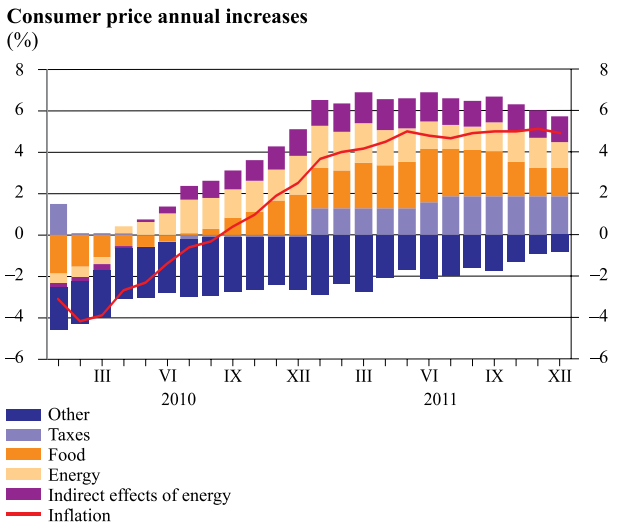
3. In Focus

A Third of Annual Inflation Generated by Tax Hikes

Lower levels of inflation seen next year – 2.5–3.0%



June inflation data point to a small drop in annual inflation – to 4.8%. In May the annual inflation stood at 5%, which led some forecasters to expect a rise to 5.5% or even 6% in June. That has not materialized: the reason for the decline is a slower increase in heating tariffs compared to June of last year, as well as a fall in vegetable prices in response to shrinking demand.

In the last six months overall, the annual inflation was determined by rises in energy and food prices, which we had predicted, as well as raising of value added and excise taxes, which has generated one third of the current inflation. **The inflation forecast for this year is 4.7%.**

If we look at the inflation components, we see that the increase in food prices (2.0 percentage points) and the rise in energy prices, including its indirect effect, i.e. the pickup in production costs (2.9 percentage points overall) have contributed to inflation in almost equal measure. The raised tax rates (1.6 percentage points) are also a significant contributor. The other factors related to economic growth, on the other hand, are still acting toward lowering the inflation. Here we should also take into account the fact that lending amounts are not growing and no rapid change is expected in this respect.

The central bank's outlook regarding price dynamics in the medium term remains unchanged: the current upward move in inflation has been caused by one-off and temporary factors, and, as their influence dissipates, a further climb in prices will abate. As the impact of global price rises and tax increases moderates, **we will observe a much lower inflation as early as next year** – between **2.5 and 3.0 percent**.

While Latvia cannot affect or change the impact of the global markets on energy or food prices, it can choose its own taxation policies. As the Minister of Finance has declared, it is important not to raise the main tax rates or introduce new taxes. **Yet to bring the inflation down substantially, more must be done: no taxes should be raised either in 2012, or in 2013.**

That would also lead to more rapid economic growth. Such an approach should also be a part of **the anti-inflation measures** that the Ministry of Finance plans to have in place by the end of July. These measures should include provisions that salaries can only be raised alongside productivity growth and that the budget consolidation must be accomplished only on account of expenditure cuts instead of tax increases. Structural unemployment, which may act as an additional pressure on inflation, should also be brought down. That can be attained by changing the education process, allowing a wider participation by entrepreneurs themselves.