

Macroeconomic Projections Report

2026 | June

ISSN 3044-702X

Macroeconomic Projections Report

2026 | June



Macroeconomic Projections Report

June 2026, No 5

© Latvijas Banka, 2026

The source is to be indicated when reproduced.

Latvijas Banka

K. Valdemāra iela 2A, Rīga, LV-1050

Tel.: +371 67022300; info@bank.lv

www.bank.lv; www.makroekonomika.lv

Additional information

The cut-off date for the information used in the Macroeconomic Projections Report (June 2026, No 5) and in the forecast is 27 May 2026 (21 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 11 June 2026.

Contents

Key points in brief

Global uncertainty remains high. At the beginning of this year, it appeared to be on a downward trajectory. However, following the outbreak of hostilities involving the United States, Israel, and Iran, this trend has reversed. A ceasefire alone provides little benefit to the global economy if maritime traffic through the Strait of Hormuz is not resumed. The availability of energy commodities has declined, while their prices have risen. At the same time, peace negotiations concerning Ukraine have lost momentum and, pending a resolution of the conflict in the Middle East, have been pushed into the background.

Heightened geopolitical uncertainty and rising energy prices have weakened the outlook for external demand, weighing on growth and demand prospects in Latvia's main trading partners. Although economic activity in the Baltic States has remained relatively resilient, the weaker outlook for Germany and the EU as a whole continues to constrain Latvia's export growth prospects.

Since the beginning of the year, the Governing Council of the ECB has increased the key interest rates by 25 basis points. The energy supply shock caused by the war in the Middle East, together with the resulting increase in energy prices, has led to tighter financial conditions.

Despite heightened geopolitical uncertainty and higher market interest rates, the availability of financing in Latvia remains favourable in both the capital market and the banking sector. The loan portfolio continues to expand in both the corporate and household sectors, with corporate lending increasing across a broad range of industries.

The budget deficit for this year is projected to be slightly above 3% of GDP, with the assessment broadly unchanged from previous projections. Legislative changes aimed at maintaining high defence expenditure also in the future, together with sizeable deliveries of military equipment in 2028, are expected to increase the projected budget deficit, bringing it close to 5% of GDP. Rising budget expenditure in the coming years will increase borrowing needs, and the government debt ratio is expected to exceed 51% of GDP over the medium term.

The war in the Middle East is weighing on both domestic and external demand, resulting in slower growth in aggregate demand than previously projected. At the same time, investments in the production of military and dual-use goods are becoming an increasingly important driver of growth. This

allows for a moderately optimistic outlook for future economic developments.

The deterioration in the geopolitical environment is delaying a stronger recovery in external demand and prompting consumers to remain cautious. This weakens growth prospects in both export- and domestic consumption-oriented sectors.

Labour supply is not increasing significantly, but labour demand is easing somewhat in the context of weaker economic growth. Nonetheless, the labour market remains tight, and unemployment will continue declining over the projection horizon, albeit at a slower pace than previously anticipated.

Wage growth is expected to remain strong, although it will be moderated somewhat by economic uncertainty and a slight easing in labour demand.

The inflation projection has been revised upwards for both this year and next, primarily reflecting higher global energy prices amid the war in the Middle East. This impact was mitigated by lower global food commodity prices and more moderate wage growth. Inflation is expected to approach 4% over the projection horizon, exceeding that level in some months.

Projections in figures^{*}

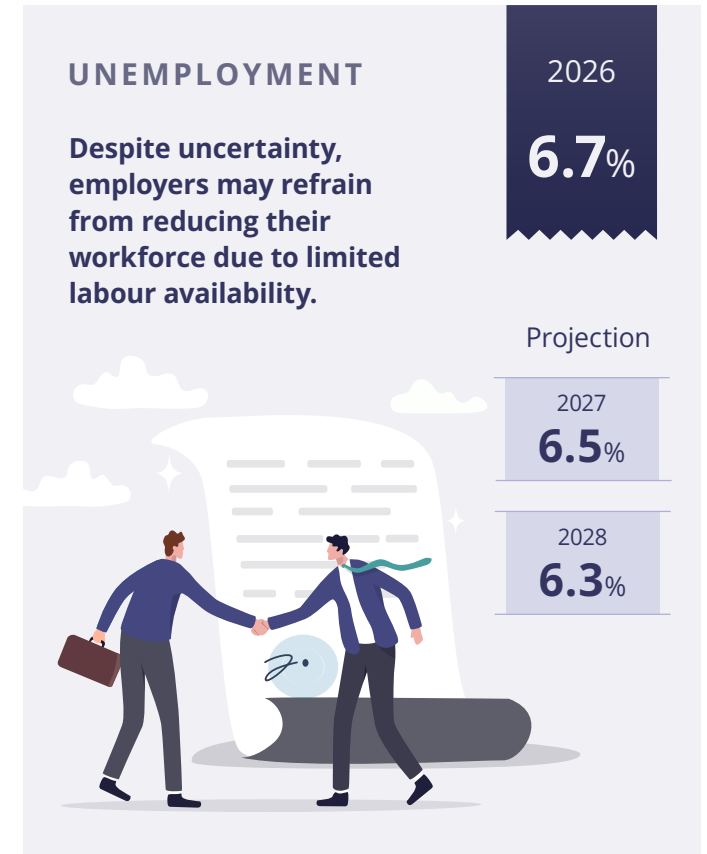
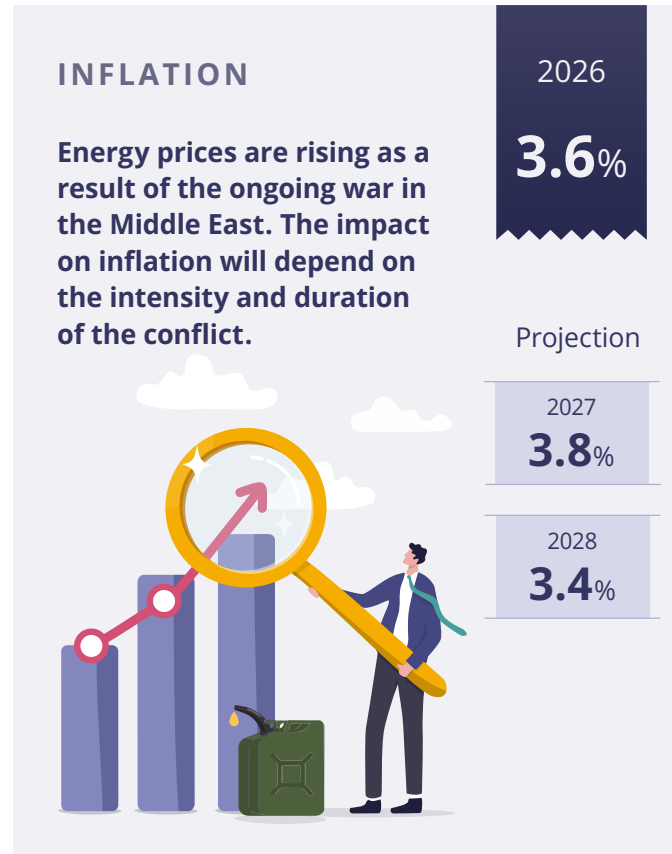
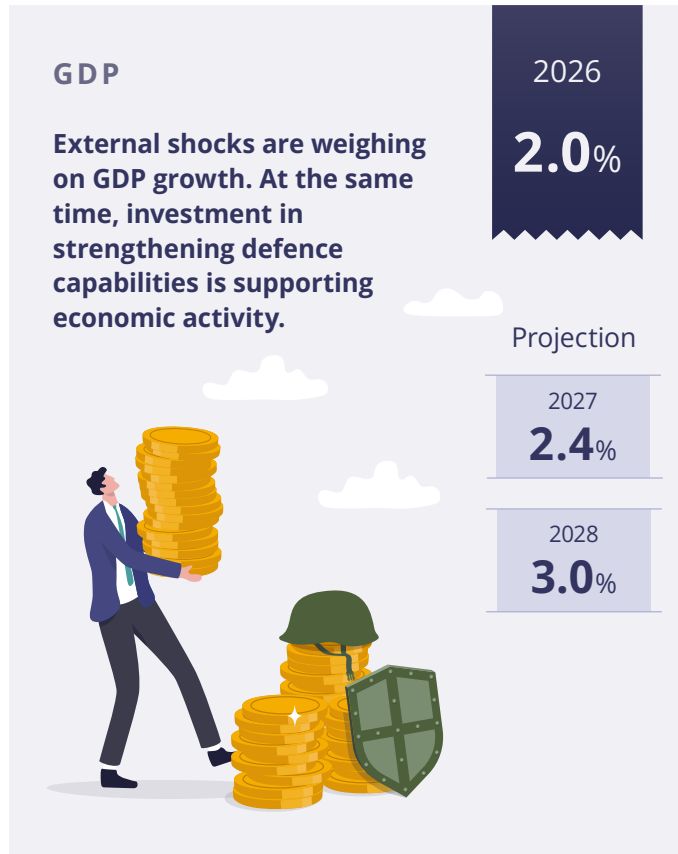
^{*} The cut-off date for the information used in the forecast is 27 May (21 May for the information used in some technical assumptions).

Table 1

Macroeconomic fundamentals: Latvijas Banka's projections

	2025 Actual	2026	2027	2028
Economic activity (annual changes; %; at constant prices; seasonally adjusted data)				
GDP	2.1	2.0	2.4	3.0
Private consumption	0.7	2.1	2.7	3.0
Government consumption	5.9	0.7	1.2	1.5
Investment	9.4	2.2	1.5	5.6
Exports	0.1	0.7	2.7	3.3
Imports	5.7	0.2	2.0	3.6
Inflation (annual changes; %)				
HICP	3.8	3.6	3.8	3.4
Core inflation (excluding food and energy prices)	3.5	3.3	4.0	4.3
Labour market				
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	6.7	6.5	6.3
Nominal gross wage (annual changes; %)	7.7	7.4	7.3	7.5
External sector				
Current account balance (% of GDP)	-3.4	-4.6	-4.2	-4.4
Government finances (% of GDP)				
Budget balance	-2.5	-3.3	-3.9	-4.8
General government debt	46.9	47.9	51.3	51.2

Projections in brief



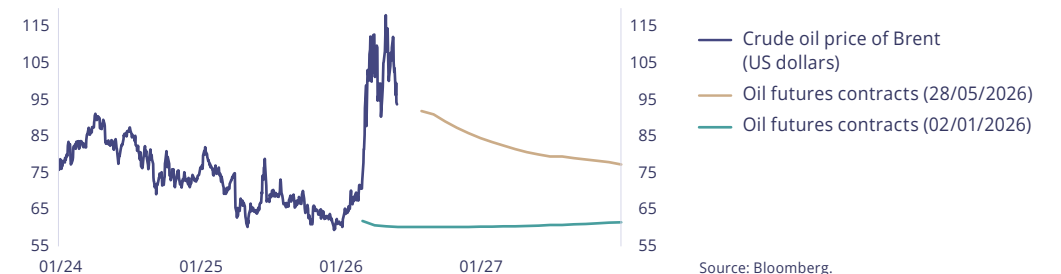
Global environment

Global uncertainty remains high. At the beginning of this year, it appeared to be on a downward trajectory. However, following the outbreak of hostilities involving the United States, Israel, and Iran, this trend has reversed. A ceasefire alone provides little benefit to the global economy if maritime traffic through the Strait of Hormuz is not resumed. The availability of energy commodities has declined, while their prices have risen. At the same time, peace negotiations concerning Ukraine have lost momentum and, pending a resolution of the conflict in the Middle East, have been pushed into the background.

Global prices of goods

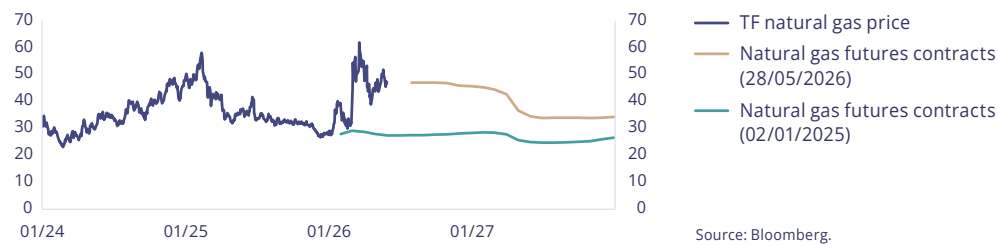
Global oil, natural gas, and grain prices have risen sharply due to supply disruptions and higher energy costs caused by the war in the Middle East. Global oil prices rose rapidly following the outbreak of hostilities in the Middle East. Prior to the war, oil prices fluctuated between USD 60 and USD 65 per barrel. With the escalation of military action, however, they climbed to almost USD 120 per barrel. The war has significantly reduced the global availability of oil by effectively bringing maritime traffic through the Strait of Hormuz to a standstill. Before the war, a substantial share of global oil shipments passed through this strategic maritime route. To mitigate the sharp increase in oil prices, member countries of the International Energy Agency unanimously agreed to release 400 million barrels of oil from their strategic reserves. At the same time, non-OPEC countries have modestly increased oil production, helping to ease upward pressure on oil prices. The future path of oil prices will largely depend on developments in the Middle East. If oil exports from the Persian Gulf countries can be restored to their pre-war levels, prices are expected to decline gradually. Nevertheless, a return to pre-war price levels is likely to take time. Conversely, without a resolution of the conflict in the Middle East that enables maritime traffic through the Strait of Hormuz to resume, upward pressure on oil prices is expected to persist.

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



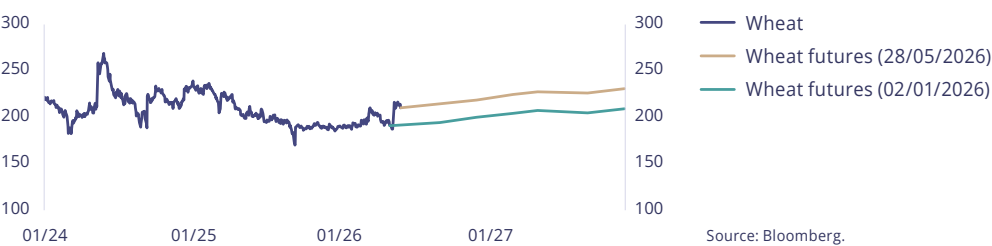
Natural gas prices in Europe have also risen significantly. As with oil, the increase in natural gas prices has been driven by the war in the Middle East. Persian Gulf countries, such as Qatar and the UAE, are major exporters of liquefied natural gas (LNG). However, the closure of the Strait of Hormuz has effectively prevented these exports from reaching the global market. The end of the heating season, increased supplies from the US, and a renewed shift towards coal-fired power generation in several Asian economies have helped contain a more pronounced increase in prices. Looking ahead, developments in natural gas prices will largely depend on how the situation in the Middle East evolves. Even if a favourable agreement is reached, damage to natural gas infrastructure would prevent exports from returning quickly to their previous levels. However, a substantial increase in the US LNG export capacity is expected in 2027–2028, which could contribute to a marked decline in prices.

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



Global grain prices have also increased. Higher grain prices are primarily driven by rising energy prices and the subsequent increase in fertiliser prices. In addition, adverse weather conditions in the US and reduced sown areas in Australia add further upward pressure on grain prices. However, favourable crop prospects in the EU and relatively high global grain inventories are limiting sharper increases in grain prices.

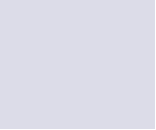
Chart 3. Wheat prices on the Euronext exchange (euro/t)



Monetary policy at the leading central banks across the world

Central banks	Changes in interest rates since the beginning of summer	Main policy rate	Market expectations of future interest rate developments	Considerations
Fed	-	3.50–3.75	Interest rates will increase	Concerns that energy prices will accelerate inflation. At the same time, the labour market continues to cool down
Bank of England	-	3.75	Interest rates will increase	Concerns that energy prices will accelerate inflation
Bank of Japan	-	0.75	Interest rates will increase	Concerns that energy prices will accelerate inflation

Leading central banks, including the Fed, the Bank of England. and the Bank of Japan, have kept their interest rates unchanged since the beginning of the year. However, developments in the Middle East and the subsequent rise in energy prices have significantly altered their outlook for



monetary policy. Before the outbreak of the war in the Middle East, both the Fed and the Bank of England were expected to continue reducing interest rates. However, the next interest rate decision is now more likely to be an increase. With regard to the Fed, which has been chaired by Kevin Warsh since 22 May 2026, financial market expectations remain cautious. Markets are pricing in only around a 50% probability of a single rate increase by next spring. This is driven by both the Fed's dual mandate, as the US labour market continues to soften, and the possibility of political pressure given the US President's opposition to higher interest rates. As regards the Bank of England, financial markets have priced in two full 25-basis-point interest rate increases. Markets also expect the Bank of Japan to raise interest rates twice, by 25 basis points on each occasion.

External demand

Heightened geopolitical uncertainty and rising energy prices have weakened the outlook for external demand, weighing on growth and demand prospects in Latvia's main trading partners. Although economic activity in the Baltic States has remained relatively resilient, the weaker outlook for Germany and the EU as a whole continues to constrain Latvia's export growth prospects.

The global and euro area economy

Global economic growth remains subdued and subject to elevated risks. This is driven by heightened geopolitical uncertainty, including the war in the Middle East and the associated increase in energy prices, as well as broader geopolitical tensions among the world's major economies. Although the global economy has so far demonstrated a degree of resilience, these factors hinder a stronger recovery in economic activity and constrain the expansion of international trade. According to the IMF's latest Spring World Economic Outlook, global GDP growth is projected at 3.1% in 2026 and 3.2% in 2027.

The outlook for global growth is shaped by a number of opposing forces. Economic activity is supported by more favourable financial conditions, fiscal stimulus in several major economies, and stronger investment related to artificial intelligence. At the same time, elevated public debt, supply chain vulnerabilities, rising protectionism, and the risk that expectations of productivity gains from artificial intelligence may prove overly optimistic continue to weigh on growth prospects.

According to the IMF's projections, global inflation is expected to rise temporarily in 2026 before resuming its downward path in 2027. This suggests that the disinflation process is becoming less smooth and that central banks will need to balance the objective of maintaining price stability against the risks posed by weaker growth. Commodity price developments will remain one of the key factors shaping the outlook for both inflation and monetary policy.

Economic activity in the euro area proved more resilient in 2025 than previously expected.

Over the course of the year, the ECB gradually revised its 2025 growth projections upwards, reflecting stronger domestic demand and more favourable economic momentum in the second half of the year.

At the same time, the ECB's March 2026 projections reflect a more cautious outlook on future developments. Real GDP growth in the euro area is now projected at 0.9% in 2026, 1.3% in 2027, and 1.4% in 2028. Compared with the December 2025 projections, GDP growth has been revised down by 0.3 percentage points for 2026 and by 0.1 percentage point for 2027, primarily reflecting a weaker outlook for external demand, heightened uncertainty, and higher energy prices.

Over the medium term, euro area growth is expected to be supported by domestic demand, a resilient labour market, and government spending on infrastructure and defence, particularly in Germany. Nevertheless, private consumption and investment are likely to remain subdued

in the near term. Economic activity in Germany is gradually strengthening, with GDP expanding for a second consecutive quarter, while growth in France is constrained by weaker domestic demand and softer export performance.

Over the coming quarters, the inflation outlook for the euro area will increasingly be shaped by risks related to energy markets and geopolitical developments, adding to uncertainty about the pace at which inflation will return to the ECB's target. According to the ECB's March 2026 projections, headline inflation is expected to reach 2.6% in 2026, 2.0% in 2027, and 2.1% in 2028, with energy prices remaining the main driver of inflation. Over the medium term, the continued moderation in core inflation will be supported by slower wage growth and more subdued demand.

Latvia's major trade partners

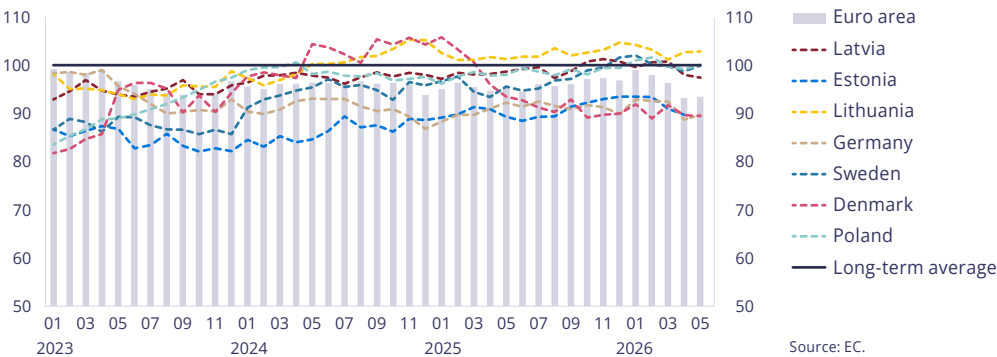
Since last December, the external environment has become even more challenging. The uncertainty stemming from US tariffs has not subsided and has been compounded by uncertainty arising from the war in the Middle East. In its May 2026 Forecast, the EC revised its 2026 EU growth projection down to 1.1%, primarily reflecting higher energy prices, which are dampening demand while adding to inflationary pressures. This implies that changes in external demand for Latvian goods and services are no longer driven solely by tariff-related trade disruptions, but also by weaker household purchasing power and corporate investment plans amid higher costs.

Lithuania, Latvia's most important trading partner, continues to record relatively strong economic growth. According to the EC's May 2026 Forecast, Lithuania's GDP is expected to increase by 3.0% this year before slowing to 2.1% in 2027. Demand in Lithuania is expected to be supported this year by rising household incomes, including the temporary boost to consumption resulting from the possibility of withdrawing funds from second-pillar pension

savings. This could provide short-term support for Lithuanian demand for Latvian goods and services. The inflation projection has been revised up significantly, largely reflecting higher energy prices and the above-mentioned second-pillar pension reform.

The outlook for Estonia is broadly similar. Before the outbreak of the war in the Middle East, signs of economic recovery had become more pronounced, business confidence had improved, sales had increased in both domestic and export markets, and exporters reported stronger competitiveness. However, reflecting heightened uncertainty, the EC has lowered its 2026 growth projection to 1.6% since last November. A positive development is that recent income tax changes (this year's introduction of a universal monthly non-taxable minimum of EUR 700) are expected to strengthen household purchasing power significantly, thereby supporting consumption. As a result, the outlook for the Estonian market no longer appears as weak for Latvian exporters as previously expected.

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



Germany enters the current period from a somewhat stronger starting point than in December 2025, although its future outlook has deteriorated. On the one hand, after several

years of economic downturn, signs of recovery in the German economy began to emerge early this year, supported by an improving order book in manufacturing and higher public expenditure on defence, infrastructure, and climate-related investment. On the other hand, the energy price shock significantly delayed this recovery. Higher energy prices are eroding household purchasing power and reducing corporate profitability, while export prospects continue to be constrained by the US tariff policy, elevated uncertainty, and weak external demand. From Latvia's perspective, this suggests that German demand for Latvian goods, particularly industrial- and construction-related goods, is likely to remain subdued. Although fiscal stimulus may create opportunities in selected sectors, such as defence, demand from Germany is expected to remain more of a restraining than a supporting factor.

The outlook for Sweden is somewhat more favourable than for Germany, although new risks have also emerged. In May 2026, Sveriges Riksbank left its policy rate unchanged, noting that inflation remains below target and that growth at the beginning of the year was weaker than expected. However, the war in the Middle East has increased the risk that inflation could once again become higher and more persistent. For Latvian exporters, the key question is whether the period of lower interest rates will begin to translate more visibly into stronger activity in Sweden's construction and housing markets. If this recovery continues, demand for Latvian timber products and construction materials could gradually strengthen. Nevertheless, household caution and uncertainty regarding the future path of inflation may slow the pace of the recovery.

Monetary policy in the euro area

Since the beginning of the year, the Governing Council of the ECB has increased the key interest rates by 25 basis points. The energy supply shock caused by the war in the Middle East, together with the resulting increase in energy prices, has led to tighter financial conditions.

ECB monetary policy

The Governing Council of the ECB has noted that developments in the Middle East have increased the risks of both higher inflation and weaker growth. At the same time, it has reaffirmed its commitment to maintaining a monetary policy stance that will ensure inflation stabilises around the target over the medium term.

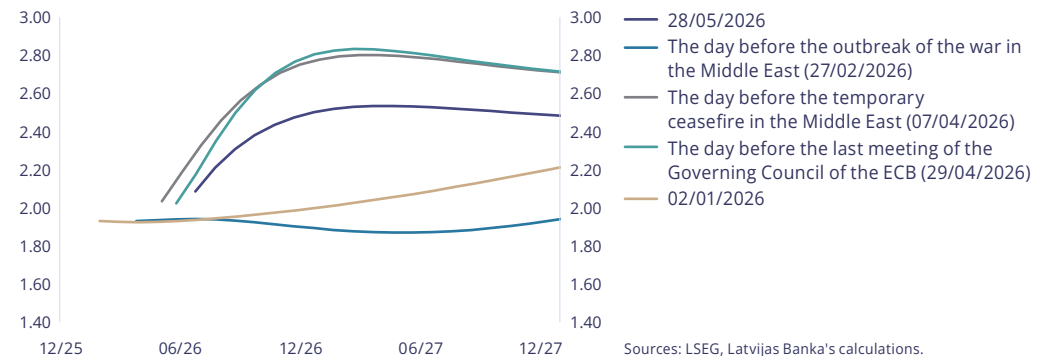
The war in the Middle East has driven up energy prices, creating upward pressure on inflation and weighing on economic sentiment. In the Governing Council's assessment, the medium-term impact of the war on inflation and economic activity will depend on the magnitude and persistence of the energy price shock, as well as the strength of indirect and second-round

effects. The longer the conflict in the Middle East remains unresolved and energy commodities remain unavailable to the global market, the greater the expected impact on both inflation and the economy.

The Governing Council has also emphasised that, despite the current uncertainty, the euro area economy remains well positioned to absorb this shock. The economy entered the period of sharply rising energy prices with inflation close to the 2% target, having remained resilient over recent quarters. Long-term inflation expectations remain well anchored, although shorter-term expectations have increased significantly. The Governing Council continues to monitor the situation closely and will determine the appropriate monetary policy stance by following a data-dependent and meeting-by-meeting approach. At the same time, the Governing Council notes that the high level of uncertainty does not allow it to pre-commit to a particular rate path.

Financial markets currently expect the Governing Council to raise policy rates once more by 25 basis points before the end of this year, with rates then expected to remain broadly unchanged until the end of 2027.

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



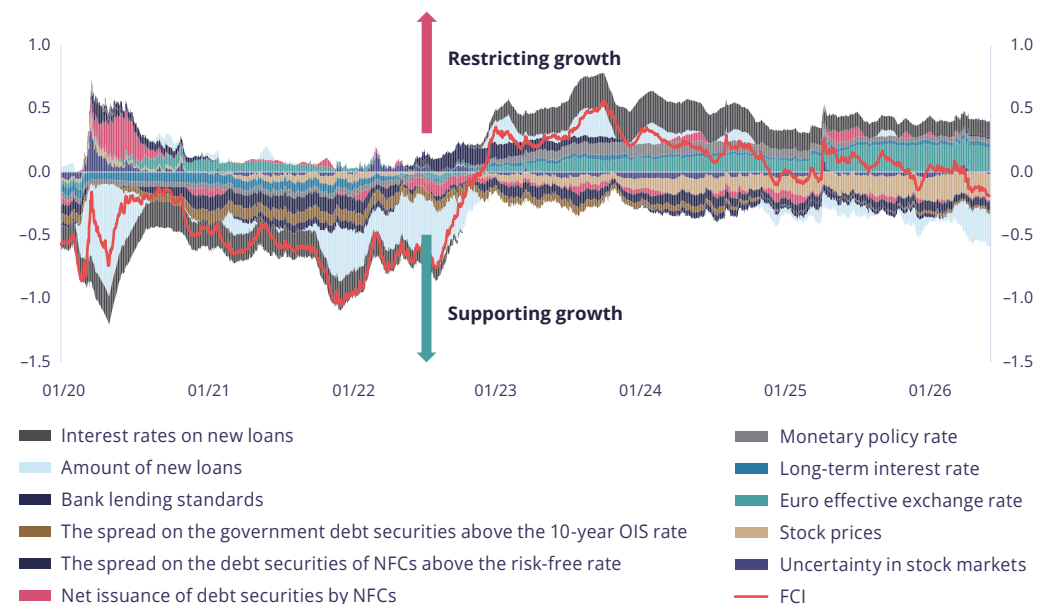
Financial conditions in the euro area

Financial conditions in the euro area have improved over the past six months despite geopolitical turmoil. Financial markets continued to be driven by optimism about advances in artificial intelligence, supporting equity prices while also increasing expected equity price volatility. At the same time, the war in the Middle East prompted banks to tighten lending standards, even as the volume of new lending increased significantly. Spreads over the risk-free rate widened in the corporate debt securities segment. The appreciation of the euro supported more favourable financing conditions. Although the ECB's key interest rates have remained unchanged, yields on 10-year government bonds have declined modestly, suggesting an increase in the risk appetite of market participants.

Financing conditions in capital markets remained relatively favourable, while the banking sector adopted a more cautious approach to new lending. The euro area bank lending survey suggests that lending standards for non-financial corporations tightened significantly in the first quarter of 2026. This was driven primarily by increased risk perceptions related to geopolitical factors. Demand for corporate loans declined as firms became less willing to invest in fixed assets. Lending rates increased following the sharp rise in money market rates after the outbreak of hostilities in Iran.

Lending standards in the housing lending segment also tightened, reflecting higher risk assessments and a less favourable outlook for housing markets. Demand for housing loans declined for the first time in more than two years, as consumer sentiment weakened. Mortgage interest rates also increased, broadly in line with the corporate loan segment.

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



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

Looking ahead, developments in financial conditions will continue to depend largely on the situation in the Middle East. So far, financial markets' expectations of a swift resolution to the war have helped maintain favourable financing conditions. Nevertheless, elevated uncertainty and weaker economic growth prospects continue to exert pressure on lending conditions. Should these risks materialise and require the ECB to maintain a tighter monetary policy stance for longer, financial conditions could also tighten considerably in the future.

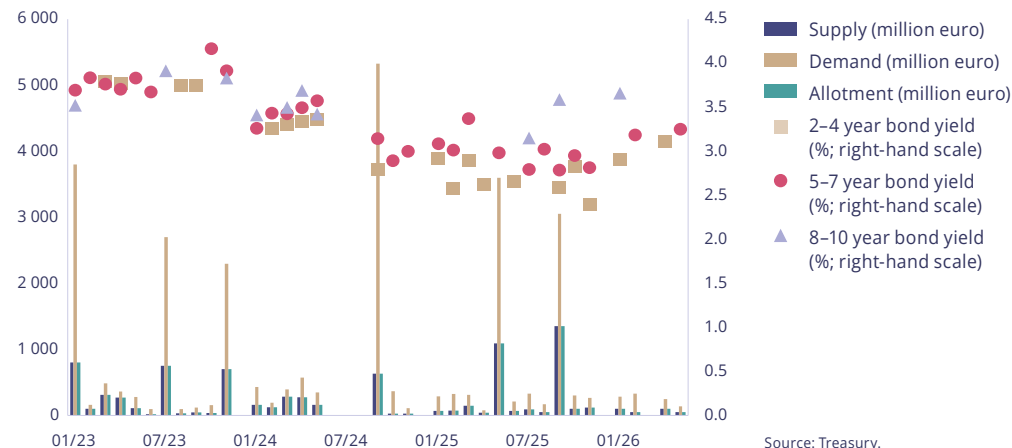
Financial conditions in Latvia

Despite heightened geopolitical uncertainty and higher market interest rates, the availability of financing in Latvia remains favourable in both the capital market and the banking sector. The loan portfolio continues to expand in both the corporate and household sectors, with corporate lending increasing across a broad range of industries.

Latvian capital market

The Latvian government and companies continued to enjoy favourable access to capital market financing, while the international credit rating agencies Moody's, Fitch Ratings, and R&I affirmed Latvia's credit ratings with stable outlooks. At the same time, the yield on Latvian 10-year government bonds increased from 3.55% to 3.74%. Similar developments were observed across most euro area countries. The Treasury relied primarily on domestic market issuance to meet its financing needs. A positive development was the broadening of the investor base: German bank DZ BANK joined the list of participants in Treasury auctions, potentially strengthening competition and boosting demand for Latvian government securities in the primary market.

Chart 7. Results of Latvian government securities auctions (million euro)



The most significant transaction in the corporate debt securities market was the issuance of EUR 400 million in European Green Bonds on international markets by AS Latvenergo. The bonds were issued with a five-year maturity and a coupon rate of 3.612%. Meanwhile, demand substantially exceeded the issue size, reaching EUR 2.2 billion.

Chart 8. Outstanding debt securities of Latvia's issuers, by issuer group (million euro)

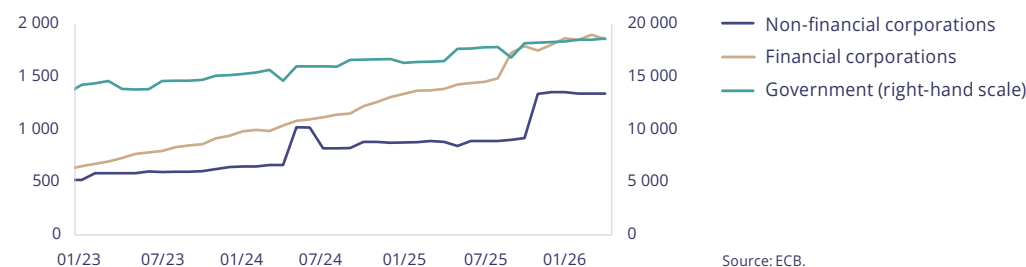
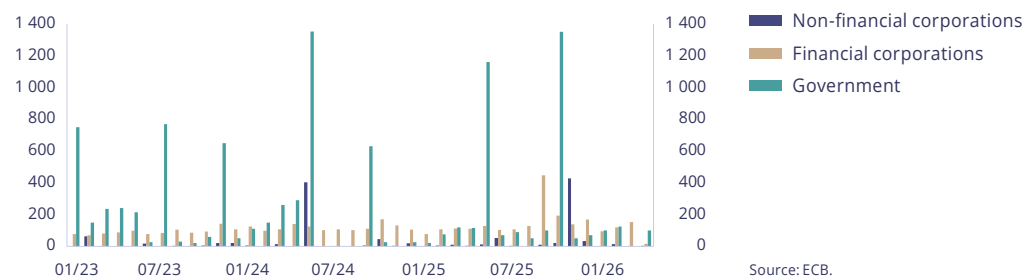


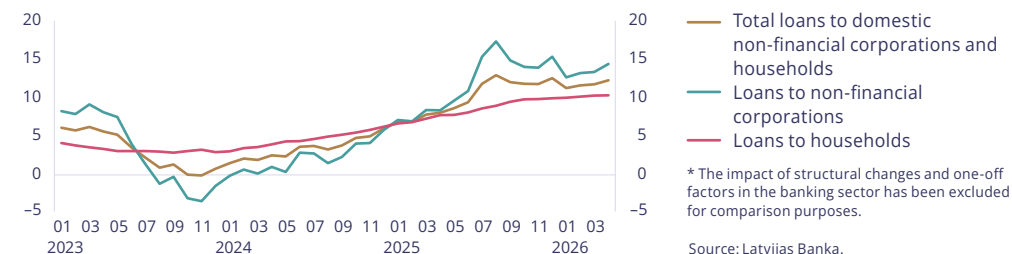
Chart 9. New issues of debt securities by Latvia's issuers, by issuer group
(million euro)



Banking sector

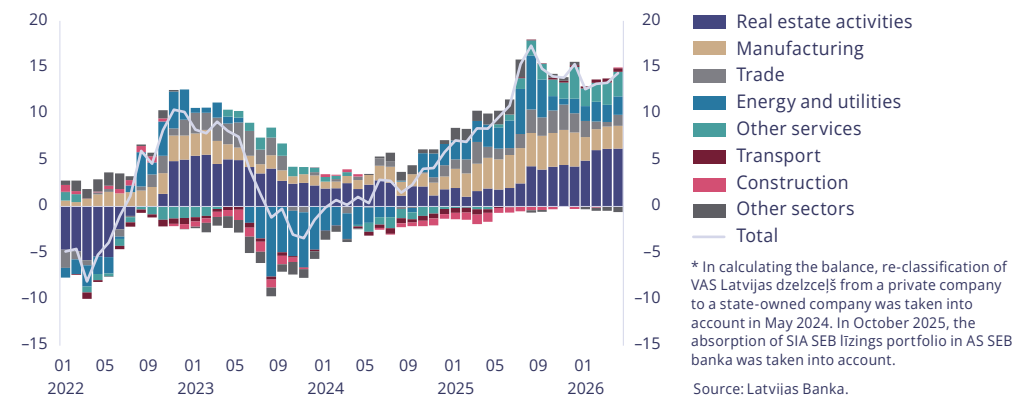
Lending activity in Latvia remains relatively robust. Among euro area countries, only Lithuania has recorded faster growth in the private non-financial sector loan portfolio. In response to geopolitical developments, financial markets have already priced in higher interest rates, which could dampen lending growth going forward. Nevertheless, lending to both non-financial corporations and households continued to expand in April 2026. Overall, the loan portfolio has increased to 31.8% of GDP.

Chart 10. Annual changes in domestic loans* (outstanding amount; %)



Outstanding loans to non-financial corporations continued to grow at a relatively strong pace at the beginning of this year. In April, the annual growth rate reached 14.4%, driven in particular by an increase in outstanding longer-term liabilities. The loan portfolio continues to expand across a broad range of industries, with the real estate sector standing out most recently. By loan type, much of the increase reflects financing for real estate acquisitions and other investment. The continued growth in precisely this type of long-term liabilities suggests that lending is likely to provide an increasingly important boost to economic growth. So far, there has been no noticeable increase in demand for short-term financing stemming from energy price hikes. However, should the war in the Middle East persist, a rise in various costs could lead to stronger demand for short-term loans.

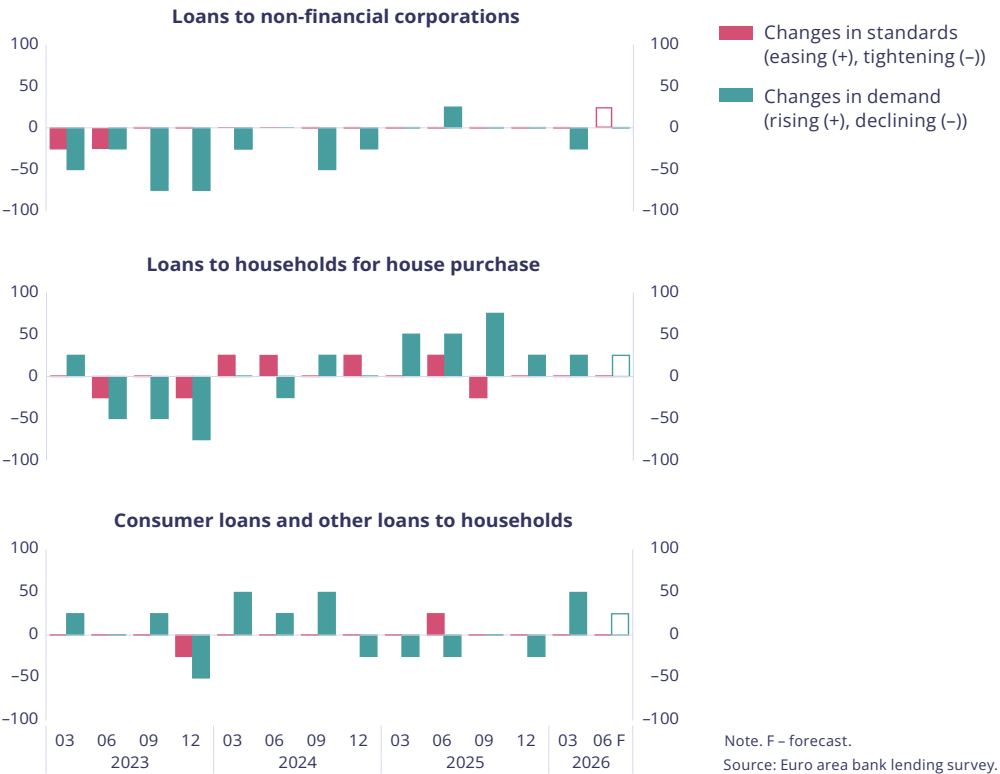
Chart 11. Annual growth rate of outstanding loans to non-financial corporations, by sector* (%)



The loan portfolio of households also continues to expand, with annual growth rate remaining close to 10%. The annual growth rate of housing loans also reached another record high of 9.7% in April 2026, while consumer lending and other loans expanded even more rapidly, with a

considerable share related to housing purchases. The rise in EURIBOR has not dampened new lending. The volume of newly signed loan agreements exceeded EUR 120 million in both March and April 2026, compared with around EUR 100 million in the corresponding months of the previous year.

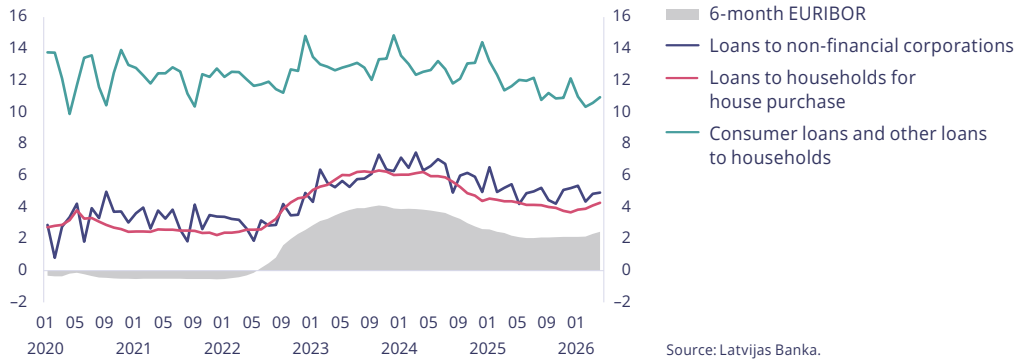
Chart 12. Changes in lending standards and loan demand (net; %)



In contrast to the lending data, the euro area bank lending survey continues to show no significant increase in demand for loans to non-financial corporations, with respondents even reporting a slight decline in demand in the first quarter of this year. No major changes in demand are expected over the next three months. At the same time, banks report that stronger competition is contributing to a further easing of lending standards and conditions. The picture is different for households. Loan demand continues to strengthen and is expected to remain on an upward trajectory.

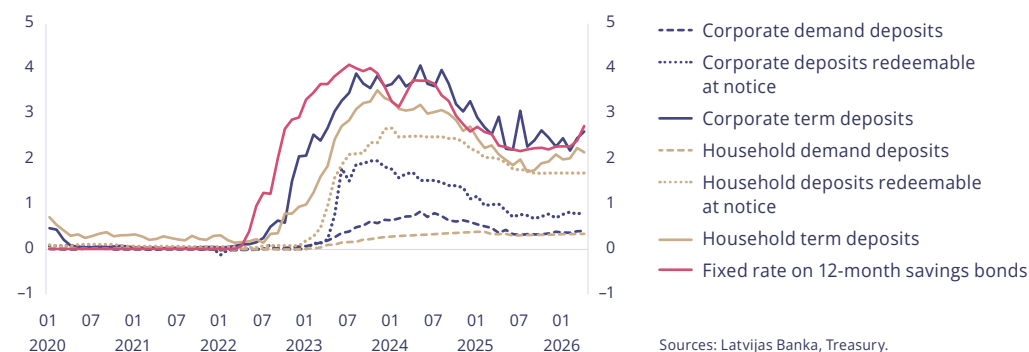
Interest rates on new loans have edged higher, largely driven by the increase in EURIBOR as financial markets price in further interest rate hikes. Lending rates on new loans have risen from around 4.5% at the end of 2025 to almost 5% in April 2026. In turn, mortgage rates for households have once again exceeded the 4% threshold. Intense competition among banks has helped contain lending rates, with mortgage markups remaining below the levels observed a few years ago. Nevertheless, higher EURIBOR rates may somewhat temper the strong pace of lending growth, particularly if the war in the Middle East continues without an early resolution.

Chart 13. Interest rates on new euro-denominated domestic loans and the 6-month EURIBOR (%)



The increase in savings is driven by household caution, as they continue to build up their deposits. Overall, deposits held by both households and non-financial corporations increased by 10% year on year in April 2026. This strong growth is driven both by household caution, coupled with rising incomes, and robust corporate lending, with approved but undrawn loans adding to deposit volumes. Overall, household deposits rose by 8.7% year on year, while deposits of non-financial corporations increased even more rapidly, rising by 12.5%. Since last autumn, outstanding deposits have grown faster than lending. As a result, the ratio of deposits to loans in the private non-financial sector declined from 70% in October 2025 to 67.5% in April 2026, confirming that deposits remain a highly attractive source of funding.

Chart 14. Interest rates on new euro-denominated domestic deposits and the 12-month savings bonds (%)



Deposit rates have become somewhat more attractive amid rising yields, while caution continues to support growth in savings. Although real deposit rates remain negative, nominal deposit rates have increased, particularly on Treasury savings bonds. The yield on 12-month savings bonds has risen to 2.85%, compared with 2.15% on household term deposits held with banks in April 2026 (it should be noted that interest income on Treasury savings bonds is

exempt from taxation). Although real interest rates remain negative, household caution could continue to underpin deposit growth, provided that global conditions remain broadly stable. As geopolitical tensions gradually ease, households may increasingly shift from saving towards consumption over the coming years, slowing the pace of deposit growth.

Fiscal policy in Latvia

The budget deficit for this year is projected to be slightly above 3% of GDP, with the assessment broadly unchanged from previous projections. Legislative changes aimed at maintaining high defence expenditure also in the future, together with sizeable deliveries of military equipment in 2028, are expected to increase the projected budget deficit, bringing it close to 5% of GDP. Rising budget expenditure in the coming years will increase borrowing needs, and the government debt ratio is expected to exceed 51% of GDP over the medium term.

Projections	2025	2026		2027		2028	
	Actual	Dec.	June	Dec.	June	Dec.	June
Budget surplus/deficit (% of GDP)	-2.5	-3.5	-3.3	-3.5	-3.9	-3.1	-4.8
General government debt (% of GDP)	46.9	49.4	47.9	50.8	51.3	50.8	51.2

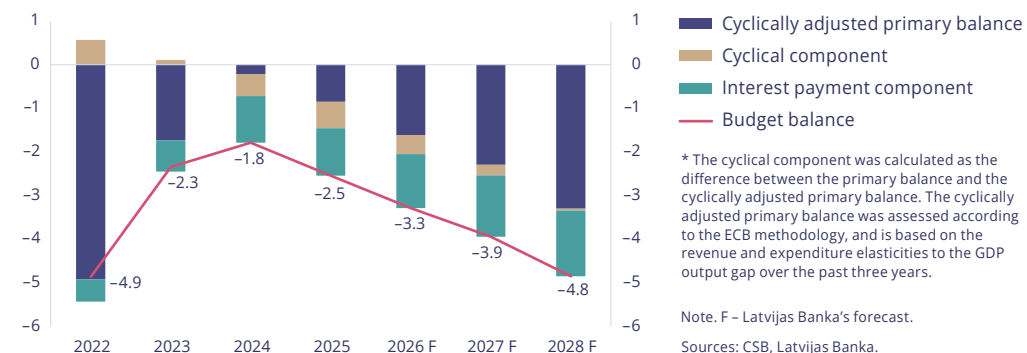
The budget deficit assessment for this year has improved somewhat. However, the budget deficit is expected to increase in the coming years on account of a more rapid increase in defence expenditure and larger military deliveries. It is projected to exceed 3% of GDP throughout the projection horizon, as permitted for Latvia under the activation of the national escape clause. The clause provides a Member State that increases defence expenditure with the possibility to deviate from the approved annual expenditure growth path for up to four years and thereby exceed the 3% of GDP deficit threshold. To ensure fiscal sustainability in the medium term, the derogation limits the annual additional increase in defence expenditure to 1.5% of GDP. The current assessment envisages an increase in defence expenditure of 1.1–1.3 percentage points of GDP per year throughout the projection horizon, remaining within the maximum deviation permitted under the national escape clause.

Over the medium term, budget revenue growth will be driven by tax revenues, supported by sustained wage growth and the impact of inflation on the dynamics of nominal private consumption. Despite weaker real economic growth, tax revenues are expected to increase slightly faster this year than last year, taking into account stronger growth in nominal private consumption, while growth in total tax revenues is expected to strengthen over the coming years. The largest contribution is expected to come from mandatory state social security contributions and VAT revenues. The reduction in excise duty aimed at limiting the diesel fuel price is expected to have a negligible impact on excise duty revenues this year, as the decline in excise duty revenues will be offset by a higher value of VAT-taxable transactions. At the same time, the medium-term dynamics of total revenues will be affected by receipts from the EU budget, which will be lower next year following the final payment for projects financed under the Recovery and Resilience Facility scheduled for this year.

Budget expenditure is expected to continue rising over the medium term and accelerate in 2028, taking into account the latest assessment of substantial deliveries of military equipment. The expenditure forecast is affected by amendments to the State Defence Financing Law, which provide for a faster increase in defence expenditure in 2027–2028 than previously planned. This will increase government consumption in the respective years, while public investment will rise with a lag, in line with the deadlines for implementing the newly signed contracts. At the same time, the latest information on the planned deliveries of military equipment ordered in previous years suggests that public investment will increase significantly towards the end of the projection horizon. Expenditure envisaged for the implementation of the Rail Baltica project is also expected to increase gradually in the coming years. However, the project's slow implementation and construction delays are the main reasons why the updated forecast includes lower expenditure throughout the projection horizon. As a result, total public investment over the projection horizon is expected to be lower than previously projected, but it will remain above its historical levels.

Budget expenditure is also expected to increase in other categories, such as interest payments on government debt, taking into account growing borrowing needs and the refinancing of existing debt at higher interest rates. Expenditure on social benefits will increase as a result of both a larger number of beneficiaries (e.g. old-age pension recipients) and higher average levels of different benefits (e.g. old-age pensions, sickness benefits, and parental benefits). The latest expenditure forecast also incorporates a faster increase in contributions to the EU budget in 2028, based on the assumption that Member States' contributions under the next multi-annual budget could be higher due to proposals currently under discussion to introduce new ways of securing own resources, such as a fee on e-waste and an excise duty on tobacco.

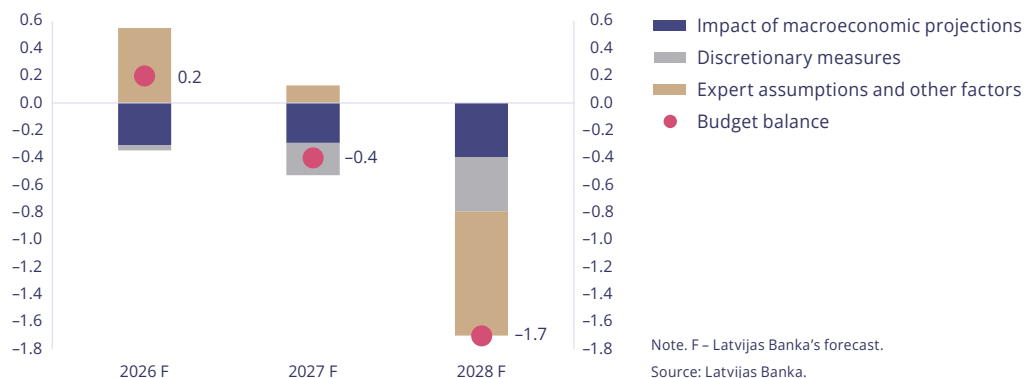
Chart 15. General government budget* balance (% of GDP)



The budget deficit is projected to widen in the coming years. Compared with the December 2025 forecast, the updated assessment of the economic indicators increases the deficit throughout the projection horizon. For example, slower wage growth reduces the labour tax revenue forecast, while weaker growth in real private consumption similarly affects excise duty revenues. The decision to reduce the excise duty on diesel fuel to mitigate the increase in its price also has a small negative impact on excise duty revenues. At the same time, the slight improvement in the budget balance this year is driven by an increase in other revenues, such as revenues from paid services, as well as lower expenditure on the Rail Baltica project, with expenditure expected to remain below the previously projected level throughout the projection horizon. Moreover, the reduction in expenditure is expected to become more pronounced over the next two years, reflecting the slow implementation of the project. Meanwhile, the higher budget deficit in the coming years will be primarily driven by changes related to security and defence. The forecast incorporates both higher expenditure related to the legislative amendments on additional defence funding announced in March of this year, applicable from 2027 onwards, and the expert assessment of substantial deliveries

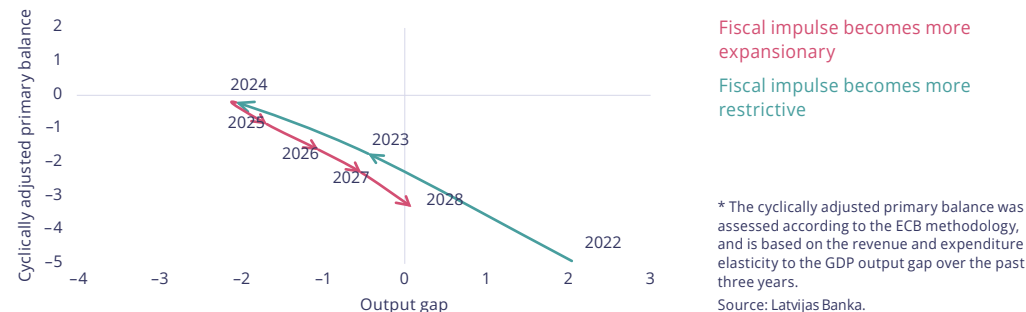
of military equipment towards the end of the projection horizon. These expenditure changes have different implications for the budget deficit. As most of the Rail Baltica project is assumed to be financed from foreign funds, including EU funds, the reduction in project expenditure is projected to have only a partial impact on the budget deficit. Meanwhile, higher defence expenditure and larger deliveries increase budget expenditure, including public investment, thereby also widening the budget deficit. As a result, the impact due to higher security-related expenditure is expected to become increasingly significant each year.

Chart 16. Changes in the budget balance forecast versus the previous forecast, and the underlying factors (in percentage points)



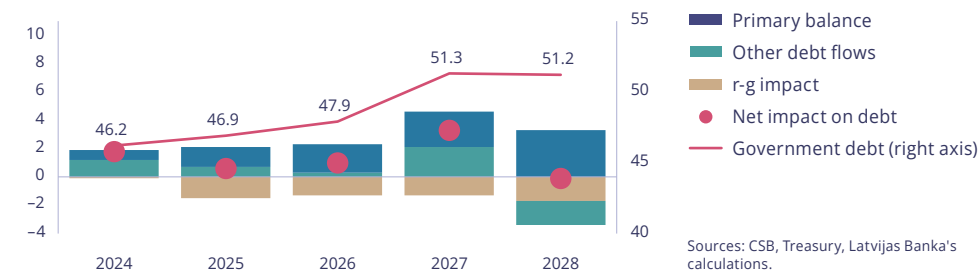
Fiscal policy will remain expansionary over the medium term, with the fiscal impulse becoming more expansionary towards the end of the projection horizon. The cyclically adjusted primary deficit will increase from 0.9% of potential GDP in 2025 to 3.3% of potential GDP in 2008.

Chart 17. Cyclically adjusted primary balance* and GDP output gap (% of potential GDP)



The government debt is projected to increase more rapidly over the medium term than anticipated in December 2025. Rising budget expenditure will keep the debt ratio on an upward trajectory in the coming years, with the debt level exceeding 51% of GDP over the medium term. The faster increase will be driven by revised refinancing assumptions, with borrowing being brought forward to earlier fiscal years. At the same time, debt sustainability will benefit from a more favourable interest expenditure-to-growth ratio, along with higher inflation, than projected in December 2025.

Chart 18. Government debt (% of GDP) and the underlying factors (contribution, in percentage points)



Gross domestic product: demand

The war in the Middle East is weighing on both domestic and external demand, resulting in slower growth in aggregate demand than previously projected. At the same time, investments in the production of military and dual-use goods are becoming an increasingly important driver of growth. This allows for a moderately optimistic outlook for future economic developments.

Projections	2025	2026		2027		2028	
	Actual	Dec.	June	Dec.	June	Dec.	June
GDP (annual changes, %; at constant prices; seasonally adjusted data)	2.1	2.8	2.0	2.9	2.4	3.2	3.0

Investments by many countries in the production of military and dual-use goods could currently become a significant driver of growth. Short-term indicators for January and February of this year, i.e. before the outbreak of the war in the Middle East, already pointed to relatively cautious sentiment in the economy, while geopolitical developments in recent months provide little reason to expect an increase in economic activity. The war in the Middle East is raising costs, disrupting supply chains and increasing uncertainty among households and businesses, thereby negatively affecting both domestic and external demand. At the same time, some positive developments are also evident, such as the recovery in lending and housing construction activity, but particularly substantial investments in the production of military and dual-use goods, which allow GDP forecasts for the coming years to remain moderately positive.

Previously accumulated savings will cushion new waves of precautionary behaviour and help maintain moderate growth in private consumption. The stronger recovery in consumption projected earlier will have to be postponed again, mainly due to geopolitical shocks. However, Latvia's political environment is also characterised by a combination of positive and negative factors. On the one hand, the economy is supported by political activity ahead of the parliamentary elections scheduled for October of this year. On the other hand, the change of government triggers renewed feelings of disappointment and hope, as well as uncertainty about the potential policy objectives of the new government. Thus, households are expected to remain cautious this year, with a stronger recovery in private consumption being estimated only from 2027 onwards.

Household caution continues to support the growth of household deposits. Household deposits continued to increase at a relatively rapid pace in the first months of this year, with the annual growth rate reaching just below 9% in April. Higher deposit rates provide a further incentive to save. The interest rate on 12-month savings bonds has returned to the level recorded at the end of 2024. With inflation even easing slightly at the beginning of this year, deposit rates are becoming more attractive overall. Combined with consumers' caution related

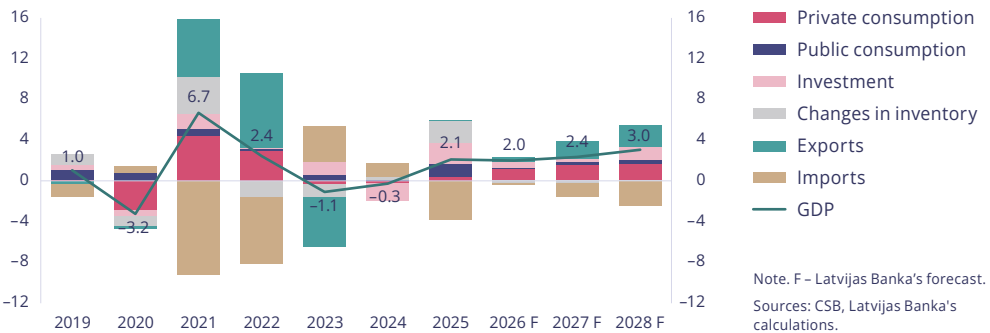
to global developments, this may contribute to a further increase in household deposits.

The prevailing uncertainty will slow investment growth; however, the high level of investment reached last year will persist overall. Total real growth in investment reached 9.4% in 2025. Combined with the high level of investment, this supports positive assumptions about the continuation of modest growth throughout the projection horizon. Total investment is expected to grow more slowly in 2026–2027 than projected previously, but is not expected to decline significantly despite geopolitical turmoil. Several factors, including investment in the production of military goods, the development of housing construction, large government investment plans, and defence expenditure, will help sustain this relative stability.

With continued growth in lending activity, stronger demand has also supported more dynamic growth in housing construction. Major real estate developers confirm¹ their readiness to continue the construction of residential buildings despite the geopolitical environment. Although this segment is relatively small, these investments also contribute to investment growth amid heightened uncertainty.

¹ "The new housing market is recovering", Dianas Bizness, 28.04.2026.

Chart 19. GDP (annual changes, %; seasonally adjusted data) and expenditure components, and Latvijas Banka's projections (contribution, in percentage points)



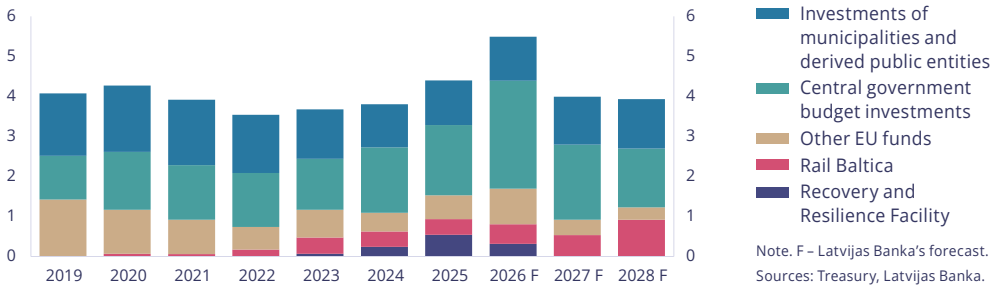
Investment in defence is supporting both private and public investment. Geopolitical shocks in this area serve as an additional incentive, both by strengthening the desire to increase national defence capacity and by allowing for a more stable outlook for military goods sales in export markets. Accordingly, in this segment, the logic behind investors' decisions runs in the opposite direction to that of the majority of economic agents.

Public investment is projected to remain above its historical level over the coming years.

This year, its growth will be supported by investment in projects financed under the Recovery and Resilience Facility to ensure the full absorption of the available funding in the final year. As a result, investment related to EU-funded projects is expected to decline temporarily next year. Investment dynamics will be supported by investment in national security and defence, including the continued construction of military facilities and deliveries of military equipment. According to the latest information, investment is expected to increase particularly strongly towards the end of the projection horizon, driven by deliveries of military equipment. At the same time, investment growth will also be gradually supported by the construction of the large

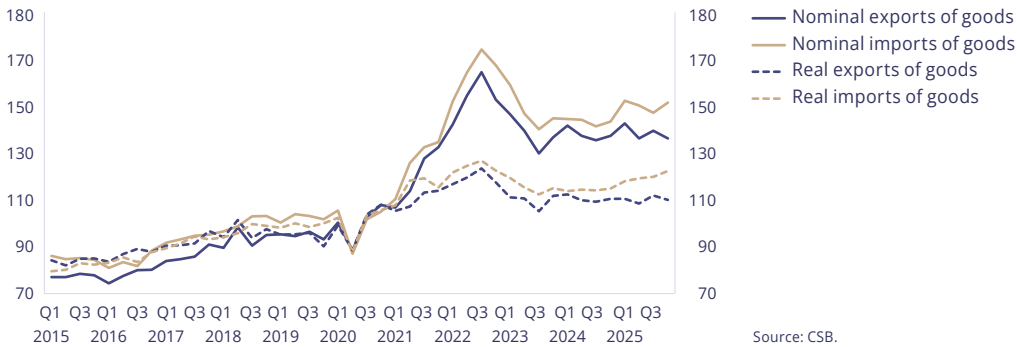
infrastructure project Rail Baltica. However, the amount of expenditure has been reduced compared with previous projections, taking into account the project's slower implementation. As a result, the total level of public investment has been revised downwards over the medium term. Nevertheless, it is expected to remain significant, exceeding historical levels of public investment.

Chart 20. **Public investment** (cash flow, % of GDP)



The prospects for exporters have been adversely affected by the war in the Middle East. It has slowed the recovery in external demand, while also increasing costs and disrupting supply chains. Despite the shocks to global trade, Latvia's exports of goods in nominal terms recorded a modest increase in 2025 for the first time following two consecutive years of decline, although export value in real terms was slightly below their 2024 level. Although goods exports recorded strong growth in March 2026, the increase at the beginning of the year was modest. At the same time, goods imports are growing considerably faster than goods exports, thus leading to a deterioration in the goods trade balance.

Chart 21. **Nominal and real exports and imports of goods** (2020 = 100; seasonally adjusted data)



Meanwhile, services exports continue to expand and remain at a historical high, partly offsetting the weaker performance of goods exports. The largest contribution continues to come from information and communication technologies, professional, technical and other business services, where growth is resilient and less dependent on short-term fluctuations in trade. Travel exports also maintain a positive trend, supported by inbound tourism activity, as do construction services, which are driven by the participation of Latvian companies in foreign projects. Meanwhile, downside risks persist in the air transport segment following the cessation of operations by SmartLynx Airlines' and the cancellation of flights by several other airlines.

Growth in services imports continues, particularly in the segment of imports of information technology, professional and technical services, reflecting companies' digitalisation needs and demand for services provided by foreign specialists. Travel imports are also increasing, pointing to the resilience of Latvian residents' travel activity. With large-scale construction works, energy infrastructure modernisation and engineering projects underway, imports of construction services are also most likely to remain elevated.

Economic sectors

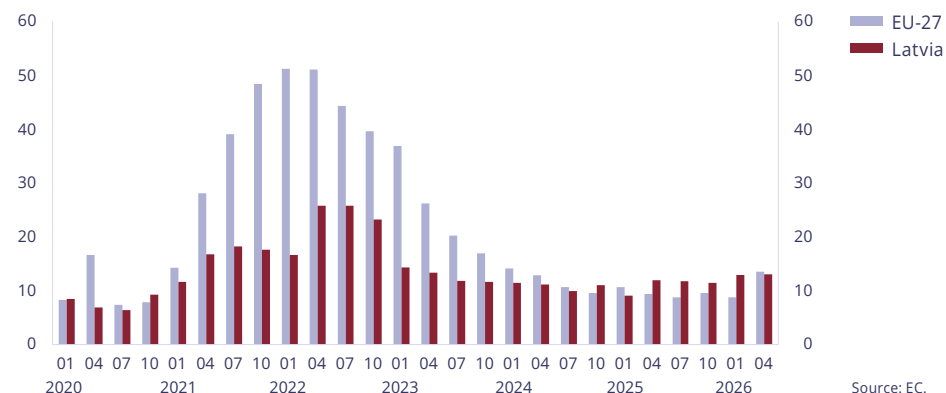
The deterioration in the geopolitical situation is delaying a stronger recovery in external demand and prompting consumers to remain cautious. This weakens growth prospects in both export- and domestic consumption-oriented sectors.

The vigorous recovery in manufacturing is starting to lose momentum, while the war in the Middle East weighs on export projections this year. The most significant fluctuations in production volumes in recent years were observed among goods in the construction-related segment of manufacture – construction materials, wood products, and fabricated metal products – which also largely determine the overall manufacturing performance. The rapid recovery trend that began last year has proved to be short-lived. Against the geopolitical backdrop, which may significantly affect construction activity more broadly, the prospects for a continued recovery remain limited.

Challenges for European manufacturers are also posed by restrictions on transit through the Strait of Hormuz, a decline in the extraction of commodities (particularly oil products), rising costs, and disruptions in the supply of certain commodities. However, the surveys conducted by manufacturing companies in April of this year suggest a more optimistic outlook for the

operating conditions of Latvian manufacturers – although in April, shortages of materials as a factor limiting production intensified overall across Europe, they have remained, on average, at a higher but stable level in Latvia. This gives reason to hope that the economic activity of Latvian manufacturers is unlikely to be significantly affected. At the same time, it would be premature to exclude these concerns from the list of risk factors, as for many manufacturers (similarly to farmers in the case of mineral fertilisers), the issue of input materials has not yet become pressing, as they have built up stocks of commodities, packaging, and components. However, this may become relevant in the future when new purchases are made. This allows for a timely assessment of price and supply conditions and for the mitigation of potential cost increases.

Chart 23. Shortages of materials and equipment as a factor limiting production (%)



The overall growth of industrial production at the beginning of the year was supported by energy production and its consumption due to the cold winter. At the same time, the war in the Middle East may have a smaller impact on the Latvian economy through the energy sector than Russia's invasion of Ukraine in 2022, as it currently mainly affects the fuel price rather than the

availability of natural gas. Since 2022, the regional natural gas supply landscape has changed significantly: the transmission capacity between Lithuania and Latvia has been strengthened, a new liquefied natural gas terminal in Inkoo (Finland) has become operational, and alternative gas suppliers have been secured. The risk of rising costs for society stems from the fact that oil product consumption is relatively inelastic in absolute terms: unlike natural gas consumption, oil product consumption in Latvia has remained stable for an extended period, despite a declining population and a diminishing role of the transport sector in the economy.

The more cautious assessment of growth in the construction sector reflects weaker performance of civil engineering, slower progress in the implementation of public investment projects, and the impact of oil prices on construction costs. Activity in the sector is expected to continue increasing, although growth will be more moderate than previously projected. While civil engineering has so far been the main driver of growth in the sector, its contribution is weakening. The construction season was delayed by the prolonged winter and adverse weather conditions, while higher oil prices are affecting road construction costs, of which fuel, bitumen, and transport component is quite significant. Developments in housing construction are becoming more favourable, partly offsetting weaker performance of civil engineering. Investment volumes in residential building construction are recovering more rapidly than previously expected. This is supported by favourable financing conditions, sustained growth in household demand, and the gradual return of previously postponed projects to the market.

Public sector investment and EU-funded projects continue to support infrastructure and public building construction activity, although the implementation of large-scale projects is progressing more slowly than expected. As a result, part of the construction works is expected to be postponed to a later period. In addition, cost volatility and heightened geopolitical uncertainty are prompting businesses to adopt a more cautious approach to the launch of new projects.

The development of retail trade is being held back by several adverse factors: following higher heating-related expenditure during the cold winter, the persistently challenging geopolitical background make households to reassess their spending decisions more carefully. The impact of the war in the Middle East on the sector is so far estimated to be minimal; however, future contracts between retailers and suppliers may begin to reflect higher transportation and insurance costs, as well as the relocation of production stages and supply chains to other regions. The EC's sentiment surveys point to a quite significant increase in retailers' price expectations, coinciding with a deterioration in consumer sentiment. Developments in the sector were uneven in the first quarter of this year: following an unusually strong increase in January, real turnover returned to more typical levels. Deposit developments suggest that at least part of the increase in household income has been reflected in higher savings. While awaiting their monthly heating bills and monitoring geopolitical developments, households remained cautious in their purchasing decisions. The government support to mitigate the impact of higher energy prices, such as the reduction in the excise duty on diesel fuel, is expected to improve consumer sentiment. However, given its limited overall scale, it is unlikely to have a significant impact on retail trade growth. Activity in motor vehicle sales remains at a consistently high level, and further growth could be driven by government support for the purchase of more environmentally friendly vehicles.

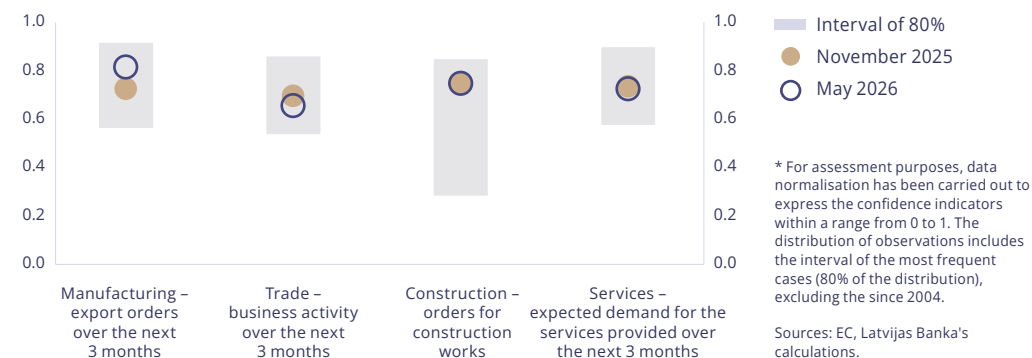
The growth in the transport sector is being constrained by rising fuel costs and heightened uncertainty, and the sector's performance is expected to be weaker than previously projected. Activity in transportation by road remains resilient, with demand being supported by growth in domestic and external trade flows. However, growth in the sector is expected to be more moderate than anticipated, as road user charges (as of 1 March of this year, the toll road network was expanded and revised vignette charges for heavy goods vehicles exceeding 3.5 tonnes entered into force) and rising fuel prices are exerting additional pressure on transport operators' profit margins.

The growth outlook for railway transport and ports remains weak. Activity is mainly constrained by the weak replacement of transit flows and the limited ability to attract new cargo. In the medium term, the outlook could improve due to the development of industrial projects and the diversification of port activities; however, the weak replacement of transit flows and subdued investment dynamics suggest that cargo volumes are unlikely to increase in the near term.

Activity in the air transport segment continues to increase, although uncertainty surrounding its future development has risen significantly. Developments in the Middle East have contributed to higher aviation fuel prices, and airline operating costs have increased. This has reduced route profitability and is expected to constrain further growth. Uncertainty in the sector has been further heightened by the deterioration in the financial performance of Air Baltic Corporation AS, raising concerns about the company's liquidity, access to financing, and ability to maintain stable operations.

Weaker external demand and more cautious household consumption are already reflected in less favourable business prospects. Since the start of the war in the Middle East, businesses' assessment of their future activity has deteriorated substantially. However, manufacturers and construction firms continue to assess business outlook more favourably than at the end of the last year, while retailers and service providers have become more pessimistic.

Chart 24. Assessment of future business growth by businesses* (coefficient; 3-month moving average)



Labour market – unemployment

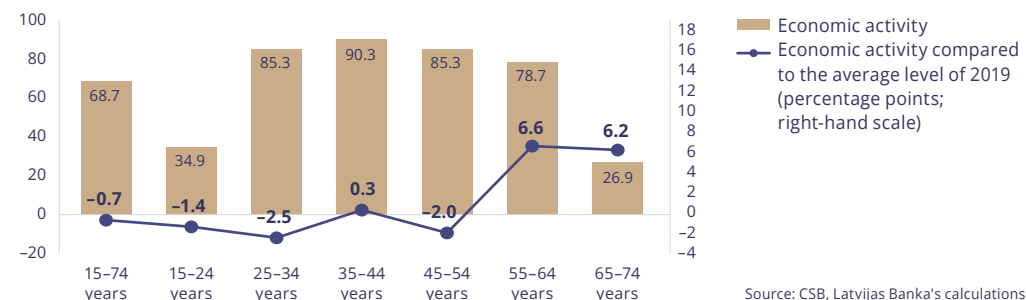
Labour supply is not increasing significantly, but labour demand is easing somewhat in the context of weaker economic growth. Nonetheless, the labour market remains tight, and unemployment will continue declining over the projection horizon, albeit at a slower pace than previously anticipated.

Projections	2025	2026		2027		2028	
	Actual	Dec.	June	Dec.	June	Dec.	June
Unemployment (% of the economically active population; seasonally adjusted data)	6.9	6.6	6.7	6.4	6.5	6.2	6.3

In the short term, labour supply will be supported by an increase in the economic activity rate of the population, with this indicator approaching its pre-pandemic level. However, given population dynamics, the age structure, and migration flows, no increase in the number of economically active persons is expected in the medium term. In the short term, economic

activity will be boosted by young people aged 15–19, who are already included in the labour force statistics but are currently primarily focused on education and may also enter the labour market in the coming years. At the same time, the next youth cohort is already smaller (as a result, the economic activity will be less affected by individual decisions of this group to continue education or to enter the labour market).

Chart 25. Economic activity of the population by age group in the first quarter of 2026 (%) and changes in economic activity compared to the average level of 2019 (percentage points)

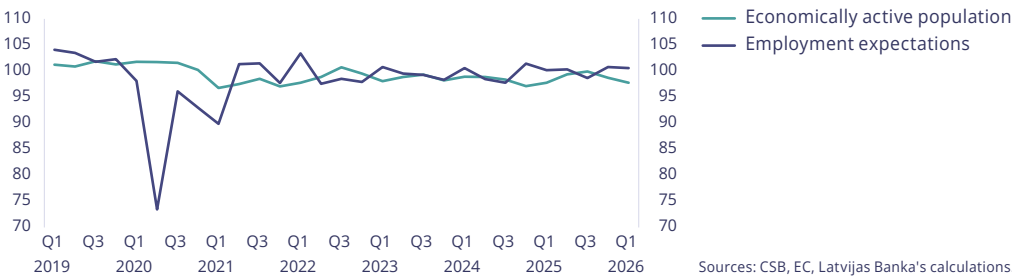


Labour supply shortages are further offset by individuals of pre-retirement and retirement age who choose to continue working, and whose economic activity has increased significantly compared with pre-pandemic levels. In the medium and long term, the economic activity of these groups is likely to remain elevated, both in response to labour demand and as an opportunity for individuals in these age groups to earn additional income. However, the labour resources available in the economy are constrained overall and, with migration trends remaining unchanged, are expected to decline gradually.

Although the economic environment remains uncertain, labour demand is declining only slightly. Businesses' employment expectations for the coming months are currently in line

with historical averages; however, their trend has been downward in recent months, and they have declined somewhat compared with the end of last year. This is most evident in the services sector, where the number of employed persons could decline in the coming months. Slowing external demand as well as more cautious domestic consumer spending may pose new challenges for individual businesses; however, a significant increase in unemployment is not expected at the national level. Unemployment is also expected to continue declining over the coming years, although at a slower pace than previously projected, according to the current assessment.

Chart 26. **Economically active population** (index; 2019=100) and **businesses' employment expectations** (100 = historical average)



Labour market – wages

Wage growth is expected to remain strong, although it will be moderated somewhat by economic uncertainty and a slight easing in labour demand.

Projections	2025	2026		2027		2028	
	Actual	Dec.	June	Dec.	June	Dec.	June
Nominal gross wage (annual changes; %)	7.7	7.6	7.4	7.6	7.3	7.9	7.5

The wage growth forecast has been revised downwards based on the wage data for the end of the last year and more moderate labour demand. Wage growth slowed towards the end of 2025, and this also affects the average wage projection for 2026. Moreover, as the labour market becomes slightly less tight, at least in the short term, and the aggregate labour demand eases, employees' bargaining position in wage negotiations may weaken, leading to more moderate average wage growth. However, higher inflation may encourage employees to seek higher wage increases, although rising input prices at the same time also increase businesses'

costs, which cannot always be passed on to consumers through higher final product prices, thereby enabling businesses to raise employees' wages more rapidly.

Wage growth is expected to moderate in the short term but to pick up again at a later stage as the economy recovers. As unemployment declines at a more gradual pace and the economy continues to face uncertainty, wage growth is expected to moderate in 2026 and 2027, while remaining robust. Private sector wages are expected to grow faster than public sector wages throughout the projection horizon.

The impact of the proposed legislative amendments is likely to be felt more strongly at the level of individual businesses or sectors, but no significant effects on overall labour market conditions are expected. Several amendments to the Labour Law are currently being considered by the Saeima, including a proposal to apply a lower minimum overtime pay rate to a broader group of employees. These amendments are likely to have a greater impact on sectors where overtime work is more widely used during seasonal peaks, such as agriculture. In the long term, such changes could potentially lead to adjustments in regular remuneration; however, at present, no significant impact on the wage growth projection is expected from these possible amendments.

Inflation

The inflation projection has been revised upwards for both this year and next, primarily reflecting higher global energy prices amid the war in the Middle East. This impact was mitigated by lower global food commodity prices and more moderate wage growth. Inflation is expected to approach 4% over the projection horizon, exceeding that level in some months.

Projections	2025	2026		2027		2028	
	Actual	Dec.	June	Dec.	June	Dec.	June
Inflation (HICP; annual changes; %)	3.8	3.2	3.6	2.9	3.8	3.6	3.4

The global energy price projections have been revised significantly upwards. This was driven by the war that began on 28 February of this year in the Middle East – a region where significant oil and natural gas extraction and refining capacity is located and which encompasses the

Strait of Hormuz, whose blockade disrupts exports of these products to the rest of the world. As a result, oil and natural gas price projections, which are based on the prices of futures contracts, for this year have increased by one and a half times. Oil refining costs have also risen significantly; therefore, prices of some oil products, such as diesel and aviation fuel, have increased in Europe even more than crude oil prices.

Chart 27. **Oil price** (US dollars per barrel)

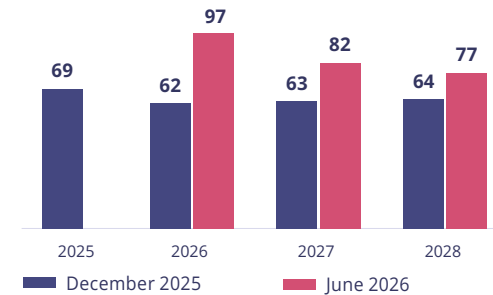
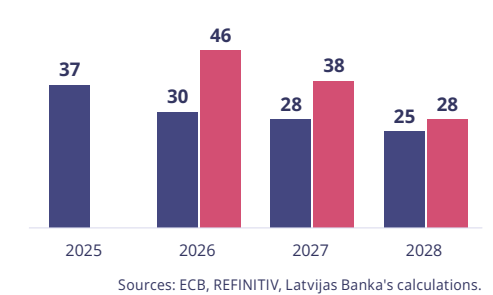


Chart 28. **Natural gas price** (euro/MWh)



The war in the Middle East has significantly raised upward risks to inflation projections. First, daily energy price fluctuations and the uncertainty surrounding their outlook have intensified. The market is analysing various scenarios for future developments, including those implying a further increase in energy prices, for example, if the war is prolonged and the oil and gas extraction infrastructure in the Persian Gulf countries is significantly affected. Second, the war in the Middle East is increasing food production costs through various channels: higher fuel prices raise the costs of planting, harvesting, and transporting crops; higher natural gas prices increase the cost of nitrogen fertiliser production; and a blockade of the Strait of Hormuz disrupts supplies of ammonia and nitrogen, which are essential for fertiliser production.

Third, the output of petrochemical by-products, which are widely used in manufacturing, has declined. For example, lower sulphur and thus sulphuric acid supply increases production costs across a wide range of goods, including metals, electronics, pharmaceuticals, and detergents. Fourth, a positive and persistent price shock may raise inflation expectations and generate second-round price pressure. For example, the loss of the purchasing power of wages due to inflation, in the context of labour shortages, may motivate employees to demand higher wages than would be justified by productivity gains.

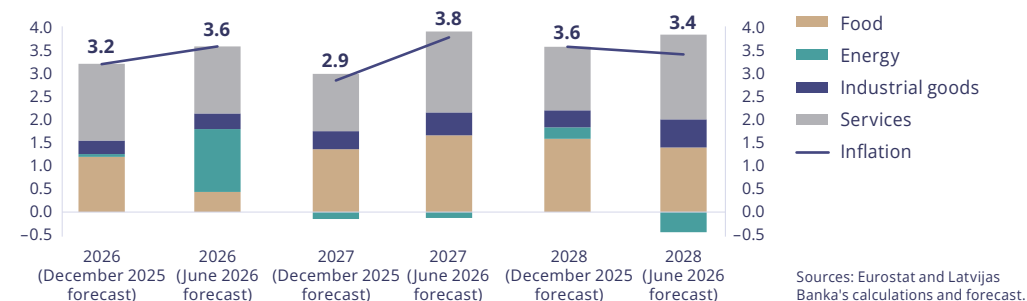
Higher energy prices increase core inflation with a lag. Several core inflation components, such as air transport, tourist trips or driving school lessons, are directly affected by higher fuel prices, while higher heating bills may increase the prices of several other services.

Global food commodity prices and domestic labour costs are lower than expected. This has a dampening effect on the inflation projection. Concerns about a significant increase in global food commodity prices due to the ongoing war in the Middle East have not materialised so far. On the contrary, global food commodity prices are currently slightly below their level at the end of last year. This has been driven by several factors: large global grain stocks and favourable prospects for cereal harvests in EU countries due to good weather conditions, a global surplus of dairy products and sugar, and forecasts of a record coffee harvest in Brazil. Wage growth at the end of last year and in the first quarter of this year was lower than projected, and the wage growth projection has been revised slightly downwards.

Inflation is being contained by a lower excise duty on diesel fuel and a reduced VAT rate on certain food products. To partially mitigate the impact of rapidly rising diesel fuel prices on the economy and households, the excise duty on diesel fuel was reduced for a three-month period (from April to June 2026). A reduction in fuel prices of EUR 8.6 cents per litre can offset approximately one sixth of the diesel fuel price increase caused by the war in the Middle East. Taking into account a full pass-through of the impact to fuel prices and the indirect effects on

the prices of other goods, the inflation projection for this year has been revised downwards by 0.06 percentage points. Meanwhile, the decision to reduce the VAT rate on certain food products (bread, poultry, milk, and eggs; from 21% to 12%) for a one-year period starting in July 2026 reduces the inflation projection for this year by 0.11 percentage points (assuming a 75% pass-through to consumer prices, which is in line with the developments observed in 2018). Overall, the impact of tax changes on inflation will remain on the upside: for example, increases in excise duty rates on tobacco products and alcoholic beverages this year, assuming a full pass-through to prices, may raise the overall price level by 0.28 and 0.10 percentage points respectively.

Chart 29. Inflation forecast in Latvia (HICP; annual changes; %) and contributions of components (percentage points)



Scenario analysis: Scenario 1

Impact of excise duty reduction on household spending¹

Motivation

The war in the Middle East is causing energy prices to rise globally, with the increase quickly feeding through to fuel prices. In Latvia, at the end of March 2026, the fuel price had risen by 21%² compared to the average price in the previous three months and remained at a similar level until the beginning of summer. Diesel prices recorded the sharpest increase, rising by 23% over the period. The increase translated directly into higher transport costs, thereby eroding the population's purchasing power. To mitigate the adverse effects and contain inflation, the government temporarily reduced the excise duty on diesel.

The support measure was available to both businesses, including farmers, and households. Within this scenario, we focused on the household sector and assessed the direct impact of the government support on the purchasing power of different income groups and on households' transport expenses.

¹ Prepared by Baiba Brusbārde and Ludmila Fadejeva, economists at Latvijas Banka.

² Changes in the weighted average fuel prices as at 26 March 2026 compared with the prices recorded between December 2025 and the end of February 2026. Over this period, diesel prices increased by 23%, while petrol prices rose by 14%. Calculations are based on weekly oil prices (DG Energy). Source: Weekly Oil Bulletin

Scenario description

To evaluate how a reduced excise duty on diesel affected households, Latvijas Banka conducted an analysis using data from the Household Finance and Consumption Survey (HFCS)³ and the EUROMOD-ITT microsimulation model⁴.

Within the scenario, the following assumptions were used:

- as a support measure, an excise duty reduction for diesel is modelled at 15.2%, i.e. from EUR 467 to EUR 396 per 1000 litres;
- the support measure is temporary: from April 2026 to the end of June 2026;
- household consumption does not change in the short term; thus, spending on diesel increases in proportion to price changes;
- spending for other transport services (e.g. public transport) remains unchanged.

The analysis covers the first-round effect of the excise duty reduction on diesel and only concerns households. It does not account for the pass-through of higher diesel prices to the prices of other goods and services, nor does it assess the impact of the reduced excise duty on businesses.

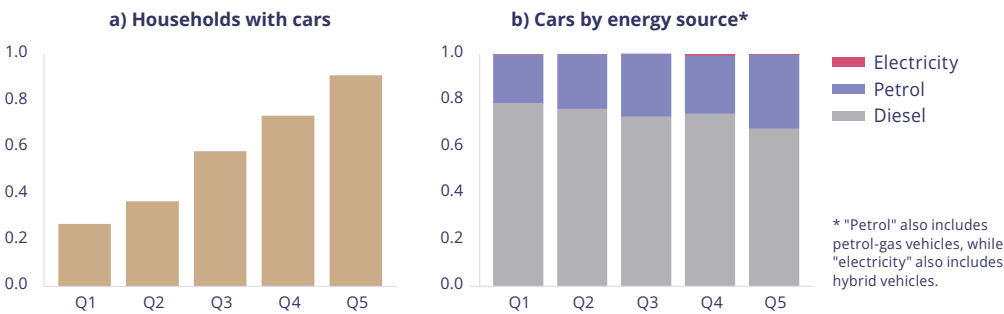
³ For more details, see: [HFCS, Latvijas Banka, Statistical data](#).

⁴ EUROMOD is the tax-benefit microsimulation model for the European Union. It enables a comparative assessment of the effects of taxes and benefits on household incomes and work incentives for individual EU countries and for the EU as a whole. Since 2021, the model has been maintained and developed by the Joint Research Centre of the EC in collaboration with Eurostat and national teams from EU countries (for more details, see: [HOME | EUROMOD](#)). The EUROMOD-ITT model has been supplemented with a consumption block and indirect taxes, including excise duty. Thus, this model combines EU-SILC data on household disposable income (for more details, see: [EU-SILC, Central Statistical Bureau of Latvia](#)) and CSB survey data on household budgets (for more details, see: [MBA, Central Statistical Bureau of Latvia](#)), which include data on consumption structure at the level of classification of individual consumption according to purpose (COICOP), as well as price and income indexation until 2025.

Share of diesel vehicles in Latvia

HFCS data for 2023 suggest that around 27% of households in the lowest income group own a car. By contrast, more than 90% of households in the highest income group own a car, with an average of 1.9 cars per household. Diesel is the predominant fuel type for passenger cars in Latvia, accounting for approximately two thirds of the household vehicle fleet. This is true both for the lowest income group (79%) and the highest income group (68%), making Latvia one of the countries with the highest share of diesel passenger cars in the EU (EU average: 40%)⁵. The most notable difference between the two groups is the age of their vehicle fleets: in the lowest income group, more than 30% of cars are over 25 years old, whereas in the highest income group, the share of such vehicles does not exceed 10%.

Chart 1.1. Share of households owning a car and breakdown of cars by fuel type across income quintiles (decimal fractions)



Notes. Each income quintile comprises one-fifth of all households, ranked by income. Q1 represents the lowest-income households, while Q5 represents the highest-income households.
Sources: HFCS data, 2023, Latvijas Banka's calculations.

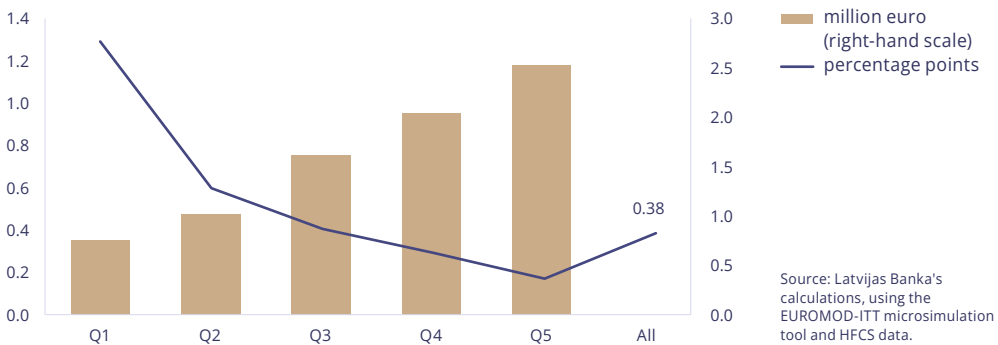
⁵ "Passenger cars in the EU", Eurostat, January 2026.

Overall, around 60% of households in Latvia own a passenger car, which is below the EU average of 78%. At the same time, the share of diesel vehicles in Latvia exceeds the EU average and is broadly similar across all household income groups. As a result, a reduced excise duty on diesel benefits a large proportion of households regardless of their income level.

Results

The results of the model simulation suggest that the reduction in the excise duty on diesel lowered inflation by 0.17 percentage points during the period from April to June this year⁶. The government support also reduced transport expenses for households owning a diesel vehicle by an average of EUR 24 per household over the three-month period. Differences in the distribution of the total support across income groups are primarily explained by the lower prevalence of private vehicle ownership among lower-income households.

Chart 1.2. Reduction in household transport expenses (million euro; three-month period; by quintile) **and in the share of transport expenses in disposable income for households owning diesel cars** (percentage points; by quintile)



Source: Latvijas Banka's calculations, using the EUROMOD-ITT microsimulation tool and HFCS data.

⁶ This does not include the impact of higher fuel prices on the prices of other goods and services.

Measured against households' disposable income, the EUR 24 support reduced the share of transport expenses in the budgets of households owning diesel vehicles by 0.38 percentage points on average. The effect was more pronounced for households in the lowest income quintile, where the share declined by 1.2 percentage points, as the support represented a larger proportion of their income.

Conclusion

The reduction in the excise duty on diesel during a period of rising prices slightly reduces inflation in the short term and lowers households' transport expenses. The measure is targeted at diesel – the energy source most affected by the price shock and the predominant fuel used by household-owned vehicles in Latvia. However, its effects are not distributed evenly across income groups. This reflects differences in car ownership rates and vehicle use across the income distribution. Relative to income, the support is more significant for lower-income households owning diesel vehicles than for higher-income households.

Overall, such a support measure can serve as a rapidly deployable policy instrument to mitigate inflationary pressures and reduce transport costs. At the same time, from the perspective of fiscal discipline, it is important that the measure remains temporary and well targeted. It also weakens incentives to reduce energy consumption.

Scenario analysis: Scenario 2

Impact of the war in the Middle East on Latvia's economy¹

Motivation

Since late February 2026, the war in the Middle East has led to a significant reduction in global energy supply. Direct damage to energy infrastructure and restricted maritime traffic through the Strait of Hormuz have reduced global oil² and natural gas³ supplies by 14% and 20% respectively. As a result, energy prices have risen sharply.

Scenario description

To assess the impact of energy prices on inflation and GDP, four possible oil and natural gas price scenarios are considered: a baseline, an adverse, a severe, and a milder scenario. All four scenarios are based on the ECB's assumptions regarding the future path of oil and natural gas prices.

1. The baseline scenario assumes that current market expectations for energy prices reflect

¹ Prepared by Andrejs Bessonovs, Patrick Grüning, and Andrejs Zlobins, economists at Latvijas Banka.

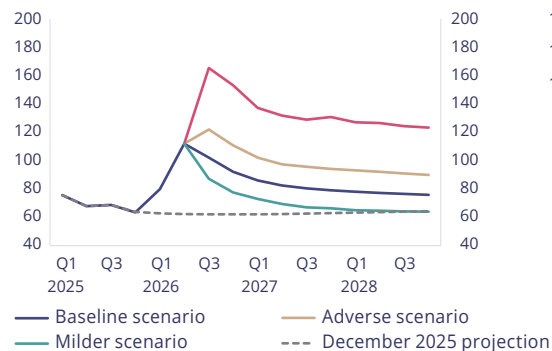
² Oil Market Report – May 2026, International Energy Agency.

³ Gas Market Report, Q2-2026, International Energy Agency.

the most likely course of the war. Oil prices are assumed to rise to USD 110–115 per barrel in early 2026 before gradually declining and stabilising at slightly above USD 75 per barrel. Natural gas prices are assumed to increase to EUR 45–50 per MWh before gradually declining over the following years. This scenario assumes that the most significant supply disruptions are temporary and that alternative sources of supply partially offset the loss of energy exports.

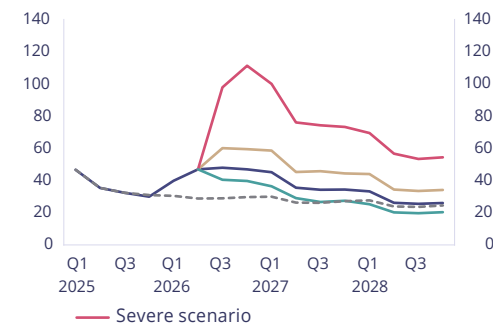
2. The adverse scenario envisages more prolonged disruptions to energy supplies, lasting at least until the third quarter of 2026, without any further significant damage to energy infrastructure in the Persian Gulf region. Oil prices are assumed to reach around USD 120 per barrel, while natural gas prices rise to approximately EUR 60 per MWh. Energy prices and supply volumes are expected to begin normalising from the fourth quarter of 2026. Energy prices remain elevated for a prolonged period, reflecting persistent export restrictions and a higher geopolitical risk premium.
3. The severe scenario assumes that supply disruptions persist at least until the fourth quarter of 2026 and are accompanied by significant damage to energy infrastructure in the Persian Gulf region. This results in severe and prolonged disruptions to maritime traffic through the Strait of Hormuz, substantially reducing energy exports from the Persian Gulf countries. Oil prices temporarily peak at around USD 160 per barrel, while natural gas prices climb above EUR 100 per MWh. Energy prices and supply volumes begin to normalise in the first quarter of 2027. Despite a gradual decline thereafter, prices remain well above those in the baseline scenario throughout the projection horizon due to the damage to energy infrastructure.
4. The milder scenario assumes that the war in the Middle East comes to an end within a very short period. Oil and natural gas prices are assumed to be 15–20% lower in the third quarter of 2026 compared to the baseline scenario. As global oil and natural gas markets normalise, prices decline rapidly in the second half of 2026, returning by the end of the year to their pre-war levels.

Chart 2.1. Oil price assumptions
(US dollars per barrel)



Sources: ECB un REFINITIV data, authors' calculations.

Chart 2.2. Natural gas price assumptions
(euro/MWh)



The following Latvijas Banka's models and tools are used to assess the impact of the scenarios on inflation and Latvia's GDP:

- an empirical Bayesian vector autoregression (BVAR) model comprising the key macroeconomic variables (real GDP, inflation, and the short-term interest rate – the 3-month EURIBOR) together with energy prices (the crude oil price of Brent and the Title Transfer Facility (TTF) natural gas price). Energy price shocks are identified using a sign- and zero-restriction approach, while controlling for aggregate demand, aggregate supply, and monetary policy shocks;
- Basic Model Elasticities (BMEs), which measure the partial responsiveness of macroeconomic variables to individual exogenous shocks and are estimated using Latvia's macroeconomic model⁴;

⁴ Benkovskis, K., Stikuts, D., [Latvia's Macroeconomic Model](#), makroekonomika.lv, 13.06.2006.

- the DSGE model for Latvia⁵, where the impact of higher energy prices is modelled as an import price shock, based on the BME estimate of the elasticity of the import deflator with respect to changes in oil and natural gas prices;
- an E-DSGE model of a small open economy with production networks⁶, calibrated to reflect the structure of the Latvian economy. The impact of higher energy prices is modelled as a fossil fuel price shock, represented by a synthetic index of oil and natural gas prices. The model encompasses 16 sectors at the NACE 1 level, two types of households (optimising and restricted) with different consumption baskets, and an energy sector consisting of both green and brown energy producers. Green energy is produced using capital and renewable energy sources, whereas brown energy is generated exclusively using fossil fuels.

Impact on inflation

The modelling results indicate that higher energy prices exert significant upward pressure on inflation under all scenarios, particularly in 2026, when the energy price shock is most pronounced. In the baseline scenario, the average impact on inflation in 2026 is estimated at between 1 and 1.5 percentage points. The impact gradually diminishes in subsequent years but remains positive in 2027. By 2028, the effects in most models have largely faded, with the estimated impact close to zero or slightly negative as the base effects of energy prices unwind.

In the adverse scenario, the increase in inflation is more pronounced, reaching around 1.5–2 percentage points in 2026 and remaining close to 2 percentage points in 2027. This reflects a more persistent period of elevated energy prices.

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

⁶ Grüning, P., Kantur, Z. (to be published), Energy Shocks, Supply Disruptions, and Fiscal Policy in Euro Area Production Networks, a working paper by Latvijas Banka.

The severe scenario implies a very significant inflationary impact. Depending on the model, inflation in 2026 could be 2.5–4 percentage points higher than in the baseline scenario. The impact remains substantial in 2027, exceeding 3 percentage points in some models. This suggests that a prolonged and severe energy price shock could significantly delay the return of inflation to the ECB's target.

Under the milder scenario, the inflationary impact is considerably smaller than under the other scenarios. In 2026, inflation is only around 0.5–1 percentage point higher than in the December 2025 projection, largely reflecting the actual increase in energy prices. By 2027, however, the impact becomes negligible. By 2028, some models even point to a small negative effect on inflation, reflecting the rapid normalisation of energy prices following the end of the war.

It should be noted that the range of results across the models is relatively wide, particularly under the severe scenario. This highlights considerable uncertainty surrounding the pass-through of energy price shocks to consumer prices.

Impact on GDP

At the same time, the energy price shock weighs on economic activity as it pushes up inflation. Higher energy costs reduce firms' competitiveness, constrain investment, and dampen household consumption.

In the baseline scenario, Latvia's GDP growth is roughly 1 percentage point lower in 2026. The adverse impact persists in 2027, although it becomes less pronounced. By 2028, the economy gradually adjusts to higher energy prices in most models, and the impact diminishes significantly.

In the adverse scenario, GDP growth is reduced by around 1–1.5 percentage points in 2026–2027. Although some models indicate an almost neutral effect in 2028, economic activity

remains below the level projected under the baseline scenario.

The severe scenario points to a substantial negative impact on economic activity. On average, GDP growth in 2026 is nearly 2 percentage points lower, while some models suggest a decline of more than 3 percentage points. The strongest effects are observed in 2027, when GDP growth is more than 3 percentage points below the baseline scenario in some models. Although the impact gradually diminishes by 2028, the loss in economic activity is not fully reversed.

Under the milder scenario, the negative impact on economic activity is limited and short-lived. GDP growth in 2026 is, on average, approximately 0.5–1 percentage point lower, but by 2027, the impact has largely faded. Some models even indicate a small positive effect on GDP growth in 2028, as lower energy prices boost households' purchasing power and reduce firms' production costs.

Chart 2.3. Impact on inflation
(percentage points)

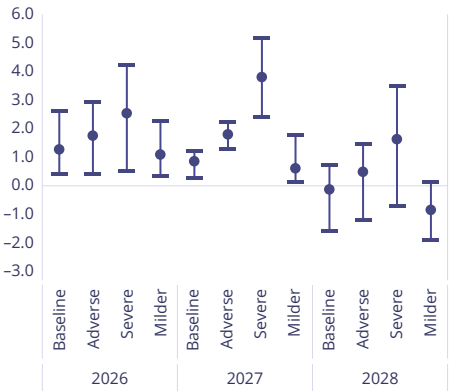
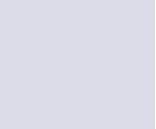


Chart 2.4. Impact on GDP growth
(percentage points)



Source: Latvijas Banka's calculations.
Notes. The ranges show the minimum, maximum, and average values across the models used.



Overall, the results suggest that the energy price shock triggered by the war in the Middle East would create a classic supply shock for the Latvian economy, simultaneously pushing up inflation and slowing economic growth. As the analysis moves from the baseline to the adverse and, in particular, the severe scenario, the negative effects on the Latvian economy become significantly more pronounced. This points to significant macroeconomic risks in the event of a prolonged geopolitical escalation.

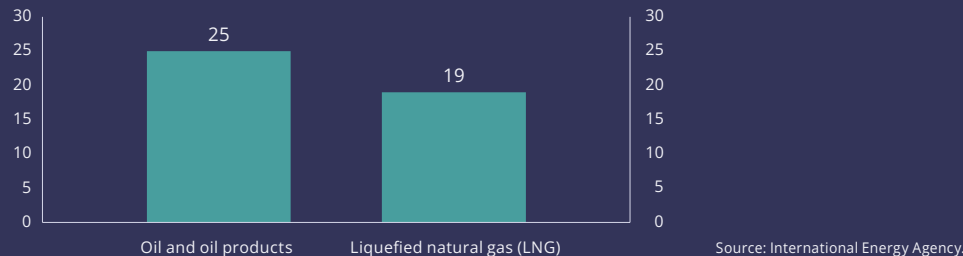
Conclusions

The scenario analysis suggests that the impact on the Latvian economy depends critically on how persistent the energy price shock triggered by the war in the Middle East proves to be. Under the milder scenario, the increase in energy prices is temporary, and the impact on inflation and economic activity remains relatively limited. In the baseline scenario, deviations from the December 2025 projections are moderate and short-lived, whereas under the severe scenario, the effects on inflation and GDP amount to several percentage points over the medium term. From a monetary policy perspective, persistently high energy prices increase the risk that inflation expectations become de-anchored from the ECB's 2% medium-term inflation target. This amplifies the adverse effects of the initial energy price shock and requires the central bank to take action to keep inflation expectations firmly anchored to the price stability objective.

Box 1. What is the impact of the war in the Middle East on global oil and natural gas markets?¹

With the outbreak of the war in the Middle East involving the US, Israel, and Iran, energy commodity prices rose sharply. The Persian Gulf region and its neighbouring countries are among the world's leading producers of oil and natural gas. Therefore, the war immediately raised concerns about the availability of energy resources on global markets. In order to export oil or natural gas from the Persian Gulf, vessels must cross the Strait of Hormuz – a 167 km long waterway that is 39 km wide at its narrowest point. Before the outbreak of the war, around 25% of global oil and oil product shipments, as well as around 19% of global liquefied natural gas shipments passed through the Strait of Hormuz.

Chart 1.1. Shares of global energy commodity trade passing through the Strait of Hormuz (%)

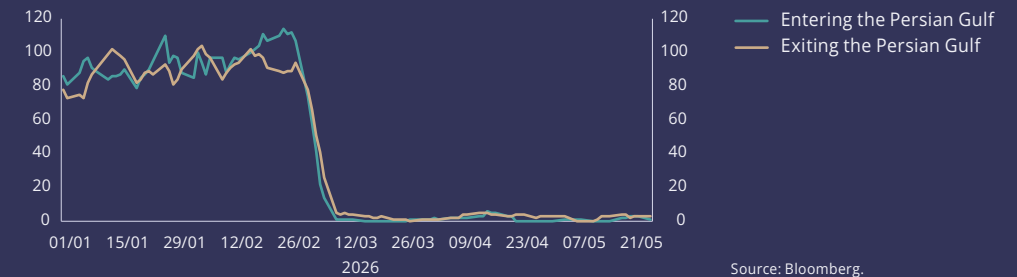


Before the outbreak of the war in the Middle East, up to 100 vessels crossed the Strait of Hormuz in each direction every day. However, once the war began, the traffic came to a virtual standstill.

¹ Prepared by Erlands Krongorns, economist at Latvijas Banka.

Already in the first days of the war, the Islamic Revolutionary Guard Corps announced that it would open fire on vessels attempting to cross the Strait, and a number of such incidents also occurred. Insurance companies began to withdraw insurance policies that had already been issued, while new policies (if offered at all) became several times more expensive. This further disrupted oil and natural gas exports via this route and increased their cost.

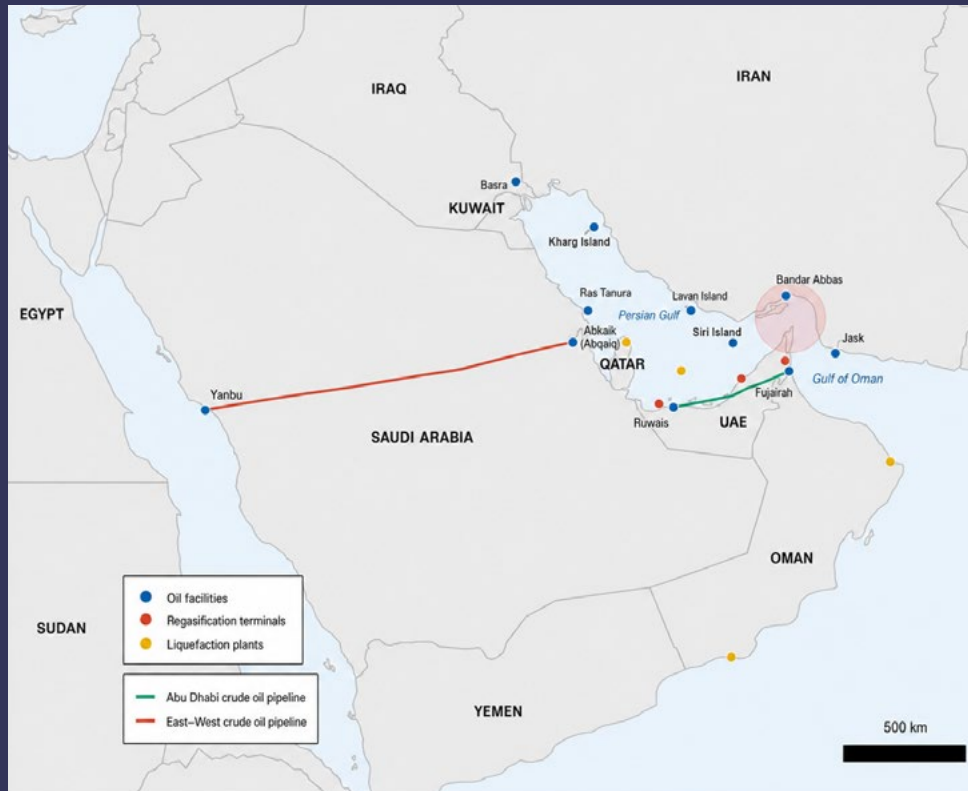
Chart 1.2. Tanker traffic in the Strait of Hormuz (number of tankers)



Although most oil and natural gas from the Persian Gulf is exported to Asian countries, the impact is felt worldwide. Energy markets are global, and exporters, where permitted under their contractual obligations, tend to redirect supplies to markets offering higher prices.

The scope for using alternative transport routes for oil and liquefied natural gas is limited. Saudi Arabia and the UAE have redirected part of their oil exports through pipelines that bypass the Strait of Hormuz. However, the capacity of these pipelines is insufficient to ensure the volume of exports these countries shipped before the outbreak of the war. By contrast, Iraq, Kuwait, Qatar, and Bahrain have virtually no significant alternative export routes that would enable them to bypass the Strait of Hormuz.

Chart 1.3. Map of the Middle East



Most of the world's free oil production capacity is concentrated in the Persian Gulf countries. This means that, without the full restoration of transit through the Strait of Hormuz, it is not possible to fully replace the missing supply on the global market.

Although some oil-extraction countries have been able to increase their output, this is insufficient to compensate for the export volumes stranded in the Persian Gulf. Therefore, part of the current demand is being met by using strategic and commercial oil reserves. In the natural gas market, price pressures have been partly eased by the end of the heating season in Europe and by the return of some Asian countries to greater use of coal for energy production.

Oil prices have responded to the war in the Middle East in a manner similar to their response to Russia's invasion of Ukraine, whereas the increase in natural gas prices is much more modest. The global natural gas market has changed significantly since 2022. Europe has developed an infrastructure for receiving liquefied natural gas, while natural gas-rich countries have substantially expanded their export capacity. This has helped contain price volatility and prevent price spikes similar to those experienced at the beginning of the war in Ukraine.

Looking ahead, the UAE have already announced that a new oil pipeline which will allow them to significantly increase export volumes, while bypassing the Strait of Hormuz, will become operational in 2027. The natural gas market is also expected to benefit from a substantial increase in the US liquefied natural gas export capacity over the coming years. If these projects are implemented as planned, they could ease tensions in energy markets over the medium term and contribute to lower energy prices.

Box 2. One year after the start of the tariff war: the effective US tariff rate on Latvia's exports¹

In early 2025, after the new US government took office, the US introduced new import tariffs. They varied across both exporting countries and product groups. Moreover, they were repeatedly revised and adjusted over the course of the year. The US government actively uses tariffs as an instrument to reduce its negative trade balance.

To assess how the tariff burden borne by US importers – and, indirectly, by Latvian exporters to the extent that part of these costs was passed on to them – actually changed, changes in the effective tariff rate were analysed, while also taking into account changes in the import structure, i.e. the fact that the composition of imports may shift towards goods subject to higher or lower tariffs. For this purpose, changes in the effective tariff rate were grouped into several components.

$$\Delta ETR_t = \underbrace{\sum_i s_{it}^{ref} (r_{it}^t - r_{it}^{ref})}_{\text{Policy effect}} + \underbrace{\sum_i (s_{it}^t - s_{it}^{ref}) r_{it}^t}_{\text{Composition effect}},$$

where $s_{i,t}^t$ – denotes the share of product i in total imports in month t during 2025–2026 (the period of increased import tariffs), s_i^{ref} – denotes the share of product i in total imports in t month of the base year, r_i^t – denotes the nominal tariff rate for product i in month t during 2025–2026, and r_i^{ref} – denotes the nominal tariff rate for product i in the corresponding t month of the base year. The base year in this equation is 2024, i.e. the year preceding the introduction of higher tariffs.

This formula decomposes changes in the effective tariff rate into two components. The policy effect captures the extent to which the effective tariff rate changed due to changes in nominal tariff rates, assuming that the import structure remains the same as in the base year. This means that greater weight is assigned to products for which tariff rates increased more and which, at the same time, accounted for a larger share of total imports in the base year. By contrast, the composition effect captures the extent to which changes in the effective tariff rate are explained by changes in the composition of imports, i.e. by changes over time in the shares of different products in total imports. This effect is estimated taking into account the nominal tariff rate applicable to each product in the respective month of 2025–2026.

The calculations are based on US customs data on imported consumer goods, in both value and volume terms, at the 10-digit product classification level in order to determine the actual import tariff rates. In addition, the US Harmonized Tariff Schedule (HTS), which compiles the standard or Most-Favoured Nation (MFN) import tariff rates applied by the World Trade Organization members to one another, was used. These tariff rates serve as the basis on which the increased additional import tariffs were determined in 2025–2026. The calculations also use the US government documents identifying the products and countries subject to the new tariffs or exempted from them, referring to the legislation under which the new tariffs are introduced, and indicating the dates on which these measures enter into force or are repealed.

The calculations assume that tariff rates introduced under different legal acts (for example, the International Emergency Economic Powers Act (IEEPA) and Section 232 of the U.S. Trade Expansion Act of 1962) are cumulative for some product groups but not for others. Tariff rates are not cumulative for iron, steel, copper and wood products, whereas they are cumulative for semiconductors, automobiles, automotive parts, trucks and truck parts.

¹ Prepared by Mareks Mateušs, economist at Latvijas Banka.

At the same time, it should be noted that the products included in the tariff schedules do not always correspond precisely to a particular product group. For example, the list of automotive parts may also include products classified as electrical goods under the Combined Nomenclature. Therefore, in this case, product group names serve primarily as labels rather than precise descriptions of their content.

The applicable tariff rate is calculated using monthly trade flow data, although tariff changes themselves enter into force on different dates within a given month. Accordingly, the calculations assume that new tariffs take effect in the month in which they are announced, except where they are announced at the end of the month.

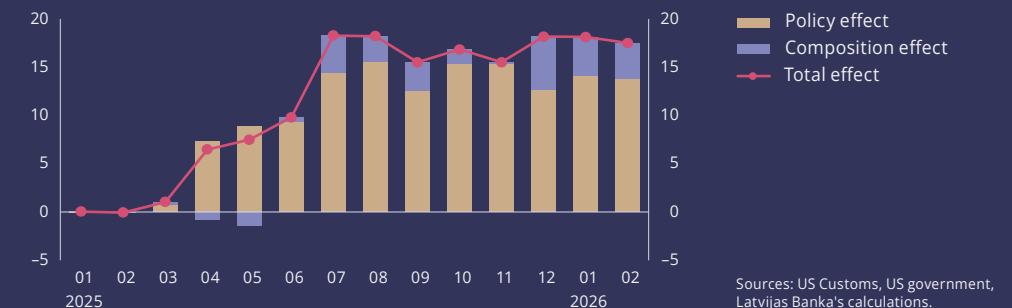
In practice, tariffs may not be applied to products included in certain tariff schedules if the importer proves that the products are intended for use in manufacturing in the US. As the data used do not provide information on the subsequent use of imported products, the calculations assume, for simplicity, that this exemption does not apply. Thus, the estimated changes in tariff rates may be slightly overstated.

For products containing copper, tariffs are, in practice, applied in proportion to the copper content of the particular product. As the data used in these calculations do not contain information on copper content, it is assumed that the tariff applies to the full value of the respective products.

Chart 2.1 shows that the sharpest increase in the effective tariff rate was observed in July and August 2025, shortly before the US–EU trade agreement entered into force and the general import tariff rate on goods originating in the EU reached 15%. Meanwhile, the largest month-on-month increase was recorded in July 2025, when the general tariff rate on goods originating in the EU rose from 10% to 20%.

Notably, during the initial phase of tariff implementation, US importers and Latvian exporters tried to avoid trading goods subject to higher tariffs. This is reflected in the negative contribution of the composition effect during those months. Subsequently, however, tariffs were extended to an increasingly broad range of products, and as differences in tariff rates across countries widened, it became increasingly difficult to switch to products subject to lower tariffs. At the same time, it was beneficial for Latvian exporters to continue exporting to the US, as exports from other countries, particularly China, to the US declined much more sharply due to higher tariffs. Therefore, Latvian exporters maintained their activity in the US market, which in turn increased overall changes in the effective tariff rate.

Chart 2.1. Decomposition of the effective import tariff rate (%)



The results of the decomposition of the overall tariff rate do not necessarily reflect developments in individual product groups, where the pattern may differ substantially. For example, the decomposition of the tariff rate for wood products shows that the policy effect is the dominant component. This may reflect the fact that US companies continued to collaborate with their existing suppliers, with whom they had established long-standing and stable trading

relationships. Moreover, differences in tariff rates and transport costs between the EU and other countries were not sufficiently large to encourage significant changes in supply chains.

By contrast, exports of electrical equipment from Latvia showed the opposite trend – exports to the US also increased in the context of higher tariffs. This is reflected in the substantial role of the composition effect in decomposition. This may indicate that US importers started to increasingly purchase goods from countries with lower overall costs, including tariffs, compared to other countries. For example, part of imports could shift from China to relatively lower-cost suppliers, including Latvia.

Chart 2.2. Decomposition of the effective import tariff rate for wood products (%)



Chart 2.3. Decomposition of the effective import tariff rate for machinery (%)

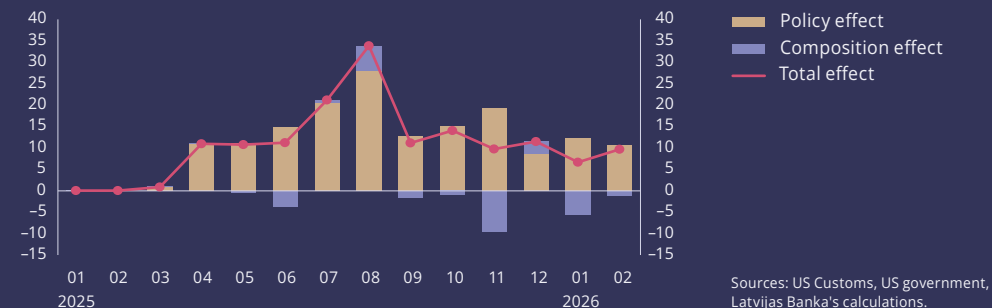
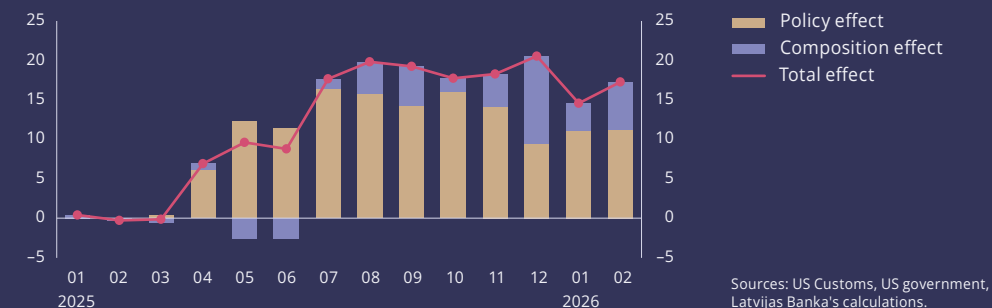


Chart 2.4. Decomposition of the effective import tariff rate for electrical equipment (%)



Box 3. Are the effects of fuel price increases and decreases symmetric?¹

In spring 2026, fuel prices rose sharply. This was driven by the war that began on 28 February in the Middle East – a region that hosts significant oil extraction and refining capacity and includes the Strait of Hormuz, the blockade of which disrupts oil product exports to the rest of the world. Some observers felt that fuel prices (especially diesel prices) at Latvian petrol stations increased significantly faster than global crude oil prices. This contributed to the public perception that fuel prices at petrol stations respond more strongly and more quickly to increases in global prices than to decreases. How justified is this view?

Fuel prices at petrol stations are determined not only by global crude oil prices but also by several other factors:

- the oil refining costs and the oil refining companies' margins;
- the transport costs (determined both by the transportation of oil from extraction sites to oil refineries and by the subsequent delivery of fuel from oil refineries to Latvian petrol stations);
- the fluctuations in the exchange rates of the euro and the US dollar (the crude oil price is quoted in US dollars on commodity exchanges, whereas the fuel price at petrol stations is denominated in euro);
- the changes in fuel taxes (excise duty and VAT), as well as in the service fee for the maintenance of emergency oil stocks;
- the biofuel blending requirements and the biofuel prices;
- the demand and supply in European fuel markets, as well as the fuel inventory levels;
- the competition in the fuel market and the pricing policies of companies operating petrol stations.

¹ Prepared by Andrejs Bessonovs and Oļegs Krasnopjorovs, economists at Latvijas Banka.

Apart from the last factor, companies operating petrol stations cannot influence any of these factors.

The relationship between diesel prices at Latvian petrol stations and diesel purchase prices in Europe² is very strong. Overall, diesel prices at petrol stations react to increases in purchase prices in a similar way as they react to decreases.

Chart 3.1. Average daily diesel prices in Latvia (euro per litre)



Notes. Average prices reflect daily petrol station prices at Neste, Virši-A, Circle K, and Viada since 2005. Prices are shown excluding individual discounts linked to customer loyalty cards. The procurement price of fuel reflects the gasoil exchange price (US dollars per tonne), converted into euro per litre, taking into account the delivery premium, diesel density, and the euro exchange rate against the US dollar. Prices excluding taxes at petrol stations are obtained by subtracting the excise duty, VAT, and the service fee for the maintenance of emergency oil stocks.

The pass-through³ of fuel purchase prices to petrol station prices is complete and very fast. When gasoil prices in Europe increase by 10 cents per litre, diesel prices at Latvian petrol stations

² Gasoil prices are considered the benchmark for diesel prices in Europe; therefore, gasoil exchange prices are used in the calculations. In practice, diesel prices at which Latvian companies operating petrol stations purchase diesel fuel are higher than gasoil prices, i.e. they include a larger premium. The size of the premium varies depending on the degree of diesel "purity" (sulphur content), biodiesel blending, the delivery region, and the European diesel market conditions.

³ To assess the pass-through of fuel purchase prices to prices at Latvian petrol stations, an ARDL (Autoregressive Distributed Lag) model was used (Pesaran et al., 2001; Shin et al., 2014).

rise by 10 cents within 25–30 business days. Half of this effect is realised in the fifth to sixth business day. This means that already within one week, diesel prices at Latvian petrol stations increase by 5 cents per litre.

A slight short-term asymmetry was identified: the pass-through of diesel purchase prices to petrol station prices is faster during price increases and slower during price decreases. The asymmetric price response is a short-term phenomenon observed mainly during the first weeks after a purchase price shock, and it fully disappears within 25–30 business days. This asymmetry is a recent development – it was not observed previously, but has become more pronounced in data after 2022, possibly due to the Russian invasion of Ukraine and the gradual EU shift away from diesel fuel originating in Russia.

Does a slower response of petrol stations to decreases in diesel purchase prices mean that petrol stations increase their profits when fuel prices fall than when they rise? Not necessarily. The asymmetry may be related to daily fluctuations in fuel demand or to changes in petrol station pricing strategies in recent years under conditions of significant fuel price volatility. For example, when global oil prices rise sharply, drivers tend to purchase fuel in advance at previous (lower) prices, which may cause retail fuel prices at petrol stations to increase faster than purchase prices due to higher demand. Moreover, this price asymmetry may reflect larger discounts for regular customers or greater price differentiation across individual petrol stations within a single company (these factors increase the gap between the average fuel price in Latvia on a given day that is used in the analysis and the fuel price actually paid by a fuel buyer at the petrol station on the same day).

Chart 3.2. Pass-through of purchase price shock to petrol station prices in the linear model

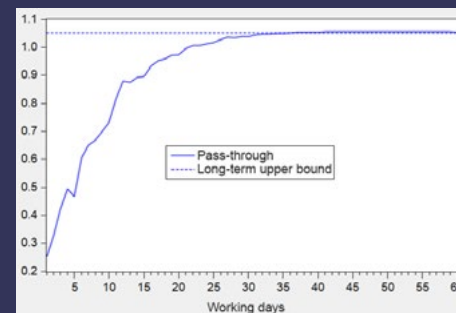
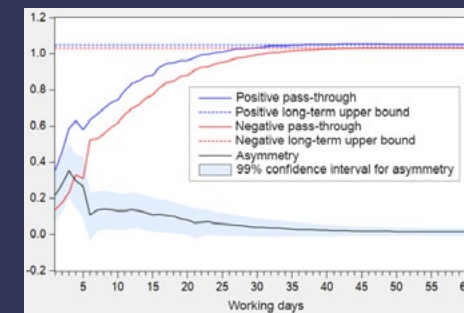


Chart 3.3. Pass-through of purchase price shock to petrol station prices in the non-linear model



Notes. Both linear and non-linear ARDL models are used to estimate the pass-through effect. The models use petrol station prices excluding taxes. The estimation is carried out for the period from 2005 to 2026, using business day data. By construction, the linear model does not distinguish between price increases and decreases. The non-linear model differentiates between cumulative price increases and decreases (Shin et al., 2014), resulting in an asymmetry effect. The number of lags in the ARDL models is selected automatically according to the Hannan–Quinn criterion.

Abbreviations

€STR – euro short-term rate
CSB – Central Statistical Bureau of Latvia
EC – European Commission
ECB – European Central Bank
EU – European Union
EURIBOR – Euro Interbank Offered Rate
Fed – US Federal Reserve System
GDP – gross domestic product
HICP – Harmonised Index of Consumer Prices
IMF – International Monetary Fund
OIS – Overnight Index Swap
OPEC – Organisation of the Petroleum Exporting Countries
PS – petrol station
RE – real estate
UAE – United Arab Emirates
UK – United Kingdom
US – United States of America
VAT – value added tax