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Inflation Story: Reasons and Consequences. Case of Latvia

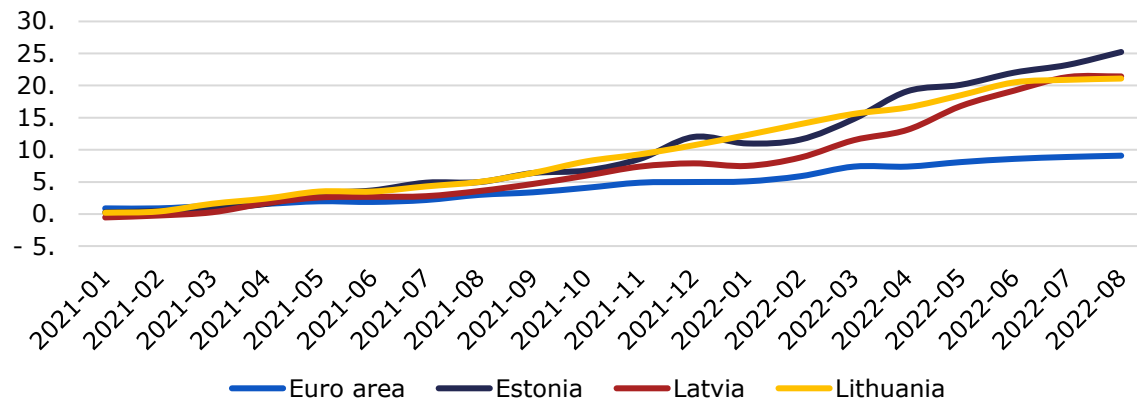
Prof. Inna Šteinbuka
Fiscal Discipline Council

Up and Down of Inflation in 2021-2024: Key Reasons



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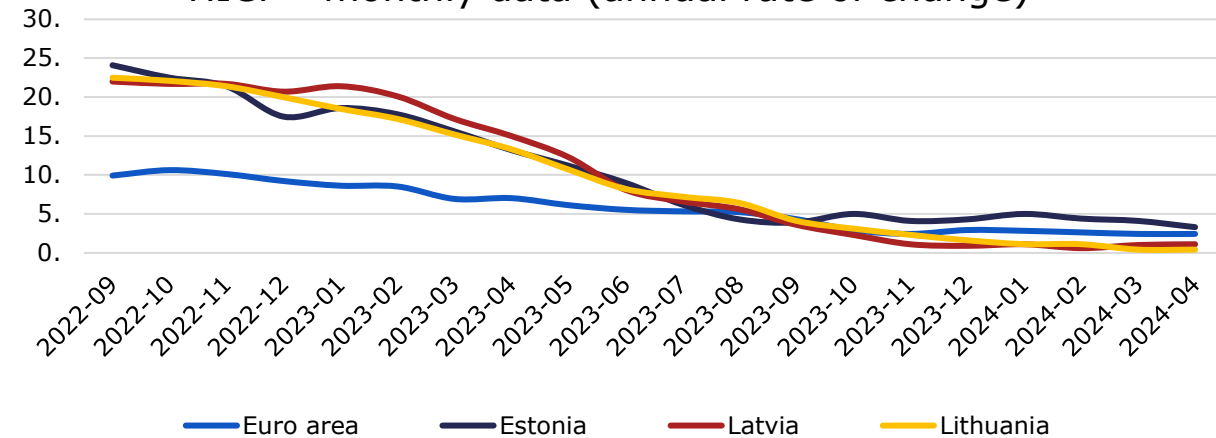
HICP - monthly data (annual rate of change)



Source: Eurostat

- COVID-related expansionary fiscal and monetary policy (inflationary effect in end-2021).
- Disruption of supply chains and costs increase of supplies during COVID.
- In early 2022, «gas war» with Russia. Surge of gas prices.

HICP - monthly data (annual rate of change)



Source: Eurostat

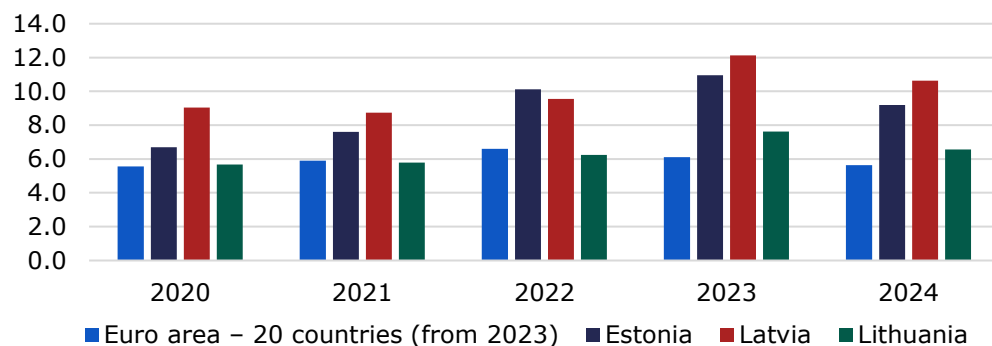
- In 2022/1st half, beginning of alternative gas supply.
- The Baltic States are developing liquefied gas supplies.
- In the middle of 2022, ECB started restrictive monetary policy.
- In May 2023: gradual normalization of gas prices.

Inflation in the Baltic States - Why Higher than in Euro Area?



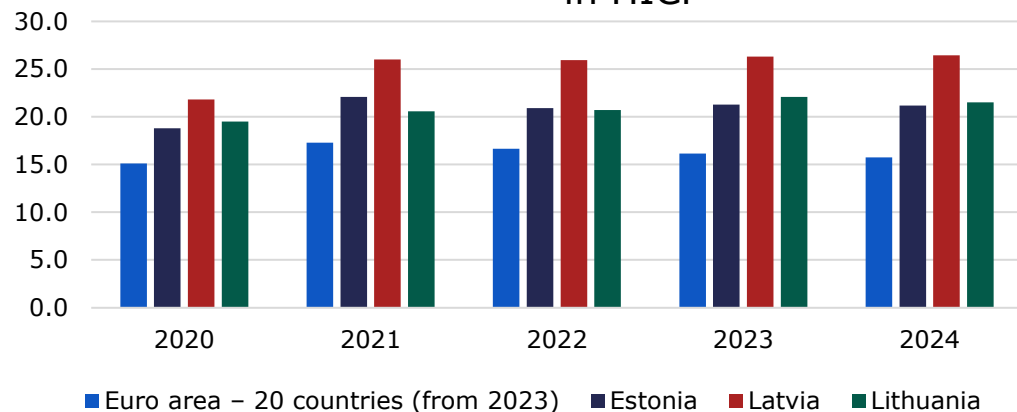
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Weight of electricity, gas and other fuels in HICP



Source: Eurostat

Weight of food and non-alcoholic beverages in HICP



Source: Eurostat

The specifics of the consumption basket in the Baltics:

- much larger proportion of food and energy costs in the Baltic countries' consumption;
- long heating seasons.

High dependence on Russian gas supplies, insufficient infrastructure to diversify supplies:

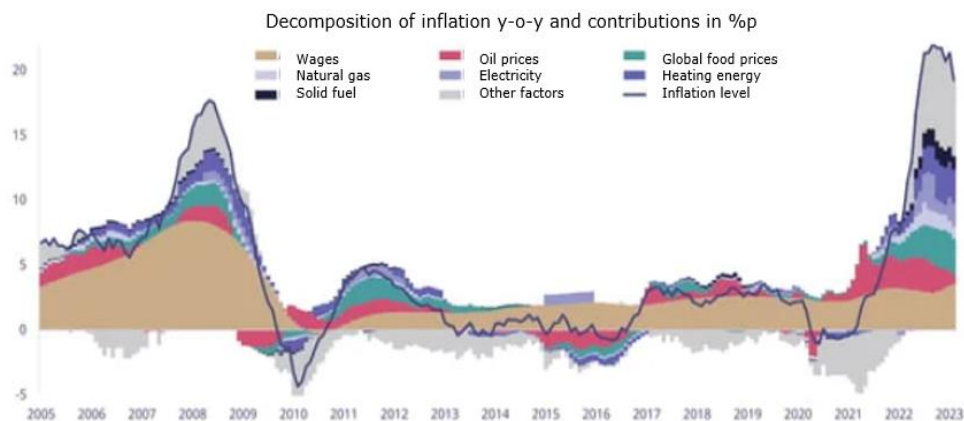
- liquid gas terminal – only in Lithuania (Klaipeda);
- Inco gas terminal in Finland (early-2023);
- Accident at Balticconnector gas-grid disrupted gas supply from Finland in period from October 2023 until April this year (no impact on inflation).

Inflation in Latvia: Why Higher than in LT and EST (mostly in 2023)?

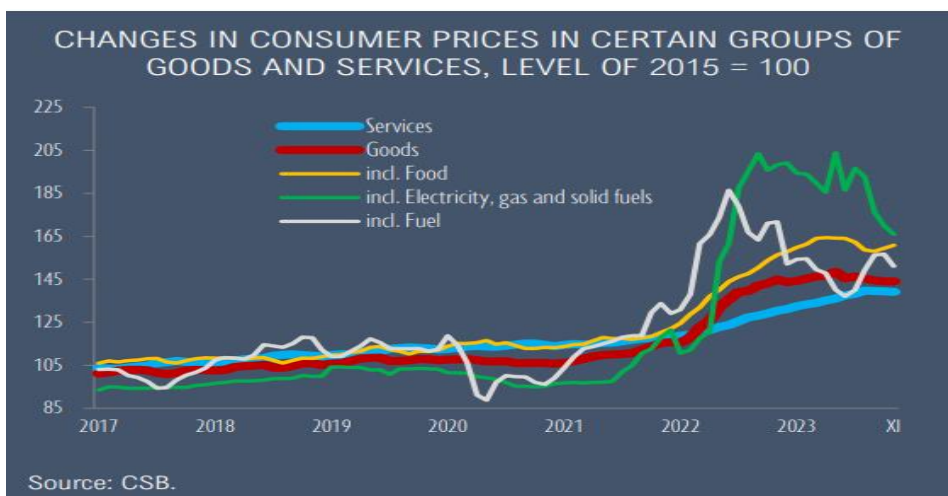


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Inflation decomposition case of Latvia



Source: BoL



Source: CSB.

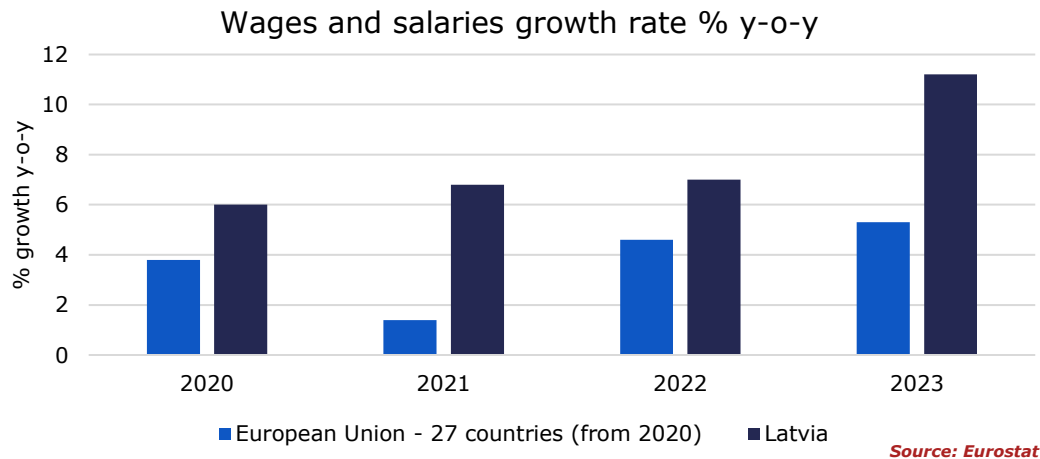
Source: CSPB LU, LV PEAK

- *Main reasons* (common for all Baltic States):
 - ✓ high energy prices,
 - ✓ specifics of consumer baskets, where goods and services with limited demand elasticity prevail.
- The inflation decomposition (BoL) shows that 1/3 of LV HICP cannot be explained by these factors.
- Fiscal Discipline Council hypothesis: the lack of competition (supply side) and «envelope wages» (demand side).
- Currently, inflation in Latvia is one of the lowest in the Eurozone.

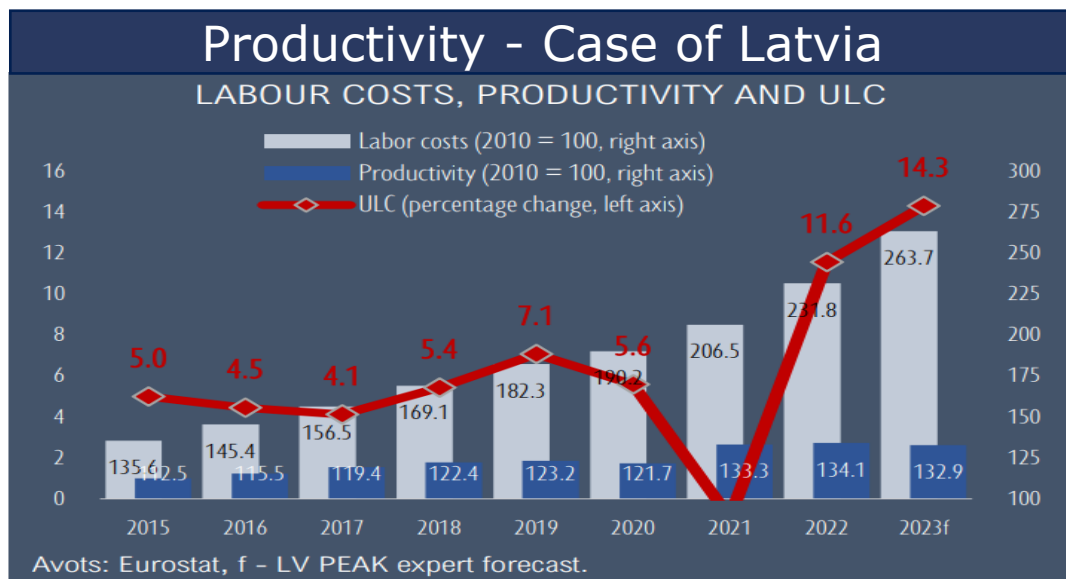
Inflation, Production Costs and Productivity



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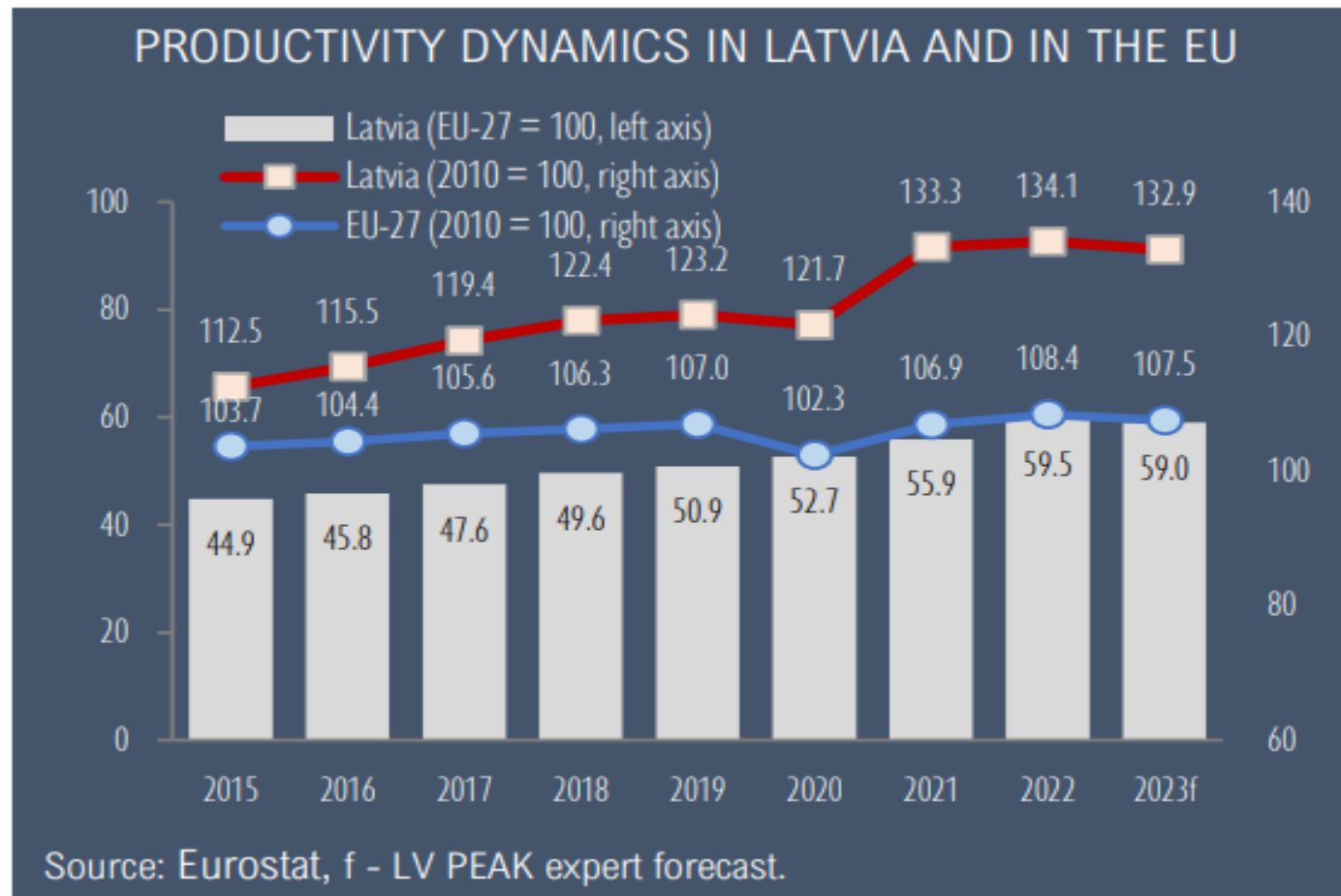
- High inflation and a tight labour market put increased pressure on employers to raise wages.
- In Latvia, productivity is increasingly lagging behind wage growth.
- Negative impact on competitiveness.



Inflation, Production Costs and Productivity



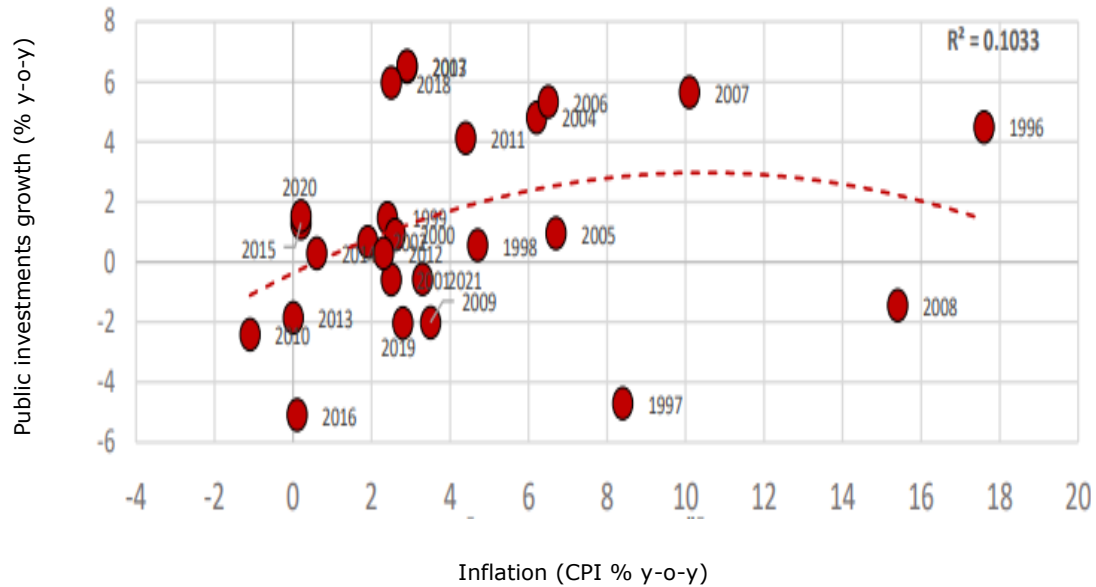
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Private Investments and Inflation



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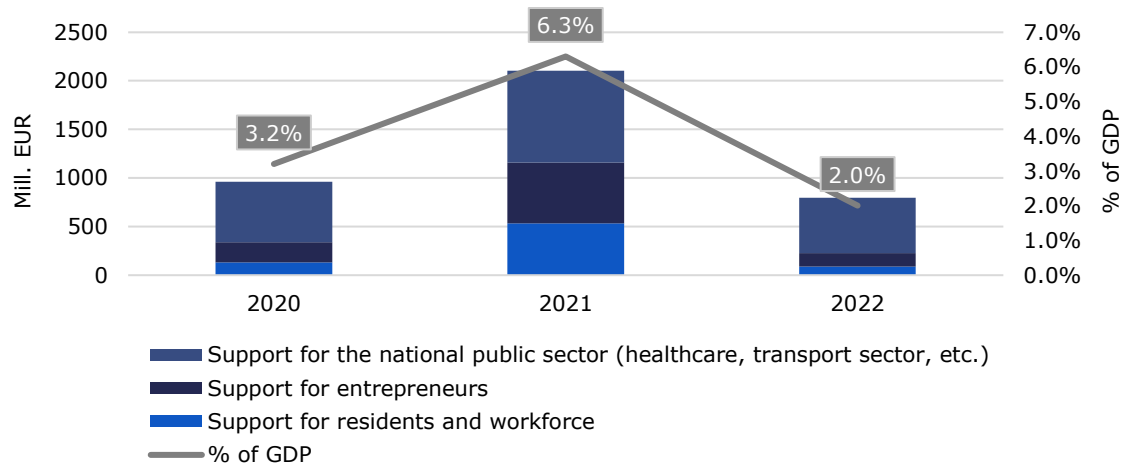


Source: LV PEAK

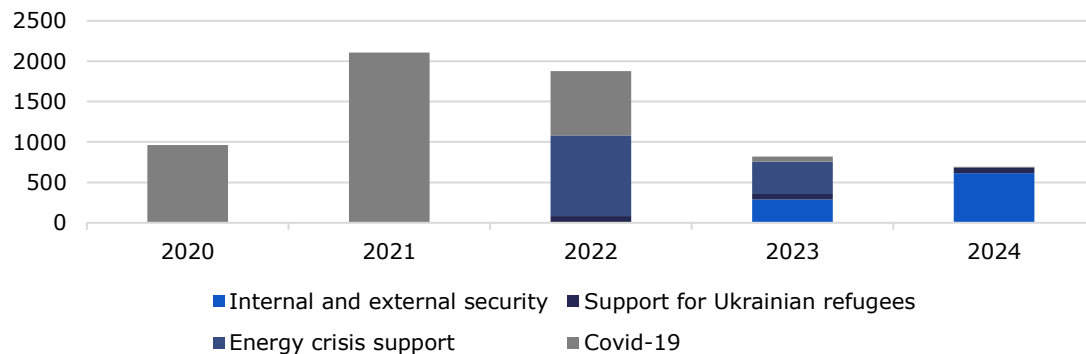
- **There is no undisputable evidence of inflation impact on investments inflow in Latvia**(«Think Tank» LV PEAK).
- The low level of private investment is influenced by
 - ✓ high geopolitical uncertainty,
 - ✓ weak lending,
 - ✓ unnecessary bureaucracy,
 - ✓ relatively high private debt level,
 - ✓ high income tax on low salary employees
- The restrictive monetary policy of the ECB has been effective in reducing inflation; however, it had a negative impact on the already weak lending.

Government Response to Covid-19, Energy crisis and Security Challenges

Public support measures in Latvia during the Covid-19 time (impact on the GG budget (mill.EUR))



Public reaction on Covid-19, energy crisis and security challenges (impact on the GG budget (mill. EUR))

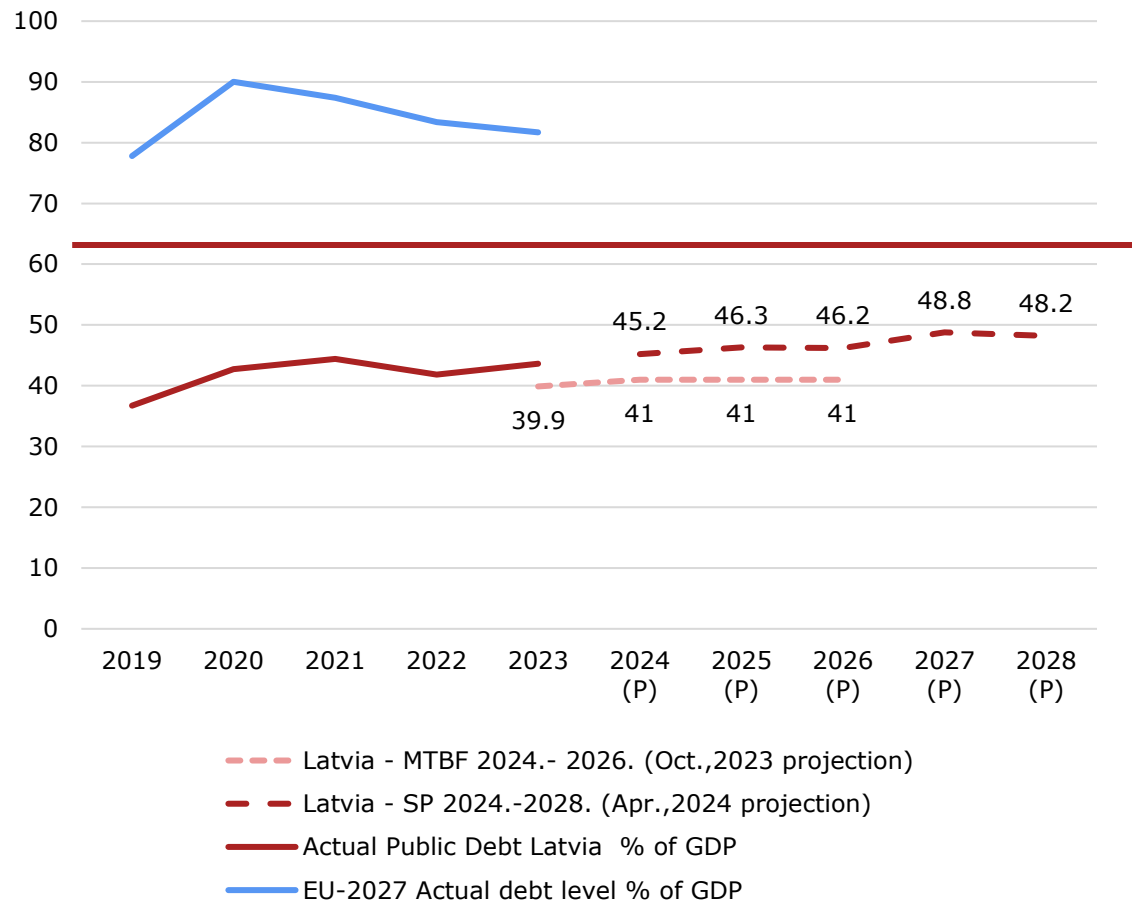


- Since 2020, expansive government support.
- During **Covid-19** - a wide range of measures: **partly targeted** support of population, public sector and enterprises.
- **Energy Crisis** related additional state support for covering heating expenses of residents.
- In 2022, energy support measures had the greatest effect on the budget balance - their amount exceeded 1 billion euros or 2.6% of GDP.
- **War in Ukraine:** significant expansion of public spending for external and internal security; support to Ukrainian refugees.
- The total additional expenses in GG budget from 2020 to 2023 amounted to 5.8 billion euros.
- Budgetary injections into economy fuelled inflation.

Inflation and Fiscal Indicators



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Source: Eurostat, Latvian Treasury

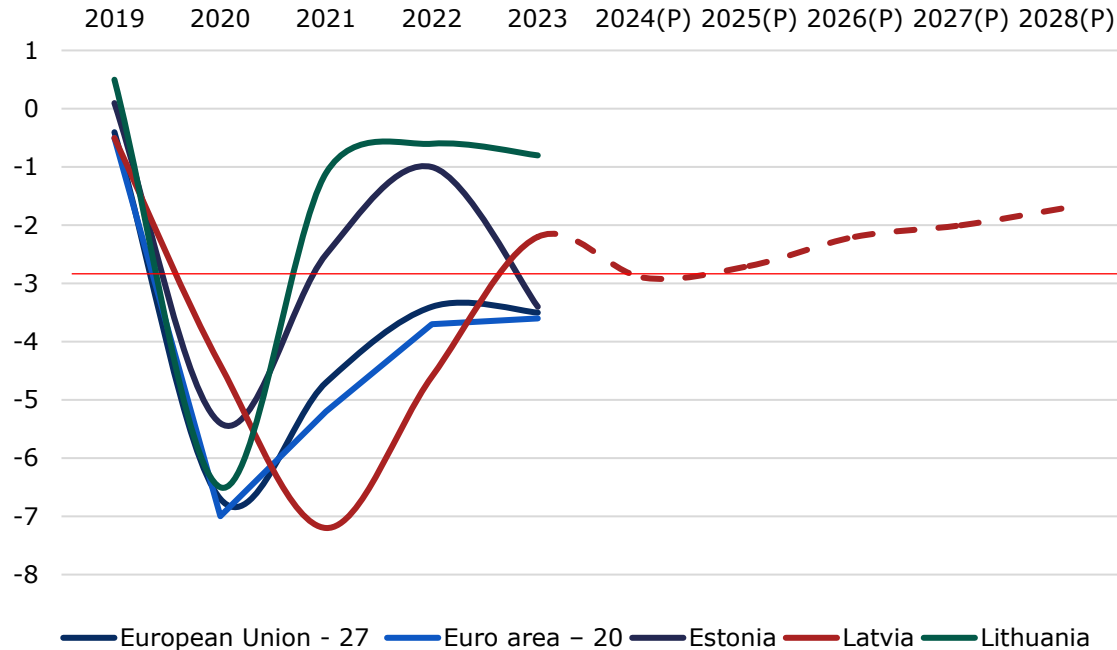
- Latvia still has one of the lowest debt levels in the EU.
- In the period of 2022 - 2023, due to high inflation, the ratio of the debt to GDP improved.
- MoF predicted that in 2023 the debt level will remain below 40% of GDP.
- The actual growth of nominal GDP in 2023 was significantly lower than forecasted (5% against 11%) and the debt-to-GDP ratio reached 43.4%.
- In 2028, debt-to-GDP level can reach 50%.

Transition from Expansionary Fiscal Policies to Fiscal Tightening



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General government deficit % of GDP



Source: Eurostat, MoF of Latvia

- High inflation in short run improved both the deficit and public debt-to-GDP ratios.
- The *general escape clause* had a "calming effect" on governments and allowed the deficit and debt to rise.
- The return to fiscal discipline requires prioritization/limitation of spending and, if necessary, tax increase.
- The new fiscal regulation makes it necessary to limit spending and facilitate growth in the medium term.
- The inflationary effect of new regulation most likely will be neutral.

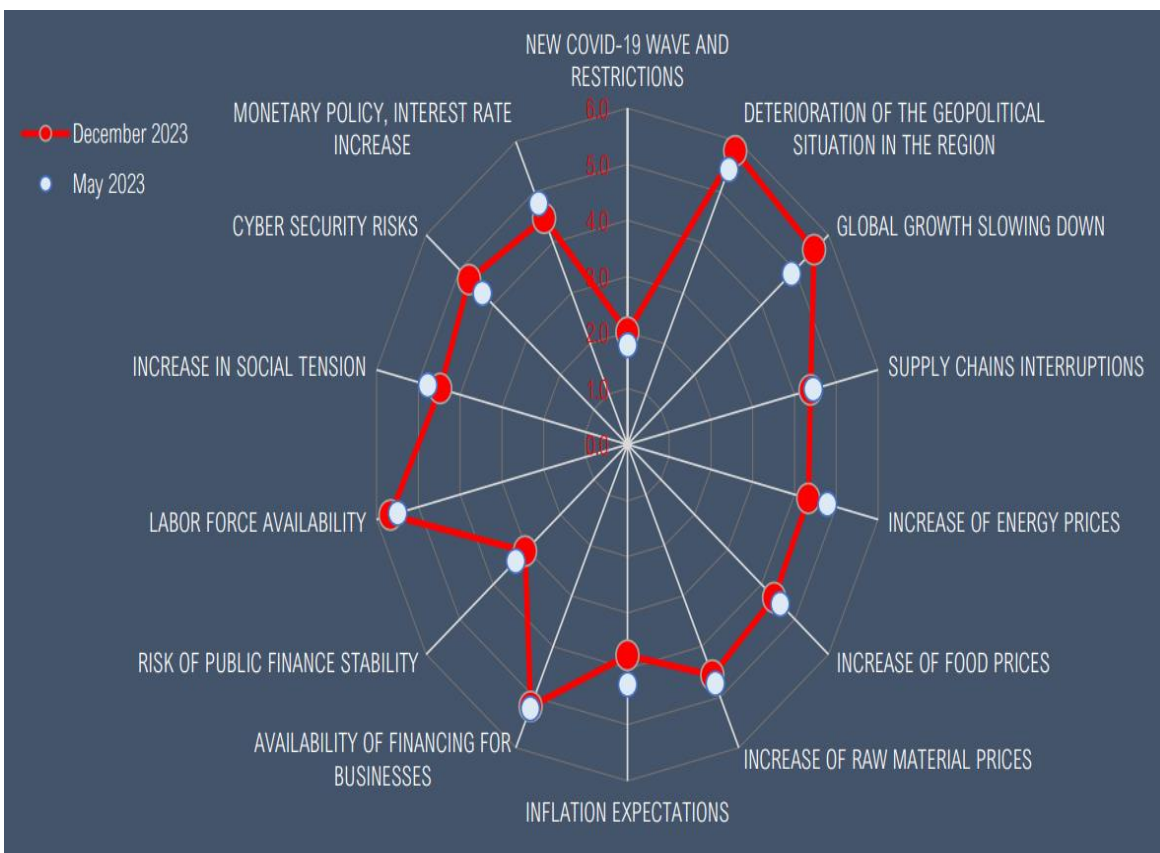
Short and medium term risks in after-inflation period



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Short term risks

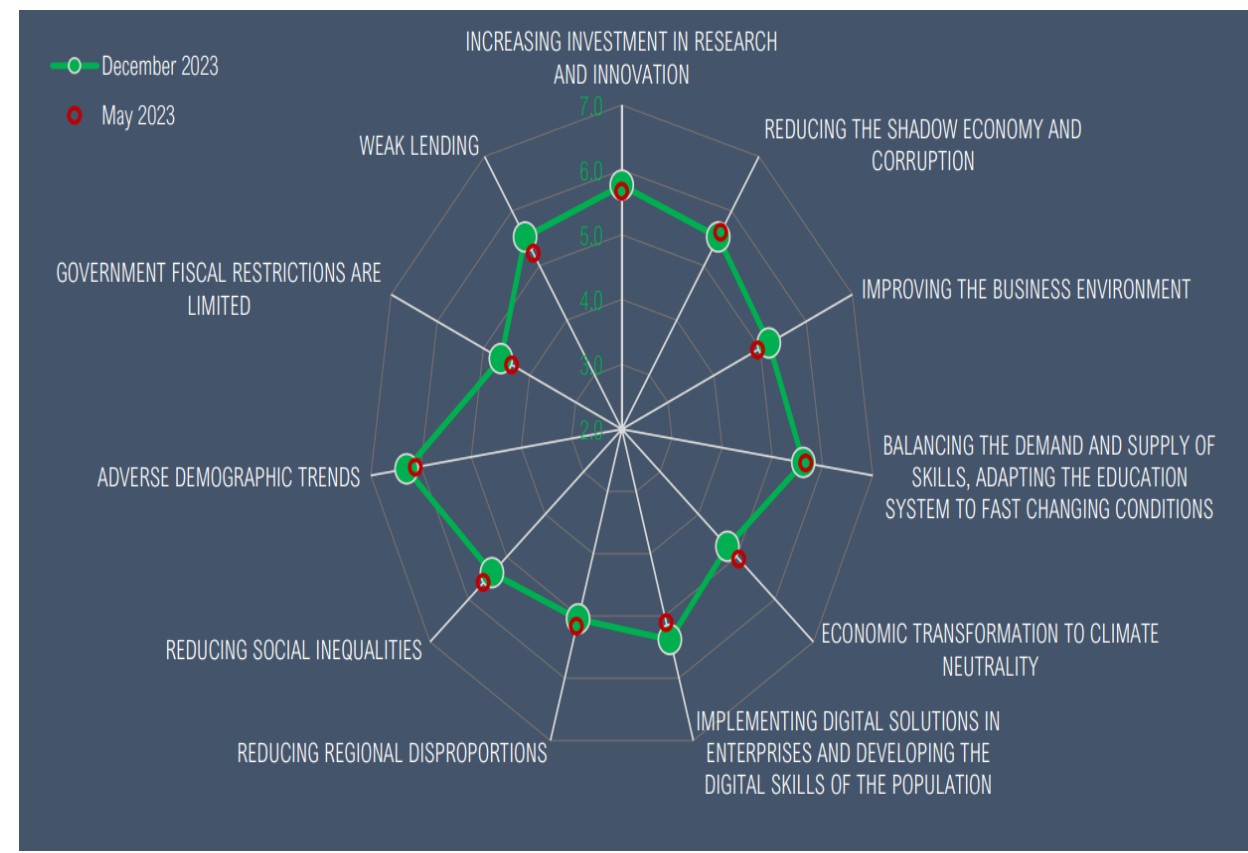
Risks for growth external environment, labour availability, financial resources and investments



Source: LV PEAK

Medium term risks

Challenges for growth – demographic trends, investments in research, development and human capital



Source: LV PEAK



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Thank You!!!

Contacts

6708 3650

info@fdp.gov.lv

Smilšu street 1-512, Riga, LV-1919, Latvia