Latvia

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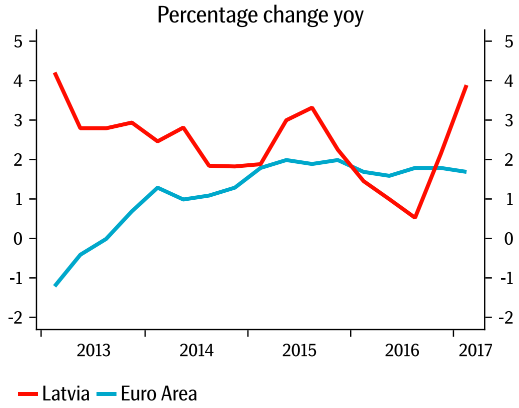
Economic growth slowed last year on the back of lower investment activity. Meanwhile, household spending fuelled by rapid wage increases remained strong. External and public sector balances strengthened somewhat. Risks are mainly of external character involving Latvia's openness and geopolitical situation.

Country Risk Analysis

Recent economic developments

Economic growth slowed on lower investment. Strong household spending supported by a recovery in real incomes pushed real GDP growth to 2% in 2016. This was faster than in the other Baltic economies and the euro area. Still, it was a slowdown from 2.7% in 2015 and was caused mainly by a sharp drop in investment due to lower disbursements of EU structural funds. This serves as a reminder of Latvia's dependence on EU funds. The first GDP estimate from the first quarter of 2017 indicated accelerating growth.

Real GDP
Percentage change yoy



Source: Macrobond

Inflation on the rise from low 2016 levels. Inflation averaged only 0.1% in 2016 but jumped significantly higher at the end of the year. In April, it continued up to 3.3% driven largely by energy and food price rises. Expectations are that inflation will be 3% in 2017, quite above inflation in the euro area which is natural given the economy's ongoing catching up.

Mixed developments in the labour market. The situation in the labour market has been mixed in the past year with the continued, unrelenting decline in working age population casting its shadow over some improvements. Unemployment edged down to 9.3% but is still high by Latvian standards and higher than in the neighbouring Baltic economies. Meanwhile, average wage growth slowed slightly from 6.8% to 5% in 2016. Rapid wage increases have partly come as a reaction to the period of wage cuts that constituted Latvia's internal devaluation following the global financial crisis. Although the pace of wage increases has slowed in the past couple of years, they have been leading to rising unit labour costs as productivity growth has been feeble. The jury is out on whether cost competitiveness is already suffering, but it is a fact that Latvia has been losing export shares recently.

External balances show small improvement. Latvian exports continue to fare reasonably well despite weak trade with Russia (taking less than 8% of total exports). Data show signs of some successful diversification of exports to other markets such as China and the US. In this context we would also note that Latvia has a higher degree of diversification of its export products than many of its rating peers. The current account balances shifted from a small deficit to a surplus of 1.5% of GDP in 2016. Foreign direct investment (FDI) inflows slowed last year and as Latvian investments abroad were significant, net FDI was negative.

External debt is high but on declining path. Gross external debt has declined in the past two years to about 130% of GDP in 2016 which is still high compared to most rating peers. The IMF projects a continued decline to below 120% by end-2019. Nearly half of the debt is owed by the banking sector 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. Roughly one third of external debt is short-term. This is also high compared to similarly-rated economies. Most of the short-term debt is related to non-resident bank deposits.

Economic policies

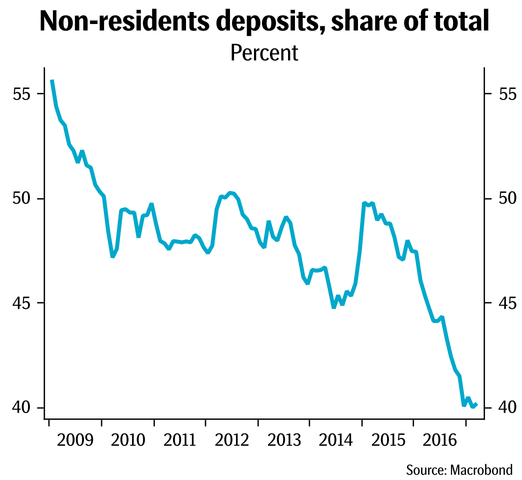
Government balanced the budget in 2016. Latvia's sharp improvement in government finances during the post crisis years was matched by very few countries, and reflected a broad political support for prudent fiscal management. The authorities' commitment to sound public finances appear to remain strong. In 2016, for the first time in decades, the general government budget balance did not show red numbers. Official data reflect a balanced budget which implies an improvement from last year's deficit of 1.3% of GDP. The authorities aim for a slightly expansionary fiscal stance in 2017 with a budget deficit of 1.1% of GDP.

Tax reform on the way. A key policy priority in the coming years is a tax reform. Although it involves cutting income taxes (with compensating hikes in other areas) it is also expected to support the government's ambitions to raise tax revenues as a share of GDP by strengthening the incentives to work in the formal labour market. Latvia has a large but, according to some estimates, declining informal labour market. The European Commission recently referred to estimates that about one fifth of GDP is generated in the informal sector. This is higher than among rating peers.

Government debt edges up but remains low. Government debt has fluctuated around 35-40% of GDP in the past few years and ended at 40.1% in 2016. In early 2017, Latvia issued a 30-year bond, its longest tenor ever, which was oversubscribed. The incomes from the issuance will more or less cover the country's financing needs for the year. Most observers expect the debt ratio to gradually decline. The current 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 is large in a regional comparison, with total assets surpassing 130% of GDP and is dominated by Nordic banks. It remains well capitalized and liquid with average capital ratios substantially above the required minimum in mid-2016, according to the IMF. The main risk remains related to the banks that are focussed on attracting non-resident deposits (NRD).

Declining share of non-resident deposits. The amount of NRD is substantial as noted above. However, the share of these deposits has been on a declining path in the past two years and currently makes up just above 40% the bank sector's total deposits. The lion's share of these originates from Russia and other CIS countries. Therefore, one explanation to the decline could be the challenging economic environment in that region. Other reasons could be a clampdown on money laundering (stepped up following Latvia's OECD membership in 2016) or stricter regulatory requirements for banks specialised in NRD.



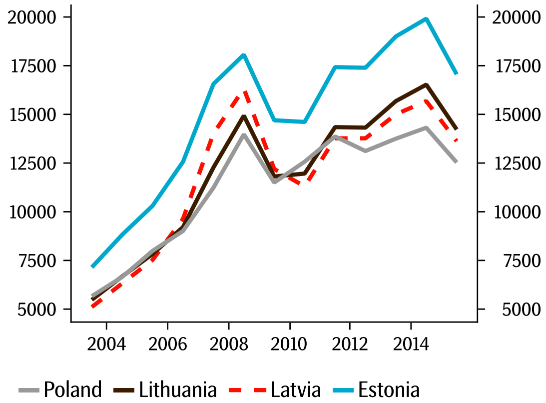
Risks are evident but there are mitigating factors too. As with deposits in general, the NRD makes the bank sector vulnerable to a sudden withdrawal and, as with short-term debt in general, the economy too. However, Bank of Latvia's stress test shows that the bank sector, apart from a couple of small banks, would manage a deposit outflow of 60% of NRD. The risk is also mitigated by the limited number and size of such banks and the fact that they play a very limited role in the real domestic economy. They stand for a very small share of domestic lending and resident deposits. In addition NRD specialised banks, face stricter regulations.

Political developments

Ruling coalition focuses on health, education and defense. Along with the above mentioned tax reform, the governing coalition headed by Prime Minister Kucinskis of the Union of Greens and Farmers, maintain a broad policy focus on the areas healthcare, education and defense. The latter is a reflection of the commitment to increase defense spending to 2% of GDP by 2018. The World Bank's governance indicators showed a worsening ranking on political stability in the surveys performed in 2014 and 2015. Meanwhile, in Freedom House's 2017 survey, Latvia's score on political rights was lifted to the best possible grade. The organisation noted a gradual decrease in the influence of oligarchic business interests on political affairs**.**

Outlook

Economy to recover in 2017. With private and public investment set to gather pace on the back of renewed EU fund inflows, GDP is expected to rise by 3.5% in 2017. In the medium-term, we share the view of many other observers that growth of 3.5-4% is plausible given continued implementation of reforms that promote productivity. This would contribute to a continued gradual convergence towards per capita income levels of the EU and consistent with a better country risk. This is a key feature leading us to hold a positive outlook on country risk in Latvia.



Source: World Bank

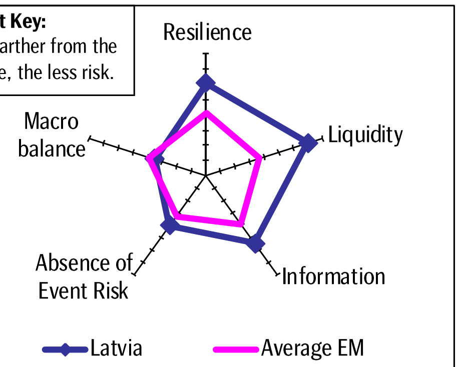
Near-term risks mainly related to the external environment. Risks going ahead are related to the small size and openness of the economy and its proximity to Russia. This leaves Latvia vulnerable to changes in global demand and to political and security risk in its geographical neighbourhood. Although Latvia's direct trade links to Russia has declined, an intensification of Russia's economic and financial woes could raise global financial market risk aversion and disrupt trade and commodity markets. A mitigating development is Latvia's increasing integration into EU and other multilateral cooperative frameworks such as the OECD.

Maintained competitiveness is a longer-term challenge. Longer-term risks refer mainly to the country's ability to maintain competitiveness in the euro zone. Wage levels remain low by EU standards, even adjusted for productivity differences. Furthermore, with the labour force expected to continue to decline and skill shortages in parts of the economy, wage growth is expected to remain high in the years ahead. However, if these increases are not matched with productivity gains, there is a risk that competitiveness and hence export performance and growth could be lower than we expect.

Latvia: Risk Profile

Key figures	**2017**
Population (mn)	1.96
GDP/capita (USD)	16 329
Real GDP (% chg)	3.5
Inflation (%)	3.0
Current Account Balance (% of GDP)	-1.9
Reserves/imports (months)	1.9
Budget balance (% of GDP)	-1.2
Government debt (% of GDP)	35

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	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP real (% chg)	2.9	2.1	2.7	2.0	3.5	3.5	4.0	4.0
GDP (USD bn)	30.8	32.0	27.8	29.3	31.4	34.3	34.3	34.3
GDP/capita (USD)	15 387	16 108	14 149	15 070	16 329	18 037	18 253	18 482
Investments/GDP (%)	20.3	19.6	18.7	16.1	16.4	16.2	16.0	15.8
Trade/GDP (%)	112	110	130	127	124	119	125	131
Money & Prices								
CPI inflation (%)	0.0	0.6	0.2	0.1	3.0	2.0	1.8	2.0
Money, M2 (% chg)	6.0	14.4	20.6	26.5	22.1	18.3	17.2	18.5
Interest rates (%)	0.1	0.1	-0.2	-0.3	-0.3	-0.2	-0.1	0.2
Stock prices (% chg)	16.9	9.9	50.1	59.5	62.3	19.6	3.7	22.9
Exchange Rate (USD)	1.33	1.33	1.11	1.11	1.08	1.10	1.11	1.13
Oil price (Brent, USD)	109	99	52	44	52	52	59	68
Government Finances								
Budget balance/GDP (%)	-0.9	-1.6	-1.3	0.0	-1.2	-1.6	-1.0	-0.5
Govt debt/GDP (%)	39.0	40.8	36.5	40.1	35.4	39.5	38.3	0.0
Balance of Payments (USD bn)								
Current account	-0.8	-0.6	-0.2	0.4	-0.5	-0.6	-0.6	-0.7
(% of GDP)	-2.7	-2.0	-1.2	1.5	-1.9	-1.7	-1.8	-2.0
Exports of goods	16.9	17.5	18.0	18.5	19.2	20.2	21.2	22.2
Imports of goods	17.6	17.7	18.0	18.8	19.7	20.7	21.7	22.7
Other current account flows	-0.1	-0.5	-0.2	0.8	0.0	-0.1	-0.1	-0.2
Net FDI	0.5	0.5	0.6	-0.1	0.1	0.1	0.1	0.1
Debt service requirement	4.6	4.4	4.8	4.9	5.1	5.1	5.1	5.1
Net other capital flows	5.9	0.3	1.6	0.7	2.7	8.1	8.8	9.7
Chg in intl reserves	1.0	-4.3	-2.8	-3.8	-2.8	2.6	3.2	4.0
External Debt & Liquidity (USD bn)								
Reserves	7.4	2.8	3.1	3.1	4.6	5.4	6.2	7.1
Gross external debt (% of GDP)	134	124	131	130	129	122	116	111
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