# Latvia



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*The ongoing economic downturn is expected to be deep although not as severe as during the global financial crisis. Measures to dampen the shock to the economy should generate a sharp rise in the government budget deficit and push the government debt to GDP ratio to record high levels. The authorities' strong track record of fiscal prudence leaves us confident that measures will be taken to put the debt ratio on a declining trend in the medium-term.*

## Country Risk Analysis

### *Recent economic developments*

**Economy slowed more than expected in 2019.** Slowing export demand and moderate investments contributed to a slowdown in GDP growth last year. The recorded 2.2% followed on a streak of high economic growth over the past 5 years and was lower than we initially expected. Despite the past years rapid growth, there are few signs of any major imbalances. In the first quarter of 2020, growth fell 1.5% yoy according to the first estimate.

**Labour market conditions remained tight last year but are changing**. The declining working age population has continued to cast its shadow over the labour market in the past year. Combined with high labour demand, this contributed to reducing the unemployment rate to an average of 6.3% in 2019 and pushing labour force participation to new highs. In early 2020, however, the unemployment rate started to rise.

**Inflation in negative territory**. Unemployment below its natural rate generated average gross wages increases of more than 7 % in 2019, a marginal deceleration compared to 2018. Wage levels are still low in an EU perspective, even after adjusting for lower than average productivity levels. Despite rapid wage growth, price pressures have been moderate. In April, as the economic shock had set in, headline inflation fell to -0.1% yoy.

**Current account showing small deficit.** Strong domestic demand kept the current account balance in a small deficit in 2019. The deficit is more than covered by inflows of EU funds on the capital side and by foreign direct investment (FDI) on the financial side.

**External debt is high but falling**. Gross external debt declined to about 116% of GDP in 2019. This is still high compared to most country risk peers. The gradual decline comes on the back of continued deleveraging in the banking sector in the past year, most importantly through the continued unwinding of non-resident bank deposits (NRD). NRD declined particularly sharply in 2018, following the moratorium on the ABLV bank. The expected further decline will contribute to reducing the country's short-term external debt.

**Banking sector in good shape to handle downturn**. Aggregate vulnerability indicators reflect a banking sector that remains well capitalized and liquid with average capital ratios substantially above the required minimum. The authorities have made progress in improving supervision of money laundering related risk, particularly over the past two years. In early 2020, MONEYVAL announced that Latvia is now largely compliant with most of its recommendations in combating money-laundering and financial terrorism. Moreover, the Financial Action Task Force (FATF) recently announced that it will not place the country under increased monitoring. This and the continued winding down of non-resident deposits (previously a key country risk) reduces risks relating to AML/CTF issues in the sector. The still comparably high share of NRD of total deposits remain a vulnerability.

## *Economic policies*

**Solid public finances leaves policy room to counter the downturn**. Latvia has a strong fiscal framework and a long track record of sticking to strict fiscal targets. The government budget deficit shrank to 0.2% of GDP in 2019 despite lower than expected taxes on consumption. In 2020, a sharp deterioration of the government deficit to some 8% of GDP is projected as a result of the economic downturn and the adoption of temporary stimulus measures.

**Government debt edged down in 2019.** A strong commitment to fiscal prudence has kept government debt fluctuating around 35-40% of GDP in the past few years. In 2019 the ratio edged down to 36.9% of GDP (Maastricht definition). This is lower than most country risk peers, and significantly lower than the limits set by the Fiscal Discipline Law (60%). Other debt metrics such as interest payments as a share of revenues are also slightly lower than most peers. On the other hand, contingent liabilities stemming from the debt of state-owned enterprises, particularly in the electricity and transport sectors, are non-negligible.

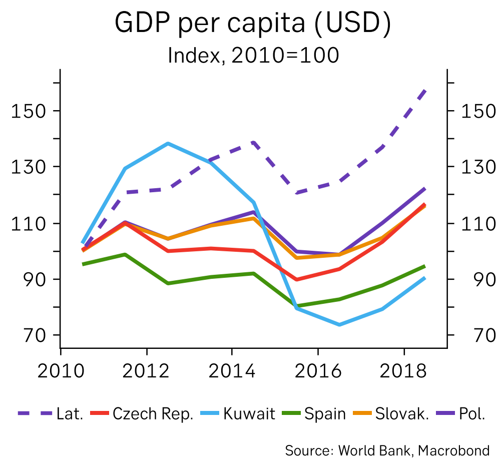
**Expected rise in debt should be manageable**. The higher budget deficit expected should push government debt to 48% of GDP in 2020. This would represent an all-time high level. A reduction in the government's precautionary cash resources should milden the increase in the debt ratio. Although there might be a further increase in 2021, the government's positive track record of fiscal prudence leaves us (and most analysts) confident that measures will be taken to put the debt ratio on a declining trend in the medium-term. Latvia has met favourable financing conditions recently as evidenced when issuing a EUR 1bn three-year Eurobond in April at an interest rate of 0.2%. As parts of a strategy to lengthen the average maturity of debt, the government successfully issued a 30-year bond in 2019.

**Rating agencies changing views in early 2020.** In February 2020, one of the major credit rating agencies improved their sovereign rating on Latvia one notch. The agency mainly based the change on its expectations of a fall in Latvia's "already modest" public debt, despite moderate growth. At the time, they expected positive growth and debt to fall to below 30% of GDP by 2023. In March, another rating agency switched the outlook for their sovereign credit rating to negative. They mainly argued that is was due to the worsened fiscal outlook caused by the shock to growth and the higher spending needs to counter the downturn. The agency forecasts debt to GDP to reach record highs in 2020 on the back of a surging fiscal deficit. Although we broadly agree with this reasoning we would note that debt would still be lower than average among country risk peers.

## *Economic and institutional factors*

**Institutions and governance are relatively strong.** The unravelling of irregularities in the financial sector in 2018 suggested that institutional quality and governance related to the financial sector had not been as strong as previously expected. However, recent positive evaluations of FATF and MONEYVAL confirm that significant improvements in this area has been made. In general, most World Bank indicators of governance and institutional quality are broadly in line with risk class peers, corruption related indicators apart. Furthermore, Latvia ranks 47 of 141 economies in World Economic Forum's index measuring institutional quality. This is lower than country risk peers such as Malaysia and the Czech Republic but ahead of Poland. As to the quality of the business climate, Latvia ranks 19 of 190 countries in the World Bank's Ease of Doing Business index. This is broadly at par with Estonia. Latvia's relatively large shadow economy is a weakness when we assess the economy's resilience. The extent of the informal sector, in most surveys, compares unfavourably to risk class peers and to Estonia and Lithuania.

**Low level of GDP per capita is country risk weakness.** High growth rates have led to a continued convergence toward average nominal GDP per capita levels in the EU. Although incomes per capita are low compared to most country risk peers and thus a negative for country risk, Latvia is ahead of countries such as Chile and Malaysia.

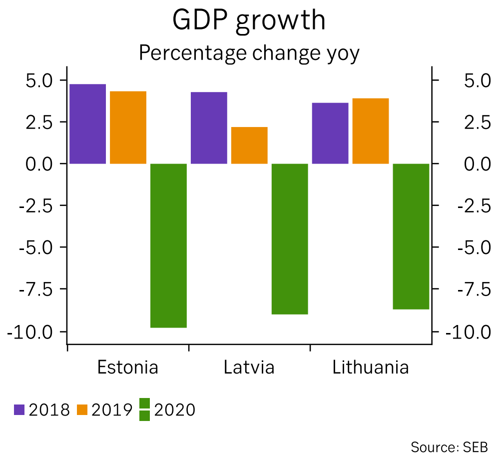



## *Political developments*

**Coalition government holding together.** A five party coalition headed by New Unity (JV) formed a new government in early 2019. Together they hold 61 of 100 seats in parliament. Tensions within the government coalition have been present but the reform agenda, especially regarding the country's financial sector, has largely stayed on track. However, similar to many other countries, the handling of the coronavirus emergency is now slowing the pace of economic reform. This includes work on tax reform and other business environment improvements which the JV party had hoped to advance.

## *Outlook*

**Sharp downturn, but not as bad as during financial crisis.** We expect that GDP will decline by 9 per cent this year before gaining 5 per cent in 2021. The scale and speed of the bounce-back will largely depend on how fast the EU can emerge from recession. In this scenario the downturn would be less severe than during the global financial crisis (GFC) and would thus be a testament to the economy's improved resilience since then. Even in the wake of the GFC, the economy recovered sharply and grew more than 3% for several years. We expect a continued gradual convergence towards per capita income levels of the EU which would be consistent with a better country risk.




**External risks relate to the geopolitical environment and to the vigour of foreign demand.** A key external risk is Latvia's exposure to political and security risk in its geographical neighbourhood. Although any military intervention by Russia is considered a tail risk event, other forms of low intensity political pressures and cyber-attacks that destabilises the economy cannot be ruled out. Direct trade links with Russia have declined but Russian export transit is still important. A mitigating development is Latvia's increasing integration into EU and other multilateral cooperative frameworks such as the OECD. Another external risk to the growth outlook relates to the small size and openness of the economy. Although the export share of GDP at about 60% is lower than in Estonia and Lithuania, the economy is vulnerable to changes in global demand. Two thirds of exports go to the EU while about 13% of exports are bought by Russia.

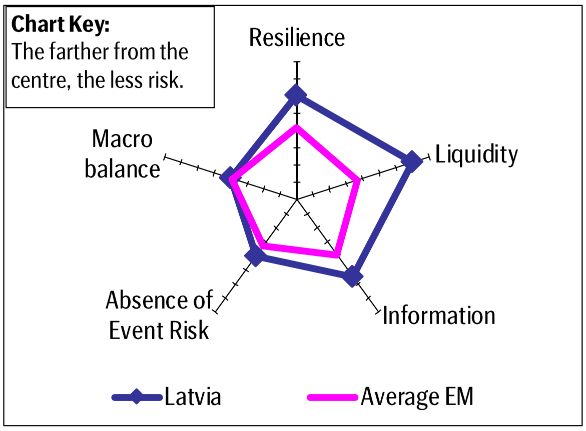
**Loss of competitiveness remains medium-term risk..**.Although the current downturn will relieve pressures on the labour market, with the unemployment expected to rise to 9.8%, medium term risks to competitiveness remain. If jobs are not increasingly being created in higher value-added sectors this would lead to higher than expected wage-productivity differentials. As a consequence, the risk would rise that competitiveness and hence export performance and growth could be lower than we expect.

**…as is lower EU funding**. The flow of EU funding, an important fuel for investment activity, is expected to continue at solid levels in the next two years despite the formal termination of the EU:s current multiannual financing framework this year. However, funding available for Latvia will decline in the next budget period (2021-2027) due to a likely smaller EU budget and Latvia's income convergence. Expectations among observers are generally for 10-25% lower funding levels.

**Longer-term challenges mainly relate to demographics**. The population has continued to decline over the past few years, despite some decline in net migration numbers. Projections point to a decline in the working age population by more than 30% by 2050, posing challenges to economic growth and per capita incomes. The simultaneous ageing of the population adds to this challenge. The IMF estimates that Latvia's potential GDP growth, which they and the authorities see at about 3%, could be reduced to 1.5% in the long run if further counteracting policies are not implemented.

## Latvia: Risk Profile

| Key figures | 2020 |
|---|---|
| Population (mn) | 1,90 |
| GDP/capita (USD) | 17 833 |
| Real GDP (% chg) | -9,0 |
| Inflation (%) | 0,3 |
| Current Account Balance (% of GDP) | -0,5 |
| Reserves/imports (months) | 1,9 |
| Budget balance (% of GDP) | -5,5 |
| Government debt (% of GDP) | 48 |




**External Ratings:**
Fitch: A- / Neg.
Moody's: A3 / Stable
S&P: A+ / Stable

**Peers:**
Saudi Arabia
Spain
Lithuania

**Graph:** Resilience to shocks stem from a favourable business climate, strong political institutions, and prudent fiscal and monetary policies. Although event risk has risen it still compares favourably to other EMs.

## Latvia: Key Economic Indicators

| **Macroeconomic** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** | **2023** |
|---|---|---|---|---|---|---|---|---|
| GDP real (% chg) | 1,6 | 3,8 | 4,5 | 2,2 | -9,0 | 5,0 | 3,5 | 2,7 |
| GDP (USD bn) | 27,7 | 30,3 | 34,3 | 34,1 | 33,7 | 36,1 | 39,3 | 42,8 |
| GDP/capita (USD) | 14 227 | 15 638 | 17 865 | 17 900 | 17 833 | 19 242 | 21 124 | 23 224 |
| Investments/GDP (%) | 19,7 | 20,5 | 21,8 | 21,5 | 20,8 | 20,4 | 20,0 | 19,6 |
| Trade/GDP (%) | 131 | 129 | 120 | 123 | 123 | 119 | 113 | 107 |
| **Money & Prices** | | | | | | | | |
| CPI inflation (%) | 0,1 | 2,9 | 2,5 | 2,8 | 0,3 | 1,8 | 2,3 | 2,3 |
| Money, M2 (% chg) | 33,8 | 37,9 | 52,0 | 58,3 | 48,3 | 45,8 | 43,4 | 45,4 |
| Interest rates (%) | -0,3 | -0,3 | -0,3 | -0,4 | -0,3 | -0,4 | -0,3 | 0,0 |
| Exchange Rate (USD) | 0,90 | 0,89 | 0,85 | 0,89 | 0,92 | 0,92 | 0,89 | 0,85 |
| Oil price (Brent, USD) | 44 | 54 | 71 | 64 | 38 | 44 | 49 | 53 |
| **Government Finances** | | | | | | | | |
| Budget balance/GDP (%) | 0,1 | -0,5 | -0,7 | -0,2 | -5,5 | -5,0 | -3,5 | -2,7 |
| Govt debt/GDP (%) | 40,5 | 40,0 | 37,2 | 36,9 | 48,0 | 50,5 | 51,5 | 45,0 |
| **Balance of Payments (USD bn)** | | | | | | | | |
| Current account | 0,4 | 0,3 | -0,2 | -0,1 | -0,2 | -0,2 | -0,1 | 0,1 |
| (% of GDP) | 1,4 | 1,0 | -0,6 | -0,4 | -0,5 | -0,6 | -0,2 | 0,3 |
| Exports of goods | 18,3 | 19,4 | 20,2 | 20,6 | 20,4 | 21,2 | 21,9 | 22,5 |
| Imports of goods | 18,2 | 19,7 | 20,9 | 21,4 | 21,2 | 21,8 | 22,5 | 23,1 |
| Other current account flows | 0,3 | 0,6 | 0,5 | 0,7 | 0,6 | 0,4 | 0,5 | 0,7 |
| Net FDI | 0,1 | 0,5 | 0,8 | 0,4 | 0,4 | 0,5 | 0,5 | 0,6 |
| Debt service requirement | 6,0 | 6,2 | 6,6 | 6,4 | 7,0 | 7,0 | 7,4 | 7,8 |
| Net other capital flows | 2,1 | 2,5 | 4,1 | 3,1 | 4,6 | 10,0 | 10,8 | 11,7 |
| **External Debt & Liquidity (USD bn)** | | | | | | | | |
| Reserves | 3,1 | 4,2 | 3,9 | 4,0 | 5,3 | 6,1 | 6,8 | 7,7 |
| Gross external debt | 36,1 | 36,6 | 37,2 | 37,9 | 38,6 | 39,2 | 39,8 | 40,4 |
| o/w short term debt | 10,9 | 11,1 | 11,2 | 11,4 | 11,6 | 11,8 | 12,0 | 12,2 |
| percent of GDP | 149 | 141 | 121 | 116 | 114 | 109 | 102 | 95 |

*Source: Oxford Economics, IMF and SEB estimates.*

| **Rating history (end of year)** | | | | |
|---|---|---|---|---|
| Fitch | A- | A- | A- | A- |
| Moodys | A3 | A3 | A3 | A3 |
| S&P | | | A- | A |

**Other:**

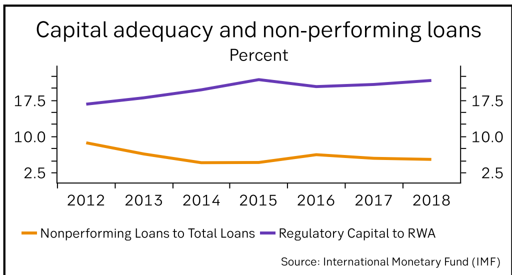
Type of government: Parliamentary democracy

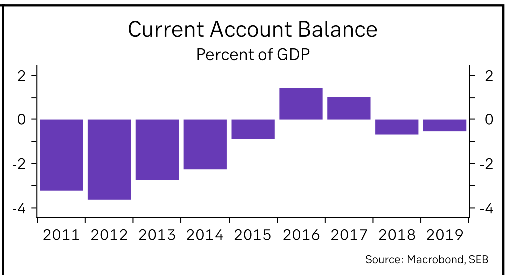
Next elections: Presidential 2023, Parliamentary 2022

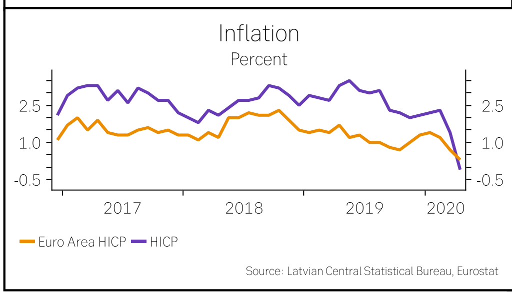
**Other:**

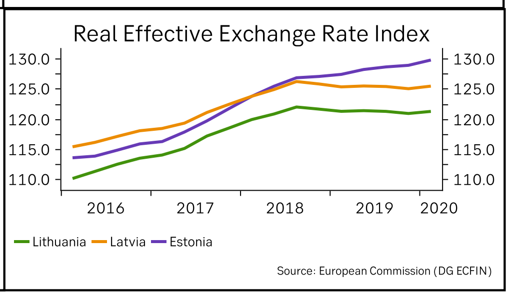
Latest PC deal

Latest IMF arrangements: 2008 SBA, concluded 2011



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