. The remaining employees either join the pool of the long-term unemployed (around a third of the unemployed in Latvia) or pensioners or, due to other circumstances, leave the labour market over the medium term.

Scenario 4 envisages an increase in revenue by raising the VAT rate by around 3 percentage points.

Scenario 5 envisages a rise in revenue by raising all taxes and taking into account their share in the budget.

The results of the simulation (Chart 1.1) show that the third consolidation scenario is the least harmful for the Latvian economy in the medium term. This scenario involves reducing expenditure along with cuts in the number of public sector employees, with some transitioning

[4] According to the plan "Long-term Development of the National Armed Forces in 2025–2036", the peacetime force of 31 000 troops will consist of 4000 national defence service conscripts serving 11-month terms, 8000 professional soldiers, 12 000 National Guard personnel, and 7000 high-readiness reserve soldiers, who are called up annually for training to maintain their skills and combat readiness. A further 30 000 troops will form the general readiness reserve, consisting mainly of those who have completed service in the high-readiness reserve and the National Guard. Their skills will be maintained at an individual level through cyclical call-ups for training once every four years.

[5] Bušs, G., & Grüning, P. (2023). Fiscal DSGE model for Latvia. Baltic Journal of Economics, 23(1), 1–44.

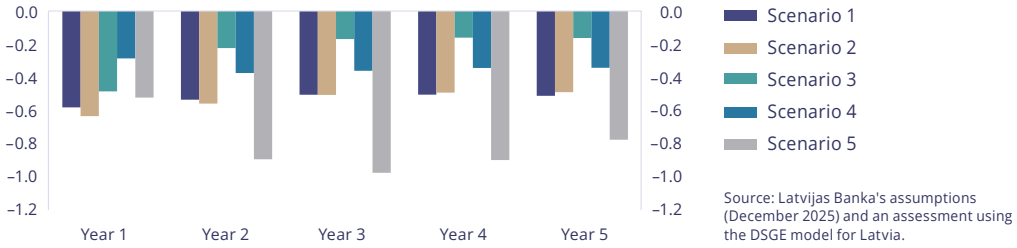
[6] See Public sector employment as a share of total employment, 2020 (OECD): Latvia 22.7%, Lithuania 22.3%, and Estonia 21.5% (data last updated on 1 November 2023; accessed on 20 November 2025)

to work in the private sector. However, if such a transition does not occur or the situation corresponds to the second scenario, it becomes one of the most economically unfavourable consolidation paths, comparable in terms of impact to linear expenditure cuts. In particular, the reduction in the number of employees in the public sector is envisaged to occur when private sector companies require additional labour force.

The results also draw attention to the fact that the structure of the expenditure cuts has a significant effect. International studies as well as research by Latvijas Banka show that limiting public investment is one of the least economically efficient consolidation paths[7]. Therefore, a well-considered reduction in expenditure is critical to the consolidation of the expenditure side.

According to the results of the model, the second least harmful solution for the economy is to raise consumption taxes. By contrast, increasing revenue by raising all taxes proportionally to their budgetary share has the strongest negative impact on the economy in the medium term, particularly due to higher employer mandatory state social security contributions, which would directly weaken the competitiveness of Latvian firms.

Chart 1.1. **Impact of consolidation on Latvia's GDP, cumulative deviation from the initial level** (%)



Source: Latvijas Banka's assumptions (December 2025) and an assessment using the DSGE model for Latvia.

It can be concluded that ensuring an effective fiscal consolidation process with minimal adverse effects on the economy requires a targeted approach and timely preparatory work. This includes planning a public sector employment reform and developing support mechanisms for retraining employees to ensure their effective integration into the private sector labour market. Moreover, fiscal policy instruments should be carefully assessed, prioritising consolidation paths with the most favourable economic impact.

[7] IMF Working Paper "The Fiscal Multiplier of Public Investment: The Role of Corporate Balance Sheet", WP/20/199, September 2020; Bušs, G., & Grüning, P. (2023). Fiscal DSGE model for Latvia. Baltic Journal of Economics, 23(1), 1–44.

Scenario analysis: Scenario 2

Macroeconomic impact of lending growth[1]

Motivation

Since the beginning of 2024, lending activity in Latvia has significantly increased. This is the case for loans to both households and non-financial corporations, with the amount outstanding having increased by 19% and 14% respectively since the beginning of 2024. Several factors contributed to the recovery of lending: the easing of lending standards by credit institutions, the government's policies, as well as decisions by the Governing Council of the ECB, which have resulted in a decrease in key interest rates from 4% to 2% since June 2024.

The DSGE model for Latvia has been used to assess both the past and future effects of lending on the Latvian economy[2]. The model enables detailed analysis of how different loan types affect the economy.

Scenario description

The scenario assessment consists of past and future lending estimates. The reference point is the beginning of 2024, when lending was at its lowest. The impact of the past lending recovery is thus assessed against a scenario where the loan-to-GDP ratio is assumed to have remained unchanged from its early-2024 level. For the period beyond 2025, two scenarios for lending development are envisaged.

- Moderate scenario: between 2026 and 2028, the annual growth rate of the loan portfolio amounts to 8% (corresponding to the average growth rate over the last two years).
- Rapid scenario: between 2026 and 2028, the annual growth rate of the loan portfolio amounts to 16% (corresponding to the growth rate during the third quarter of 2025).

The scenario analysis further assumes that loans are allocated for specific purposes, in line with the structure of the current loan portfolio:

- investment loans to non-financial corporations (32% of total loans);
- short-term loans to non-financial corporations (16% of total loans);
- mortgage loans to households (43% of total loans)[3];
- consumer loans to households (9% of total loans).

Results

The results of the scenario analysis suggest that the improvement in lending activity provided a significant boost to economic growth. The lending increase observed over the last two years has supported real GDP growth by approximately 1.5%, mainly owing to a rise in outstanding mortgage and investment loans.

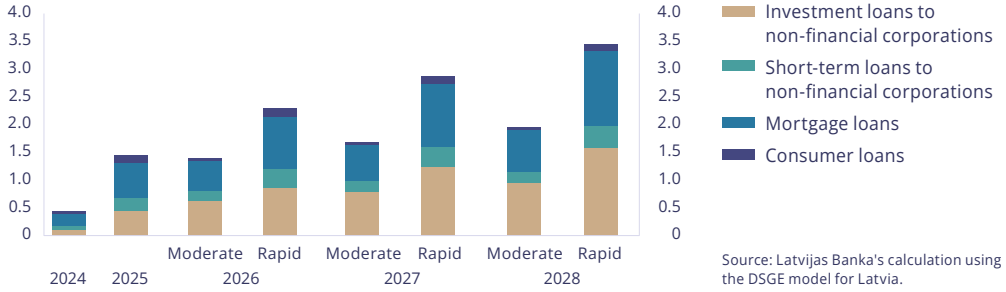
If lending activity continues at its current pace (rapid scenario), its cumulative contribution to economic growth could reach roughly 3.4% by the end of 2028. In the case of less rapid lending growth, this contribution would be close to 1.9%.

[1] Prepared by Ginters Bušs and Klāvs Zutis, economists of Latvijas Banka.

[2] Bušs, G., & Grüning, P. (2023). Fiscal DSGE model for Latvia. Baltic Journal of Economics, 23(1), 1–44.

[3] The ratio between consumption and investment is assumed to be 2:1 for short-term loans to non-financial corporations and 1:1 for mortgage loans to households.

Chart 2.1. **Impact of lending on GDP** (deviation from the baseline scenario, %)



Source: Latvijas Banka's calculation using the DSGE model for Latvia.

Conclusions

Lending is a key facilitator of economic growth, and the improvement in its activity has already been reflected in real GDP growth. The scenario analysis shows that, as lending continues to improve, it can have a significant positive impact on economic activity. In Latvia, the loan-to-GDP ratio remains among the lowest in the euro area, pointing to large untapped potential. To fully harness the growth-enhancing potential of lending, it is important to ensure that the recent recovery is not short-lived.

Scenario analysis: Scenario 3

Macroeconomic impact of various ETS2 revenue recycling options in the euro area and Latvia[1]

Motivation

In its June 2025 Macroeconomics Projections Report, Latvijas Banka analysed the effect of the introduction of the second EU Emissions Trading System (ETS2) in 2027 for household heating in detail. However, the analysis did not cover the full ETS2 introduction (as it is also foreseen to be applied to fossil-based fuels for road transport) nor did it feature an analysis on the use of revenues from ETS2. Additionally, the EU has recently decided to delay the introduction of ETS2 by one year to 2028 to give EU Member States more time to prepare for ETS2 implementation, leading to higher uncertainty on the prices of emission certificates within ETS2.

Therefore, Latvijas Banka has conducted a scenario analysis focusing on the impacts of various ETS2 revenue recycling options for the euro area and Latvia on GDP, using updated price paths for the first three years of ETS2, based on an environmental dynamic stochastic general equilibrium (E-DSGE) model for the euro area[2] and the CGE-EUROMOD model for Latvia[3].

[1] By Patrick Grüning and Oļegs Matvejevs, research economists at Latvijas Banka.

[2] See Grüning, P. & Kantur, Z. (2023), "Stranded Capital in Production Networks: Implications for the Economy of the Euro Area", Latvijas Banka Working Paper No 6/2023.

[3] See Benkovskis, K., Jaunzems, D. & Matvejevs, O. (2023), "A Purpose-Based Energy Substitution Structure For CGE", Latvijas Banka Working Paper No 7/2023.

Description of the models and conducted simulations

To analyse the impact on the euro area (EA) economy, a closed economy multi-sector E-DSGE model with production and investment networks is used.[4] The model encompasses 44 sectors[5], calibrated to the euro area using input-output tables from the FIGARO database.

In turn, the CGE-EUROMOD model is used to assess the impact on Latvia. This model incorporates all linkages between narrow sectors and thus explicitly features a break-down of the energy sector into the heating, natural gas, and electricity industries, as well as an enhanced production structure that allows for a more realistic substitution of energy goods.

In the analysis, the focus is placed on the medium-term effects of the ETS2 introduction and associated revenue recycling schemes, i.e. up to five years. Two different price paths for an ETS2 emission certificate are used in the subsequent analysis. As the benchmark scenario, a price of EUR 46 per tonne of carbon dioxide equivalent in 2028, a price of EUR 58 in 2029, and a price of EUR 62 in 2030 is assumed. As an alternative, a higher price scenario with the following sequence of prices in 2028, 2029, and 2030 is assumed: EUR 59, 61, and 62 respectively.[6] After these three years, any changes to the economy relative to the scenario without ETS2 are only those reflecting the adjustment to higher carbon prices, for example, they capture the adoption of greener heating and road transport technologies (e.g. heat pumps and electric vehicles).

Four distinct revenue recycling options are considered. As the baseline, in the first scenario,

[4] The presence of production networks implies that the production of a certain good requires the input of goods from other sectors in the economy. Additionally, investment in the modernisation or extension of a specific sector's productive capabilities also requires the input of other sectors' goods to capture investment networks in the model.

[5] The NACE sectors A (agriculture, forestry and fishing), C (manufacturing), G (wholesale and retail trade, repair of motor vehicles and motorcycles), and H (transportation and storage) are present in the model at NACE 2 level, while all other sectors are present in the model at NACE 1 level only. The NACE sectors T (activities of households as employers; undifferentiated goods- and services-producing activities of households for own use) and U (activities of extra-territorial organisations and bodies) are not represented within the model due to their negligible importance and poor data coverage.

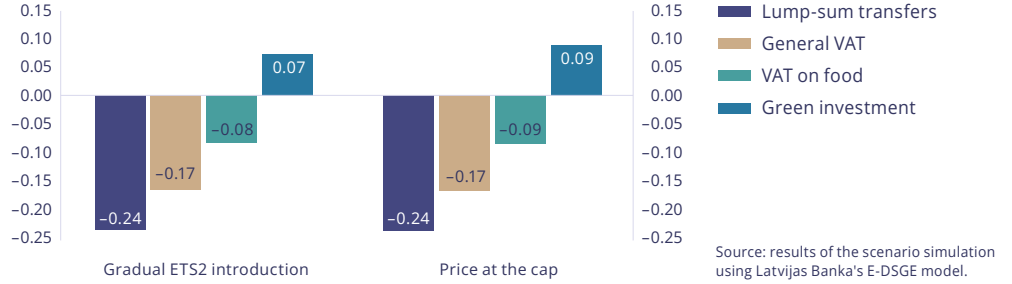
[6] This is a useful "worst-case" scenario because these prices correspond to the previously legally set maximum price of one EU ETS2 allowance.

we consider a less productive use of ETS2 revenues: lump-sum transfers to households in the E-DSGE model and a proportional increase in government consumption in the CGE-EUROMOD model. In the second scenario, we simulate a reduction of value added taxes (VAT), reducing government budget revenues by the same amount that ETS2 generates. For both the EA and Latvia, we analyse the result of a homogenous reduction of the VAT rate for all consumption goods and, in a separate scenario, a reduction only for food consumption goods,[7] which is motivated by the persistent food price inflation in recent years that has a greater impact on less wealthy households. Finally, another revenue recycling option uses the revenues to provide investment subsidies to sectors that are instrumental in providing goods and services for the build-up of renewable energy capacity.[8] In the last scenario, we also assume that the price of electricity declines due to a productivity increase in NACE sector D, which includes electricity.

Economic impact of various ETS2 revenue recycling options

The results of the model simulation[9] for the euro area, depicted in Chart 3.1, suggest that EA GDP is 0.24% lower five years after the introduction of ETS2 in 2028 if the revenues are not recycled in a productive fashion (i.e. lump-sum transfers to households), using the benchmark price path.[10] Note that the additional revenues generated by ETS2 amount to about 0.25% of GDP, or roughly EUR 44.4 billion annually if using euro area GDP in 2024. This GDP reduction can be contained to 0.17% or 0.07% respectively by reducing VAT rates for all consumption goods or only food consumption goods.[11] Furthermore, the consumer price index does not substantially increase in these cases.[12] The effect on GDP after five years even turns slightly positive (+0.07%) if the ETS2 revenues are used to provide investment subsidies.[13] Note that these productive recycling options have the drawback of reducing the aggregate tax revenue to GDP ratio due to second-round effects (higher consumption of less taxed sectors and a shift from consumption to investment). The alternative, higher price scenario leads to marginal differences after five years. The GDP reduction is slightly higher after one year, –0.19% vs –0.17% if ETS2 revenues are used as lump-sum transfers.

Chart 3.1. **EU ETS 2 revenue recycling options: 5-year GDP impact in the EA** (change relative to current policy, %)



Source: results of the scenario simulation using Latvijas Banka's E-DSGE model.

[7] The sectors providing food consumption to households are: NACE sectors A01 (crop and animal production, hunting and related service activities), A03 (fishing and aquaculture), and C10T12 (manufacture of food products, beverages, and tobacco products).

[8] These sectors are: NACE sectors C25 (manufacture of fabricated metal products, except machinery and equipment), C27 (manufacture of electrical equipment), C28 (manufacture of machinery and equipment, not elsewhere classified), F (construction), and M (professional, scientific and technical activities).

[9] The relevant sectors that are exposed to the novel EU ETS2 regulation are the following NACE sectors: C19 (manufacture of coke and refined petroleum products), D (electricity, gas, steam and air conditioning supply), G47 (retail trade, except of motor vehicles and motorcycles), and H49 (land transport and transport via pipelines). EU ETS2 is introduced in these sectors via an emission-based sales tax since firms rather than consumers must buy the emission certificates. Since 40% is the fraction of buildings' heating in the final energy consumption of the residential and commercial sectors, only 40% of the total GHG emissions of sector D are taxed. Furthermore, since 36% is estimated to be the share of gasoline consumption within household consumption of sector G47 goods and services, only 36% of the total GHG emissions of sector G47 are taxed.

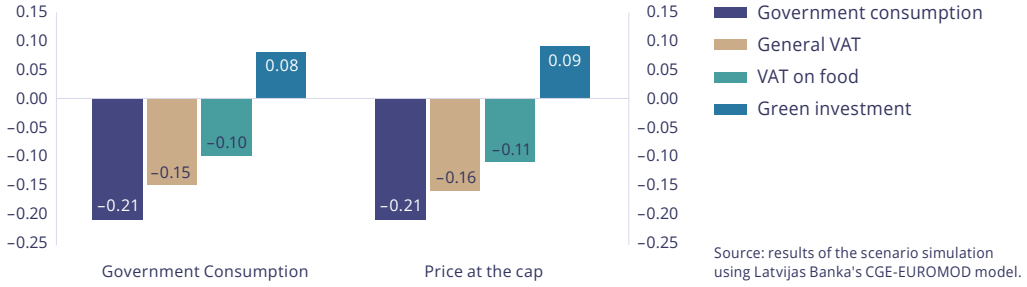
[10] Additionally, there are higher prices due to a persistent inflation increase of 0.11 pp after 5 years and reductions in consumption (–0.13%) and investment (–0.63%). The good news being that greenhouse gas emissions are reduced by 0.41%.

[11] The reason for the stronger effect of the food VAT reduction is the relatively large VAT reductions in the food sectors (–3.65 percentage points vs –0.36 percentage points in the general VAT reduction scenario) that combined have a rather high share in the consumption basket of households and, due to the input-output linkages, in the model.

[12] Indeed, HICP inflation is even slightly negative at –0.07 pp and –0.09 pp in the two VAT reduction scenarios. Due to the stimulated consumption, the emission reduction turns out to be smaller as well, i.e. –0.31% and –0.27% respectively.

[13] It should be noted, however, that this comes at the cost of substantially lower household consumption (–0.74%) and a stronger price response (HICP inflation still up by 0.19 pp after five years), as well as higher short-run GDP costs (–0.19% with investment subsidies vs –0.17% with lump-sum transfers after one year of the introduction of EU ETS2). However, there is a greater decrease in greenhouse gas emissions (–0.49%).

Chart 3.2. **EU ETS 2 revenue recycling options: 5-year GDP impact in Latvia** (% change relative to current policy)



Source: results of the scenario simulation using Latvijas Banka's CGE-EUROMOD model.

The results for Latvia, obtained[14] from the CGE-EUROMOD model, are depicted in Chart 3.2 and are quite similar to those for the euro area. After the introduction of ETS2, if the collected tax revenue[15] is utilised to proportionally increase government consumption, economic activity decreases in the medium term, with real GDP being 0.21% lower than in the case without ETS2.[16] Moreover, the increase in government consumption has the largest price effect, with HICP inflation being 0.1 percentage points higher after five years[17]. If, considering that the ETS2 constitutes a higher tax burden, the government decides to lower VAT equally on all goods, Latvia's economy would decelerate by 0.15%,[18] with inflation being marginally lower than in the counterfactual scenario. In turn, if the VAT is reduced only on food, the economic slowdown becomes 0.10%.[19] Finally, if revenues from ETS2 are recycled back into the economy through supporting green investment, in particular, the development of renewable energy generation capacity[20], GDP will increase by 0.08%. More renewable energy gradually leads to reduced electricity prices, which boosts the competitiveness of the whole economy, raising employment and export.[21] However, the positive impact on household income is just 0.01% in this scenario relative to the scenario without ETS2.[22]

The difference between a gradual and an abrupt introduction of ETS2 plays only a minor role in determining the magnitude of economic effects in the first years, while becoming immaterial 4–5 years after the start of ETS2.

Concluding remarks

The usage of revenues generated by ETS2 from 2028 onward can have a profound effect on the economic impact of ETS2. Relative to providing lump-sum transfers to households or increasing government consumption, limiting the increase in the total tax burden by reducing VAT rates, decreases the inflationary effect of ETS2 and results in a relatively higher GDP. However, greenhouse gas emissions do not decrease as much. If the revenues are used to stimulate green investment, the combined impact on the economy after five years becomes even slightly positive and greenhouse gas emissions decrease even more. However, in the short run, the inflationary response and costs to households are amplified in this scenario.

[14] Since the improved CGE model features an improved energy sector with a standalone heating industry (35.3 rather than Sector D together) and each energy good including diesel, gasoline, LPG separately, as well as GHG emissions accounting and carbon pricing blocks, the additional EU ETS2 cost is directly imposed on the heating industry and road transportation fuels proportionate to the amount of greenhouse gases they produce. No change in the rest of the world is assumed in the scenario analysis.

[15] The government budget revenues increase by approximately EUR 120 million when the EU ETS2 carbon price is set at EUR 46/tCO_2e or 0.29% of Latvia's GDP and by around EUR 150 million in total (0.37% of GDP) when the price of the EU ETS2 allowance reaches EUR 62/tCO_2e.

[16] The price of heating is 7% higher in the medium term, and Latvia's total GHG emissions are 0.12% lower.

[17] The price level relative to the counterfactual scenario (accumulated HICP inflation difference over five years) constitutes 0.7 pp.

[18] The price of heating is 6% higher in the medium term, and Latvia's total GHG emissions are only 0.03% lower.

[19] If EU ETS2 revenue is used to lower VAT on food only, the average real wage becomes 0.07% lower, whereas total private consumption falls only by 0.03% because food constitutes a larger share of less well-off households' spending, which implies that this policy slightly reduces inequality.

[20] The funding will be sufficient to add 500 MW of renewable power to the grid by 2032, which will reduce the price of electricity in the Baltics by at least 3%.

[21] The increase in the price of heating is just 4%, while Latvia's total GHG emissions fall by 0.23% in the medium term.

[22] Households pay higher taxes on heating, gasoline, and diesel, while benefitting from cheaper electricity and higher incomes thanks to a more competitive industry. These effects nearly balance each other out on average, although the former slightly increases inequality, while the latter ameliorates this effect through increased employment.

Therefore, to achieve the best combination of GHG emissions reduction, economic performance, and impact on household incomes, it is justified to use the budget revenue from ETS2 to facilitate green investment, while some share of the revenue should be dedicated to ameliorating the negative effects on households in the short term.

Box 1. Impact of credit institutions' solidarity contributions on lending[1]

The Solidarity Contribution Law, which entered into force in 2025, was introduced with the primary objective of providing additional funding for national defence needs. The law was drafted on the premise that rapid interest rate changes (including EURIBOR) had led to a significant increase in banking sector profits, without being directly linked to the development of new services or efficiency improvements.

The legal framework stipulates that credit institutions can make the solidarity contribution in two ways – directly or indirectly. The direct contribution takes the form of payments to the state budget equal to 60% of the share of net interest income that significantly exceeds the average of previous years. Alternatively, credit institutions may comply with the law indirectly by substantially increasing lending to the economy (thereby receiving a solidarity contribution reduction of up to 100%). Subsequently, such an increase in lending supports overall economic growth, which in turn leads to higher tax revenues for the state budget, thereby achieving the law's fiscal objective.

Such a specific framework is not internationally widespread, and its implementation has led to discussions on whether it will achieve its objective. Market participants voiced concerns that such an instrument could produce the opposite of its intended effect. Namely, instead of stimulating lending, it could hinder it due to legal uncertainty and risks to the investment environment.

Assessing the direct impact of solidarity contributions is challenging as the Governing Council of the ECB has reduced interest rates since June 2024. This step naturally stimulates lending activity. To distinguish the impact of solidarity contributions from other macroeconomic factors, a panel data local projections approach was used. It enables an analysis of the contribution effects over time, based on minimal assumptions. The model specification is defined as follows:

$$y_{i,t+h} = \alpha_i^{(h)} + \tau_k^{(h)} + \sum_{l=0}^{6} \theta_{h,l}\ \text{Solidarity}_{i,t-l} + \sum_{l=0}^{6} \gamma_{h,l}\ \text{Euribor}_{t-l} + \sum_{l=1}^{6} \phi_{h,l}\ y_{i,t-l} + \varepsilon_{i,t+h},$$

$h = 0,1,\ldots,18$, where

i – credit institution index, t – time period (in months), h – horizon (in months), y – annual growth rate of lending (%), α – fixed effect of the credit institution (characterises the institution's time-invariant properties), τ_k – year fixed effect (characterises macroeconomic shocks related to the specific year that affect all institutions equally), θ, γ, ϕ – model estimated coefficients, and ε – model error. To monitor the impact of changes in monetary policy and interest rates on lending, the model includes the six-month EURIBOR[2].

The solidarity variable included in the assessment serves as a quantitative measure of the potential impact of contributions. This follows from the procedure established by the law and is characterised by the following equation:

$$\text{Solidarity}_{i,t} = 1\{t \geq \text{2024-01}\} \times max\left\{0; \frac{NII_{i,t}^{\text{(3-m moving average)}}}{1.5 \times \overline{NII}_{i,\text{18-22}}} - 1\right\} \times (14.75\% - y_{i,t}).$$

The equation combines information on the excess net interest income and lending performance relative to the target required to obtain a 100% reduction. The variable is calculated on a monthly basis for each bank, starting from the beginning of 2024, when the issue returned to the political agenda. This allows potential shifts in the behaviour of credit institutions to be detected even before the law is adopted[3].

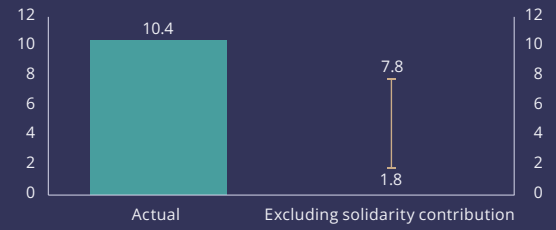
[1] Prepared by Matīss Mirošņikovs and Klāvs Zutis, economists of Latvijas Banka.

[2] Assessments cover the period from June 2018 to September 2025.

[3] Although the law provides for a contribution amounting to 60% of the excess net interest income or solidarity contribution base, the non-inclusion of such a multiplier in the equation has no impact on the results and conclusions of the assessment.

Using the elasticities obtained in the model, it is possible to approximate what the lending activity would have been in 2025 had the law not been adopted. Model assessments show that the framework had a positive impact on lending activity in 2025 (see Chart 1.1). Namely, the impact of the legal provision on the rise in outstanding loans observed in the first nine months of the year is estimated to be at least 2.6 percentage points. At the same time, given the relatively short time the solidarity contribution framework has been in place, this assessment is subject to some uncertainty, and the estimated impact should therefore be considered as indicative.

Chart 1.1. **Rise in outstanding loans to non-financial corporations and households in the first nine months of 2025 compared to the end of 2024** (%)



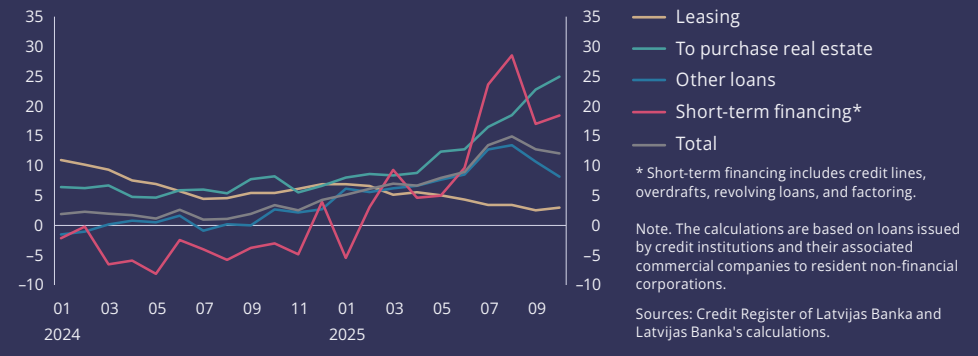
Note. The vertical line for the increase in outstanding loans, excluding the solidarity contribution, indicates the estimation uncertainty (95% confidence interval).

Source: Latvijas Banka's calculation.

Most likely, the driver is precisely the contribution reduction, which motivates banks to increase their lending activity and reduce or completely avoid solidarity contributions. However, this instrument carries risks. Frequent changes in tax policy create legal uncertainty, which may reduce the interest of foreign investors in Latvia.

In addition, data from the Credit Register point to structural changes. The rise in outstanding loans had been uneven until September 2025, with large loans and loans for purchasing real estate growing more rapidly. A disproportionate increase has also been observed in certain types of lending, notably credit lines, revolving loans, and overdrafts (see Chart 1.2). Such types of loans are most often issued with much shorter maturities than the typical loan for a company's investment needs. Therefore, the current lending trend may not be sustainable in the future. However, the available data suggest that the reduction mechanism applied to the solidarity contribution has helped ensure that at least some credit institutions achieve the objective set out in the Solidarity Contribution Law indirectly – namely, by expanding lending to the economy.

Chart 1.2. **Annual growth rate of outstanding loans by loan type** (%)



* Short-term financing includes credit lines, overdrafts, revolving loans, and factoring.

Note. The calculations are based on loans issued by credit institutions and their associated commercial companies to resident non-financial corporations.

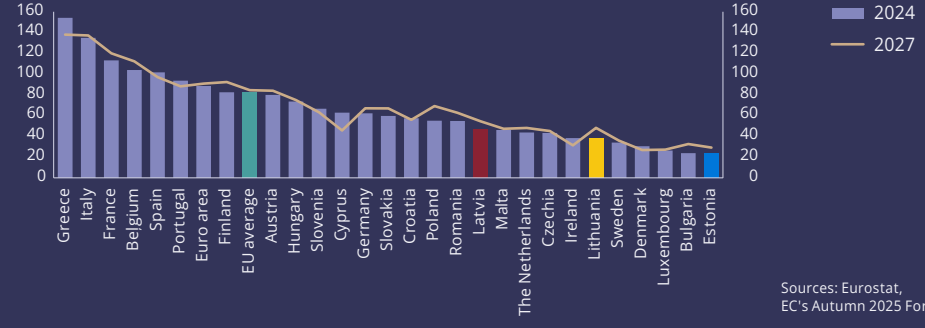
Sources: Credit Register of Latvijas Banka and Latvijas Banka's calculations.

Box 2. Member States' debt and defence expenditure dynamics[1]

Latvia's fiscal position will deteriorate in the coming years, with the budget deficit exceeding 3% of GDP and debt rising above 50% of GDP. Debt growth will be primarily driven by substantially higher defence expenditure, while the structural deficit will remain elevated, as a return to fiscally balanced policies is not currently expected to occur at a satisfactory pace.

Similar fiscal pressures can also be observed in other EU countries, with deficits and debt increasing in nearly all Member States in the coming years. According to the EC's autumn forecasts[2], debt at the European level will continue to grow at a moderate pace, reaching an average of almost 85% of GDP in the EU and 91% of GDP in the euro area in 2027. However, in major economies such as France and Italy, debt is expected to grow more slowly than in Latvia.

Chart 2.1. **General government debt** (% of GDP)



Sources: Eurostat, EC's Autumn 2025 Forecasts.

[1] Prepared by Baiba Brusbārde and Linda Oliņa, economists of Latvijas Banka.

[2] Autumn 2025 Economic Forecast: Growth will continue despite challenging circumstances, European Commission, press release, 17.11.2025.

At the same time, the IMF, in its Annual Report 2025[3], also warns that fiscal policy remains uncertain in many parts of the world and that rising expenditure related to security, as well as demographic trends (e.g. old-age pensions), increase debt risks, particularly in Europe. Meanwhile, against this overall background, the IMF projects Latvia's debt to reach a moderate level of 48.1% of GDP in 2026[4], slightly below the EC's assessment[5]. However, the debt trajectory is similarly upward in both cases.

Overall, defence financing has become an essential component of fiscal policy[6]. At the NATO Summit in June this year, Allies committed to increase basic defence expenditure to 3.5% of GDP by 2035[7], while the current average level in NATO European countries and Canada is around 2.3% of GDP. This implies that substantial additional resources will need to be mobilised over the next decade to achieve this goal. Among EU Member States, 16 countries, including Latvia[8], have applied for the activation of the national escape clause to facilitate the transition to a sustainably higher level of defence expenditure. In Latvia, defence expenditure is planned to rise to almost 5% of GDP next year and to remain at this level in the medium term. For the EU as a whole, defence expenditure is expected to increase from 1.5% of GDP in 2024 to around 2% of GDP in 2027 (COFOG

[3] World Economic Outlook, October 2025: Global Economy in Flux, Prospects Remain Dim, International Monetary Fund, October 2025.

[4] Republic of Latvia: 2025 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the Republic of Latvia, International Monetary Fund, 19.09.2025.

[5] 49.9% of GDP in 2026, autumn forecasts (see Economic forecast for Latvia, European Commission, 17.11.2025).

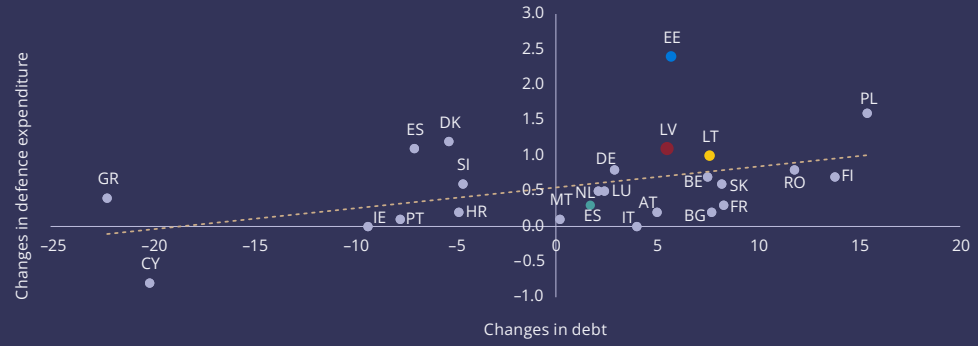
[6] Member States increased defence budgets from 218 billion euro in 2021 to 392 billion euro in 2025 (forecast; see Preserving Peace - Defence Readiness Roadmap 2030, European Commission, 16.10.2025).

[7] Defence expenditures and NATO's 5% commitment, NATO, 27.06.2025.

[8] NATO European countries: Belgium, Bulgaria, Czechia, Denmark, Germany, Estonia, Greece, Croatia, Latvia, Lithuania, Hungary, Poland, Portugal, Slovenia, Slovakia, and Finland. The clause provides additional flexibility for defence expenditure for four years and up to 1.5% of GDP per year, allowing the deficit to temporarily exceed the 3% of GDP threshold and deviate from the growth rate of net primary expenditure (see Council activates flexibility in EU fiscal rules for 15 member states to increase defence spending, Council of the European Union, press release, 08.07.2025, and Economic governance: Council approves Germany's fiscal expenditure path and its flexibility to increase defence spending, Council of the European Union, press release, 10.10.2025, on Germany).

methodology).[9] The increase in defence expenditure is contributing to rising government debt both in Latvia and across the EU.

Chart 2.2. **Changes in public debt and defence expenditure (COFOG) in 2026 compared to 2023** (share of change in GDP; percentage points)[10]



Sources: Eurostat (data accessed on 20 November 2025), the EC's Autumn 2025 Forecasts and opinions on individual national budgetary plans for 2026 or government statements, as well as Latvijas Banka's assessment and calculations.

Data from the EC's opinions on individual national budget plans for 2026, public statements, and Eurostat COFOG data are used to assess the dynamics of countries' debt and defence expenditure[11]. When evaluating the projections, a small positive correlation can be observed between changes in public debt and defence expenditure in 2026 compared to 2023. However, the dispersion is large, indicating that debt dynamics are also influenced by other factors. The Baltic States generally stand out for a more pronounced increase in defence expenditure compared with a large number of euro area countries. Meanwhile, in Estonia, defence expenditure growth is expected to be particularly rapid against a backdrop of relatively moderate debt growth, while in Poland, both debt and defence expenditure are expected to increase at a similar pace. Defence expenditure is also increasing in a number of countries (e.g. Spain and Denmark), while debt levels are stable or declining. By contrast, in France and Italy, debt levels are on an upward trajectory, while growth in defence expenditure is modest, and neither country has requested the activation of the national escape clause to increase this expenditure.

The new fiscal framework recognises higher security expenditure as warranted, provided that a country is able to demonstrate credible debt stabilisation in the long term. This will be assessed after the submission of the updated Fiscal-Structural Plans next spring. EC calculations[12] indicate that if Member States fully implement the adjustments they committed to in their initial medium-term plans, debt would fall by around 28 percentage points in countries with debt above 90% of GDP and by 24 percentage points in countries with debt between 60% and 90% of GDP by 2038. At the end of the medium term, four EU Member States will still have debt above 100% of GDP.[13]

According to EC calculations, the evolution of sovereign debt can also be influenced by the

[9] Autumn 2025 Economic Forecast: Growth will continue despite challenging circumstances, European Commission, press release, 17.11.2025.

[10] In its opinions on national budgets (published on 25 November 2025), the EC highlighted instances of non-compliance with fiscal rules in certain countries. This may imply changes in sovereign debt dynamics and/or defence expenditure. Malta and the Netherlands face a significant risk of non-compliance with the expenditure ceiling; Croatia, Lithuania, and Slovenia are forecasting expenditure growth above the ceiling in 2026; Finland's deficit exceeds the 3% of GDP reference value, and the excess is not fully explained by the allowed flexibility (see Reflecting the economic governance framework in national fiscal policy, European Commission, 25.11.2025).

[11] NATO-assessed expenditure figures are not used as they are only available up to 2025 (see Defence Expenditure of NATO Countries (2014-2025), NATO, press release).

[12] Debt Sustainability Monitor 2024, European Commission, 17.03.2025.

[13] Belgium, Greece, France, and Italy.

impact of the Russian invasion of Ukraine on the economic growth of European countries[14]. Countries bordering conflict-affected regions have experienced economic growth of around 1.4-1.8 percentage points below the EU average in recent years, with a GDP growth gap of around 6 percentage points between the closest and most distant countries to the conflict zone. This shows that countries bordering the conflict zone are particularly exposed to the negative economic effects of the war, which may in turn also affect the level of public debt: budgetary needs are increasing (including for defence), while potential growth and the budget's revenue base are weakening. Debt stabilisation in these countries requires a greater fiscal effort than the EU average.

Latvia's fiscal dynamics reflect a broader European trend: security and investment expenditure push up deficits and debt in the short term. At the same time, in several countries, such as France, Italy, and Belgium, debt is rising significantly faster than defence expenditure, whereas in the Baltic States, Germany, and the Netherlands, the changes are more proportionate. Overall, debt growth outpaces increases in defence expenditure towards the end of the period. This dynamic is only partly explained by higher security expenditure, while also reflecting the impact of other factors (economic structures, interest rates, and fiscal policy choices). In Latvia, initially low debt levels and moderate deficits have provided relative fiscal flexibility compared to the EU average[15]. However, debt dynamics indicate that fiscal policy is at a turning point. To remain resilient to future shocks, the transition from expenditure growth to a consolidation phase needs to be planned in a timely manner, particularly after 2027, when military investment is expected to peak.

[14] The cost of EU Member States' proximity to the war, European Commission, 17.11.2025.

[15] In 2024, most EU Member States recorded deficits above 3% of GDP, e.g. France (5.4%), Poland (6.6%), and Slovakia (5.3%), while it was only 1.8% in Latvia. Therefore, Latvia's fiscal position remains relatively stable despite an increase in defence expenditure.

Box 3. What is ETS2 and how does it affect prices in Latvia?[1]

ETS is the Emissions Trading System of the EU.[2] It was introduced in 2005 to reduce CO_2 emissions according to the principle "polluter pays". Revenue generated by this system is used only for climate mitigation and anti-pollution measures. In 2022, it was reformed according to the EU Green Deal, and the plan to introduce ETS2[3] was one of these changes.

ETS2[4] is an extended EU-level version planned for this Emissions Trading System that aims to cover buildings, road transport, and additional sectors (for example manufacturing, not included in ETS).[5]

When will it be introduced?

Currently, there are many unanswered questions concerning ETS2. The EC has adopted a directive[6] that sets out the principles and introduction deadlines for ETS2. It lays down that ETS2 becomes effective in 2027, but as this introduction is prescribed by a directive it must be transposed into national law.

However, on 5 November 2025, the EU Council proposed to postpone the introduction of the directive for one year, until 2028.[7] On 13 November, this initiative was also approved by the European Parliament.[8] As a result, the introduction of ETS2 is currently planned for 2028.

Some countries, including Latvia, have already implemented measures ahead of this deadline to ensure a gradual transition to ETS2 without an all-at-once economic impact in one year. As Latvia already has a natural resources tax and an excise tax, with both including the "polluter pays" principle as well as the CO_2 component, additional emission costs are already being incurred.[9] This means that prices are gradually increasing – merchants and consumers have time to adjust to avoid a concentrated impact at the exact time when ETS2 comes into force.

A specific example of this is the draft budget of Latvia[10] which includes a higher excise tax for diesel, petrol, and natural gas. The excise tax for oil products per one CO_2 component in 2025 was increased by EUR 10/tCO_2e, while in 2026 it will be increased by EUR 20/tCO_2e. This is done to ensure a smooth transition to ETS2 and to avoid rapid and significant price corrections for CO_2 emission sources, which could significantly affect consumers and entrepreneurs.

Forecast assumptions

The forecasts of Latvijas Banka in December 2025 have relied on the current legal framework of Latvia based on the following assumptions: ETS2 EUR 10/tCO_2e in 2025, and EUR 20/tCO_2e in 2026. As introduction of ETS2 will most likely be postponed until 2028 at the EU level, we assume that in 2027 the Latvian excise tax will remain the same, i.e. EUR 20/tCO_2e. However, the 2028 estimate is based on the common ECB assumption of EUR 46/tCO_2e.[11]

[1] Prepared by Ieva Opmane and Dzintars Jaunzems, economists of Latvijas Banka.

[2] For further information on ETS, see About the EU ETS, European Commission.

[3] The EU Emissions Trading System (ETS) and its reform in brief, European Parliament, 30.01.2018.

[4] About the ETS2, European Commission.

[5] ETS2: buildings, road transport and additional sectors, European Commission.

[6] Directive (EU) 2023/959 of the European Parliament and of the Council of 10 May 2023 amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union and Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading system, OJ L 130/132.

[7] 2040 climate target: Council agrees its position on a 90% emissions reduction, Council of the European Union, 05.11.2025.

[8] EU 2040 climate target: MEPs want 90% emissions reduction in EU climate law, European Parliament, 13.11.2025.

[9] For information on the current net carbon rates, see Net Effective Carbon Rates, OECD, 2025.

[10] Informative report from the Ministry of Finance "On the Review of the State Budget Revenue and Tax Policy in 2025–2027".

[11] Note that before the current votes of the EU Council and the European Parliament, other ETS2 price assumptions were used in the published forecasts of Latvijas Banka (with a stronger impact on 2027 prices).

Impact on prices in Latvia

Will introduction of the ETS2 cause a rapid hike in fuel prices? As higher excise taxes are already partially attributable to the planned ETS2 framework, we can calculate the potential effect on fuel prices. According to the plan of the Ministry of Finance[12], the direct contribution of ETS2 to higher excise taxes in 2025 was EUR 26.3 per 1000 litres for diesel (or 2.6 cents per litre). Considering the VAT, the impact on the consumer price in 2025 was 3.2 cents per litre. In 2026, a similar increase is planned due to ETS2 (3.2 cents, including VAT). However, according to ETS2 price forecasts for 2028, this factor could drive up diesel prices by 8.3 cents (including VAT). As a result, the total 4-year increase in diesel prices attributable to ETS2 could be approximately 14.7 cents (including VAT).

In 2025, the excise tax for petrol increased by EUR 23/1000 litres (2.3 cents per litre, or 2.7 cents per litre including VAT). A similar rise is also expected in 2026. However, according to ETS2 forecast assumptions, the price of this product could increase by approximately 7.1 cents in 2028 (including VAT). Thus, during the 4-year period, this factor could drive up consumer prices of petrol by approximately 12.5 cents in total.

Likewise, we can calculate the impact on the price of natural gas. The excise tax rise for natural gas used as a fuel in households and directly related to the introduction of ETS2 is EUR 1.72 per 1 MWh in 2025, as well as in 2026. According to the expected ETS2 dynamics, this excise tax may remain unchanged in 2027, though in 2028 costs related to ETS2 for this product could increase by EUR 4.47 per 1 MWh.[13] Furthermore, it should not be forgotten that the amount payable by consumers is further increased by the applicable VAT rate (21%), thus the total increase in 2025 amounts to EUR 2.08 per 1 MWh. This means that for an average house that is heated with natural gas and consumes approximately 23 MWh per year, the heating costs in general will increase by EUR 220 for the entire heating season, or EUR 18 per month on average (over the four years). Additionally, it is important to note that ETS2 is just one component of the excise tax and that its increase is also attributable to other reasons. On top of that, the market sales price of this resource also changes over time. As a result, the price paid by end consumers may fluctuate during various periods, and not all changes are related to the introduction of ETS2.

How does it affect inflation?

Depending on the applied analysis tools and economic models, impact assessments may differ. It generally depends on whether the entire impact or just a specific sector is being studied, as well as the length of the period assessed. The short-term inflation forecasting model of Latvijas Banka[14] is used to assess the impact on inflation in the coming years by directly evaluating changes in fuel and natural gas prices. Considering this and the assumptions on ETS2 price developments used in forecasting, it was estimated that the introduction of ETS2 will add +0.3 percentage points to inflation in 2028.

While with the CGE-EUROMOD and E-DSGE models, the estimated impact on medium-term inflation is 0.1 percentage points, and the cumulative impact is 0.7 percentage points. However, this effect depends on the manner used to channel ETS2 budget revenue back into the economy (see Scenario 3).

[12] Informative report from the Ministry of Finance "On the Review of the State Budget Revenue and Tax Policy in 2025–2027".

[13] The increase of the excise tax levied on natural gas used for other applications and petroleum gas used as a fuel differs.

[14] A. Bessonovs, O. Krasnopjorovs (2021), Short-Term Inflation Projections Model and Its Assessment in Latvia, Baltic Journal of Economics, vol. 21(2), pp. 184–204.

Abbreviations

€STR – euro short-term rate

CIS – Commonwealth of Independent States

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

NATO – North Atlantic Treaty Organization

NFC – non-financial corporation

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

UK – United Kingdom

US – United States of America

VAT – value added tax