LATVIJAS BANKA
EIROSISTĒMA

Macroeconomic Projections Report

2025 | June

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June 2025, No 3

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Additional information

The cut-off date for the information used in the Macroeconomic Projections Report (June 2025, No 3) and in the forecast is 21 May 2025 (14 May 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 10 June 2025.

Contents

Key points in brief

The **GDP** growth outlook for 2025 has been revised downwards compared to forecasts published earlier. This is driven by the adverse effects of tariffs imposed by the US and elevated uncertainty surrounding geopolitical tensions and trade policy. This uncertainty keeps economic agents cautious and was already partially reflected in short-term data in the first quarter of the year. The implementation of major investment projects, increased defence spending, as well as diminished uncertainty in trade policy are expected to bolster economic activity in 2026–2027. This enables the GDP growth forecast for that period to remain aligned closely with prior estimates – the slight decline is related to the weak investment activity so far, which will reduce the ability of entrepreneurs to rebound in the context of demand recovery, as well as to competitiveness challenges.

The **inflation** forecast has been revised upwards for the entire projection horizon. This was mainly driven by the incoming inflation data, which show a sharper-than-anticipated rise in food prices. Services prices also continue their increase, and their impact on inflation will remain significant throughout the projection horizon. Meanwhile, the increase in energy prices was temporary and, amid high global uncertainty, futures prices are lower than previously. This is a disinflationary factor.

Slower economic growth is also reflected in the **labour market**, with the unemployment forecast revised slightly upwards for the entire projection horizon. However, the unemployment rate is expected to remain below 7%. Labour supply rises as formerly economically inactive persons begin seeking employment. As the economy resumes faster growth, a higher availability of labour resources will ease the upward pressure on wages. However, wage growth will remain resilient at around 6% over the medium term, as the impact of demographic changes on labour supply will still be negative.

The **budget deficit** is projected at roughly 3% of GDP, and this assessment has not changed significantly. It includes an increase in defence funding, in line with the government's commitment to reach 5% of GDP by 2028. Borrowing needs are expected to remain high due to increasing budgetary expenditures, with the government debt level approaching 50% of GDP over the medium term.

Projections in figures*

- The updated forecasts assume that throughout the projection horizon, trade tariffs between the US, the EU, China, and other global partners will remain unchanged from those established following the US announcement on 12 May. This means that the US maintains a 10% import duty on goods originating from the EU (thus, the effective or average tariff on imports of goods and services from the EU stands at 6%), while preserving previously granted exemptions – such as those for semiconductors, wood, and pharmaceutical products – and the EU refrains from enacting retaliatory measures (the effective tariff on US exports of goods and services to the EU is assumed to be 1%). With respect to China, the US maintains the tariffs reduced on 12 May – namely, the 34% additional tariffs – throughout the entire projection horizon, corresponding to an effective rate of 37%, while the effective rate vis-à-vis the rest of the world is 10%. Meanwhile, a tariff rate of 20% has been adopted for US exports to China and 2% for the rest of the world. The trade policy uncertainty index is gradually declining to the average level of 2018, reflecting a return to the degree of uncertainty that prevailed during the first term of Donald Trump's presidency.
- The forecasts assume that Latvia will gradually increase defence spending to 5% of GDP by 2028. Defence is also being strengthened by other EU countries, which is reflected in the current assessment of external demand.

* The cut-off date for the information used in the forecast is 21 May (14 May for the information used in some technical assumptions).

Table 1

Macroeconomic fundamentals: Latvijas Banka's forecasts

	2024 Actual	2025	2026	2027
Economic activity (annual changes; %; at constant prices; seasonally adjusted data)				
GDP	–0.4	1.2	2.8	3.2
Private consumption	0.3	1.4	3.2	3.4
Government consumption	7.5	3.1	0.6	1.5
Investment	–6.8	0.1	5.4	4.9
Exports	–1.6	2.2	2.4	2.9
Imports	–2.4	3.5	3.1	3.1
HICP inflation (annual changes; %)				
Inflation	1.3	3.4	2.1	2.8
Core inflation (excluding food and energy prices)	3.7	3.2	2.4	2.4
Labour market				
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	6.9	6.7	6.5
Nominal gross wage (annual changes; %)	9.7	6.0	6.3	6.3
External sector				
Current account balance (% of GDP)	–2.1	–3.2	–3.9	–4.0
Government finances (% of GDP)				
Budget surplus/deficit	–1.8	–3.2	–2.8	–2.9
General government debt	46.8	47.9	48.2	49.9

Projections in brief

GDP

Tension caused by trade wars reduces GDP growth

2025 **1.2%**

The elevated uncertainty surrounding geopolitical tensions and trade policy weakens economic activity. Increased defence spending will strengthen confidence and promote growth.

Projection

2026 **2.8%**

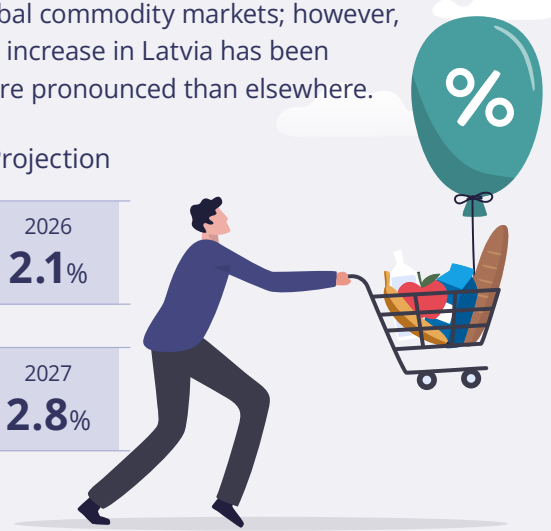
2027 **3.2%**

INFLATION

Rise in inflation is driven by food prices

2025 **3.4%**

Food prices are driven up by developments in the global commodity markets; however, the increase in Latvia has been more pronounced than elsewhere.



Projection

2026 **2.1%**

2027 **2.8%**

GROSS WAGE

Wage growth will remain robust

2025 **6.0%**

Owing to demographic changes, the labour supply will decrease. As growth resumes, businesses will face fierce competition for labour.

Projection

2026 **6.3%**

2027 **6.3%**

Global environment

The global economic outlook is overshadowed by rising geopolitical tensions and high uncertainty, which have increased significantly since the new US President took office. They reached the peak on 2 April, when Donald Trump announced surprisingly high import tariffs for nearly all countries of the world. This created uncertainty and weakened the investment and trade environment. Currently, the application of the tariff share has been temporarily postponed due to ongoing negotiations between the US and specific countries on new trade rules. This creates cautious optimism in the markets.

The war in Ukraine has entered its third year, and the efforts made so far by the US and Europe to bring about peace have not yielded the expected result. In the Middle East, hostilities between Israel and the Hamas terrorist organisation continue, but their scale has decreased. Another armed incident further east, between India and Pakistan, heightened overall geopolitical tensions.

Global prices of goods

Global commodity prices fell significantly following the announcement by the US President on 2 April regarding the introduction of comprehensive import tariffs for most countries. The threat to global economic growth from tariffs raises concerns about demand and drives prices down.

Natural gas prices peaked in mid-February. Insufficient wind and cold weather had led to higher demand for natural gas, resulting in a sharp decline in Europe's natural gas reserves. However, with the end of winter in Europe proving to be warmer than expected and the availability of liquefied natural gas in the market improving, prices began to decrease. The reduction in prices was further facilitated by the EC's proposal to allow for greater flexibility in the replenishment of European natural gas reserves – to reduce the previously set filling target level from 90% to 83%, to be achieved in the period from 1 October to 1 December, and to allow countries to deviate slightly from it in adverse market conditions. However, the strongest price drop followed the announcement of comprehensive US trade tariffs on 2 April. This raised concerns about economic growth and thus dampened expectations for natural gas demand. Natural gas prices will largely depend on US trade policy in the coming months.

Global oil prices peaked in February, similar to natural gas prices. The imposition of sanctions on Russia's shadow fleet temporarily raised concerns about oil supply; however, these proved to be unfounded. At the end of March, OPEC+ countries decided to ease oil extraction restrictions, whereas the comprehensive tariffs announced by the US President on 2 April raised concerns about economic growth and, consequently, oil demand. The OPEC+ countries have spare capacity to continue accelerating oil extraction, which would result in lower oil prices; however, it is unclear whether they will want to do so. In recent years, OPEC+ countries have lost market share to non-OPEC+ oil-exporting countries due to limiting oil extraction. Moreover, reports are emerging that the leading OPEC+ oil producers are dissatisfied with

their members' discipline in terms of compliance with these restrictions. In addition, the US President constantly urges OPEC countries to increase oil extraction.

These push and pull factors create uncertainty about future supply. However, many OPEC national budgets, which factor in higher oil prices than currently in the market, are then, as a result, incentivized to limit production. As a result, the desire to keep oil prices at a higher level could therefore remain.

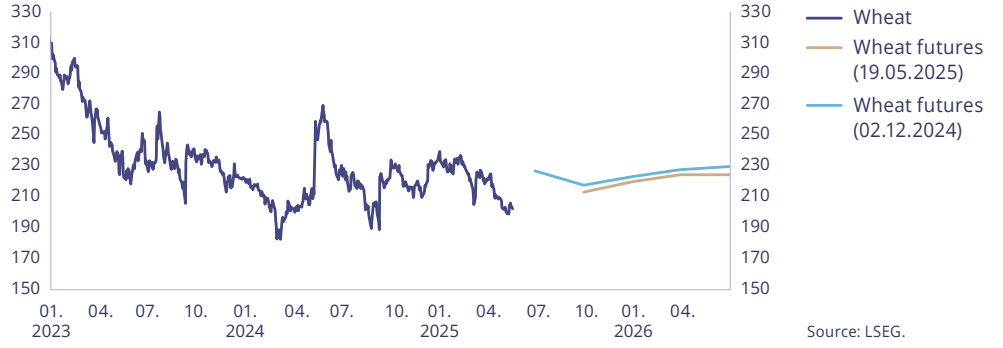
Chart 1. **Natural gas prices on the Dutch TTF trading point and Brent oil actual and future prices** (euro/MWh; US dollars/barrel)

Source: LSEG.

Global grain prices have decreased since the beginning of the year. Concerns about adverse weather conditions for wheat growing have been allayed, and EU grain production is projected to be higher this season compared to the previous one. Although the announcement of US trade tariffs was followed by a large drop in grain prices, futures grain prices suggest that this decline will be temporary. In autumn, global cereal prices might start to return to the levels seen before the announcement of US trade tariffs.

Despite trends in grain markets, global food prices continue to rise. The increase mostly occurs in the categories of dairy and meat products. This is explained by the imbalance between supply and demand. The meat category also shows a resurgence of global imports from Germany after the end of the foot-and-mouth disease epidemic was declared.

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



Source: LSEG.

Monetary policy at the leading central banks across the world

The world's leading central banks continue to tighten monetary policy and underline the high level of uncertainty that requires them to maintain flexibility in their monetary policy stance. Since last December, the Bank of England has continued to ease its monetary policy stance, while the US Fed has taken a wait-and-see approach and kept interest rates unchanged for some time. At the same time, the Bank of Japan decided to raise its key interest rate.

The target rate of the Fed has been kept unchanged at 4.25–4.50% for the last three consecutive sessions. In its latest report, the Fed states that the US economy continues to grow at a steady pace. Unemployment has stabilised at low levels, and labour market conditions remain stable. At the same time, inflation is still slightly elevated. The Fed also points to the high uncertainty surrounding the economic outlook. It is emphasised that the risks of higher unemployment and inflation have increased. Jerome Powell, the Chair of the Fed, also points to the need of maintaining flexibility and responding to the incoming data, stressing that the US administration is in a phase of trade negotiations with other countries and that the outcome of these negotiations will have a significant impact on the economic outlook. Financial markets expect the Fed to reduce its target rate at least twice by the end of this year, with a further reduction in interest rates expected in September.

The Bank of England has eased its monetary policy twice since last December, during the meetings in February and May, deciding each time to reduce the key interest rate by 25 basis points, bringing it to 4.25%. By reducing interest rates, the Bank of England pointed to progress in curbing inflation, which allows for easing the tightness of monetary policy. Weaker labour markets and slower economic growth were also noted. Financial markets expect another one or two 25 basis point interest rate cuts to follow by the end of this year.

Unlike the central banks of other major economies, the Bank of Japan acted, deciding at its end-January meeting to raise the key interest rate by 25 basis points to approximately 0.50%. The Bank of Japan justified its decision by stating that inflation and wages continue to increase. At the same time, in response to the trade tariffs imposed by the US, it has revised its economic growth outlook and points to the need for a flexible monetary policy stance. Financial markets expect a further increase of 25 basis points in the key interest rate by the end of this year.

External demand

The global and euro area economy

Global economic growth has weakened, and the downside risks to growth have risen. Forecasts have been revised downwards since autumn 2024. The IMF expects global economic growth to be 2.8% and 3% in 2025 and 2026 respectively, lower than the 3.2% and 3.3% expected in the autumn forecasts. Forecasts have been revised downwards due to the tariffs announced by the US and heightened trade uncertainty. The main downside risks include possible additional tariff hikes, the escalation of geopolitical conflicts, volatile financial markets, high debt levels, and persistent political uncertainties, which, taken together, may lead to global trade fragmentation and a slowdown in economic growth.

Economic activity in the euro area is slowly increasing, but is still expected to remain weak. Private consumption continues to be fragile, with consumer caution remaining high and sentiment indicators low. The sudden changes in the US trade policy have created significant uncertainty, which has negatively affected business sentiment. However, the dynamics of the Purchasing Managers' Index (PMI) indicate a recovery in manufacturing activity. The latest (May) EC forecast projects the euro area GDP to grow by 0.9% in 2025 and 1.4% in 2026 (November forecast – by 1.3% and 1.6% respectively). Forecasts have been revised significantly downwards since autumn 2024, mainly due to the impact of tariffs and heightened uncertainty.

Latvia's major trade partners

Tariff increases and uncertainty in global trade also adversely affect external demand for Latvian goods and services. However, the level of external demand is projected to be slightly higher for 2025, as companies are striving to outpace the introduction of US tariffs and, consequently, US imports grew significantly in the first quarter. Private consumption of Latvia's trading partners is also increasing. In contrast, forecasts for 2026 and 2027 have been revised downwards, mainly due to the impact of tariffs restricting global trade. The projected weakness in economic activity also continues to entail downside risks owing to high uncertainty.

Lithuania, Latvia's most important trading partner, will continue to contribute the most to external demand growth, as private consumption growth (4.2%) is expected to be one of the fastest in Europe in 2025 according to the EC spring forecast, and Lithuania is also expected to see a relatively large increase in investment (3.5%), supported by the absorption of EU funds and higher investment in defence. Total growth for Lithuania is also projected by the EC at 2.8%, one of the highest rates in Europe. This generally indicates greater demand for Latvian goods and services.

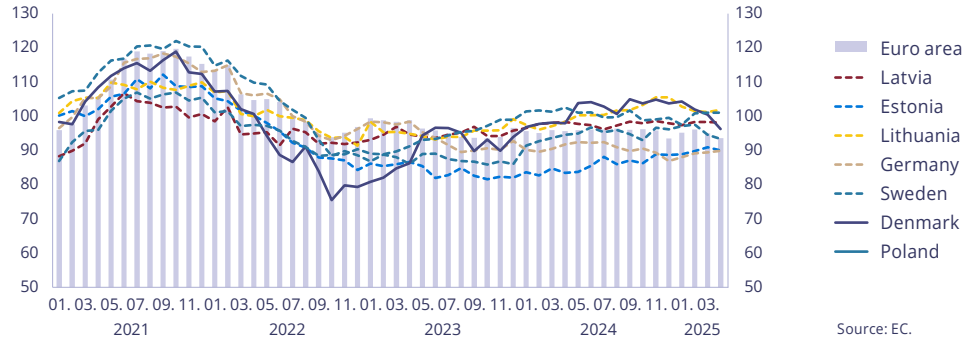
In contrast, Germany is projected to still have negative growth in 2025, which will reduce demand for Latvian products. Germany has a relatively high exposure to risk related to the US market, so the direct impact of tariffs will be relatively larger. The automotive industry, which already faced competitiveness issues before the US tariffs, will suffer more from the tariffs (the US is trying to protect its automotive industry with specific tariffs). Nevertheless, despite the tariff-induced shocks, the industrial economic sentiment indicator in Germany has risen in recent months: more expansionary fiscal policies and greater investment in military production will support its economy.

In Estonia, however, the unemployment rate has increased, and tax hikes are negatively affecting household consumption. This is bad news for Latvian exporters. As in the other Baltic States, inflation has also risen in Estonia, hampering the recovery of the population's purchasing power (this was partly expected following the tax increase, which is reflected both in the current inflation and the upwardly revised forecast). However, as in Germany, the industrial economic sentiment indicator has increased. Possible explanations lie in the growth of the military industry or higher demand for housing in Scandinavian countries, where falling interest rates may point to a revival in construction demand.

The tariffs set by the US have a relatively large impact on Sweden, similarly to Germany; therefore, the EC has revised Sweden's GDP forecast downwards. In addition, both private consumption and investment forecasts have been revised downwards, and the economic sentiment of consumers has deteriorated significantly, which negatively affects external demand for Latvian goods and services. This could be partly offset by the appreciation of the Swedish krona against the euro, as it would make imports from the euro area, including from Latvia, cheaper. However, the future outlook for monetary policy and exchange rates is also subject to high uncertainty. So far, interest rates have fallen significantly in Sweden, allowing the construction sector to show the first signs of recovery.

The UK economy grew slightly better than projected in the first quarter of 2025, with the UK concluding a trade agreement with the US. However, it still suffers from a 10% US import tariff, which is one of the reasons for the slowdown in economic growth. The Bank of England cites weak domestic consumption and reduced business investment as additional reasons for weaker growth. A downwardly revised forecast for investment and private consumption implies weaker demand for Latvian products.

Chart 3. **Economic sentiment indicator** (long-term average = 100)



Source: EC.

Monetary policy in the euro area

The Governing Council of the ECB continues to ease its monetary policy stance. This has allowed financial conditions in the euro area to become somewhat more favourable, despite the financial market turmoil caused by the US tariff announcement.

ECB monetary policy

At its January, March, April, and June meetings, the Governing Council of the ECB decided to lower its main monetary policy rate, which is currently the deposit facility rate, by 25 basis points to 2.00%.

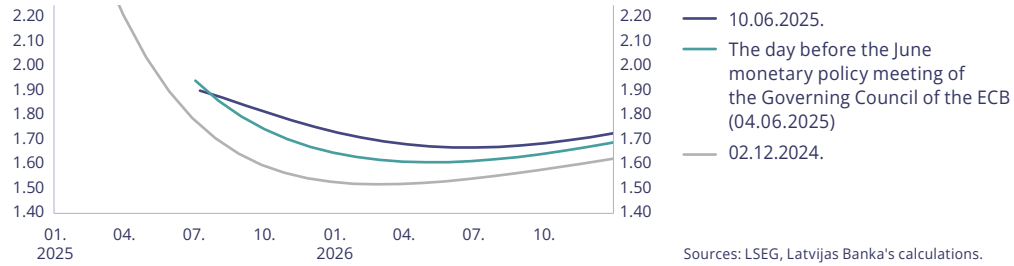
In support of its latest decision to reduce interest rates, the ECB noted that the decision taken was based on an updated assessment of the inflation outlook, the dynamics of core inflation, and the strength of monetary policy transmission.

Regarding the growth outlook, the Governing Council of the ECB states that, while trade policy uncertainty is expected to weigh particularly on business investment and exports in the short term, rising government investment in infrastructure and defence will increasingly support growth in the medium term.

When it comes inflation, the ECB indicates that the process is broadly on track, further noting that wage growth is slowing from high levels. The heightened uncertainty and market volatility in response to trade tensions in April have also eased, alleviating concerns that financing conditions may be tightening.

The ECB emphasises that, in the current context of exceptional uncertainty, it will follow a meeting-by-meeting approach to determining the appropriate monetary policy stance, assessing the latest information received, thereby striving to maintain maximum flexibility. At the same time, financial markets are pricing in a further reduction of 25 basis points in the key ECB interest rate until the end of the year.

Chart 4. **One-month €STR OIS forward rates** (%)



Sources: LSEG, Latvijas Banka's calculations.

Financial conditions in the euro area

Despite significant turbulence in financial markets, financial conditions in the euro area have become somewhat more favourable. This development was mainly driven by further reductions in the ECB's key interest rates. The rise in stock prices, which followed a sharp drop in early April, caused by the US administration's announcement of the introduction of new trade tariffs, also had a positive impact. Markets for the riskiest assets recovered and continued to grow after a 90-day tariff break was announced.

However, the reduction in key interest rates was not reflected in a decline in 10-year government bond yields. On the contrary, the yields on these bonds increased significantly following the announcement by the German government of a significant rise in defence and infrastructure expenditure. The rising public expenditure is expected to be partially funded by additional borrowing in financial markets, which contributed to the increase in government bond yields.

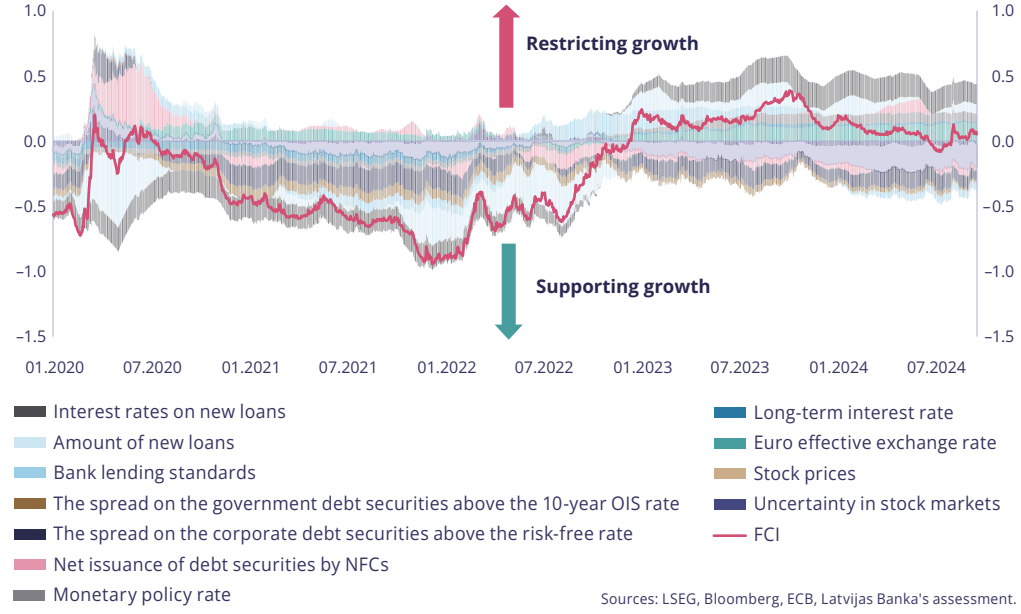
Rising uncertainty in financial markets contributed to a widening of the spreads on the euro area corporate debt securities above the risk-free rate. Despite the increase in spreads, non-financial corporations successfully raised the funding in capital markets.

The results of the euro area bank lending survey suggest that lending conditions for non-financial corporations deteriorated somewhat further in the first quarter of 2025. Pessimistic assessments of risks to economic activity led euro area banks to tighten their lending standards. As a result, despite the accommodative impact of lower interest rates, demand for loans among non-financial corporations declined again after some respite, owing to a lower need to finance working capital.

Meanwhile, in the area of housing lending, competition between credit institutions contributed to easing housing lending standards. This increase in supply was also accompanied by greater demand, driven by lower interest rates and household optimism about the development of the housing market.

However, looking ahead, euro area banks remain cautious amidst high uncertainty and expect loan supply to remain tight. Provided there are no new economic or geopolitical shocks, the interest rate cut cycle initiated by the ECB is likely to gradually improve financial conditions in the euro area and bolster economic growth. At the same time, deteriorating terms of trade and geopolitical uncertainty pose serious challenges.

Chart 5. **Euro area Financial Conditions Index of Latvijas Banka** (FCI; standard deviations from the long-term average)



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

Financial conditions in Latvia

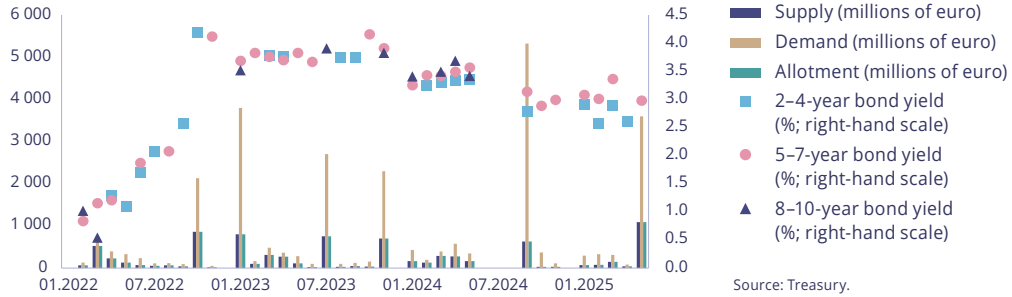
Latvia's financial conditions will be further affected by global uncertainties and a potential increase in euro area sovereign bond yields, stemming from an announced fiscal expansion. Credit demand and deposits will be determined by consumer sentiment and changes in real wages.

Latvian capital market

Activity in the primary market for government securities remained elevated, with yields exhibiting an upward trend. This reflects a heightened level of global risks. From October 2024 onwards, the leading credit rating agencies, as well as the Japanese credit rating agency R&I, kept Latvia's credit rating at its previous level. Meanwhile, Fitch Ratings revised Latvia's outlook, downgrading it from "positive" to "stable" in November. As a result, the future credit ratings assigned by all these agencies are currently maintained at a *stable* rating.

Between October 2024 and May 2025, Latvia's 10-year government bond yield rose from 3.19% to 3.49%, as of 19 May. Although the ECB continued to reduce its key interest rates, several factors contributed to the increase in Latvian government bond yields. These included heightened uncertainty in the global economy and financial markets linked to the economic policy of US President Donald Trump, announcements by several euro area countries regarding increased budget expenditures, and rising inflation levels in Latvia.

Chart 6. **Results of Latvian government securities auctions** (millions of euro)

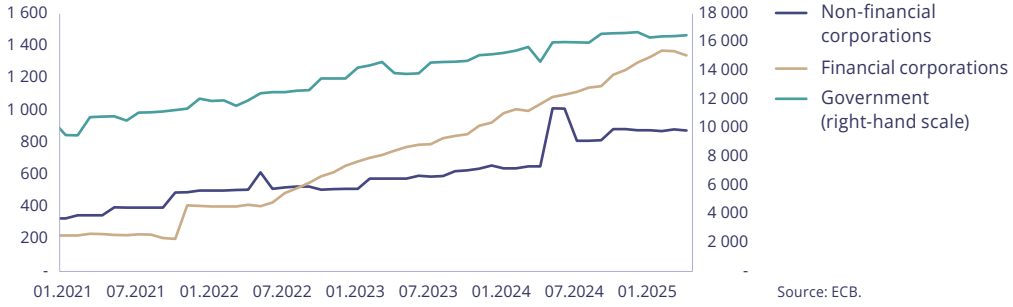


Source: Treasury.

In May, the Latvian government issued eurobonds totalling 1.0 billion euro in international markets. Investor demand exceeded 3.4 billion euro, significantly surpassing supply and reflecting strong interest. The issue yield on the eurobonds was 2.971%, with a spread of 65 basis points above the reference rate.

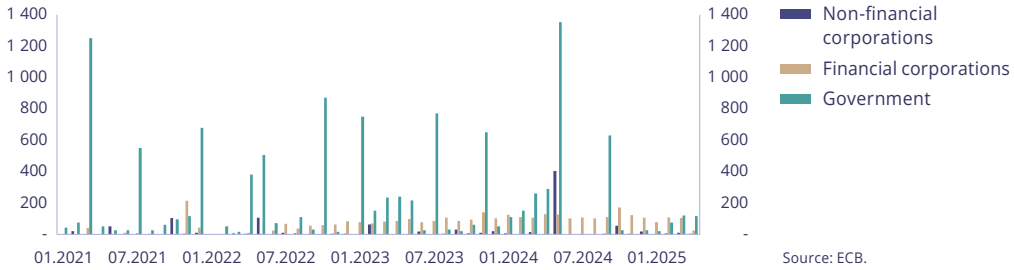
In the private debt securities market, several entities issued bonds in significant volumes. Air Baltic Corporation AS, the Latvian national airline, issued bonds totalling 40 million euro. Similarly, the non-bank lender Eleving Group issued 40 million euro in bonds, while AS Citadele banka issued bonds amounting to 35 million euro.

Chart 7. **Outstanding debt securities of Latvia's issuers by issuer group**
(millions of euro)



Source: ECB.

Chart 8. **New issues of debt securities by Latvia's issuers by issuer group**
(millions of euro)



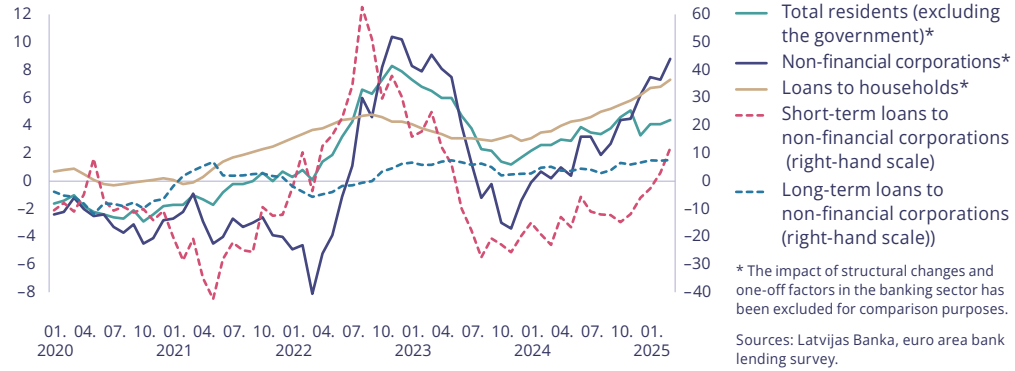
Source: ECB.

The stock index of AS Nasdaq Riga did not register any growth. This outcome was influenced by the heightened assessments of global risks and low activity levels in both the primary and secondary stock markets.

Banking sector

With lower interest rates in the fourth quarter of 2024 and the first quarter of 2025, lending experienced a rapid recovery. This growth propelled the non-financial private sector loan portfolio to the fifth highest annual growth rate within the euro area. The overall growth of the loan portfolio was supported by increased lending to both households and non-financial corporations. Despite economic stagnation, growth of the loan portfolio has outpaced the economy's growth rate, reaching 29.3% of GDP.

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

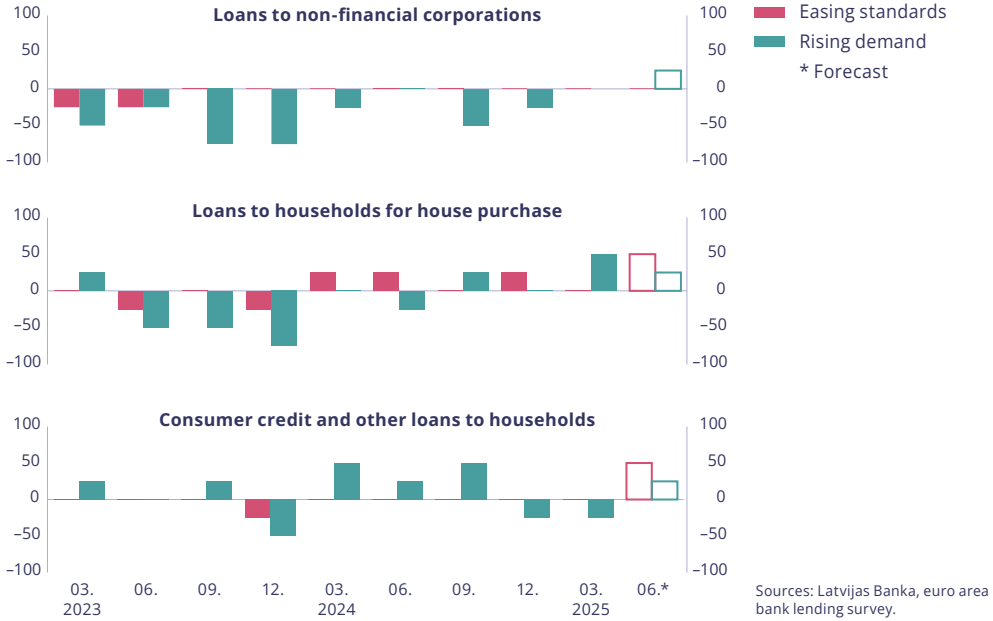


* The impact of structural changes and one-off factors in the banking sector has been excluded for comparison purposes.

Sources: Latvijas Banka, euro area bank lending survey.

The credit institution lending survey continues to indicate a decline in credit demand in the non-financial corporate sector. In contrast, the lending outlook for households is optimistic, with banks easing credit standards alongside an increase in demand for mortgage loans.

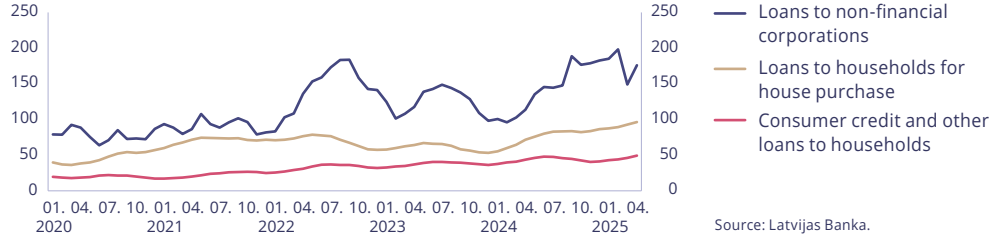
Chart 10. **Changes in lending standards and loan demand** (net; %)



Sources: Latvijas Banka, euro area bank lending survey.

Lower ECB base interest rates have also contributed to a decrease in lending rates. Interest rates on new euro-denominated loans to non-financial corporations continued to be influenced by fluctuations in the transaction structure at the turn of 2024 and 2025. In specific months, the issuance of individual large loans at significantly lower interest rates contributed to a reduction in the average cost of borrowing. In months when such transactions are absent, the average interest rate on loans tends to rise. Overall, the interest rate on new euro-denominated loans to non-financial corporations fluctuated between 5% and 6%, representing a decrease compared to the first half of 2024, when rates ranged from 6.5% to 7%.

Chart 11. **Volumes of new euro-denominated domestic loans** (millions of euro; 6-month average)

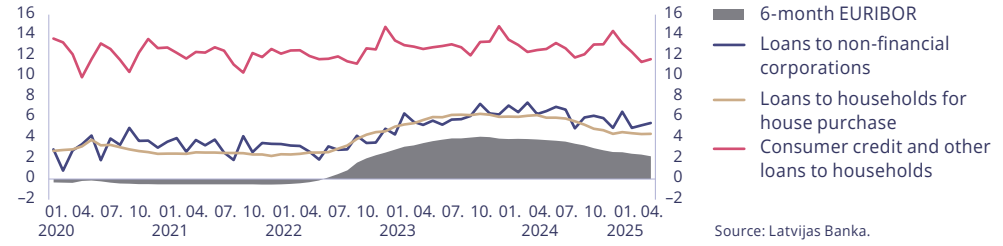


Source: Latvijas Banka.

A more pronounced decline in lending costs was observed in new loans granted to households for house purchase and construction. The average interest rate on these loans reached 4.4% in April. In addition to the decline in financial market rates, the reduction in lending rates on residential loans has also been supported by a subsequent decrease in markups.

Changes in lending rates correspond to developments in financial markets and reflect market expectations regarding future base rate movements. Therefore, potential reductions in the ECB's base rates, along with expectations of further cuts, may enhance credit availability by lowering borrowing costs.

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

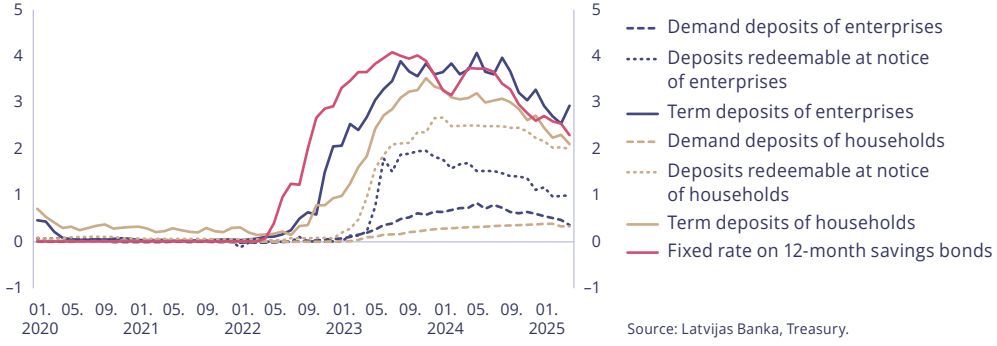


Source: Latvijas Banka.

Household deposits continued to exhibit steady growth. This growth continues to be supported by increases in real wages and cautious consumer spending on major purchases. The growth in deposits of non-financial corporations, however, was halted due to base effects arising from the transfer of savings by state non-financial corporations to the state budget.

The attractiveness of deposits has declined as the rate of inflation has surpassed the interest rates offered by credit institutions. As a result, households are no longer actively allocating funds to fixed-term deposits, leading to a gradual decline in their share within the total household deposit portfolio.

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



Source: Latvijas Banka, Treasury.

Looking ahead, further declines in deposit rates may dampen deposit growth significantly. However, with lower inflation and a strengthening of consumer confidence, the demand for precautionary savings is expected to decrease. Consequently, real wage growth may be increasingly directed towards consumption rather than savings. This shift is expected to reduce household deposits, while leading to an increase in account balances of non-financial corporations.

Fiscal policy in Latvia

The assessment of the budget deficit for the current and following year remains largely unchanged from previous forecasts, with the deficit expected to be approximately 3% of GDP. A more pronounced increase in defence spending is projected to have the greatest impact on government expenditure and the budget balance towards the end of the forecast horizon. As a result, a higher budget deficit is projected for 2027. Borrowing needs are expected to remain high due to increasing budgetary expenditures, with the government debt level approaching 50% of GDP over the medium term.

Projections	2024	2025		2026		2027	
	Actual	Dec	**Jun**	Dec	**Jun**	Dec	**Jun**
Budget surplus/deficit (% of GDP)	–1.8	–3.4	**–3.2**	–3.0	**–2.8**	–2.6	**–2.9**
General government debt (% of GDP)	46.8	49.0	**47.9**	49.6	**48.2**	51.1	**49.9**

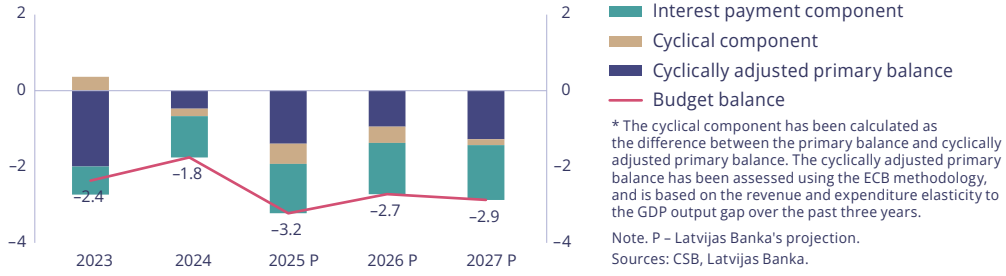
The assessment of the general government deficit for this year and the following remains largely unchanged, as a faster increase in defence expenditure is expected to be offset by changes in revenue and other expenditures. For this year, and the subsequent years, higher revenues from value-added tax and other indirect taxes, excluding excise duties, are expected. This is being driven by a higher tax base – that is nominal private consumption. Other revenues will be positively influenced by non-tax revenues, including higher dividend income from state-owned enterprises. In line with the slower pace of wage growth in the economy, labour tax revenues are also expected to increase at a more moderate rate over the projection horizon.

Despite the accelerated increase in defence spending, the overall level of government expenditure for this year and the following is projected to be slightly lower than in the previous forecast. The latest forecast anticipates a more rapid increase in defence funding this year and in the coming years, aiming to reach 5% of GDP by 2028, in accordance with NATO's expenditure accounting methodology. This year, the increase in defence spending is not expected to have an additional impact on the budget balance, based on the assumption that, consistent with trends observed in previous years, other planned budget expenditures will not be fully utilised. It has been announced that next year's contributions to the EU budget will be significantly lower than previously planned, following a revision of historical gross national income data. Together with other, less significant expenditure reductions, such as in social benefits, the overall spending cuts are expected to exceed the funding required for increased defence expenditure. The impact of increased defence spending is expected to become more significant in 2027, contributing to a larger budget deficit. This year will also see a more notable impact on increased government consumption and investments.

Latvia has submitted a request to the EC to activate the national escape clause. This clause allows a Member State increasing defence expenditure to deviate from the agreed annual expenditure growth rate for years, thereby permitting a budget deficit that exceeds the 3%

of GDP threshold. To ensure fiscal sustainability in the medium term, the derogation will be limited to an annual additional increase in defence expenditure of up to 1.5% of GDP.

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

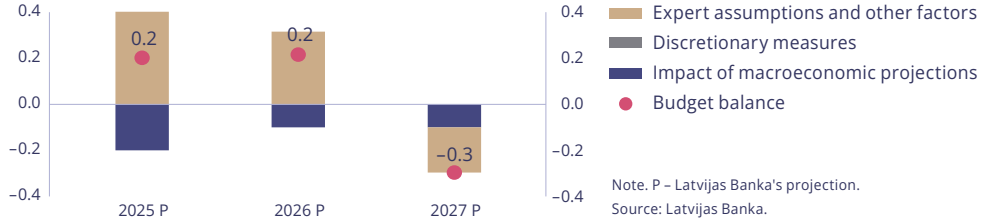


* The cyclical component has been calculated as the difference between the primary balance and cyclically adjusted primary balance. The cyclically adjusted primary balance has been assessed using the ECB methodology, and is based on the revenue and expenditure elasticity to the GDP output gap over the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

Note. P – Latvijas Banka's projection.
Sources: CSB, Latvijas Banka.

Compared to the December 2024 forecast, the budget balance has improved for this year and the next. This improvement is primarily attributed to the aforementioned changes in assumptions, including increased revenues and reduced expenditures. By contrast, the outlook for economic growth has become more pessimistic, resulting in an overall negative impact on the budget balance.

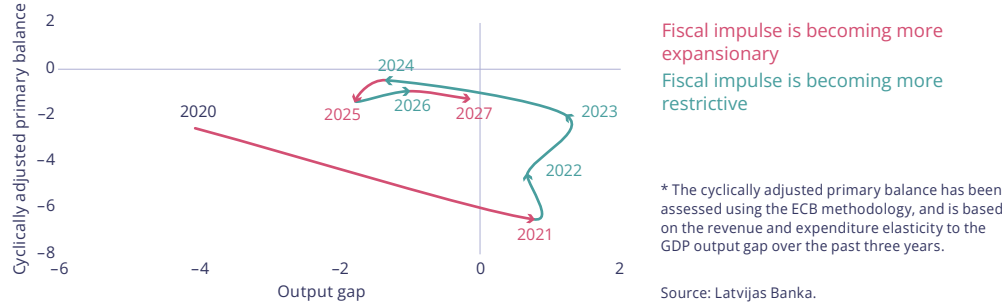
Chart 15. **Changes in the budget balance forecast relative to the previous forecast and the factors affecting it** (percentage points)



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

National fiscal policy in the medium term remains supportive, characterised by a variable fiscal impulse. This year and in 2027, the fiscal impulse is expected to become more expansionary, while a contractionary stance is anticipated for 2026. The cyclically adjusted primary deficit is projected to remain around 1.2% of potential GDP over the medium term.

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

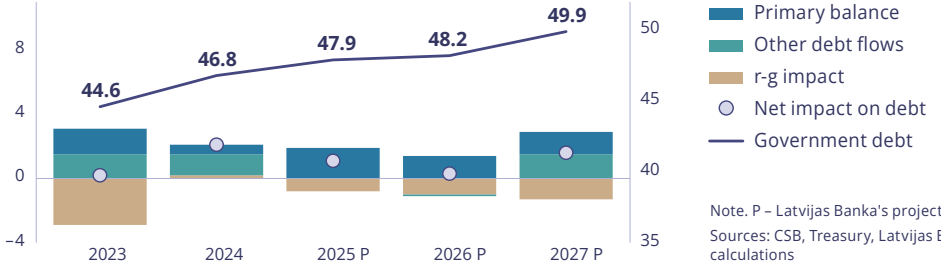


* The cyclically adjusted primary balance has been assessed using the ECB methodology, and is based on the revenue and expenditure elasticity to the GDP output gap over the past three years.

Source: Latvijas Banka.

The government debt levels over the medium term are expected to be lower than previously projected. Government debt dynamics are expected to continue on an upward trajectory in the coming years; however, the debt-to-GDP ratio is projected to remain lower than previously anticipated. The revision of the projections is primarily driven by lower debt levels in 2024 and higher-than-expected inflation over the medium term. Upward debt dynamics in the coming years will continue to be driven by increased budgetary expenditures, while rising effective interest rates on the government's debt portfolio will further elevate debt servicing costs, causing the government debt level to approach 50% of GDP over the medium term.

Chart 17. **Trend of government debt** (% of GDP) **and the underlying factors** (contribution; percentage points)



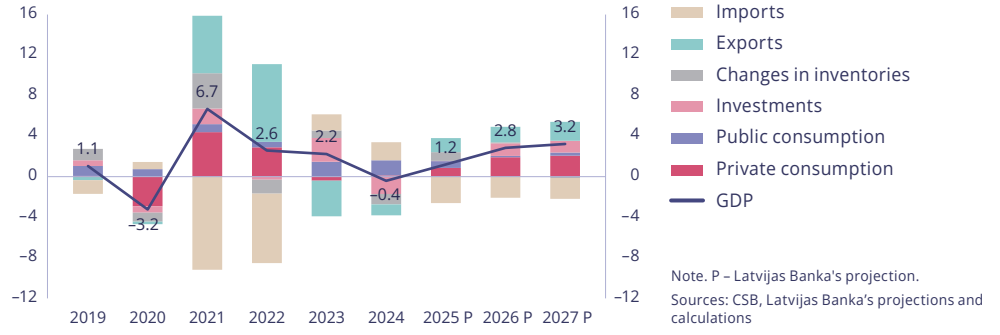
Note. P – Latvijas Banka's projection.
Sources: CSB, Treasury, Latvijas Banka's calculations

Gross domestic product: demand

The rise in geopolitical risks and delays in investments are dampening already weak GDP growth. However, in 2026–2027, development is expected to be supported by investments in strengthening defence capacity in both Latvia and its trade partners, partially offsetting the adverse effects of geopolitical shocks.

Projections	2024	2025		2026		2027	
	Actual	Dec	**Jun**	Dec	**Jun**	Dec	**Jun**
GDP (annual changes; %; at constant prices; seasonally adjusted data)	–0.4	2.1	**1.2**	3.0	**2.8**	3.3	**3.2**

Chart 18. **GDP** (annual changes; %; seasonally adjusted data) **and expenditure components** (contribution; percentage points)



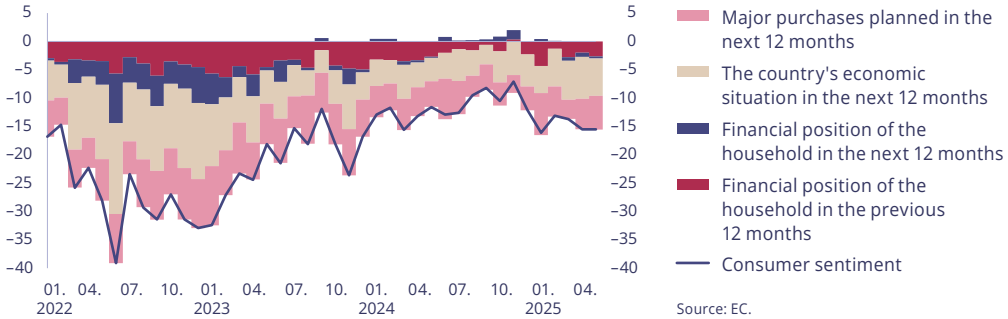
Note. P – Latvijas Banka's projection.
Sources: CSB, Latvijas Banka's projections and calculations

The prevailing climate of uncertainty is the primary factor constraining economic development. Under the baseline assumptions (see the section on Latvijas Banka's projections in figures for more details), no trade policy escalation is anticipated. The level of uncertainty in international trade is expected to gradually decline, thereby facilitating a recovery in economic activity. The impact of existing tariffs on Latvia's GDP, resulting from their application to Latvia's direct and indirect trade outside the euro area, is expected to be modest, reducing GDP growth by 0.12 percentage points in 2025 and 0.07 percentage points in 2026. Additionally, Latvia's trade with key euro area partners – those with significant exposure to the US – will exert a negative effect on economic growth. Latvia has a small and open economy, highly influenced by global developments; however, domestic factors also play a significant role. Government investment projects, notably Rail Baltica, are experiencing delays. The development prospects for Air Baltic Corporation AS remain uncertain. Additionally, pre-election disputes are contributing to public discontent and heightening uncertainty regarding the country's outlook. Following the recent local elections, a clearer framework should emerge to guide household and business decisions, particularly regarding investment activities.

The real purchasing power of the population is expected to continue growing at a relatively rapid pace; however, due to precautionary considerations, a portion of the income increase is likely to be retained in savings for some time. Although real deposit interest rates for households are currently negative – given that inflation exceeded the yield of 2.1% in March – precautionary behaviour remains evident. Household deposits have continued to grow rapidly, increasing by 9% compared to the same period last year.

Heightened uncertainty has delayed the anticipated recovery in consumption, pushing it further towards the end of this year. Consumer sentiment data also indicate a marked increase in pessimism compared to the end of last year, with negative expectations regarding the country's economic situation over the next 12 months ever more prevailing. Consequently, the likelihood of households proceeding with planned major purchases is also being assessed more negatively.

Chart 19. **Consumer sentiment** (net responses; percentage points)



Source: EC.

The rise in uncertainty has dampened the short-term investment outlook; however, military investment is expected to provide a positive stimulus over the longer term. Financing conditions are becoming more favourable, with credit data reflecting a progressively positive trend – mortgage and corporate lending have recently experienced significant increases; however, prevailing uncertainty continues to constrain faster growth. Private investments are the most sensitive component of demand during periods of geopolitical and economic shocks; therefore, in the short term, public investments will continue to serve as the backbone of overall investments.

The dynamics of public investments in the coming years are expected to remain consistent with previous forecasts. Their growth over the medium term will be supported by investments aimed at enhancing internal and external security, as well as the implementation of EU-funded projects and the Rail Baltica project. Compared to the previous forecast, security-enhancing investments have been increased throughout the forecast horizon, raising total defence spending to 5% of GDP by 2028, in accordance with NATO's expenditure accounting methodology. The most significant impact on public investments is projected to occur in 2027. Substantial investments to enhance national defence and security will continue, encompassing both the construction of military facilities and the procurement of military equipment, with a significant increase anticipated from 2026 onwards. Simultaneously, the partial implementation of Cohesion policy projects has been postponed to subsequent years to concentrate efforts on the full absorption of Recovery and Resilience Facility funding.

The planned increase in defence expenditures, both in Latvia and in its trade partners, is expected to stimulate investments in this realm. This is expected to enhance the sense of security among the population and investors, potentially serving as a long-term catalyst for development. Investments in production facilities for dual-use goods – serving both civil and military purposes – is particularly welcome as it enables the continued creation of added value, even when security expenditures stabilise and new military production orders decline.

Box 1. The impact of military spending on Latvia's economy

International trade tensions are expected to restrain export growth in the short term, while investment delays caused by uncertainty will weigh on medium-term growth prospects. However, the rise in defence expenditures among foreign trade partners is expected to create additional opportunities for Latvian exporters, at least partially offsetting the adverse effects of prevailing uncertainty.

The year 2025 began on a relatively positive note for exports, with service exports maintaining a relatively high growth rate and goods exports showing a slight increase during the first months of the year. Rising food prices have contributed to increased incomes, notably through exports of eggs and dairy products. A slight increase in exports of wood products has been observed, partly attributable to companies' efforts to pre-empt the introduction and enforcement of US tariffs. Additionally, the ongoing decline in interest rates continues to support demand for these goods, as evidenced by rising construction activity in regions such as Scandinavia. Export growth could also be supported by European countries' plans to increase security-related expenditures. However, the level of uncertainty remains elevated. This continues to constrain investments and consumption in other countries, thereby reducing demand for various goods produced in Latvia.

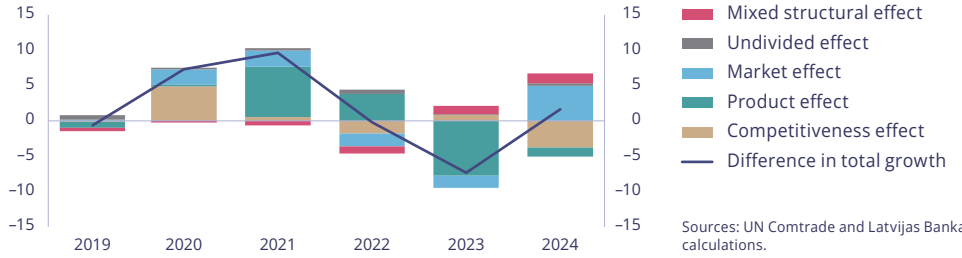
To date, the export of services has been supported by strong performance in air and road transport services, alongside continued relatively high activity from foreign tourists. However, the outlook for Air Baltic Corporation AS remains uncertain, posing downside risks to the future performance of air transport service exports. In contrast, exports of port and rail transport services continue to decline, remaining at a subdued level. Exports of construction services have also recorded a slight increase, which could be further supported in the future by the recovery of construction activity in the Nordic countries and the implementation of major infrastructure projects in neighbouring Baltic states.

A more pronounced increase has been observed in the imports of construction services. This trend is expected to continue, driven by rising imports of various construction-related goods linked to the implementation of major infrastructure projects in Latvia and increased investments in the defence sector.

Box 2. Which Latvian companies continue to trade with Russia?

In the context of elevated global uncertainty, maintaining competitiveness is crucial for the Latvian economy; however, recent competitiveness indicators have shown unfavourable trends. Rising unit labour costs have contributed to a weakening of Latvian export price competitiveness, resulting in a continued decline in global market shares for goods exports, a trend also observed among neighbouring Baltic countries. Furthermore, in previous years, the demand for Latvian export goods, such as wood, was weaker compared to other countries, with Latvian export markets underperforming relative to the global average. Currently, Latvia is losing market shares in specific markets and product segments, notably cereals and metal products, with Sweden and Germany identified as key markets where this decline is taking place. However, conditions for the trade of goods continue to improve moderately, with Latvian companies able to export goods at prices higher than their import costs.

Chart 20. **Difference in the growth rate of Latvian goods exports compared to global imports** (12-month moving average compared to the previous 12 months; %; contributions; percentage points)



Sources: UN Comtrade and Latvijas Banka's calculations.

Economic sectors

Uncertainty surrounding trade policy will continue to hinder the development of export-oriented sectors, particularly manufacturing. Along with heightened consumer caution, the growth of trade and other services is also estimated to slow. Stronger growth is expected in construction, supported by orders for public investment projects.

Caution among domestic economic agents was already evident in the first quarter of 2025. Thus, a weaker than previously estimated start of the year, combined with an unexpectedly modest outcome in the fourth quarter of 2024, explains the low level of activity at the beginning of this year. Construction is reviving, driven by the resumption of previously delayed civil engineering projects. Trade was adversely affected by consumer sentiment, while the rise in manufacturing was hindered by persistently weak external demand. Additionally, pertaining to agriculture, the cold and rainy spring season could negatively impact crops.

The changing US tariff policy, along with existing US trade tariffs, has not had a significant and direct impact on Latvian production and exports. However, over the projection horizon, these indicators continue to be affected by indirect effects from goods whose value is partly added in countries exporting final products to the US, as well as by declining demand from Latvia's trading partners due to tariffs. The increase in defence spending will gradually boost demand for military and dual-use goods and technologies, creating growth opportunities in certain segments of manufacturing and IT services, both domestically and in the export market.

Manufacturing will face short-term challenges due to international trade tensions, while in the long term, new opportunities in producing military goods for both domestic and export markets are expected to strengthen the sector. Production and export volumes in manufacturing in the second quarter will be somewhat boosted by frontloading to the US in order to avoid potentially higher import tariffs. However, the following quarter may already see a decline in exports and a weakening of trade ties with the US. Moreover, increased uncertainty around the planning and adjustment of these tariffs has a broader and more negative impact on the production of goods that are not directly or indirectly sold in the US, including those intended for further processing in other countries. Growth in demand for goods in the construction segment was also weak in the first quarter of this year. However, uncertainty may have dampened investors' appetite and the potential for construction activity, possibly delaying a rebound in demand for construction goods.

However, there is also a group of goods experiencing stronger growth – namely, food products – whose production volume and turnover have increased more rapidly since the end of last year. This segment is unlikely to see rapid growth over an extended period. Although investments made in previous years have increased the production capacity of food products, the potential weakening of competitiveness could limit faster growth. Export prices of food products are rising faster than import prices. On the one hand, it improves exporters' income, but on the other hand, it raises concerns about maintaining market shares in export markets if production costs increase faster than those of competitors. Competitiveness issues are also relevant for other groups of manufacturing goods.

Growth in the construction sector is expected to recover sooner than anticipated, supported by a faster increase in civil engineering activity. The construction sector is starting to recover from the downturn and shows signs of improvement; however, the situation varies considerably across different construction segments. Activity in the construction of buildings remains low, especially in the residential segment, where order volumes are restrained by tight lending conditions and low project profitability due to accumulated construction costs. Production volumes are driven by the industrial building segment. Moreover, growing activity in commercial building projects contributes to a positive outlook for the continued development of building construction.

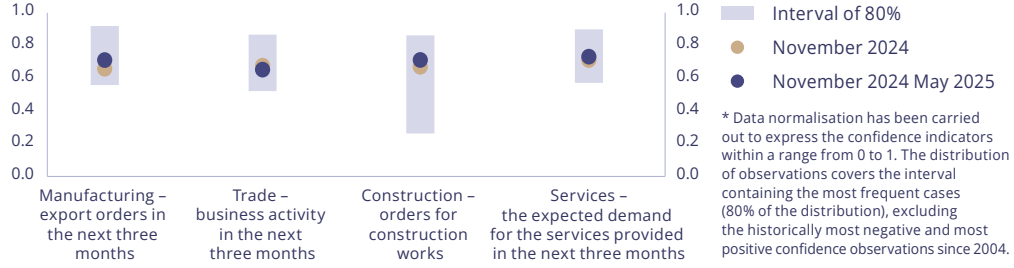
Civil engineering has become the key sector contributing to stability and driving growth. The development of infrastructure projects ensured a steady increase in activity last year. Moreover, business sentiment about the sector's future outlook remains very optimistic. The performance of the sector has been supported by increased volumes of local government and public procurement projects. Moreover, with the acceleration of EU fund investment flows, future growth in civil engineering is also expected to remain stable.

Retail growth is being held back by intensifying competition and shrinking profit margins driven by online sales, cautious consumer behaviour, and a gradual population decline. However, in the medium term, as consumer sentiment stabilises and income rises, activity in the sector could increase. Despite the rise in disposable income, supported by an increase in the minimum wage and tax changes, consumers remained cautious about their spending in the first quarter, and retail trade turnover at constant prices declined after a temporary uptick. A decline in real turnover was also observed in retail outlets primarily selling food. The temporary increase in car sales, driven by the anticipated rise in the car registration tax in Estonia from last September to December, is gradually giving way to a return to more typical levels. A temporary boost can be expected from support instruments for the purchase of more sustainable vehicles. Meanwhile, in terms of value added, the trade sector's overall contribution to GDP consistently moves in the opposite direction of real turnover. This makes trade statistics difficult to interpret.

The development of the transport sector will remain moderate. A faster rebound in growth is being held back by uncertainties in international trade. Freight transport by road is expected to maintain a moderate yet sustainable growth trend this year. Demand for international freight transport in Europe continues to grow, particularly in countries where Latvian carriers already hold a certain market share. Growth is also expected to recover in import and export transport, where freight turnover remained relatively weak last year.

The transit sector has experienced a significant drop in freight volumes in recent years. Although transit flows no longer play a significant role in Latvia's transport sector, freight volumes continue to be negatively affected by the geopolitical situation. The potential to attract alternative freight in rail transport is very limited, so it will not be possible to offset the further decline in freight turnover. The share of transit freight in ports is relatively low, and trans-shipped freight volumes are expected to stabilise this year; moreover, some freight segments are expected to resume moderate growth.

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



* Data normalisation has been carried out to express the confidence indicators within a range from 0 to 1. The distribution of observations covers the interval containing the most frequent cases (80% of the distribution), excluding the historically most negative and most positive confidence observations since 2004.

Sources: EC, Latvijas Banka's estimates.

The air transport sector is expected to maintain a stable growth rate, supported by increasing passenger flows and moderate growth in the freight segment. Lower oil prices in the global market support the sector's profitability; however, growth prospects are dampened by weakening demand and uncertainty surrounding the future development of Air Baltic Corporation AS. The airline's unfulfilled plans for a public share offering (IPO) hinder its strategic development and negatively affect the industry's future growth potential.

Labour market – unemployment

Unemployment is expected to remain close to 7% amid weak economic activity. The recovery of economic growth, which is now expected to be weaker than previously estimated, does not allow unemployment to approach the level projected in June for the medium term. As a result, the unemployment forecast has been revised slightly upwards for the entire projection horizon.

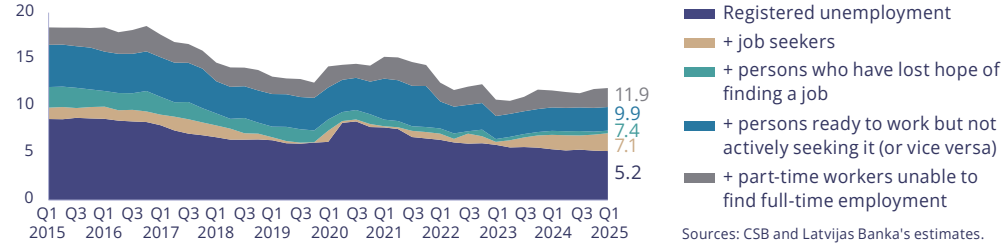
Projections	2024	2025		2026		2027	
	Actual	December	**June**	December	**June**	December	**June**
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	6.8	**6.9**	6.5	**6.7**	6.3	**6.5**

In early 2025, increased job-seeking activity among previously economically inactive people led to a rise in the number of unemployed. This was not reflected in an increase in registered unemployment – which continued to decline at the beginning of the year – as previously inactive people are not eligible for unemployment benefits unless they were employed for a certain period prior to applying. Consequently, registering as unemployed held little relevance for such individuals.

An increase in the number of active people raises the unemployment rate in the short term but is not expected to affect the medium-term downward trend in unemployment. A rise in labour supply in the labour market is generally positive news, as it could help alleviate labour shortages in some sectors. Labour shortages increased in March and April 2025, particularly in the construction sector, where further capacity will be needed to support large-scale projects.

The labour market remains resilient. Although employment expectations do not indicate high labour demand yet, the number of employed persons continues to rise slightly. This suggests that the chances of finding a job – even in times of high uncertainty – are not hopeless. Although external factors will continue to negatively affect the Latvian economy this year, major shocks in the labour market are not expected.

Chart 22. **Alternative unemployment indicators** (% of the economically active population; seasonally adjusted data)



Sources: CSB and Latvijas Banka's estimates.

Despite the current economic uncertainty, entrepreneurs seeking workers will be able to choose from a wider pool of jobseekers. However, the increase in the number of economically active people is short-lived, as demographic changes will eventually alter the situation, and entrepreneurs will then have to compete for the labour more vigorously, especially when the economy resumes growing more rapidly.

Labour market – wages

As a result of weaker labour demand and higher unemployment, the forecast for wage growth has been revised slightly downwards for the entire projection horizon, while remaining close to its long-term average.

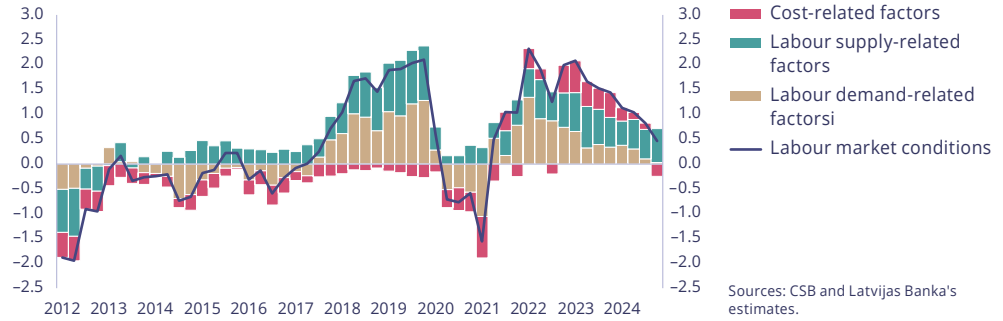
Projections	2024	2025		2026		2027	
	Actual	December	**June**	December	**June**	December	**June**
Nominal gross wage (annual changes; %)	9.7	6.2	**6.0**	6.5	**6.3**	6.5	**6.3**

Wage growth is expected to remain resilient in the medium term (around 6%), as labour supply shrinks due to demographic changes and business competition for workers resumes. Risks to wage growth remain on the upside in some sectors, despite the previous relatively strong increase in labour costs. In the construction sector, large-scale projects planned for the coming years will require increased capacity, including a rise in the number of employees. Taking into account the plans to strengthen national security and defence, the attraction of professional specialists could also lead to a faster rise in wages in this sector.

Growth in real labour income will weaken not only due to lower nominal wage growth but also at the expense of somewhat higher inflation. Wage convergence by sector points to faster wage growth for the lowest wage earners, a trend further accelerated by the decision to regularly review the minimum wage and link it to average wage dynamics. Under the current legal framework, minimum wages will be reviewed at least every two years. The indicative minimum wage is set at 780 euro in 2026 and 820 euro in 2027 but may vary depending on the average wage.

Lower labour demand started to slow wage growth already at the end of 2024, and the trend is expected to continue in 2025. Moreover, the slowdown in wage growth in 2025 is also driven by restrictions on public sector wage increases.

Chart 23. **Labour market conditions** (index; deviation from the long-term average)



Sources: CSB and Latvijas Banka's estimates.

Notes. The labour market composite index reflects the overall trend of 13 labour market indicators. The index is obtained using the principal component method. Before the evaluation, the indicators were standardised (mean = 0 and standard deviation = 1). The division by demand and supply is based on the contributions of indicators that primarily reflect the respective factor. Labour demand is represented by employment growth (annual changes), the employment level, the vacancy rate, labour shortages, and the increase in the number of hours worked (annual changes). Labour supply reflects the unemployment gap, the participation rate, and the number of unemployed persons by job search duration: up to 3 months, from 3 to 12 months, and from 12 to 24 months. Costs are reflected by the increase in average wages (annual changes), the rise in unit labour costs (annual changes), and the growth in compensation per employee (annual changes).

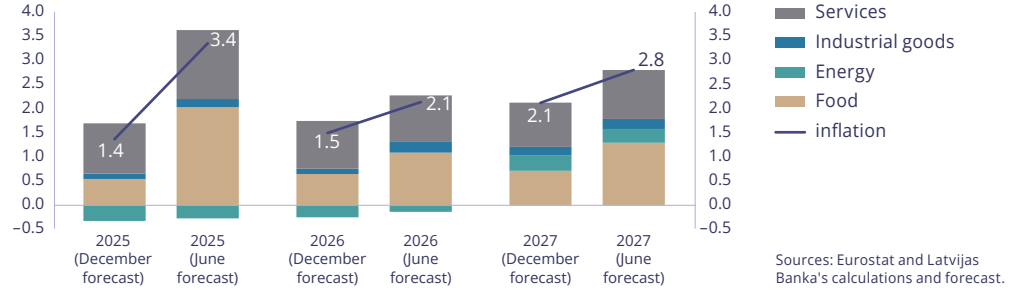
Inflation

Inflation has increased in the first months of the year, and the inflation forecast for this year and the next years has been revised upwards. Prices for food products and services have risen most rapidly.

Projections	2024	2025		2026		2027	
	Actual	December	**June**	December	**June**	December	**June**
Inflation (HICP; annual changes; %)	1.3	1.4	**3.4**	1.5	**2.1**	2.1	**2.8**

The inflation forecast has been revised upwards for the entire projection horizon. Inflation has been higher than expected in all months since December. Earlier this year, the rise in inflation was driven by a faster increase in global oil and gas prices. In February, when the availability of renewable electricity was limited, electricity prices rose particularly rapidly. In March, however, higher excise duty rates on alcoholic beverages came into force. Although in some months the rise in inflation could be explained by one-off factors, the sharp increase in prices also continued in April (4.0% year on year), when Latvia's HICP inflation was among the highest in the euro area. Inflation is also higher in the other Baltic States (4.4% in Estonia, 3.6% in Lithuania in April) than on average in the euro area, where it has stabilised close to the 2% target (2.2% in April).

Chart 24. **Harmonised consumer price inflation in Latvia and contributions, changes in the forecast** (percentage points; annual changes)



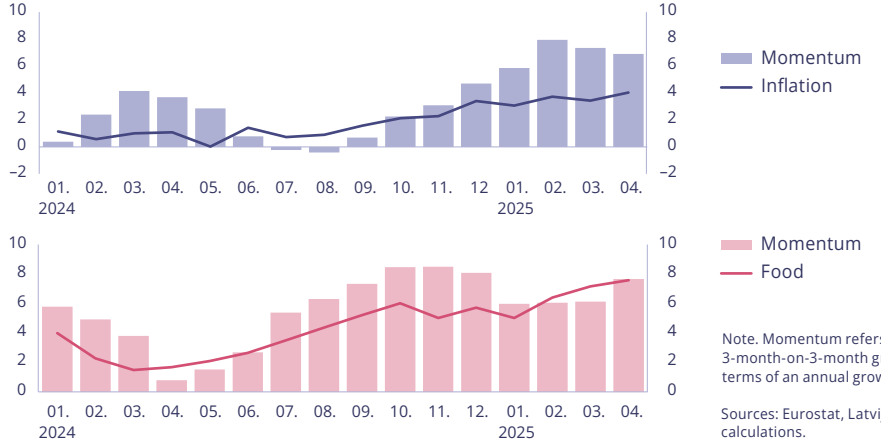
Sources: Eurostat and Latvijas Banka's calculations and forecast.

Services prices continue to rise rapidly in Latvia, increasing by 5.9% year-on-year in the first four months of the year, compared to an average increase of 5.3% in 2024. The rise in prices for labour-intensive services is gradually slowing down. Meanwhile, the increase in prices for administered services remains strong. The prices for accommodation services increased more rapidly in December of last year, while a sharp rise in the prices for air transport services was observed in April of this year. As average wage growth in Latvia moderates, services prices are expected to increase somewhat more slowly in the future; yet their impact on inflation will remain significant throughout the entire projection horizon.

The rate of increase in food prices has accelerated significantly in recent months, rising by 5.4% in the first four months of the year compared with the same period a year earlier; in contrast, the average increase in food prices was only 2.5% in 2024. Prices have risen sharply for coffee, chocolate, poultry, butter, and several other products. This price increase can be partly explained by rising prices in global commodity markets, higher labour costs, and

additional packaging expenses resulting from the increasing natural resources tax. However, the rise in food prices is more rapid than these factors alone can explain, moreover, consumer food prices have grown faster than producer or food import prices.

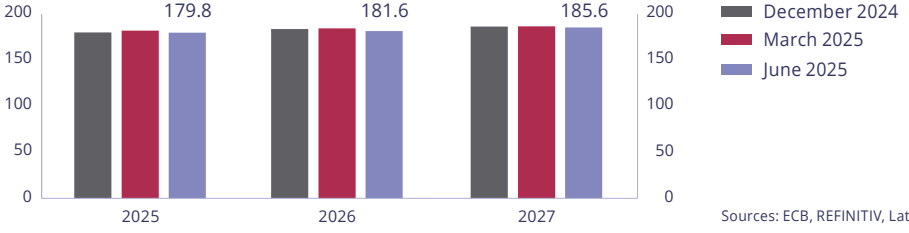
Chart 25. **Inflation and food prices** (annual changes; % and annualised 3-month changes compared to the previous three months)



Note. Momentum refers to the 3-month-on-3-month growth rate, in terms of an annual growth rate.

Sources: Eurostat, Latvijas Banka's calculations.

Chart 26. **Agricultural product prices** (index; 2005=100)



Sources: ECB, REFINITIV, Latvijas Banka's

Global energy prices have declined. Both oil and gas prices, along with their futures prices, declined as uncertainty increased, hampering global economic growth. This eases inflationary pressures. Meanwhile, the impact of global food prices and expected wage developments on inflation is limited. Current assumptions regarding possible changes in trade tariffs also have a negligible impact on the inflation outlook.

Chart 27. **Oil price forecast** (euro)

Sources: ECB, REFINITIV, Latvijas Banka's

Following the finalisation of the December forecasts, work was also undertaken to develop and improve inflation modelling. Latvijas Banka's inflation forecasting model was econometrically reassessed by extending its assessment period up to 2024, thus allowing for a better approximation of variable relationships also observed during periods of rapid inflation growth and decline. As a result of the reassessment of the model, taking into account the evolving responses to changes in wages, global prices, and other variables, the inflation forecast has been revised upwards for the entire projection horizon.

Box 3. What drives the rise in food prices?

Scenario analysis

The impact of the US tariff increase on the Latvian economy: pessimistic scenario[1]

Motivation

At the beginning of April 2025, the President of the United States announced an intention to implement a significant increase in import tariffs, affecting goods originating from nearly all countries worldwide. Although Latvia's direct trade with the US is limited (3.8% of total exports and 2.4% of GDP in 2024), the impact of the tariffs extends beyond bilateral trade. Disruptions to trade flows may also trigger domino effects through Latvia's key European trade partners, whose declining export volumes and economic growth could, in turn, indirectly impact Latvian businesses and households. The specific tariff rates imposed by the US vary across countries and categories of goods, and are subject to frequent adjustments in connection with the conclusion of trade agreements between the US and its partner countries. Not all countries have yet clarified whether they intend to implement retaliatory tariffs, and, if so, at what level such measures would be applied. Consequently, the assessment of tariff impacts involves significant uncertainty and relies heavily on underlying assumptions.

The **assumptions** underpinning Latvijas Banka's forecast have been outlined in the preceding sections. However, given the elevated uncertainty, this analysis considers a more pessimistic scenario in which the tariffs imposed by the US on Latvia and other trade partners are substantially higher. The economic impact of the tariffs has been assessed using the Latvian EAGLE model with tariffs[2] and the Latvian fiscal DSGE[3] model.

Simulation

This section analyses the potential impact of US tariffs and retaliatory measures by trade partners on the Latvian economy, based on the following assumptions.

- Effective tariff applied by the US on goods and services:

  a) 12% – from the EU[4],
  b) 119% – from China, and
  c) 15% – from the rest of the world.

- Tariffs applied to goods and services exported by the US:

  a) 8% – to the EU,
  b) 78% – to China, and
  c) 2% – to the rest of the world.

The impact on the Latvian economy occurs through three distinct channels.

1) Decrease in direct trade with the US: following the introduction of tariffs, Latvian products become more expensive in the US market, leading to a reduction in export volumes to the US.

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

[2] The Latvian EAGLE model with tariffs is an extension of the original EAGLE model (S. Gomes, P. Jacquinot, and M. Pisani (2012) "The EAGLE. A Model for Policy Analysis of Macroeconomic Interdependence in the Euro Area" (Economic Modelling, Elsevier, vol. 29(5), pp. 1686–1714). This extended version incorporates a tariff modelling mechanism based on the work of W. Bolt, K. Mavromatis, and S. van Wijnbergen (2019) in "The Global Macroeconomics of a Trade War: The EAGLE Model on the US-China Trade Conflict" (CEPR Discussion Papers 13495). The model has been calibrated for Latvia, the rest of the euro area, the US, and the rest of the world.

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

[4] Or a nominal tariff of 20% for goods.

2) Indirect trade with the US: Latvian products serve as intermediate inputs in the production of goods in other countries, whose final destination is the US market. Latvia's value added that is embedded in US imports is approximately twice the value of its direct exports to the US. The assessment of this channel assumes that Latvia's (re)exports to the US via the EU are of comparable volume to Latvia's direct exports to the US. Tariffs imposed on EU exports to the US would also lead to a reduction in output among these Latvian companies.

3) Second-round effect due to demand reduction in Latvia's other trade partners: lower export volumes to the US are expected to translate into reduced GDP growth, which in turn will diminish demand for products from Latvian companies. The calibration of this channel assumes that the percentage decline in the EU economy mirrors that of the broader euro area. Additionally, it is assumed that the market for Latvian goods and services outside the US is approximately distributed as follows: 70% within the EU and 30% to the rest of the world.

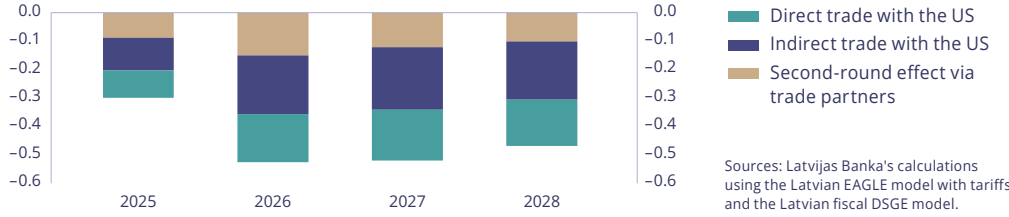
It is assumed that tariffs are increased at the beginning of 2025 and remain constant throughout the simulation horizon. The Latvian EAGLE model is employed to assess the impact of tariffs on: 1) Latvian exports to the US; 2) EU and the rest of the world exports to the US; 3) GDP of the EU and the rest of the world.

In turn, the Latvian fiscal DSGE model, owing to its greater data compatibility and higher level of detail, has been used to estimate the impact of these three external demand[5] channels on Latvia's GDP.

Results

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

Chart 1. **Impact of US tariffs and retaliatory measures by partner countries on Latvia's GDP: the pessimistic scenario** (cumulative changes; %)



Sources: Latvijas Banka's calculations using the Latvian EAGLE model with tariffs and the Latvian fiscal DSGE model.

The simulation results indicate that the direct impact of tariffs reduces Latvia's GDP by up to 0.17%, while the decline in value added through EU exports contributes a further reduction of up to 0.22%. Additionally, the second-round effect stemming from decreased total demand in the EU and the rest of the world lowers GDP by up to 0.15%. Overall, the impact of tariffs on Latvia's GDP via trade channels amounts to approximately 0.5%.

Conclusions

The results of this scenario suggest that Latvia's GDP could decline by approximately 0.5% in a more pessimistic scenario, characterised by a substantial increase in tariffs imposed on Latvia and other US partner countries, followed by retaliatory measures. Furthermore, this scenario accounts solely for the impact of tariffs transmitted through trade channels. It is important to note that tariffs and trade tensions may also influence consumer, producer, and investor sentiment; financial market conditions; the cost of external financing; credit ratings; among other factors. The extent of these impacts remains highly uncertain at the time of developing this scenario.

[5] In the general equilibrium framework of the Latvian EAGLE model, the demand-side effects of tariffs dominate over supply-side effects, resulting in a modest negative impact on inflation.

Scenario analysis

The economic impact of the EU ETS 2 on the euro area and Latvia[1]

Motivation

The EU Emissions Trading System (ETS) covers approximately 34% of the total greenhouse gas (GHG) emissions of the EU, which has led to a 48% reduction of GHG emissions from production facilities regulated by the ETS since its inception in 2005.[2] Despite various extensions since 2005,[3] not all economic sectors are covered as of 2025.

Therefore, a separate EU-wide cap-and-trade system, the EU ETS 2, will be introduced in 2027 and will cover the GHG emissions from buildings and road transport. As a result, the combined coverage of the new and original EU ETS will reach roughly 75% of GHG emissions in the EU.[4] In practice, energy suppliers of buildings and road transport services have to purchase emission permits from 2027 onward.[5] Latvijas Banka has conducted a scenario analysis focusing on the economic effects of the EU ETS 2 in the heating industry[6] for the euro area and Latvia, based on an environmental dynamic stochastic general equilibrium (E-DSGE) model for the euro area[7] and the CGE-EUROMOD model for Latvia[8].

Description of the models and conducted simulations

To analyse the impact on the euro area economy, a closed economy, the multi-sector E-DSGE model with production and investment networks is used.[9] The model encompasses 19 sectors at the NACE 1 level, 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 on the medium-term effects of the EU ETS 2 introduction, i.e. 3–5 years. Both models are best suited to simulate changes over this period, since neither of them allows for substantial long-term technological progress. Conversely, short-term effects are not

[1] Prepared by Patrick Grüning and Oļegs Matvejevs, research economists of Latvijas Banka.

[2] See Greenhouse gas emissions under the EU Emissions Trading System | European Environment Agency's home page.

[3] Intra-EU aviation has been covered by the EU ETS since 2012 and maritime shipping since 2024.

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

[5] Unlike in the original EU ETS, free emission allowances are not foreseen in the implementation of the EU ETS 2.

[6] The road transport fuel has been left out of the simulation because it is generally subject to high excise taxes in almost all EU Member States, with those taxes changing regularly. Moreover, if national carbon taxes are higher than the EU ETS 2 price, EU Member States can opt out of the scheme until 2030. In Latvia, the excise tax on diesel was essentially equivalent to 138 euro/tCO2e in 2024 and is confirmed to rise to 156 euro/tCO2e by 2026, while the excise tax on petrol was 220euro/tCO2e in 2024 and will reach 240 euro/tCO2e in 2026. Thus, Latvia charges several times higher levies on road transport fuels than required by the EU ETS 2 and increases them regularly. It is therefore reasonable to assume that the EU ETS 2 will not have a significant impact on the taxation of road transport fuels.

[7] 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.

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

[9] 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.

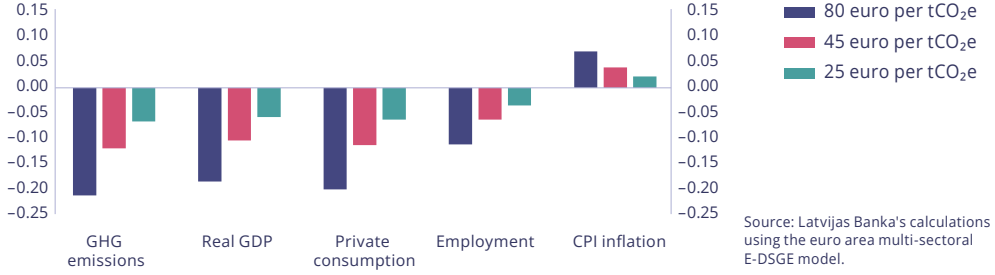
examined in detail due to the considerable uncertainty surrounding the timing and pace of the system's implementation.

Three different prices for the EU ETS 2 emission certificate are used in the subsequent analysis. As the benchmark scenario, a price of 45 euro per tonne of carbon dioxide equivalent (EUR/tCO_2e) for an EU ETS 2 emission certificate is assumed. Since the EU ETS price is higher than 45 euro/tCO_2e, and since the price of an EU ETS 2 emission certificate will be capped at around 45 euro/tCO_2e in the first three years, this price is very likely to materialise. For a sensitivity analysis, both a lower price of 25 euro/tCO_2e and a higher price of 80 euro/tCO_2e are analysed.[10]

Impact on the euro area and Latvia

The results of the model simulation[11] for the euro area, depicted in Chart 1, suggest that the energy price rises by about 1% after 5 years in the benchmark scenario and that the aggregate macroeconomic impact entails reductions of about 0.10% for real GDP, GHG emissions, aggregate price consumption expenditure, and a decline in employment of about 0.05%. The impact on consumer price inflation (CPI) after 5 years is relatively small at 0.04% after 5 years, but the effect is persistent[12].

Chart 1. **Results of scenario analysis: Impact of the introduction of the EU ETS2 on the euro area economy** (changes vis-à-vis the current policy; %)



Source: Latvijas Banka's calculations using the euro area multi-sectoral E-DSGE model.

Chart 2. **Results of scenario analysis: Impact of the introduction of the EU ETS2 on the Latvian economy** (changes vis-à-vis the current policy; %)

Source: Latvijas Banka's calculations using the Latvian CGE EUROMOD model.

The results for Latvia, obtained[13] from the CGE-EUROMOD model, are depicted in Chart 2 and are quite similar to those for the euro area. GHG emissions fall by about 0.15% in the benchmark scenario, real GDP and aggregate private consumption expenditure by 0.10% and 0.14%, respectively, aggregate employment by 0.09%, while CPI inflation increases by 0.07%.

[10] On the one hand, the European Commission has stipulated that the price of EU ETS 2 allowances could be reduced or the whole system paused for a few years if energy prices are excessively high. On the other hand, the reduction of GHG emissions from sources covered by ETS2 is much slower compared to GHG emissions covered by the original ETS. A shortage of EU ETS 2 allowances is therefore expected, which will be reflected in higher prices. However, the European Commission will likely prevent the EU ETS 2 allowance price to exceed the price in the original EU ETS, which has fluctuated on average around 80 euro/tCO2e over the last three years, as the lower EU ETS 2 allowance price was the main reason for separating the two systems. See The State of the EU ETS 2: Europe's New Carbon Market.

[11] The relevant sector that is exposed to the novel EU ETS 2 regulation is the whole energy sector. Since 40% is the fraction of buildings' heating in the final energy consumption of the residential and commercial sectors, and since heating suppliers rather than consumers are subject to the EU ETS 2, the EU ETS 2 is introduced via an emission-based sales tax, levied on 40% of the total GHG emission of the energy sector.

[12] This is due to the fact that price adjustments are assumed to be rigid and therefore the firms in the energy sector pass on the price increase in a staggered fashion. If the EU ETS 2 price was introduced in the simulation as an additional consumption or excise tax, CPI inflation would increase by about 0.38 percentage points. However, this effect would be relatively short-lived.

[13] The additional EU ETS 2 cost is directly imposed on the heating industry and the fraction of the natural gas industry providing heating in buildings. Similarly to the E-DSGE model, the cost is applied as a sales tax levied on the firms operating in the aforementioned sectors. No change in the rest of the world is assumed in the scenario analysis.

The most affected sector in Latvia's economy is the heating industry: its output becomes 0.4% lower, a 1% reduction in GHG emissions is achieved, while heating becomes more expensive by about 2%.

Conclusions

The EU ETS has successfully contributed to considerably reducing GHG emissions in the EU. The conducted scenario analysis suggests that extending the coverage of the emission trading scheme to include the heating sector via a separate system, the EU ETS 2, from 2027 onward implies relatively small negative aggregate macroeconomic effects over the first five years for the euro area and Latvia, while meaningfully contributing to reducing GHG emissions.

Since technological progress is not accounted for explicitly, as it would have a limited effect for horizons of 3–5 years, these economic costs are not unexpected. The planned tightening of the EU ETS 2 emission cap over time will likely induce such technology adoptions in the longer run. Furthermore, no options of EU ETS 2 revenue recycling have been explored here, which could be the topic of another scenario analysis in the future. This all implies that in the long term, the EU ETS 2 will lead to an even larger GHG emissions reduction, while the negative economic consequences will become smaller and might even be outweighed by gains from the adoption of more efficient technology in heating.

Box 1. The impact of military spending on Latvia's economy[1]

EU Member States' defence spending has increased by more than a third since 2021, and its growth rate has accelerated significantly compared to the situation before Russia's invasion of Ukraine. However, the spending of European countries remains much lower than that of the US, Russia, or China and amounts to an average of 1.3% of GDP[2]. At the same time, it is expected to increase significantly over the next four years. This box presents Latvijas Banka's assessment of the impact made by these changes on Latvia's GDP.

To strengthen Europe's defence capabilities and develop additional flexibility to increase defence spending in national budgets, the EC developed the Readiness 2030 Plan (initially presented as the ReArm Europe Plan). It called on Member States to activate the national escape clause, which allows for an increase in defence spending above the current trajectory of national budget expenses, as agreed with the EC and the Council. Flexibility in defence spending will be available for four years, starting from 2025. Expenditure growth must not exceed 1.5% of GDP for each year the clause is activated, calculating the deviation from the current expenditure trend[3]. At the end of April this year, Latvia, together with 11 other Member States[4], requested the activation of the national escape clause, with at least 4 more countries expressing an interest in the activation of the clause[5]. According to EC calculations, if all Member States used the available derogation to its maximum extent, the available funding for defence would rise by around 650 billion euro over four years.

Several Member States, including Germany, France, the Baltic States, and Poland, have already announced substantial increases in defence spending. At the same time, Germany has decided to lift fiscal restrictions and set up a new, extra-budgetary fund for defence and infrastructure. Approximately one trillion euro is planned to be invested in strengthening Germany's military capabilities and economic development over the next 12 years. Considering that several of these countries are important foreign trade partners for Latvia, the increase in military spending in these EU Member States may promote a rise in external demand and opportunities for Latvia to engage in various stages of production chains, which, in turn, may facilitate Latvia's economic growth.

In order to assess the impact of the increase in EU Member States military spending on the GDP of Latvia, Latvijas Banka has carried out an analysis using the DSGE model for Latvia. The assumptions are based on the EC Readiness 2030 guidelines and explanations until 31 March 2025, the decisions taken in Latvia until 10 May 2025, and the current forecasts of Latvijas Banka (June 2025). The assumptions are as follows:

1) Latvia's defence spending amounts to 5% of GDP in 2028.

- Annual increase in defence expenditure above the approved medium-term budget plan for 2025–2027[6]: 0.1 percentage points of GDP in 2025 and 0.4 percentage points each year from 2026 to 2028.
- The structure of additional expenditure: investment – 50%, staff remuneration – 25%, and goods, services, and other expenses – 25%.

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

[2] In 2023, 1.3% of GDP according to the Classification of the Functions of Government (COFOG) and 1.8% of GDP according to NATO's expenditure accounting methodology for NATO EU Member States.

[3] For other expenditure, compliance with the expenditure path remains a requirement. The increase in defence expenditure is planned to be calculated based on the 2021 level. This reference year ensures equal treatment of Member States that have already increased their defence spending following the commencement of Russia's aggressive war against Ukraine.

[4] These countries are Belgium, Denmark, Greece, Estonia, Latvia, Poland, Portugal, Slovakia, Slovenia, Finland, Hungary, and Germany. See the EC press release "12 Member States request activation of the national escape clause", 30 April 2025 [last viewed on 24 May 2025].

[5] Coordinated activation of the National Escape Clause, Council of the European Union press release, 30 April 2025 [last viewed on 24 May 2025].

[6] The Ministry of Defence's 2025 budget; calculated based on the updated GDP assessment by Latvijas Banka (June 2025).

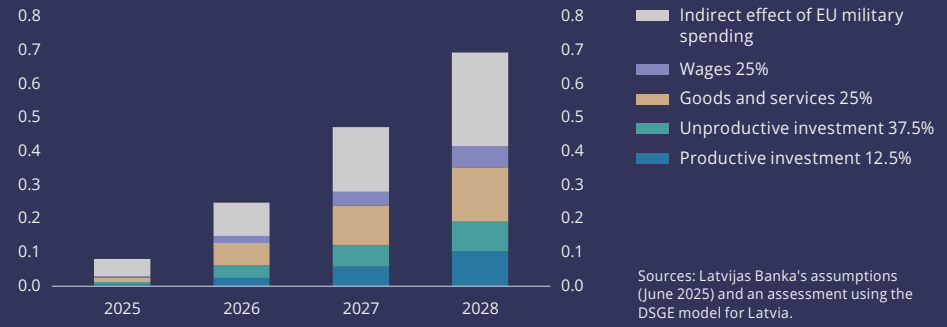
2) Indirect effects from the increase in external demand: EU Member States are raising military spending in line with the EC's assessment of the use of the national escape clause. The total rise in military expenditure planned by EU Member States for 2025–2028 amounts to 1.6% of EU GDP.

The simulation assumes that only a part of Latvia's investment contributes to economic productivity. A quarter of the investment is modelled as productive investment by the government, while the rest is modelled as government consumption. Investments have a 70% share of imports. Staff remuneration is modelled as government transfers to households, whereas goods and services are modelled as government consumption with a 30% share of imports. Defence expenditure growth is assumed to be financed at the expense of the budget deficit, and the fiscal rules are not binding on the government.[7] In turn, the EU Member States' military expenditures are assumed to have a GDP multiplier of 0.75 in the EU, which is approximately the middle of those mentioned in the literature.[8]

The simulation results show that the increase in defence spending in Latvia and the rest of the EU raises Latvia's GDP by broadly 0.7% over four years. Latvia's four-year rise in defence spending boosts GDP growth by 0.4%. The relatively small GDP multiplier (0.32) stems from the high import component of Latvia's military expenditure. Meanwhile, the indirect impact of higher defence spending in the rest of the EU provides an additional 0.3% to Latvia's GDP.

On the one hand, the impact on Latvia's economic growth may be smaller if the supply of equipment is delayed or if the import component of defence expenditure is larger than assumed in the analysis. On the other hand, this analysis does not assess the potentially positive impact of the increased defence spending on the sentiment of the Latvian population and foreign investors, which may additionally stimulate Latvia's economy.

Chart 1.1. **Defence spending impact on Latvia's GDP**
(deviation from the initial level; %)



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

[7] The model suspends fiscal rules for the first two years, after which a small lump-sum tax on wealthy households is imposed.

[8] See, e.g. G. B. Wolff, A. Steinbach, and J. Zettelmeyer (2025) "The governance and funding of European rearmament", Bruegel Policy Brief, Bruegel, 7 April 2025.

Box 2. Which Latvian companies continue to trade with Russia?[1]

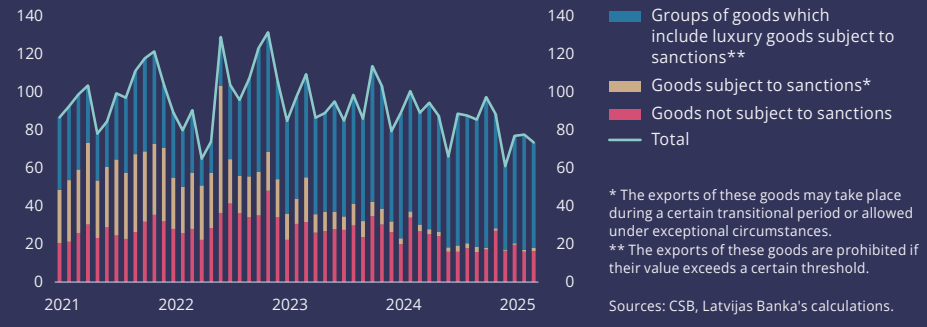
More than three years after Russia's full-scale invasion of Ukraine, exports of Latvian goods remain relatively high, with Russia still ranked among the top five export markets. In part, the resilience of such exports can be explained by Latvia being located on the EU's external border with Russia, and only for logistical reasons, a large physical flow of goods from the EU to Russia takes place via Latvia.

However, while the value of exports to Russia has been relatively stable, the composition of exports has changed significantly in at least two respects – the type of goods traded, and the companies involved in trade with Russia. As discussed earlier (in Box 2 of the Macroeconomic Projections Report of October 2024), sanctions have resulted in almost no exports of sanctioned goods (except for cases where a transitional period has been set or exports have been allowed under exceptional circumstances), while a rise has been observed in exports of groups of goods, which include various luxury goods, whose exports are prohibited if their value exceeds a certain threshold. For Latvia, these are mostly alcoholic beverages, clothing, footwear, etc. Exports of other goods (mainly pharmaceuticals), which are not subject to sanctions, are ongoing but have declined over time.

Three (or four) types of companies can be distinguished (Chart 2.2) based on their dependence on the Russian market (the share of exports to Russia above 10% of the company's turnover is considered highly dependent) and changes in their exports to Russia between 2021 and 2023. The fourth type of company cannot be included in this chart as they only started exporting to Russia in 2022–2023, not having exported to this market previously. However, we also included these companies in the analysis.

[1] Prepared by Nicolas Gavoille and Matīss Mirošņikovs, economists of Latvijas Banka.

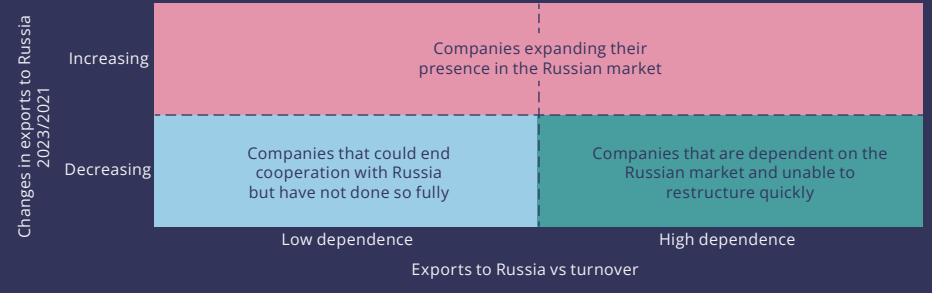
Chart 2.1. **Exports of Latvian goods to Russia** (millions of euro)



* The exports of these goods may take place during a certain transitional period or allowed under exceptional circumstances.
** The exports of these goods are prohibited if their value exceeds a certain threshold.

Sources: CSB, Latvijas Banka's calculations.

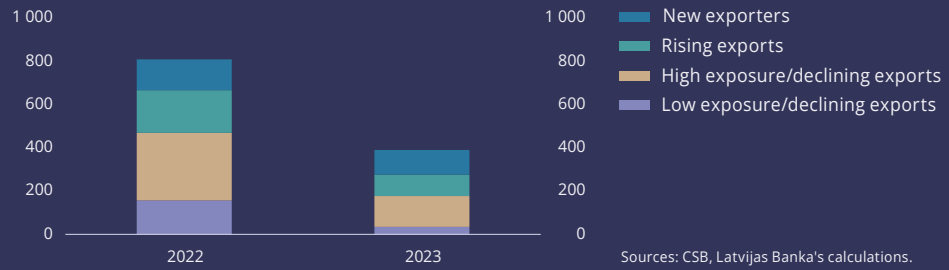
Chart 2.2. **Companies' dependence on the Russian market and changes in exports to Russia**



As shown in Chart 2.3, the number of companies exporting to Russia in 2023 was half the 2022 number. Companies that were able and willing to cease collaboration with Russia did so: in 2023, exports to Russia continued mostly for those for whom the Russian market was vital. At the

same time, more than half of the exporters that continued to cooperate with Russia in 2023 were those whose exports to Russia increased or who had just started exporting to Russia.

Chart 2.3. **Profile of Latvian companies continuing exports to Russia in 2022 and 2023** (number)



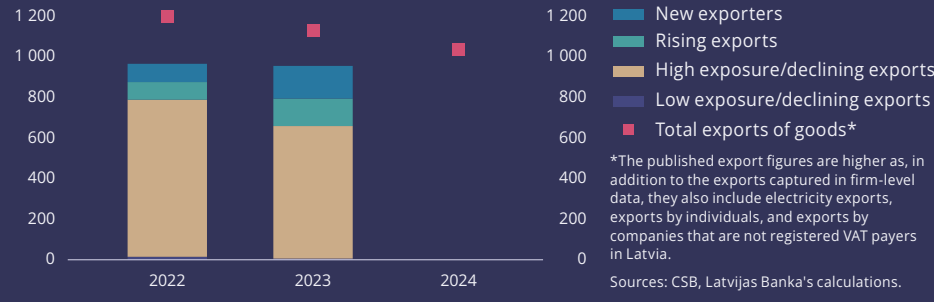
Sources: CSB, Latvijas Banka's calculations.

Looking at the total value of exports by company, it becomes evident that companies for which Russia is a key market account for the largest share of exports, although exports to this country are on the decline. In 2023, these companies saw a 120 million euro drop in exports year on year. This reduction is offset by exporters whose exports to Russia are growing – both post-war entrants and pre-existing exporters.

Accordingly, the resilience of Latvian exports to Russia has been shaped by companies heavily reliant on the Russian market. However, some companies have capitalised on the situation, increasing their export volumes, with many initiating exports to Russia where none existed before.

Trade and transport companies are the most prominently represented across sectors – including both those expanding exports to Russia and many others with high exposure to the Russian market whose exports are now declining. Exporters include manufacturing companies, but these are mostly companies with a relatively high dependence on the Russian market and are gradually exiting it, such as pharmaceutical companies, whose transition to new markets is time-consuming.

Chart 2.4. **Exports of Latvian companies to Russia: company profile in 2022 and 2023 and total exports of goods in 2022–2024** (millions of euro)



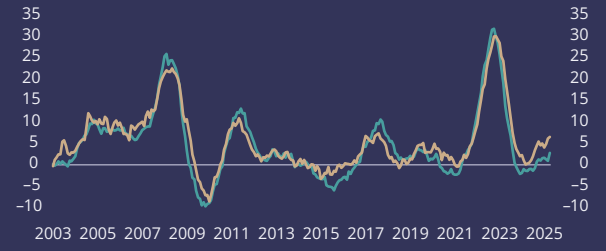
*The published export figures are higher as, in addition to the exports captured in firm-level data, they also include electricity exports, exports by individuals, and exports by companies that are not registered VAT payers in Latvia.

Sources: CSB, Latvijas Banka's calculations.

Box 3. What drives the rise in food prices?[1]

April 2025 saw a 7.4% increase in consumer food prices year on year. This is well above the historical average (4–5%). Meanwhile, the rise in food producer prices has been far more moderate – just 1–2% in the first four months of this year compared to the same period last year (Chart 3.1). Why are food retail prices growing so rapidly?

Chart 3.1. **Aligned HICP and PPI food inflation in Latvia** (annual changes; percentage points)

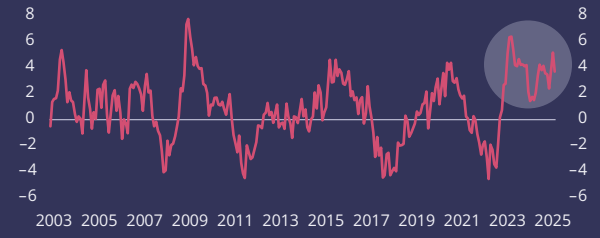


Notes. HICP food inflation excluding beverages, alcohol, and tobacco. PPI food inflation follows the C10 NACE classification, with producer prices referring to goods sold on the domestic market.

Sources: CSB, Latvijas Banka's calculations.

Food producer prices have historically shown a strong correlation with retail prices. That means food prices in shops reflect changes in production costs. These related price changes were apparent prior to the financial crisis in 2007, throughout the recovery from the financial crisis in 2011, and during the regional food price hike in 2017. The last significant episode of rising food producer prices is linked to the disruption of supply chains during the COVID pandemic and the Russian aggression in Ukraine. Since 2023, however, food producer prices have been stable. At the same time, retail food prices have been growing rapidly for several consecutive quarters and have not followed producer prices (Chart 3.2).

Chart 3.2. **Relative HICP and PPI food inflation in Latvia** (annual changes; percentage points)

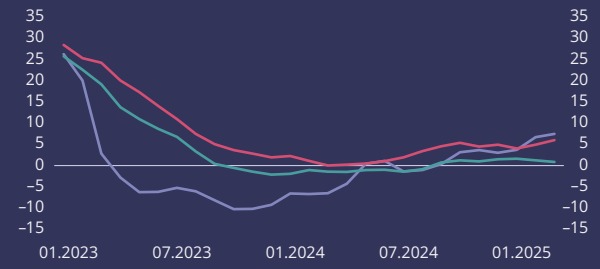


Notes. Relative inflation shows the difference between HICP food inflation and PPI food inflation. HICP food inflation excludes the prices of beverages, alcohol, and tobacco.

Sources: CSB, Latvijas Banka's calculations.

The uptick in food retail prices is shaped by several contributing factors. Although the total costs of food production are not rising, prices for certain food categories, driven by global trends, continue to increase (Chart 3.3). For example, the prices of milk, meat, and coffee have also grown in global markets.

Chart 3.3. **Food commodity prices, food HICP and PPI** (annual changes; percentage points)



Notes. Global food prices are depicted as the FAO Food Price Index. Consumer food prices are HICP food prices (excluding beverages, alcohol, and tobacco).

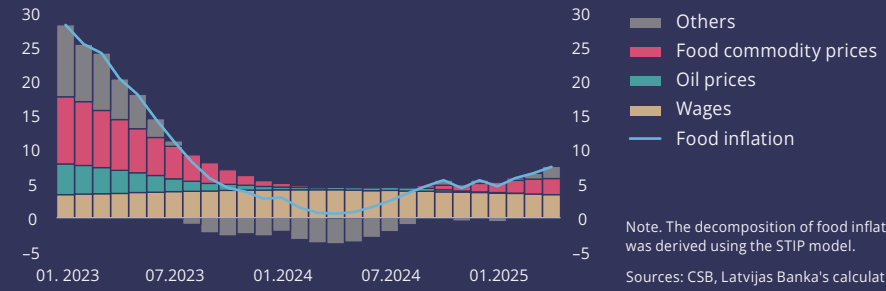
Sources: CSB, Latvijas Banka's calculations.

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

Food prices are also affected by domestic factors, the most significant being wage increase, which is still above the historical average growth rates. However, as wage growth moderates over the projection horizon, the impact of this factor on food price increases will diminish.

At the same time, the surge in food prices stems only partially from the commodity price increase and labour costs. Our calculations show that food price inflation is currently growing faster than we can explain by historical relationships (Chart 3.4). This may reflect the willingness of some participants along the production, import, or sales chain to increase prices beyond rising costs, aiming to boost their profit margins.

Chart 3.4. **Latvia's food inflation by contributing factor** (annual changes; percentage points)



Note. The decomposition of food inflation was derived using the STIP model.

Sources: CSB, Latvijas Banka's calculations.

Abbreviations

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

GHG – greenhouse gases

HICP – Harmonised Index of Consumer Prices

IMF – International Monetary Fund

ISIN – International Securities Identification Number

LSEG – London Stock Exchange Group plc

OIS – Overnight Index Swap

OPEC – Organisation of the Petroleum Exporting Countries

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

PIT – personal income tax

PPI – Producer Price Index

PUC – Public Utilities Commission

UK – United Kingdom

US – United States of America

VAT – value added tax