Fiskālās disciplīnas padome

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SUMMARY

1. In response to the heightened geopolitical situation, the President of the European Commission, following consultations with European and partner country leaders, has immediately announced the ReArm Europe plan[1]. This plan envisions a significant increase in defence funding for member states and an expansion of military production capacity. It aims to utilize all available financial levers, mobilizing nearly €800 billion to build a secure and resilient Europe, which amounts to approximately 4.7% of the EU's GDP.
2. The ReArm Europe plan encompasses five strategic action areas: (i) Expansion of fiscal space – a proposal will soon be introduced to activate the exception clause of Stability and Growth Pact, allowing member states to significantly increase defence expenditures without triggering the excessive budget deficit procedure; (ii) establishment of a joint defence procurement system – a centralized military equipment acquisition process will be implemented to reduce costs, enhance interoperability, and strengthen the Europe's defence industry; (iii) reallocation of Cohesion Funds – a portion of EU Cohesion Policy funding will be redirected toward defence objectives; (iv-v) mobilization of private capital – the plan will promote the creation of a Savings and Investment Union, with the European Investment Bank playing a pivotal role in financing defence initiatives.
3. Latvia will inevitably need to further increase its national defence expenditures, targeting 4% and subsequently 5% of GDP. Preliminary calculations by the Council indicate that under a scenario where 5% of GDP is allocated to defence, national debt would rise to 56.8% of GDP by 2028, while the budget deficit would exceed the 3% threshold annually from 2025 onward. Debt servicing costs, already a significant expenditure, according to the Fiscal Structural Plan (FSP)[2] are projected at 1.2% of GDP in 2025, rising to 1.4% in 2026, and 1.5% in both 2027 and 2028. An increase in defence spending would further amplify these costs.
4. Last Thursday German politicians agreed on changes to debt policy, allowing for higher defence spending. Along with the threat of U.S. tariff increases, this decision triggered the largest one-day increase in German bond yields since German reunification 35 years ago[3]. The 10-year bond yield rose by 0.3 percentage points. Given that German bond yields serve as a benchmark for other Eurozone countries, it is likely that Latvia's government bond yields will also increase, leading to higher debt servicing costs than projected in the FSP.
5. According to the Budget law, the general government budget deficit for 2025-2028 is projected to average 2.5% of GDP. Raising defence spending to 4% of GDP would increase the deficit to an average of 3% of GDP, while allocating 5% to defence would push the deficit to an average of 4% of GDP. Likewise, the national debt, which under the revised macroeconomic forecasts for 2025-2028 is projected to average 51.8% of GDP, would rise as follows: increasing defence spending to 4% of GDP would elevate debt levels to an average of 54.7% of GDP, while a 5% allocation would raise it to 55.7% of GDP.
6. While the geopolitical climate necessitates increased defence spending, this presents a challenge given the sluggish economic growth. According to CSB data, in 2024, the gross domestic product in constant prices declined by 0.4%. A sharper downturn was averted due to modest positive contributions from household consumption (+0.2%) and government consumption (+1.6%). However, these gains were insufficient to counterbalance the negative impact of declining investments (-1.6%) and exports

[1] Press statement by the President on the defence package
[2] Fiscal Structural Plan of Latvia for 2025-2028
[3] https://www.cnbc.com/2025/03/06/bond-yields-rise-globally-german-bunds-continue-selloff.html

(-1.1%). The latest Eurostat data on EU GDP growth in 2024 also indicate weakness in the largest EU economies. Latvia's key trading partners experienced economic contractions – Germany declined by 0.2%, and Estonia by 0.3%. However, other Latvian trading partners performed significantly better. Lithuania led the Baltic region with 2.7% growth, Denmark ranked third in the EU with 3.6% GDP growth, while Sweden, with 1% growth, was in line with the EU's overall growth rate of 1% in 2024.

7. In 2024, inflation decreased to 1.3%, which is a positive trend. However, this decline also led to a reduction in nominal GDP. The industrial sector experienced a downturn (-2.2%), including a decline in manufacturing (-2.6%). Goods exports decreased by 1.9% or €365.4 million, primarily due to weakened external demand. On the other hand, the export of services performed better—after a decline in the first half of the year, there was a strong recovery in the second half, resulting in an annual growth of 2.4%.
8. In Latvia, the imbalance between wage growth and productivity continues to increase. In 2024, the average gross salary grew by 9.7%, with an 8.7% increase in the private sector and 12.2% in the public sector. Wage growth in the general government sector was even higher, at 12.4%. Latvia's productivity growth has long lagged behind wage increases. The Ministry of Finance (MoF) forecasts that productivity will grow by only 1.3% this year, with a medium-term growth projection of 2.1%. The Council views positively the government's intentions to reduce bureaucracy and public expenditures, as this could enhance productivity and improve fiscal outcomes during challenging times.
9. On February 12, 2025, the Fiscal Discipline Council approved the macroeconomic forecasts prepared by the Ministry of Finance, which will serve as the basis for the development of the Fiscal Structural Plan Progress Report. This year, real GDP is projected to grow by 1.2%, while next year, it is expected to reach 2.1%. Inflation is forecasted at 2.5% this year and 2.2% next year. In the medium term, real GDP growth is expected to be around 1.9%, indicating relatively slow economic growth, while inflation is projected to average 2.4%, which is above the ECB's 2% threshold. The Council considers these forecasts to be conservative but highlights that they do not account for recent geopolitical developments, particularly regarding U.S. trade policy and the increasing role of the military sector in the economy, both in terms of expenditures and revenues.
10. According to the Law on the State Budget for 2025 and the Budget Framework for 2025, 2026, and 2027, the consolidated general budget tax revenues for 2025 are planned at €14,552.7 million. This represents a 7.1% increase (€969.2 million) compared to the actual revenue collected in 2024. Achieving this level may be challenging, as the current GDP growth projection is 1.2% and inflation at 2.5%, whereas the 2025 tax revenue projections were based on assumptions of 2.9% GDP growth and 2.2% inflation. However, in January the tax collection target was exceeded, reaching 103.9% of the plan, giving hope for better tax collection results this year.
11. Despite the weak macroeconomic environment, from a fiscal policy perspective, the overall 2024 results can be considered relatively positive. According to the Ministry of Finance's assessment, the general government deficit last year amounted to €849.6 million, or 2.1% of GDP—0.3 percentage points lower than in 2023 and 0.7 percentage points below the forecast. While a lower deficit is generally a positive outcome, it is important to note that one of the reasons for this was lower budget expenditures resulting from slower absorption of EU funds. This is not a positive development, as during periods of geopolitical uncertainty and slower growth, EU fund investments are one of the most important sources of economic stimulus.

12. According to the Treasury's preliminary assessment, the general government debt at the end of 2024 stood at €19.1 billion, or 47.7% of GDP[4], increasing by €1.4 billion over the year. This year, the Treasury estimates that debt could rise to 49.9% of GDP, while the European Commission's assessment projects an increase to 50.3%. In the coming years, based on the Treasury's evaluation, the debt will continue to rise, reaching 50.5% in 2026, 53.8% in 2027, 53.1% in 2028. This updated assessment reflects the Ministry of Finance's revised macroeconomic forecast.
13. In 2024, consolidated general budget tax revenues amounted to €13.6 billion, which is a 7.8% increase compared to the previous year. This can be considered a positive result, as nominal GDP growth in 2024 was only 1.2%, significantly lower than the growth in tax revenues. However, the tax revenue target set in the Budget law for 2024 at €13.8 billion[5] was not met, falling short by €247 million (1.8%)[6]. It is important to note that tax revenue projections were based on 2.5% GDP growth and 2.2% inflation, which were not achieved —actual figures stood at (-0.4%) GDP growth and 1.3% inflation.
14. In 2024, consolidated general budget expenditures were 5.4% (€1 billion) lower than planned in the Budget law, which contributed to achieving a lower-than-expected-deficit of 2.1%. This was primarily due to significantly lower spending on subsidies and grants, where actual expenditures were 25.1% (€1.4 billion) less than planned. One of the reasons for the reduction in spending on subsidies and grants was the slower implementation of EU-funded projects.

[4] Treasury - Interactive DEBT REPORT 2024 LV
[5] Law "On the State Budget for 2024 and the Budgetary Framework for 2024, 2025 and 2026" Explanatory Notes, Chapter I (fm.gov.lv), page 92.
[6] Consolidated general budget tax revenues on an accrual basis (excluding the undistributed balance in the single tax account).