Latvia

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The Latvian economy has picked up some pace, fuelled mainly by strong household spending on the back of high wage increases. Fiscal policy remains sound with the general budget deficit declining slightly and government debt remaining low. Risks to a generally favourable outlook include external shocks and a decline in the economy's competitiveness.

Country Risk Analysis

Summary

The Latvian economy has been picking up pace. It grew 2.7% in 2015, up from 2.4% in 2014. This is below the 3.4% average of the previous three years but clearly above the average growth rate in the euro zone. Exports were surprisingly strong given the weak demand in Russia, although household spending was the main growth engine. Consumers continue to be supported by high real wage growth and improving labour market conditions. Unemployment has dropped to such low levels that labour market conditions are unlikely to get much better without raising inflation.

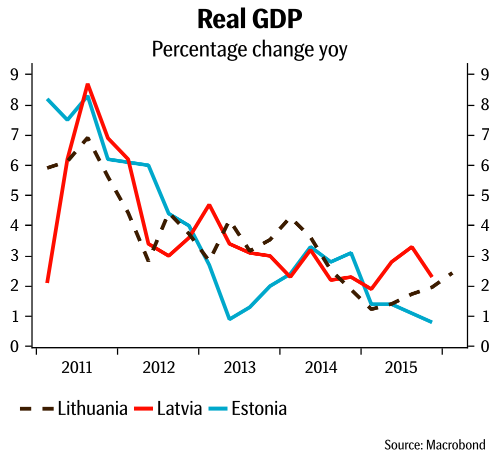
Exports rose again last year despite the challenging global environment. Modest import growth led to a shrinking trade deficit which contributed to reducing the current account deficit to just above 1% of GDP. Gross external debt has trended downwards since the peak in 2010 but rose marginally last year and is high compared to rating peers. A mitigating factor is the large share of intra-company liabilities between subsidiaries and parent companies.

Fiscal policy remains sound, with the general government deficit declining marginally in 2015. The aim is to reduce the deficit to 1% of GDP in 2016 which we believe is feasible although we see risks of some undershooting. Public sector debt which fell in 2015 is expected to rise slightly in 2016 as the government pre-finances a Eurobond repayment coming due in early 2017.

Banks are well capitalized and liquid with average capital ratios substantially above the required minimum. The stock of outstanding bank loans is still shrinking compared to a year ago although at a less rapid rate. The large but stable share of non-resident deposits in banks remains a source of concern as it constitutes a risk for banks' funding and a fiscal contingent liability.

Recent economic developments

Economic growth picked up. Despite some slowdown in the second half of the year, GDP growth was 2.7% in 2015, up from 2.4% in 2014. While this is below the 3.4% average of the previous three years, it is clearly above the euro area's 1.6%. Exports were surprisingly strong given weak demand in Russia, although household spending was the main growth engine. Consumers continue to be supported by high real wage growth and improving labour market conditions. Average real wage growth was about 7% in 2015. Meanwhile, corporate sentiment and investment activity remains relatively weak despite low interest rates, perhaps due to lingering geopolitical uncertainty.



Labour market slowly improving. The unemployment rate dropped below 10% in 2015 for the first time since the global financial crisis. The combination of high wage growth and still relatively high unemployment suggest that structural unemployment in Latvia is high. In fact, the current level is at par with most estimates of the natural rate of unemployment, prompting observers such as the IMF to advocate that measures are taken to reduce skills mismatches in the labour market.

Inflation is low, like in the rest of the EU. In the past few years, average wage increases have been above improvements in productivity, which has been reflected in rising unit labour costs. Nevertheless, economic growth below potential and low energy prices kept inflation at a meagre 0.2% in 2015. There has been a further decline in inflation the first months of 2016 (-0.6% in March) but we expect rapid wage growth and a stabilisation in oil prices to put upward pressure on inflation later in 2016.

External balances a moderate weakness. Despite the challenging global environment, Latvian exports grew again last year. While exports to Russia tumbled by 25%, producers were quick to redirect their sales to other markets, and preliminary numbers indicate that Latvian exports actually gained global market shares last year. Modest import growth led to a shrinking trade deficit. This contributed to nearly reducing the current account deficit to half its size at 1.2% of GDP in 2015.

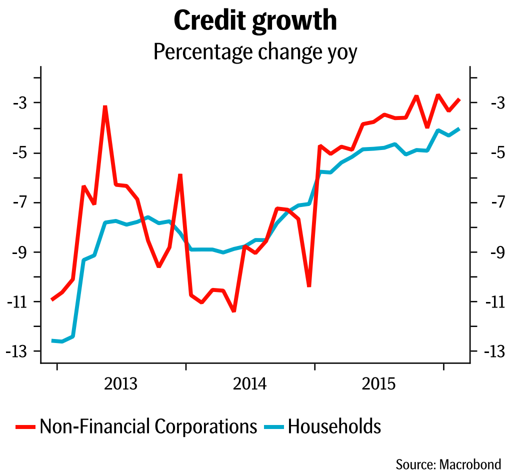
Gross external debt edged up slightly in 2015 and, at about 130% of GDP, is high compared to most rating peers. Short-term debt which makes up roughly a third of external debt is also high compared to similarly-rated economies. Nearly half of the debt stems from financial institutions as the current account has been financed partly by foreign bank lending. A mitigating factor is the large share of intra-company liabilities, primarily to Nordic parent banks, which tend to be less susceptible to sudden withdrawals.

Economic policies

Credible commitment to strong public finances. Latvia's sharp improvement in government finances during the post crisis years, going from a deficit of 9% in 2009 to -0.8% in 2012 was matched by very few countries, and reflected broad political support for prudent fiscal management. In 2015 the deficit fell to 1.3% of GDP from 1.6%, helped by higher economic activity. The budget for 2016 targets a 1% deficit and puts a high priority on defence spending, education and health. The aim remains to raise defence spending to 2% of GDP by 2018 (from 1% in 2015). Most observers, including us, expect a marginal under performance of the government's budget target in 2016. However, recent developments taken together with the government's medium-term target of a structural budget deficit of 1% of GDP gives little reason to question its commitment to fiscal discipline.

Government debt remains low. Government debt peaked at nearly 47% of GDP in 2010 and has since then come down to about 37%. The debt is expected to rise slightly in 2016 reflecting the pre-financing of a large eurobond redemption in 2017, producing swings in the debt level similar to what occurred in 2014, for the same reasons. These debt levels are in the lower range compared with rating peers. Other debt metrics such as interest payments as a share of revenues and the government debt to revenue ratio are also slightly lower than most peers.

Banking sector is stable. The banking sector remains well capitalized and liquid with average capital ratios substantially above the required minimum, according to the IMF. The main risk remains related to the banks that are focussed on attracting non-resident deposits (NRD). These deposits make up roughly half of the sector's total deposits, about the same share as a year ago. The lion's share of these deposits is estimated to originate from Russia and other CIS countries currently facing difficult economic conditions. These banks' funding may be vulnerable to a sudden withdrawal of deposits, most of which are short-term. The risk is mitigated by the limited number and size of such banks and by stricter regulations for NRD specialised banks. In addition, their external assets are generally considered to be of good quality and liquid.



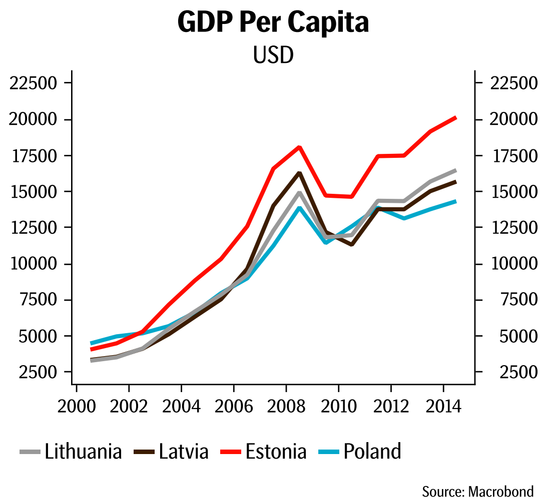
Credit growth is slowly recovering. Lending to the private sector has been low for several years with the outstanding stock of credit falling in annual terms. The explanation probably relates both to supply and demand factors. Banks may still be marked by the crisis and reluctant to take on new customers. At the same time, it appears that large corporates with stronger balance sheets do not have a need to borrow. This being said, there was a marked pick-up in credit growth towards the end of 2015, with new loans rising briskly and the pace of contraction in the stock of outstanding loans decreasing. This should reduce the risk that the lack of credit supply holds back investment.

Political developments

Reshuffling in the ruling coalition should not markedly change risk. Following increasing strains in the three-party ruling coalition, Prime Minister Straujuma resigned in late 2015. She was succeeded by Maris Kucinskis from the Greens and Farmer's Union, a party with roughly the same level of public support as the Unity Party. Observers have remarked that the change is a continuation of frequently changing coalition politics that produce some political uncertainty. However, most of the cabinet of ministers remains in place and the broader commitment to policies consistent with further EU integration are unlikely to change. Some observers argue that, on the margin, there may be a heightened risk of a less ambitious path towards a balanced budget than hitherto.

Outlook

Economy to gradually gain pace. We expect economic growth in 2016 to be roughly at par with that in 2015 as exports and investment activity picks up helped by EU assisted spending on infrastructure. Forecasts from the central bank and Ministry of Finance are slightly lower. The government, which currently sees potential GDP growth at 3%, aims at raising the pace of GDP growth to 5% in the long-term. We share the view of many other observers that a slightly lower rate of medium-term growth of around 4% looks more realistic. Still, this would contribute to a gradual convergence towards per capita income levels consistent with a better country risk.



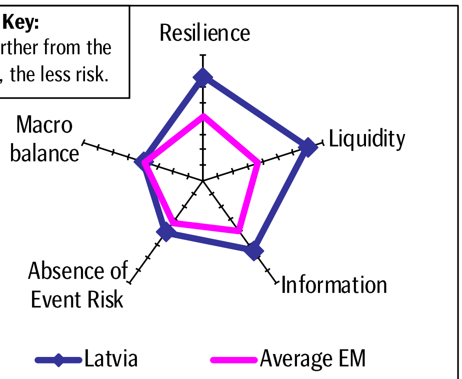
Main near-term risks related to the external environment. Risks going ahead are related to the small size and openness of the economy and its proximity to Russia. This leaves Latvia vulnerable to changes in global demand and to political and security risk in its geographical neighbourhood. While Latvia's direct trade links to Russia has declined, an intensification of Russia's economic and financial woes would probably raise global financial market risk aversion and disrupt trade and commodity markets.

Longer term risks from a decline in competitiveness. Longer-term risks include the country's ability to maintain competitiveness in the Eurozone. With skill shortages looming in parts of the economy, wage growth has been the highest in the euro area. So far pay rises higher than productivity growth has not been harming export performances. Increases have been roughly in line with accumulated productivity improvements and come from a low initial wage level compared to the EU average. However, should this divergence continue there is a clear risk that competitiveness and hence export performance and growth could be lower than we expect.

Latvia: Risk Profile

Key figures	**2016**
Population (mn)	1.96
GDP/capita (USD)	15 070
Real GDP (% chg)	2.7
Inflation (%)	0.2
Current Account Balance (% of GDP)	-1.5
Reserves/imports (months)	2.3
Budget balance (% of GDP)	-1.2
Government debt (% of GDP)	39

Chart Key: The farther from the centre, the less risk.



External Ratings:
Fitch: A- / Stable
Moody's: A3 / Stable
S&P: A- / Stable

Peers:
Hungary
Estonia
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	2012	2013	2014	2015	2016	2017	2018	2019
GDP real (% chg)	4.0	3.0	2.4	2.7	2.7	3.5	4.0	4.0
GDP (USD bn)	28.3	30.8	32.0	27.8	29.3	31.4	34.3	34.3
GDP/capita (USD)	14 005	15 387	16 108	14 149	15 070	16 329	18 037	18 253
Investments/GDP (%)	22.6	20.4	19.8	19.6	19.6	19.3	18.9	18.5
Trade/GDP (%)	121	112	110	128	128	126	121	128
Money & Prices								
CPI inflation (%)	2.2	0.0	0.6	0.2	0.2	2.1	2.4	2.4
Money, M2 (% chg)	4.0	5.7	7.3	8.9	8.4	11.4	14.1	14.8
Interest rates (%)	0.2	0.1	0.1	-0.1	-0.3	-0.2	-0.1	0.3
Stock prices (% chg)	0.6	24.0	3.1	29.2	52.7	11.4	14.1	14.8
Exchange Rate (USD)	1.28	1.33	1.33	1.11	1.09	1.06	1.09	1.12
Oil price (Brent, USD)	112	109	99	52	32	40	49	58
Government Finances								
Budget balance/GDP (%)	-0.8	-0.9	-1.6	-1.3	-1.2	-1.2	-0.4	-0.4
Govt debt/GDP (%)	40.9	38.2	40.8	36.4	38.8	35.4	36.5	34.5
Balance of Payments (USD bn)								
Current account	-0.9	-0.7	-0.6	-0.6	-0.7	-0.7	-0.8	-0.8
(% of GDP)	-3.3	-2.3	-2.0	-1.2	-1.5	-1.9	-2.2	-2.4
Exports of goods	16.7	16.9	17.4	17.6	18.4	19.4	20.5	21.7
Imports of goods	17.6	17.6	17.7	18.0	19.0	20.0	21.1	22.2
Other current account flows	0.0	0.0	-0.3	-0.2	-0.1	-0.1	-0.1	-0.3
Net FDI	0.9	0.5	0.3	0.3	0.5	0.6	0.7	0.8
Debt service requirement	4.7	4.6	4.4	4.8	5.0	5.2	5.1	5.1
Net other capital flows	5.2	5.1	1.7	1.2	1.6	7.0	7.5	7.5
Chg in intl reserves	0.5	0.3	-3.1	-3.9	-3.6	1.8	2.3	2.4
External Debt & Liquidity (USD bn)								
Reserves	7.0	7.4	2.8	3.1	3.8	4.6	5.4	6.2
Gross external debt (% of GDP)	143	134	125	131	130	127	117	109
o/w short term debt (% of GDP)	45	45	45	45	45	45	45	45

Source: OEF (Oxford Economic Forecasting), Eurostat, IMF and SEB estimates.

Rating history (end of year)				
Fitch	BBB-	BBB	BBB+	A-
Moodys	Baa3	Baa3	Baa2	Baa1
S&P			BBB+	A-

Type of government:
Next elections: Presidential 2019, Parliamentary 2018
Other:
Latest PC deal
Latest IMF arrangements: 2008 SBA, concluded 2011