INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/171

REPUBLIC OF LATVIA

June 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LATVIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 10, 2016 consideration of the staff report that concluded the Article IV consultation the Republic of Latvia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 10, 2016, following discussions that ended on May 4, 2016, with the officials of the Republic of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 17, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for the Republic of Latvia.

The documents listed below have been or will be separately released.

Selected Issues

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 16/287
FOR IMMEDIATE RELEASE
June 16, 2016

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700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with the Republic of Latvia

On June 10, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia.

GDP growth picked up to 2.7 percent in 2105, up about 0.25 percent over the previous year, despite a weak external environment. Private consumption grew by 3.3 percent, spurred by gains in employment and real wages, but weak external conditions, combined with lingering geopolitical tensions had a dampening effect. Investment saw a modest turnaround, growing at 2.1 percent following a contraction of almost 5.5 percent over 2013–14. Exports grew by only 1.4 percent, reflecting tepid growth in the euro area and the prolonged recession in Russia, although Latvian businesses proved resilient and able to penetrate alternative markets. Inflation remained well below target, falling to 0.2 percent, driven by the decline in oil and food prices and low inflation in the euro area.

The general government deficit was around 1.3 percent of GDP in 2015, 0.3 percentage points higher than targeted in the budget, but still consistent with domestic and EU fiscal rules. The higher outturn was the result of a previously agreed change of plan from long-term renting to purchasing the newly built offices of the State Revenue Services. Tax revenues were supported by strong wage growth and improved tax compliance.

Bank balance sheets continued to strengthen. Capital adequacy increased and the ratio of non-performing loans declined. Credit continued to shrink, with the stock of bank credit to the private sector declining by 2.2 percent (y-on-y) at end 2015. Non-resident deposits (NRDs) in the banking system were stable. On the regulatory front, the authorities took a series of steps to clamp down in anti-money laundering (AML) cases, including bank closures, fines and personnel actions.

Executive Board Assessment[2]

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Executive Directors commended the steady economic progress in Latvia, and the generally favorable macroeconomic conditions despite the current slowdown. They noted that the medium-term outlook is broadly positive; however, higher productivity and additional fiscal space are needed to support inclusive growth and employment.

Directors emphasized the need for continued structural reforms across a wide range of areas to enhance productivity, maintain competitiveness, and improve equity. This would be vital to maintain the pace of income convergence with the rest of Europe. Reforms are needed to improve the investment climate; enhance public infrastructure; strengthen the governance of state-owned enterprises; improve the efficiency and effectiveness of the judicial system and insolvency regime; and encourage innovation. Measures are also needed to improve labor participation and align education and vocational training with market demand. Directors urged the authorities to monitor wage developments and their impact on competitiveness. They generally considered that increases in the minimum wage should not exceed productivity growth over the medium term, while complementary policies should address inequality and poverty.

Directors noted that the gray economy is preventing Latvia from achieving its full potential by hindering the efficient allocation of resources, creating an unfair playing field, and curtailing budget revenues. They called for further efforts to improve participation in the formal economy alongside measures to enhance public services and garner public support.

Directors noted with satisfaction that Latvia's banking system is well capitalized and profitable. However, they expressed concern that the persisting weakness in bank credit constrains investment and growth. They encouraged the authorities to address the legal and structural constraints hampering lending to SMEs and households, and to use the benchmarking exercise to review banks' risk models. Directors commended the authorities' efforts to strengthen AML/CFT regulations and supervision, and urged continued vigilance to mitigate risks, especially those related to non-resident deposits. They urged the authorities to focus on implementation of the enhanced regulations and to continue to align the framework with international standards.

Directors considered the fiscal stance to be broadly appropriate, while noting that vigilance will be needed to ensure adherence to targets and EU rules. They also noted that additional fiscal space is needed over the medium term to strengthen the social safety net, promote social inclusion, and boost productive public spending. They welcomed the authorities' plan to raise tax revenue, and recommended using the ongoing reviews of tax and expenditures as an opportunity to consider comprehensive reforms to improve incentives and recalibrate the tax burden equitably.

Republic of Latvia: Selected Economic Indicators, 2010–16

	2010	2011	2012	2013	2014	2015	2016 Proj.
National accounts	(Percentage change, unless otherwise indicated)						
Real GDP	-3.8	6.2	4.0	3.0	2.4	2.7	2.5
Private consumption	2.8	3.0	3.2	5.1	2.3	3.3	3.1
Public consumption	-8.1	3.0	0.3	1.6	4.9	3.1	3.1
Gross capital formation	-18.9	48.7	-1.1	-4.3	-5.5	2.1	1.2
Gross fixed capital formation	-19.8	24.1	14.4	-6.0	0.5	2.7	1.0
Exports of goods and services	13.4	12.0	9.8	1.1	3.1	1.4	0.8
Imports of goods and services	12.4	22.0	5.4	-0.2	0.8	1.8	0.9
Nominal GDP (billions of euros)	17.9	20.2	21.8	22.8	23.6	24.4	25.1
GDP per capita (thousands of euros)	8.5	9.8	10.7	11.2	11.8	12.3	12.7
Savings and Investment							
Gross national saving (percent of GDP)	21.8	22.3	22.8	21.7	21.5	20.8	19.8
Gross capital formation (percent of GDP)	19.4	25.2	26.1	24.1	23.4	22.0	21.7
Private (percent of GDP)	16.3	21.0	22.3	20.3	19.7	17.9	18.4
HICP Inflation							
Period average	-1.2	4.2	2.3	0.0	0.7	0.2	0.2
End-period	2.4	3.9	1.6	-0.4	0.3	0.4	0.8
Labor market							
Unemployment rate (LFS; period average, percent) 1/	19.5	16.2	15.0	11.9	10.8	9.9	9.4
Real gross wages	-2.2	0.0	1.5	4.5	6.1	6.7	6.3
	(Percent of GDP, unless otherwise indicated)						
Consolidated general government 1/							
Total revenue	36.6	35.7	37.5	36.8	36.2	36.2	36.1
Total expenditure	43.1	38.8	37.4	37.4	37.9	38.0	37.3
Basic fiscal balance	-6.5	-3.1	0.1	-0.6	-1.7	-1.8	-1.2
ESA balance	-8.5	-3.4	-0.8	-0.9	-1.6	-1.3	-1.1
General government gross debt	40.3	37.6	36.9	35.9	38.5	34.8	35.0
Money and credit							
Credit to private sector (annual percentage change)	-8.4	-7.4	-11.4	-5.4	-7.0	-2.2	1.8
Broad money (annual percentage change)	9.8	1.5	4.5	2.0	36.6	8.0	8.9
Balance of payments							
Current account balance	2.3	-2.8	-3.3	-2.4	-2.0	-1.2	-1.9
Trade balance	-8.3	-12.1	-11.7	-11.2	-9.6	-8.7	-7.6
Gross external debt	168.1	146.2	138.7	134.0	142.2	137.7	128.1
Net external debt 2/	55.3	47.1	39.9	36.6	32.0	25.9	11.0
Exchange rates							
U.S. dollar per euro (period average)	1.33	1.39	1.29	1.33	1.33	1.11	...
REER (period average; CPI based, 2005=100)	121.6	124.0	120.1	120.1	121.8	…	…

Sources: Latvian authorities; Eurostat; and IMF staff estimates.

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.

2/ Gross external debt minus gross external debt assets.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

May 17, 2016

KEY ISSUES

Context. Macroeconomic conditions are broadly favorable: the output gap is almost closed; the fiscal and current account deficits are at sustainable levels; and unemployment continues to fall. Nevertheless, GDP growth has slowed recently, hampered by a weak external environment, diminishing productivity gains, and delays in EU funds absorption. Credit growth remains elusive, wage pressures have surfaced, and the gray economy remains pervasive.

Challenges. In the medium-to long-run, structural reforms to enhance productivity and maintain post-crisis competitiveness gains will be necessary to maintain the pace of income convergence with Western Europe. A resumption of credit growth is needed in the near term to support investment and support the consumption led recovery. More, and better targeted, resources are required to strengthen the social safety net, and support inclusive growth and employment.

Staff views.

- Structural reforms must progress—in areas such as the judiciary, business environment, education, infrastructure, and labor markets—to support competitiveness and productivity.
- Actions to address the gray economy will be crucial to promote the efficient allocation of resources and enhance revenues.
- Concerted efforts by the authorities and banks are needed to facilitate lending, especially to SMEs, to support growth.
- Continued vigilant supervision remains vital to mitigate real and reputational risks, in particular in the non-resident deposit (NRD) banking sector.
- Reviews of tax and expenditures provide an opportunity to improve incentives, recalibrate the tax burden equitably, and explore options for opening fiscal space

Authorities' views. The authorities broadly agreed with the assessment of the outlook, risks, and challenges facing Latvia. In particular, they agreed with the need to make continued progress on structural reforms to support competitiveness and productivity.

Approved By
Philip Gerson (EUR) and Steven Barnett (SPR)

Discussions were held in Stockholm on April 19 and in Riga during April 20–May 4, 2016. The team comprised Messrs. Kelmanson (head), Srour, Deb, and Ms. Shamloo (all EUR). Ms. Jekabsone (OED) also joined the discussions.

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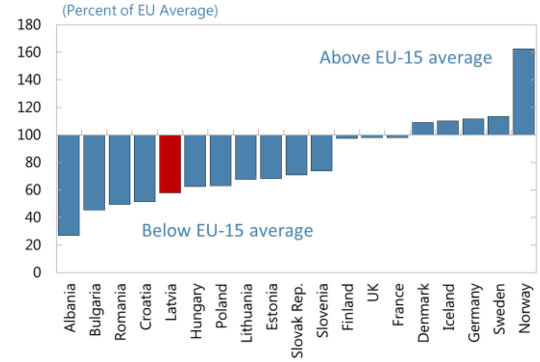
CONTEXT

1. **Latvia continues to make steady economic progress in terms of stability and growth, but per capita GDP remains well below the Western European average.** Macroeconomic conditions are generally favorable. The output gap is almost closed, the current account is broadly in line with fundamentals, and unemployment continues to decline. The fiscal deficit has been reduced to a sustainable level, and public debt is among the lowest in Europe. Nevertheless, GDP growth has slowed significantly over the last three years amid weak external conditions and diminishing productivity gains, credit growth remains elusive, and wage pressures have surfaced with tightening labor market conditions. And while income per capita continues to rise, it remains around 40 percent below the EU-15 average.

GDP per Capita Gap from EU Avg, 2015
(Percent of EU Average)



Sources: IMF World Economic Outlook and IMF staff calculations.

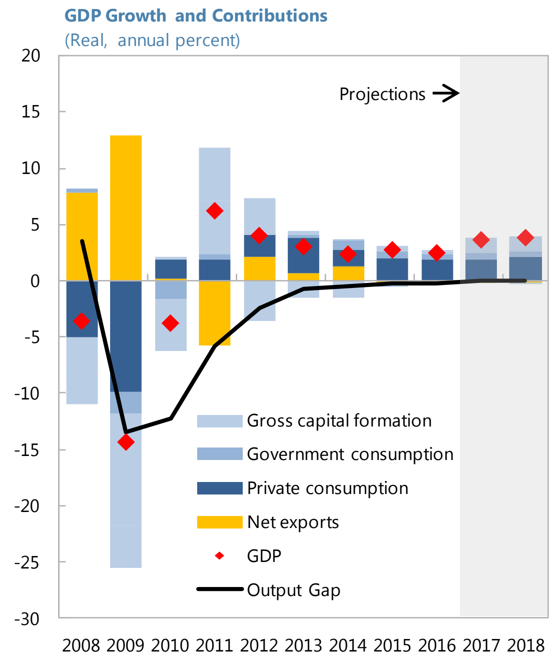
2. **A number of the 2015 Article IV policy recommendations have been broadly implemented**. Notably, measures have been adopted to increase the revenue envelope and make the tax system more progressive. The development of credit bureaus and reforms to insolvency procedures and the court system are ongoing. Close supervision of non-resident deposit (NRD) specialized banks continues and anti-money laundering (AML) supervision has been stepped up. The minimum wage in 2016 was raised in line with productivity growth, and reforms in education to reduce skills mismatches are progressing. Nonetheless, shifting the tax burden towards property taxation, improving SOE governance, and strengthening infrastructure are still to be addressed.

3. **A new government was appointed on February 11, 2016 and OECD accession is scheduled.** The new Prime Minister, Māris Kučinskis, who is from the same center-right coalition, but a different party, has indicated that there will be policy continuity. On May 11, the OECD invited Latvia to join the organization following 3 years of accession discussions.

RECENT ECONOMIC DEVELOPMENTS

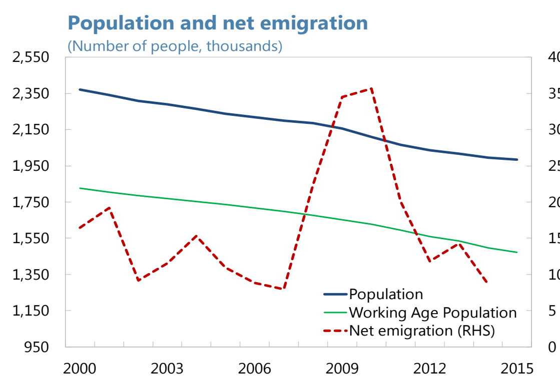
4. **Growth picked up somewhat last year despite a weak external environment.** GDP growth rose to 2.7 percent, up about ¼ percent over the previous year. A short-lived reopening of Liepajas Metalurgs (LM)—a large steel manufacturer—gave the economy a boost early in the year, and private consumption grew by 3.3 percent, spurred by gains in employment and real wages. However, weak external conditions, combined with lingering geopolitical tensions, had a dampening effect, as did the effective cessation of production by LM later in the year. Investment saw only a modest turnaround, at 2.1 percent following a contraction of almost 5.5 percent over 2013–14.

5. Exports grew by only 1.4 percent, reflecting tepid growth in the euro area and the prolonged recession in Russia, although Latvian businesses proved resilient and able to penetrate alternative markets (Box 1). The real effective exchange rate remained broadly in line with fundamentals, with the euro depreciation against the dollar offsetting the ruble depreciation (Box 2). The current account deficit narrowed to 1.2 percent of GDP, as imports fell faster than exports.



6. Inflation remained well below target, falling to 0.2 percent, driven by the decline in oil and food prices and low inflation in the euro area. Downward pressures were partially offset by the liberalization of electricity tariffs for smaller enterprises and households. Core inflation averaged 1 percent, supported by strong wage growth. Producer price growth remained negative, reaching -1.6 percent.

7. The labor market continued to tighten, keeping pressure on wages. Higher employment drove the unemployment rate down to 9.9 percent in 2015, while the working age population (15–74) declined by 1.5 percent due to demographics and emigration. Still high unemployment is largely structural in nature, partly reflecting lack of regional labor mobility and skills mismatch, with higher-skilled workers in relatively short supply. Real wages increased by 6.7 percent, following a 6 percent increase the previous year, reflecting demand, especially for higher skilled labor, and successive hikes in the minimum wage (from EUR 285 per month in 2013 to EUR 360 in 2015). However, the recorded wage increase is likely to comprise some measurement error: some workers under-report their official earnings, claiming to earn only the minimum wage to evade taxes, and the recent minimum wage increases will therefore result in large recorded official wage increases for such workers even though their actual wages would not change.

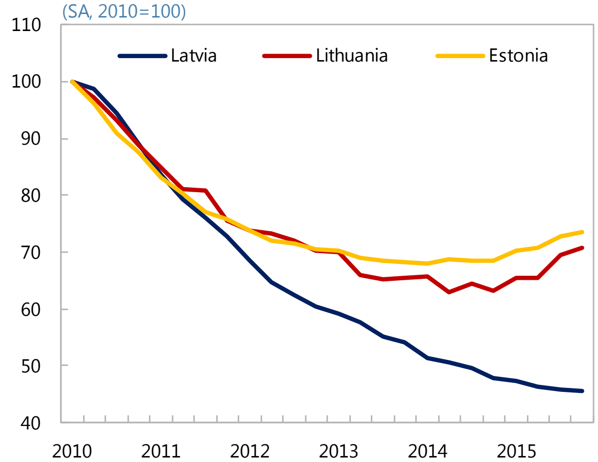


Sources: Central Statistical Bureau of Latvia

8. The financial sector continued to strengthen, as did private sector balance sheets. Banks further improved their balance sheets, bringing the non-performing loan (NPL) ratio down to 5.4 percent in March, and the capital adequacy ratio up close to 23 percent. Bank profits were robust and liquidity abundant. More broadly, asset prices are gradually recovering, while household and corporate debt continues to fall and borrowers' repayment capacity improves. On the supervisory front, the Financial and Capital Market Commission (FCMC) took a series of steps to clamp down in anti-money laundering (AML) cases, including bank fines and personnel actions, and revoking the license of a small bank—Trasta Komercbanka—in early March due to breaches of AML requirements. The bank, which accounts for only 1.4 percent of total banking sector assets, does not pose a risk to financial stability, and its remaining assets are expected to cover over 90 percent of its liabilities, including all deposits covered under the deposit insurance guarantee. Furthermore, on the recommendation of the authorities, the banks have commissioned in depth audits of their AML/CFT procedures with a number of US law firms. Rietumu Banka is undergoing an AQR ahead of the transition of its supervision responsibility to the SSM, reflecting its emergence as Latvia's third largest bank.

9. Yet credit growth remains elusive. Latvia's credit-less recovery continues, outlasting its neighbors', and broader historical, experience. The stock of bank credit to the private sector fell by 2.2 percent (y-on-y) at end-2015 compared to a drop of 7 percent at end-2014. The loan to deposit ratio continues to fall, albeit more slowly, due to a continued fall in the stock of loans as well as a robust growth of resident deposits at 9 percent (y-on-y), reflecting strong wage growth as well as precautionary sentiments. The stock of NRDs (at constant exchange rates) increased by just above 1 percent y-on-y in December 2015, compared to 15 percent a year earlier, and there has been a modest outflow in Q1 2016.

Private Sector Credit to GDP
(SA, 2010=100)



Sources: Bank of Latvia, Central Bank of the Republic of Lithuania, Bank of Estonia, and IMF staff calculations.

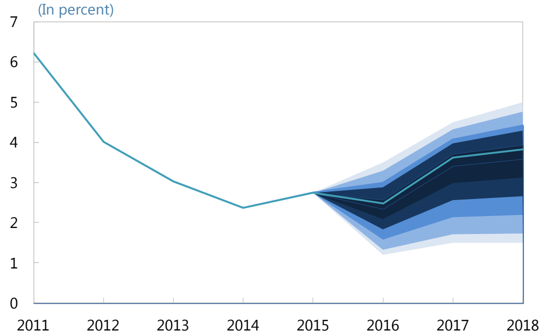
10. The general government deficit was around 1.3 percent of GDP in 2015, 0.3 percentage points higher than targeted in the budget. The higher outturn is the result of a previously agreed change of plans from long-term renting to purchasing the newly built offices of the State Revenue Services. Tax revenues were supported by strong wage growth and improved tax compliance, albeit showing signs of weakening in the first quarter of 2016. With the output gap slightly negative, staff estimates that the 2015 structural deficit was at 1.1 percent of GDP, in line with the Fiscal Discipline Law (FDL) and Latvia's European Union commitments.

OUTLOOK AND RISKS

11. Growth is expected to slow slightly in 2016 to 2½ percent. The economy, particularly the construction sector, decelerated markedly at the end of 2015 and in early 2016, reflecting delays in investment due to a slow start-up of projects related to the new 2014-2020 European Structural Funds program, continued economic and geopolitical uncertainty, and weak economic performance in the Euro Area and Russia. Growth is forecast to pick up later this year and into 2017, bolstered by robust real wage growth and higher disposable income due to low inflation, improved external conditions, and a pickup in investment and credit, partly triggered by the coming on stream of EU-funded projects. Inflation is expected to remain well below target at 0.2 percent in 2016, but is forecast to rise to 1.7 percent in 2017, reflecting primarily an upswing in oil prices and base effects, and the pick-up in growth.

The growth path is subject to uncertainty, despite being forecast to rise to potential ...

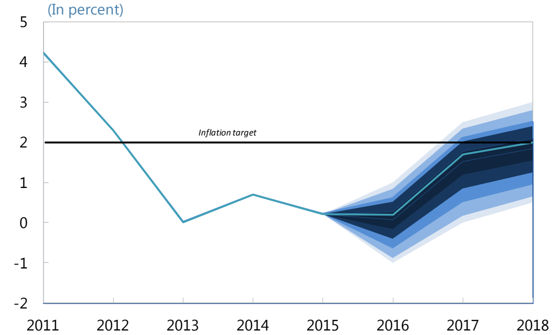
Real GDP Growth Projections
(In percent)



Sources: Statistical Office of Latvia and IMF staff calculations.

...as is the outlook for inflation... Where risks are tilted more to the downside especially in the nearer term...

HICP Growth Projections
(In percent)



Sources: Statistical Office of Latvia and IMF staff calculations.

Note: Upper and lower bounds of the fans are based on staff judgement, taking into account risks to the forecasts, with uniform probability distrubution between the central projection and the bounds.

12. **Over the medium term, the economy is projected to grow by 4 percent per year, based on the authorities' commitment to, and track record of, delivering reform.** This growth rate is roughly the average attained over the last fifteen years.[1] Growth would be led by exports and investment, and buttressed by continued robust private consumption. This outlook is predicated on implementation of structural reforms to promote investment and productivity, alleviate the tightening labor market, and on the resumption of credit growth (see Policy Discussions).

13. **The baseline outlook is subject to significant downside risks** (see Risk Assessment Matrix, Box 3). Prolonged weak growth in the Euro Area and Russia would adversely impact exports and lower confidence, while protracted geopolitical tensions could disrupt trade and heighten risk aversion. Global financial volatility could raise the cost of parent bank financing, further hindering credit growth, while non-resident deposits (NRDs) could be susceptible to sudden reversals in the event of a sufficiently large shock. Failure of credit to pick up would dampen investment and growth. Looking further ahead, a failure to tackle the structural reform agenda would impede productivity growth and further erode competitiveness, undermining growth performance and the convergence agenda. The external assessment projects a downward trend for the debt-to-GDP ratio over the medium term, but a severe growth or current account shock could reverse this (Annex II External Debt Sustainability Analysis).

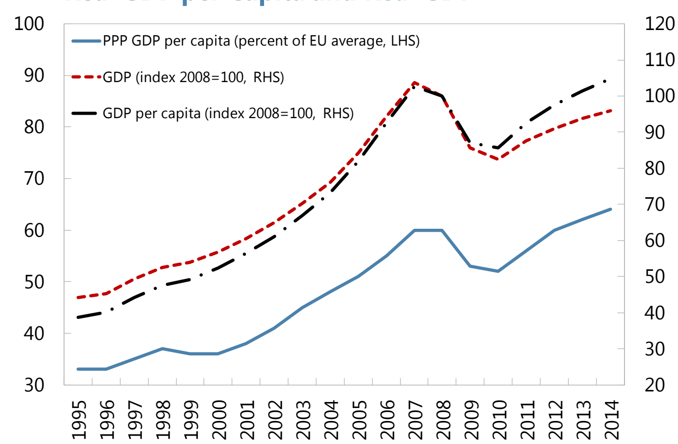
[1] This outlook is also consistent with the rate of potential growth identified in a recent selected issues paper (see Selected Issues Paper, IMF Country Report No. 15/111).

The authorities broadly concurred with the outlook and assessment of risks. Regarding the outlook, while noting that growth could indeed be more modest, especially given the external environment, they pointed out that there was a considerable downward risk stemming from the economic developments in Russia, and also from sluggish investment activity. They also noted that demographic developments will weigh on the economy in the coming years. On an upside, they noted that a stronger recovery in the Euro Area or acceleration in the absorption of EU structural funds could provide boost to economic activity. The overall balance of risks reinforced their view of the importance of prudent policymaking.

POLICY DISCUSSIONS

14. **While Latvia continues to make steady economic progress, a key challenge will be to generate the growth necessary to sustain the pace of income convergence with Western Europe.** This will require a broad two-pronged strategy based on macro-structural reforms to enhance productivity, maintain competitiveness, and improve equity in the medium-to long-run; and macro-financial policies to resuscitate credit to support investment and growth, especially in the short-run.

Real GDP per Capita and Real GDP



Sources: Eurostat and IMF staff calculations.

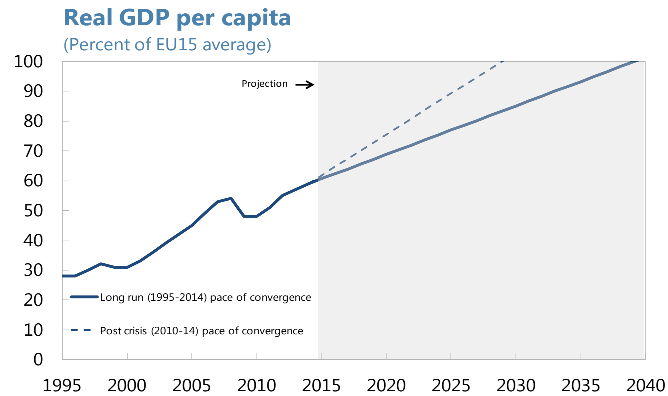
15. **Actions to address the gray—informal—economy will also be crucial**. The pervasive gray economy, which by some estimates may amount to 20-25 percent of GDP,[2] is preventing Latvia from fulfilling its potential. In particular, it is hindering the efficient allocation of resources, including access to capital, creating an unfair playing field, and limiting revenues that are necessary to develop the country to everyone's benefit.

A. Productivity

16. **Productivity growth is key to maintaining the pace of income convergence.** Latvia's PPP per capita GDP now stands around 60 percent of the EU-15 average. The rapid income convergence over the past two decades was driven largely by productivity growth, which averaged 4 percent over the period. As the labor force is projected to decline, the burden of future income convergence will need to be shouldered by investment and continued TFP growth.

[2] See Schneider, F: "Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments" and Putniņš and Sauka: "Shadow Economy Index for the Baltic Countries".

Staff simulations (see text chart) show that if the medium-term growth projections can be sustained over the long-term—which will require ongoing reform efforts—and the long run pace of convergence is maintained, the gap could be closed within a generation. In order to generate the faster pace of convergence seen in the immediate post crisis period Latvia will need to grow even faster. In addition to structural reforms, the financial sector will have to play its part by providing the credit needed to support future investment, particularly as wage pressures erode company profitability, and hence their ability to self-finance.



Sources: Eurostat and IMF staff calculations.

17. Latvia has ample scope to raise productivity, but this will require further structural reform. Maintaining productivity growth will not be simple, as easy gains have likely already been exhausted and firms are approaching their technology frontiers. Indeed, firm level data suggest that productivity growth since 2010 was largely due to "catch-up" by less productive firms (see Selected Issues Paper). Nonetheless, there is ample scope for further gains, if Latvia can move towards the "productivity frontier" set by others. Latvian labor productivity across all sectors in 2014 (measured in 2010 euros) remains at about a third of the EU15 average, with agriculture doing relatively better and manufacturing relatively worse. Closing such gaps will require continued progress on structural reforms, notably to improve state-owned enterprise (SOE) governance and strengthen the business environment, upgrade public infrastructure, and modernize legal systems (see Text Box).

- **Improving SoE governance and the business environment.** SoEs are dominant in a variety of network sectors, such as electricity, postal services, airlines, railways and telecom, potentially creating barriers to entry. Given Latvia's size, many of these represent natural monopolies, but initiatives to foster competition by unbundling services such as generation, transmission and distribution in the energy markets are welcome. Furthermore, SoE governance exhibits non-transparent accountability and shareholder power, hindering efficiency.[3] In this context, the re-introduction of independent boards and annual reporting from 2016 for the largest SOEs is welcome. While a framework law to strengthen SOE governance was passed in October 2014 and a new cross-sectoral coordination unit has been set up, implementation will be key. Furthermore, reduction in the complexity of regulatory procedures, simplification of license and permit systems, and removal of compulsory chamber membership in professional services would be important to strengthen business environment.[4]

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[3] See OECD (2015), "Review of Latvia's position relative to the OECD guidelines on corporate governance of state-owned enterprises," *OECD Publishing*.

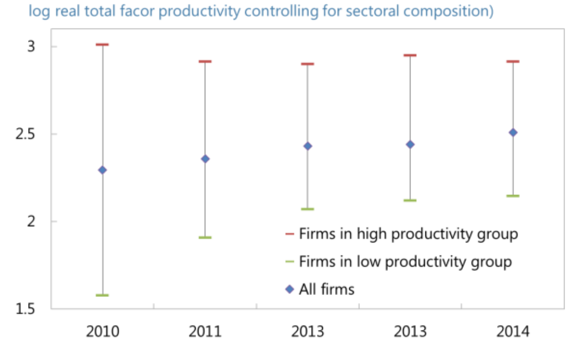
[4] See OECD (2015), "Policy areas for increasing productivity in Latvia economics," *OECD Economics Department Working Papers*, No 1255.

Productivity Developments

Relatively less productive firms saw the greatest increase in productivity…

Total Factor Productivity by Groups

(Groups based on total factor productivity in 2010, log real total facor productivity controlling for sectoral composition)

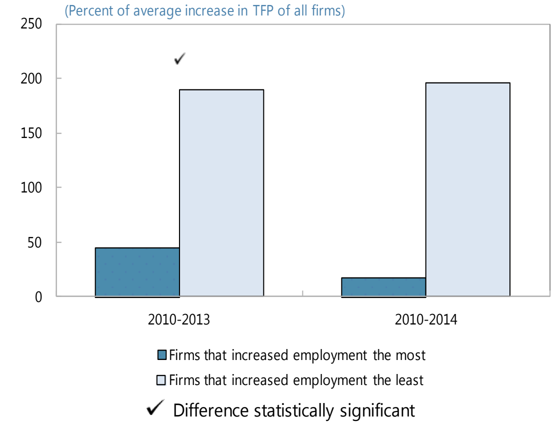


Sources: Orbis; IMF staff calculations

…while firms that increased employment less saw greater cumulative productivity gains.

Increase in productivity

(Percent of average increase in TFP of all firms)

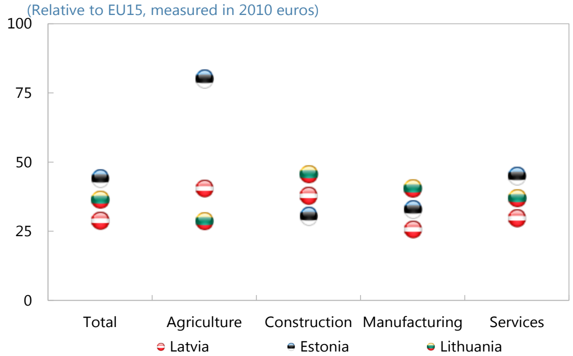


Sources: Orbis; and IMF staff calculations.

Nevertheless, labor productivity remains far from the frontier, even relative to other Baltic countries…

Labor productivity, 2014

(Relative to EU15, measured in 2010 euros)

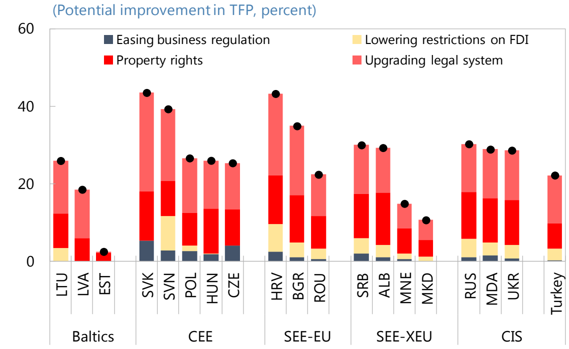


Sources: Eurostat; and IMF staff calculations.

With potential for significant gains in particular in upgrading property rights and the legal system

Potential Efficiency Gains from Structural Reforms

(Potential improvement in TFP, percent)



Sources: Eurostat and IMF staff calculations.

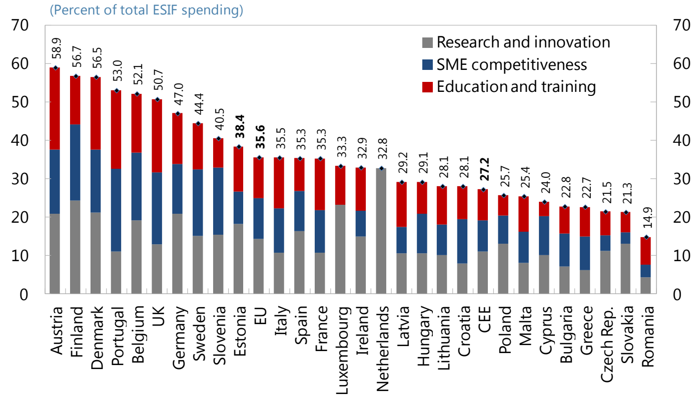
- **Enhancing public infrastructure would help attract FDI and associated technological knowhow.** An important area where reforms are both necessary and well-identified is ports: Riga and Ventspils ports both remain overly dependent on low-value added bulk traffic and face strong competition, especially from Russian ports. Rail connectivity, both cargo and passenger is limited, and while major roads that are eligible for EU investment have improved in quality and are well maintained, the majority of local roads are in a poor condition with limited funding for repairs. Energy costs, particularly those related to transmission and distribution, are relatively high and links to the wider European energy markets are still being developed. In this context, initiatives to improve connectivity such as Rail Baltics, and efforts to further integrate regional energy markets can boost efficiency and reduce costs.

- **Improving the effectiveness and efficiency of the insolvency regime will benefit firms, individuals, and the financial sector**. Recent steps to strengthen the insolvency regime and institutions including efforts to consolidate court districts, training for judges and administrators on insolvency issues, and subjecting insolvency administrators to greater income disclosure and stricter supervision, are starting to bear fruit. The length of in-court proceedings has fallen from 3 to 1.5 years in the past 5 years, and clearance rates have risen. Nonetheless, banks continue to report concerns about lengthy procedures and low recovery rates. Staff stressed that effective implementation of the recent reforms is vital to fully realize efficiency gains,[5] and called on the authorities to monitor developments and report on progress. Effort is also needed to further strengthen the transparency of, and procedures for, case assignment.

18. Sustaining growth in the longer term will likely require further structural transformation with an emphasis on high connectivity sectors and diversified and sophisticated exports.[6] Economies that have been successful at maintaining the pace of convergence, such as Czech Republic, Hong Kong SAR, Ireland, Korea, Singapore, and Taiwan Province of China, all shifted from low-skilled labor-intensive activities to developing the national innovation systems required to compete with high-income countries in more sophisticated products and pushing the global technological frontier.[7]

EU Countries: Pro-growth ESIF Spending, 2014-20[1/]

(Percent of total ESIF spending)



1/ Spending on thematic objectives 1 (research and innovation), 3 (SME competitiveness), and 10 (eductaion and training).

Sources: European Commission (https://cohesiondata.ec.europa.eu/); and IMF staff calculations.

- **Improvements in innovation and research and development could lay the ground for such a transformation and help Latvia move up the value chain.** R&D intensity remains well below the EU average and the share of high-technology exports remains small (9.2 percent in 2014). The New Industrial Policy and Smart Specialization Strategy seek to address these deficiencies but are in the initial stages of implementation. Staff supports the authorities' aim to more than double R&D spending, from the current 0.6 percent of GDP to 1.5 percent by 2020, largely through enhanced private sector spending, supported by EU-funded innovation and R&D schemes. However, achieving this target may be difficult, particularly as the total amount of financing for R&D and innovation has not been boosted. R&D and innovation incentive schemes are in place but greater uptake is needed, and industry-science links need to be strengthened.

[5] See May 2016, European Regional Economic Issues Report

[6] See IMF Country Report No. 15/337

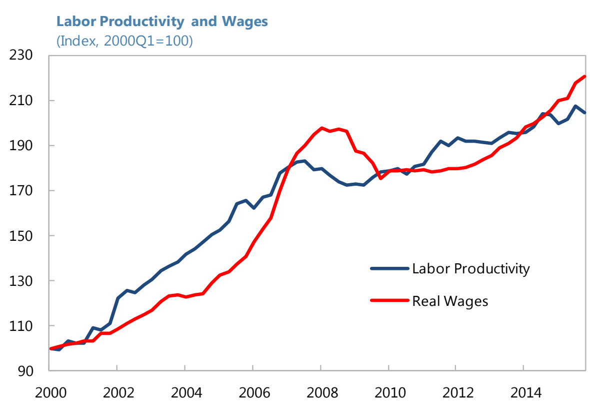
[7] See Gill and Kharas, 2007, Yusuf and Nabeshima, 2009, and Woo, 2009.

The authorities agreed with the need for reforms across various sectors to support productivity and growth. In particular they noted that progress was being made strengthening SOE governance, with the appointment of independent boards under way; gas market liberalization is planned for 2017; important progress is being made in implementing the new insolvency regime and is beginning to bear fruit; and detailed strategies under the National Development Plan and Smart Specialization Strategy have been formulated for the technological transformation of the economy. They also noted that while the goal to increase R&D spending to 1.5 percent of GDP is ambitious, relevant schemes were being redesigned based on past experience.

B. Labor Competitiveness

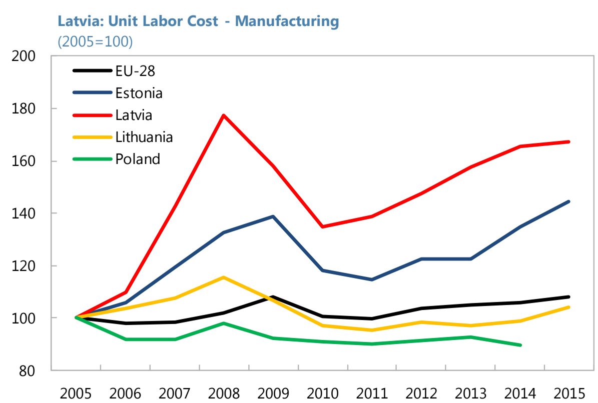
19. Rising wage pressures pose risks to competitiveness. Recent wage increases are partly the consequence of the long period of strong productivity gains and an unwinding of the wage restraint that prevailed in the aftermath of the 2009 recession. However, real unit labor costs have already risen past their 2005 pre-crisis level, and wage pressures are likely to persist over the foreseeable future, as the labor force is expected to continue to decline, due to a low birth rate and emigration, and to a lack of skilled workers. These pressures would then raise labor costs of production and erode Latvia's competitive edge if not matched by productivity gains and supported by appropriate macroeconomic policies.

Real wages have outpaced productivity in recent years...



Sources: Haver and IMF staff estimates.

And unit labor cost increases have eroded the gains made in the post-crisis period



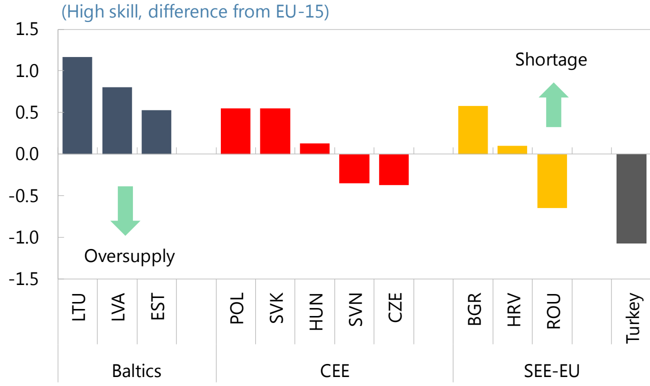
Sources: Haver Analytics and IMF staff calculations.

- **Minimum wage increases should not exceed productivity growth over the medium term** (see Cross Country Report on Minimum Wages, www.imf.org)**.** Recent hikes, well in excess of labor productivity, have raised the minimum wage to about 44 percent of the average wage in 2015, an increase of almost 4 percentage points from 2013. While the minimum wage provides support to the most vulnerable and can help reduce income inequality, staff estimates that at the current level, minimum wage increases in excess of labor productivity can be detrimental to employment—a minimum wage increase of 5 percent in excess of labor productivity could cause a 1 percent loss of employment among low-income earners. In this regard, the authorities are to be commended for putting on hold plans for further steep hikes, and raising the minimum wage appropriately by about 2.5 percent in 2016 in line with productivity. At the same time, complementary policies should be employed to address inequality concerns.

- **Further reforms are needed to alleviate the tightening labor market.** The authorities have already taken some steps to raise the participation rate and reduce structural unemployment. The statutory retirement age is being raised gradually towards 65 years by 2025—it currently stands at 62½, and the criteria for early retirement and disability have been tightened. Female labor force participation is already relatively high by regional standards, at 55 percent. Several ongoing projects are targeted at various segments of the unemployed population, including a project to facilitate regional labor mobility. Staff argued that in-work tax credits and improvements in tapering of benefits when working is needed to enhance work incentives and further encourage labor participation. Active labor market policies (ALMPs) should continue to be strengthened, and more effort should be made to attract high-skilled foreign workers.

- **Continued improvements in higher and vocational education would help reduce skills mismatches and enhance competitiveness.** The authorities have an ambitious reform agenda to build a more skilled workforce, although implementation is still at an early stage. A new performance-based financing model for higher education has been introduced. Consolidation of higher education institutions, underpinned by quality-based accreditation, is underway, while public funds are being targeted to science, technology and mathematics, and away from social sciences. Meanwhile, steps have been taken to better align vocational education programs with market demand. A pilot program based on apprenticeships and councils of social partners/sector experts was recently completed.

Skill Shortage Index, 2000-14
(High skill, difference from EU-15)



Sources: Eurostat and IMF staff calculations.
Skill shortage is defined as the difference between the share of high-skilled labor in total employment and the same share in total population.

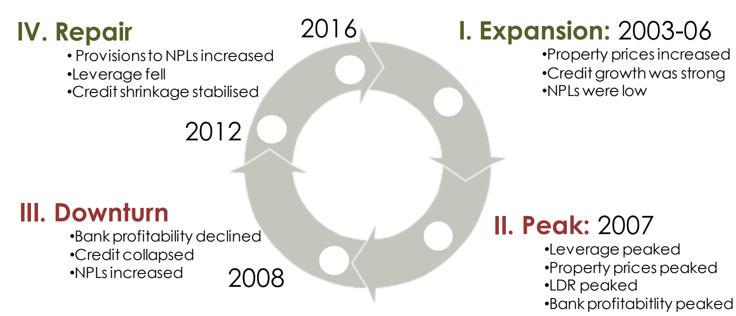
The authorities agreed that competitiveness needs to be preserved, and that action is needed across various fronts. They recognized that tightening labor market conditions need to be addressed, and that effective education reform would be crucial. They also noted that as the economic situation in Latvia improves, and wage differentials narrow, net migration may well reverse as Latvian emigres begin to return. They noted that the labor participation rate is expected to continue to rise over the medium term and that their education agenda is bearing fruit in addressing skills mismatches. They pointed out in particular, that whereas the overall student population has been declining, the number of students in sciences and technology was stable. They agreed that the minimum wage should move in line with productivity over the medium term.

C. Financial Sector

20. Latvia's banking sector is bifurcated, and dominated by commercial banks with strong cross border linkages (see Selected Issues Paper). The two segments follow very different business models: the foreign (largely Nordic) banks deal mainly with domestic clients and provide the lion's share of domestic lending (more than 85 percent); while the domestic banks rely mostly on non-resident deposits, and their assets are composed of highly liquid foreign assets.

21. The credit cycle may be close to turning, and the delay to date is likely hampering growth. The post-crisis period of deleveraging and balance sheet repair has left the banking system well capitalized, liquid, and profitable. NPLs have come down from 20 percent in 2010 to 5.4 percent at end-March 2016, provisioning is strong, and debt service capacity has improved substantially (Figure 4). Taken together these suggest that Latvia is likely towards the end of the repair stage of the credit cycle. This assessment is supported by an index of financial conditions in Latvia, which suggests a return to neutral conditions.[8] Against this background, the absence of credit growth is especially concerning as rising wage pressures could erode companies' ability to self-finance the investment that is needed to support growth both now and in the future.[9]

Latvia through the Credit Cycle

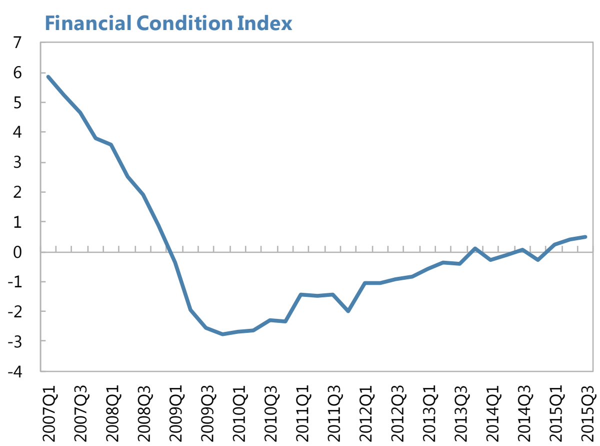


[8] The FCI is constructed using various indicators of financial conditions (NPLs, credit growth, profitability, house prices and funding ratios). For Latvia it explains more than 75 percent of the covariance of the data.

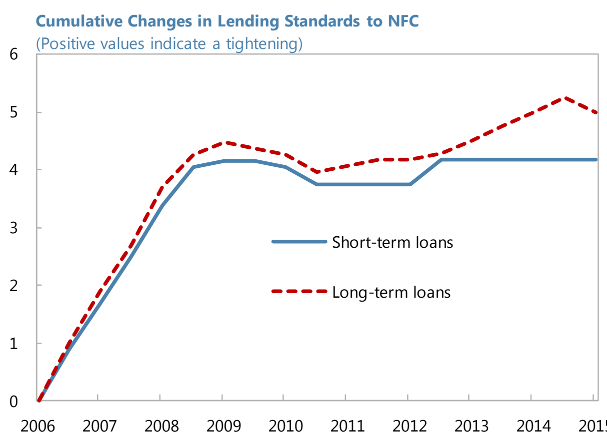
[9] For an in-depth analysis of credit-less recovery in the Baltics, see IMF Country Report 14/116.

22. **While demand factors explain subdued lending activity to larger firms, supply factors are likely more important for SMEs and households**. For SMEs and households, banks cite lack of documentable income as an important factor constraining their ability to lend. In 2007, legislation was introduced prohibiting lending to natural persons against income other than that reported to the State Revenue Services, a practice that was commonplace before the crisis. This (sound) requirement likely makes some households with undocumented income ineligible for borrowing. A lack of collateral or sufficient cash flow are important constraints on SME lending. For instance, according to one bank, out of the 200 thousand companies registered only 15–20 thousand are potentially eligible borrowers, once those firms that are loss making or have negative equity are eliminated. The larger banks have also adopted a much more cautious attitude towards lending, given their experience with the slow bankruptcy procedures and low recovery rates post crisis. This leaves most of the domestically focused banks competing over a few large and collateral rich firms, where, in fact demand seems to be lacking as investment plans are held back in the face of economic and geopolitical uncertainties, and in some cases delays in the startup of a new round of EU structural funds.

Financial conditions have turned positive…



… but banks' lending standards have not generally eased.



- **Access to credit for SMEs should be facilitated.** The SME sector is particularly credit constrained. If well designed to address market failures, Government programs such as loan guarantee schemes and subordinated loans through the Single Development Institute, are welcome. Nevertheless, these programs cannot alleviate the problem for those firms or individuals that are part of the gray economy. Staff suggested that the authorities explore the experience in other jurisdictions where supervisors have defined a code of conduct for lenders in an attempt to prevent discrimination against lending to SMEs, for instance, the Credit Review Office in Ireland.

- **Lending by Nordic subsidiaries could be better-attuned to Latvian conditions.** There is some evidence that centralized risk management by parent banks could be contributing to overly-constrained lending in Latvia. Given Latvia's recent crisis experience, and hence the higher probabilities of default, and rates of loss given default, it may be that banks' internal risk models place too much weight on the recent historical episode, relative to current conditions. Indeed, after a sharp tightening since the onset of the crisis, bank lending standards have not changed substantially.[10] Also, subsidiary level data suggests that Nordic banks' lending is more procyclical in Latvia (and the rest of the Baltics) compared to the home country. Based on this, staff urged the Latvian prudential authorities to use the results of the benchmarking exercise[11] of banks' risk models conducted with their European partners to ensure they appropriately capture risk, and that crisis legacies and associated risk aversion do not unduly constrain lending.

23. The authorities' recent actions to combat financial fraud and mitigate AML/CFT risks are commendable, yet safeguarding financial stability requires ongoing vigilance and action.

- **The risks associated with non-resident deposits (NRDs) warrant continued vigilance.** NRD banks account for about 50 percent of total deposits, of which over 80 percent are estimated to originate from Russia and CIS countries. The NRD banks[12] enjoy high liquidity ratios and stress tests suggest they can withstand outflows of close to 60 percent. Nevertheless, NRDs could be vulnerable to sudden reversals, and as required by EU law, they are covered by the state deposit guarantee scheme and thus represent a contingent fiscal liability. That said, to date there are few signs of volatility in NRD inflows (Box 1), and risks to the domestic economy are mitigated by various factors. NRD banks hold close to 60 percent of their assets in liquid instruments, and are appropriately subject to higher capital and liquidity requirements,[13] and higher contributions to Latvia's deposit guarantee scheme per dollar of deposits.

- **The authorities have stepped up their anti-money laundering (AML) efforts, but more is needed.** As noted previously, the FCMC recently imposed fines against two banks, requested board replacement of one, while revoking the license of another. More importantly, the authorities have taken steps to address some of the recommendations of the OECD's Working Group on Bribery, including widening the definition of Politically Exposed Persons (PEP). The FCMC has also adopted a risk-based supervision strategy, has already, and is planning to increase further internal resources, and has employed external resources for in-depth analyses of banks' procedures in order to impose minimum standards on their risk monitoring systems. Staff commended these efforts, encouraged the authorities to bring the AML/CFT framework in line with the FATF standard, and ensure

[10] The Bank Lending Survey conducted by the Bank of Latvia, in cooperation with the ECB, is addressed to senior loan officers, and asks about changes in lending standards in the past quarter and intentions for one quarter ahead.

[11] The annual benchmarking exercise, foreseen in Capital Requirements Directive (CRD IV), is conducted by EU institutions and competent authorities, according to the EBA methodology, and will allow for an assessment of differences in calculation of risk weights for a given portfolio across institutions.

[12] Defined as banks with more than 20 percent of their assets funded by non-resident deposits.

[13] See Appendix I, 2012 Article IV Consultation with Latvia.

that sufficient resources are allocated to AML supervision activities, in line with the recommendations of the OECD's Working Group on Bribery.

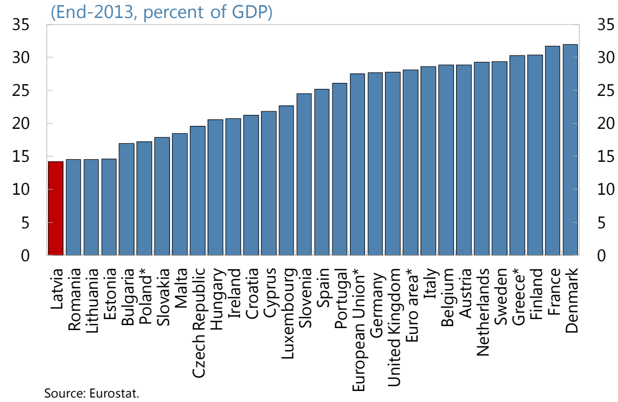
The authorities agreed that the banking system is robust, and that a resumption of credit will be vital to future growth. They shared the view that demand and supply factors were likely relevant for different segments of borrowers to varying degrees, and that a multifaceted approach should be explored while ensuring financial stability. They welcomed the suggestion of using the benchmarking exercise conducted with their European partners to review banks' internal risk models. They were also open to exploring approaches from other jurisdictions. In addition, they plan to review their post-crisis financial sector measures to see if any had outlived their usefulness. They agreed with the critical importance of vigilant supervision to mitigate both real and reputational risks, including those associated with the NRD sector. In this context, they underscored their recent enhanced efforts to address AML issues. They agreed that continued effort was needed to improve the operation of the insolvency regime.

D. Fiscal Policy

24. The 2016 budget is broadly appropriate. The 2016 budget, by targeting a structural deficit of 0.9 percent of GDP, takes a close-to-neutral stance, balancing the sluggish economic environment and the need to stay within domestic and EU fiscal rules.[14] Increases in defense and social spending of about ½ percent are offset by revenue-enhancing measures, including the introduction of a solidarity tax on high-income earners, increases in excises duties, and measures to broaden the tax base and improve tax compliance, as well as lower current expenditures.[15] Automatic stabilizers should be allowed to operate fully in the event that economic growth falls below the forecast.

25. Looking further ahead, additional fiscal space will be needed over the medium term to strengthen the social safety net and boost productive public spending. Social spending in Latvia is currently over 10 percentage points of GDP lower than the EU average, and together with public spending on healthcare, is among the lowest in Europe (as a share of GDP or per inhabitant), putting at risk vulnerable segments of the population and hindering the buildup of human capital.

Social Protection Benefits
(End-2013, percent of GDP)



Source: Eurostat.
* Denotes 2012 data.

[14] Latvia's Fiscal Discipline Law sets a medium-term objective (MTO) of 0.5 percent of GDP, but allows a deviation of about 0.5 percent of GDP this year for revenue transfers to the privately managed Pillar II pension fund.

[15] The "Solidarity Tax" effectively amounts to the removal of the cap on social security contributions for income earners over EUR 4050 per month which was introduced in 2014 but without the corresponding accumulation of benefits.

Planned spending increases, for example on defense or pensions, place additional demands on available resources. The authorities' ambitious plan to bring tax revenue up to a third of GDP by 2020 is commendable, and will require sustained efforts to improve tax collection and policy. Greater efforts are needed to strengthen the social safety net, including in particular the Guaranteed Minimum Income (GMI) benefits as recommended by the World Bank

26. The authorities' reviews of tax and expenditures, and tax compliance are welcome. The large tax-wedge in Latvia tends to discourage work and imposes a significant burden on households at the lower end of the income distribution, while the corporate income tax rate is among the lowest in the EU and tax exemptions and non-compliance are extensive. At the same time, income inequality in Latvia is among the highest in the EU, while revenues and expenditures are among the lowest. The reviews offer the chance to consider reforms comprehensively to improve incentives, recalibrate the tax burden equitably, and explore options for opening fiscal space.

- At the same time as seeking to boost revenues, the tax burden should be shifted towards growth friendly taxation, including property taxation, which currently accounts for about 0.8 percent of GDP in revenue (less than half the OECD average). This should be accompanied by implementation of the recent cadastral valuation reform, with appropriate exemptions for the poorest households. A more gradual tapering of benefits, which currently fall one-for-one with income, would improve work incentives among low-income earners. Reforms are also needed to the current micro-enterprise tax regime which has lent itself to considerable abuse. Options for the authorities to consider to create fiscal space could involve raising the CIT given its low starting point, a PIT surtax on high income earners, reducing the minimum non-taxable threshold for pensioners, and better-targeting of tax allowances and expenditures, such as child benefits.

- On the spending side, efforts could focus on better means testing to help achieve social protection objectives most efficiently, and progress could also be made to rationalize spending and improve efficiency, for instance in education.

- Some progress has been made in combating the gray economy, but more is needed. In this regard, further efforts to boost tax compliance will be important, while measureable improvements in public services can help build public support.

The authorities agreed with staff that the budget should be implemented flexibly in accordance with the FDL, and that the revenue envelope should be boosted over time. They cautioned that given the risks to the outlook, prudent fiscal policy will be needed to maintain compliance with fiscal rules, while concurring with staff that automatic stabilizers should be allowed to operate. They noted that income inequality has declined recently, partly due to the higher minimum wage, and that social spending, particularly on healthcare, is planned to increase over the medium term. They indicated that work is ongoing to revise the Guaranteed Minimum Income law, which would also allow gradual tapering of benefits in some cases, and cadastral valuation which would take into account households' ability to pay. They agreed with the adverse effects of the current micro-enterprise tax regime, noting that it is also currently under review.

STAFF APPRAISAL

27. Despite the current slowdown, growth is expected to pick up, but the timing is uncertain. Growth is expected to slow slightly to 2½ percent in 2016 due to delays in absorption of EU-funds and continued geopolitical tensions and economic uncertainties. Nevertheless, growth momentum is expected to build later this year and into 2017, as EU programs start up and the global economy strengthens, though the exact timing is uncertain. The outlook is subject to significant downside risks, including a prolonged slowdown in key trading partners, a heightening of geopolitical tensions, failure of credit to resume, or of structural reforms to be advanced.

28. An average growth rate of 4 percent is feasible going forward, but will require sustained structural reforms. Structural reforms are needed to promote investment and productivity growth, and safeguard competitiveness in the face of adverse demographic trends and slowing productivity gains. Key reform areas include: infrastructure and SOE management; increasing the efficiency and effectiveness of the operation of the judicial system and insolvency regime; tax policy to improve incentives to work; and education and vocational training to reduce skills mismatches. In light of the current level of the minimum wage to average wage ratio, increases in the minimum wage should not exceed productivity growth over the medium term, while complementary policies should address inequality and poverty.

29. Actions to address the gray economy will also be crucial. The gray economy is preventing Latvia from fulfilling its potential. Further efforts to boost tax compliance will be important, while measureable improvements in public services can help garner public support.

30. Credit flows need to resume to support investment and growth, but constraints are multifaceted. A multi-pronged response is needed to address impediments to credit growth while ensuring financial stability. Elements should include firm implementation of court and insolvency reforms, along with reporting on progress made; an analysis based on the results of the benchmarking exercise of banks' risk models, conducted in cooperation with their European partners, to ensure they appropriately capture risk, and that crisis legacies and associated risk aversion do not unduly constrain lending. An expansion of public sector initiatives to catalyze SME lending could also be considered.

31. While the 2016 budget is broadly appropriate, fiscal space is needed over the medium term to strengthen the social safety net and boost productive public spending. The authorities' plan to raise tax revenue to one third of GDP is commendable and will require tax policy changes, sustained efforts to improve compliance, along with improvements in public services to garner support. The authorities' review of tax policy and compliance and expenditures are an opportunity to consider reforms comprehensively to improve incentives, recalibrate the tax burden equitably, and explore options for opening fiscal space. In particular, while also seeking to boost revenues, the tax burden should be shifted towards more efficient and growth friendly taxation, including property taxation.

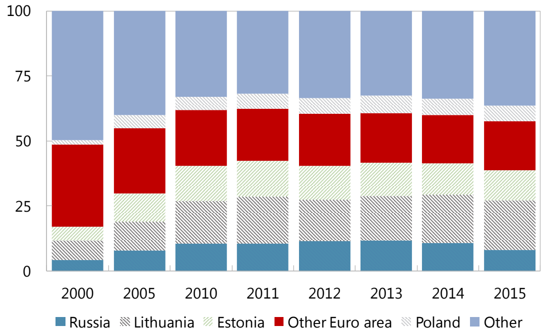
32. Strengthened AML/CFT efforts are commendable, but continued vigilant supervision is required to mitigate real and reputational risks, especially for NRD banks. The authorities should focus on implementation of the enhanced regulations, as well as ensuring that sufficient resources are allocated to AML supervision activities, in order to strengthen the reputation of the Latvian financial sector.

33. Staff recommends that the next Article IV consultation be held on the standard 12-month cycle.

Box 1. Evolving Role of Russia

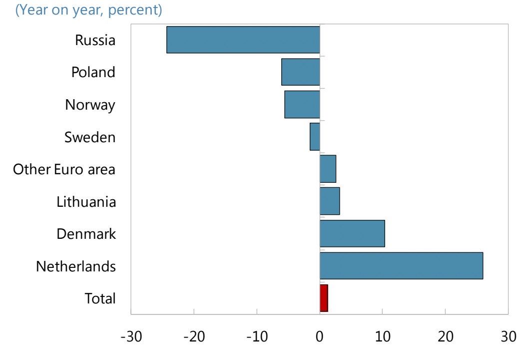
Trade linkages with Russia are strong but diminishing in importance. Trade linkages strengthened in the past decade due to the faster growth of the Russian economy compared to Latvia's other trading partners and at its peak in 2013, Russia accounted for around 11 percent of Latvia's exports of goods and services. However, since then the share of Russia in total exports have diminished somewhat due to ongoing geopolitical tensions and significantly weaker economic performance in Russia. Russia's share of total Latvian exports in 2015 stood at below 8 percent in 2015, with EU and other countries picking up the slack.

Destination of exports
(Share of total exports, percent)



Sources: CSB; and IMF staff calculations.

Export growth with major trading partners, 2015
(Year on year, percent)



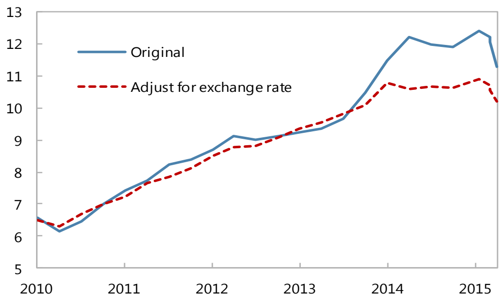
Sources: CSB; and IMF staff calculations.

Russian counter-sanctions have had only a marginal impact on Latvia's economy. The Russian measures were directed at Latvian food exports. However, the share of food products under sanctions to total Latvian exports to Russia was less than 10 percent in 2014. Moreover, Latvian food exporters were able to diversify and find new markets to substitute the loss of the Russian market. While the export of food products under sanctions (measured at the 2-digit industry level) declined 77 percent in 2015, overall exports in this category only showed a marginal decline of around 3 percent. Exports to alternative markets such as Norway, the Netherlands, Poland, and the Euro area more generally, largely cushioned the impact of the sanctions.

Geopolitical tensions have had little discernible impact on the Latvian banking system. As a regional banking center, Latvia receives a large amount of Russian deposits. More than 80 percent of non-resident deposits (NRDs) in the Latvian banking system come from CIS countries, mostly Russia. The average (over four quarters) growth rate of NRD deposits in 2015 was 19 percent, higher than the 12 percent seen in 2014. However, given that over 60 percent of NRDs are in US dollars, this figure incorporates significant valuation effects from the euro's movement against the dollar. After correcting for such valuation effects, the average growth rate in 2015 was 6.5 percent compared to 11.5 percent in 2014. Overall there was no evidence of disruption of NRD inflows, albeit following a strong pickup in the last quarter of 2014 and the first half of 2015, the pace of growth slowed down, leaving the stock of NRDs (at constant exchange rates) in December 2015 just 1 percent above the stock a year earlier. This trend continued in 2016, with the first quarter witnessing a modest outflow of 3.7 percent on a y-o-y basis.

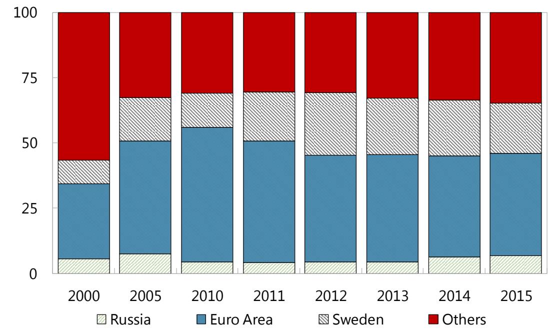
Box 1. Evolving Role of Russia (concluded)

Non-resident Deposits
(Billion euros)



Sources: FKTK; and IMF staff calculations.
Note: Dec-2010 used as base year for exchange rate adjustment

Sources of Foreign Direct Investment
(Share of total FDI, percent)



Sources: Bank of Latvia; and IMF staff calculations.

Russian FDI to Latvia has accelerated since 2014. Russia's share in inward FDI has grown to around 7 percent in 2015, up from 6 percent in 2014 and higher than around 4.5 percent in 2012–13. This is consistent with strong NRD inflows, suggesting that the incentives of Russian investors to allocate their deposits and capital to Latvia have not so far been harmed by geopolitical tensions.

Box 2. External Sector Assessment

The macroeconomic imbalances of the pre-crisis period have been largely addressed. The current account is close to balance, and although it is projected to deteriorate somewhat in 2016 and 2017 due to continued consumption demand and an expected pick-up in investment, it should narrow in the outer years as exports pick up as growth returns in Latvia's major trading partners. The external debt as a share of GDP has been on a declining trajectory. It stood at 138 percent of GDP at end-2015 and is projected to decline to about 112 percent of GDP by 2021 (see external debt sustainability framework). The gross external debt figure somewhat overstates the debt levels due to large short term liabilities of the banking sector (to their parents). Net external debt stood at 26 percent of GDP at the end of 2015. Gross public debt is comfortably below the Stability and Growth Pact threshold at 39 percent of GDP and corporate debt is modest at 25 percent of GDP.

Staff assess the real exchange rate to be broadly in line with fundamentals. Direct assessment of the exchange rate, using EBA-lite IREER model finds a small overvaluation of around 3 percent, which is broadly consistent with the evolution of the REER (Figure 5) and rising unit labor costs. The EBA-lite methodology also concludes that Latvia's policies are broadly appropriate and estimates a small policy gap of around 1 percent of GDP, mostly driven by depressed credit in the economy, suggesting that Latvia's fiscal, external (reserves and capital account), and financial policies are broadly appropriate. But the current account norm is estimated as -4.8 percent of GDP, much larger than the actual 2015 CA deficit of -1.2 percent, and results in an unrealistically large real exchange rate undervaluation. This result should be interpreted with caution, as it seems inconsistent with the country's still high negative net international investment position of 60 percent of GDP, which would deteriorate further if the actual current account deficit were in line with the model's estimated current account norm. The underlying model does not appear to capture well the specifics of the Latvian experience, in particular, the overheating of the economy prior to the crisis (with a CA deficit in excess of 20 percent), the subsequent collapse in output and demand, and the large internal devaluation that was instrumental in rebalancing the economy.

Latvia: 2016 Exchange Rate Assessment using the EBA-lite Methodology

Summary Table			
CA-Actual	-1.2%	CA-Fitted	-3.7%
CA-Norm	-4.8%	Residual	2.5%
CA-Gap	**3.6%**	Policy gap	1.1%
Elasticity	-0.35		
Real Exchange Rate Gap	**-10.1%**	Cyclical Contributions	-0.1%
		Cyclically adjusted CA	-1.1%
		Cyclically adjusted CA Norm	-4.7%

Box 3. Risk Assessment Matrix [1/]

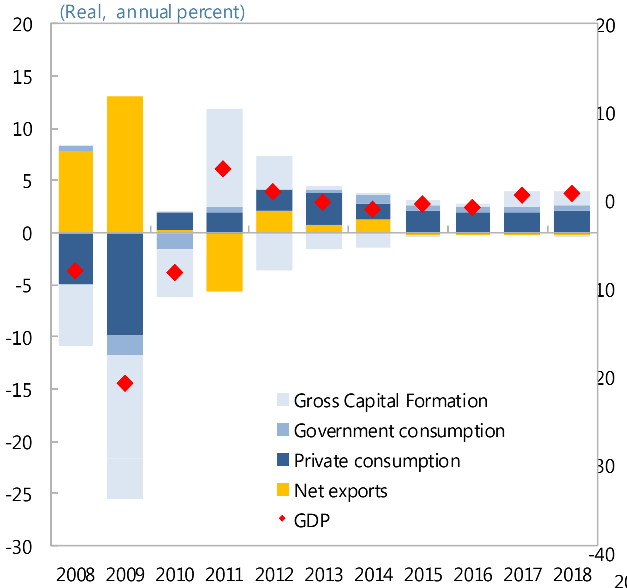
Source of Risk and Likelihood	Impact if Realized	Policy Recommendations Mitigation/Response
Medium **Sharp asset price decline and decompression of credit spreads** as investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, Fed policy rate path, and increases in U.S. term premia, with poor market liquidity amplifying volatility.	Low/Medium Could lower funding for Nordic parent banks reliant on wholesale funding, raising the cost of financing and hindering credit growth.	Euro area monetary policy is first line of defense against liquidity stress, supported if needed, by activation of backstops and resolution mechanism.
High/ Medium **Structurally weak growth in key advanced and emerging economies.** Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persisting financial imbalances.	High The Euro Area remains Latvia's single largest trade partner, while Russia and other CIS countries are also significant export destinations. A protracted slowdown would have a direct impact on exports while also eroding business and consumer confidence.	Participate in coordinated policy response at the European level. Allow automatic stabilizers to operate. If the shock is of sufficient magnitude, discretionary fiscal action could be considered.
High **Heightened risk of fragmentation/security dislocation in part of the Middle East, Africa, and Europe,** leading to a sharp rise in migrant flows, with negative global spillovers.	High A mounting Russia/Ukraine conflict would depress business confidence and heighten risk aversion. Escalating sanctions/countersanctions could threaten other sectors of the Latvian economy (apart from food exports, which are already sanctioned). Non-resident deposits (NRDs) could be susceptible to sudden stops or reversals in case of a sufficiently large shock.	Continue to diversify product and export markets. Maintain vigilant financial supervision, including AML supervision. Participate in coordinated policy response at the European level. Pursue policies to hasten integration of migrants, including active labor market policies, and language and skill training.
High **Brexit:** On June 23, 2016, the UK is holding a referendum on whether to remain in the European Union or leave.	High/ Medium An exit could pose major challenges for Europe an extended period of heightened uncertainty and disruptions in trade and financial flows that would spillover to Latvia. Potential impact on Latvian migrants in the UK could be significant.	Euro area monetary policy is first line of defense against liquidity stress, supported by activation of backstops and resolution mechanism. Allow automatic stabilizers to operate. If the shock is of sufficient magnitude, discretionary fiscal action could be considered.
Medium **Failure to advance on structural reforms.**	High In the absence of structural reforms productivity growth and the business environment would suffer, harming competitiveness and employment.	Seek to build base for support to continue with reform agenda focusing on improving the business environment, labor markets, SOEs governance, infrastructure, and human capital.
High/ Medium **Failure of credit growth to pick up**	Medium Persistently weak bank credit growth would constrain investment and growth.	Explore policy options to address market failures, and ensure appropriate macro-prudential policy settings.

[1/] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Figure 1. Republic of Latvia: Real Sector

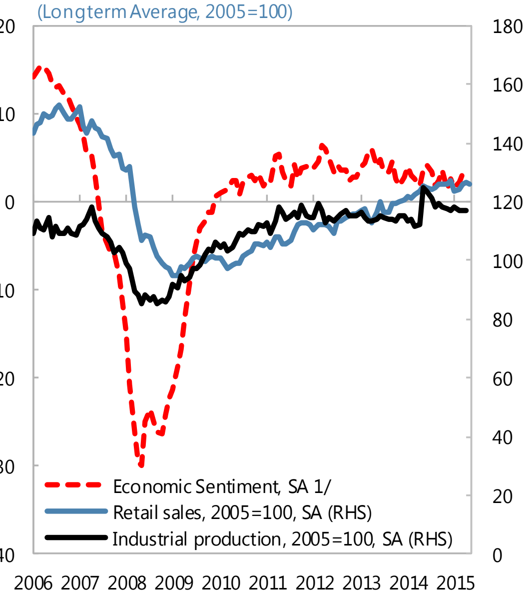
Consumption led conomic growth picked up in 2015...

GDP Growth and Contributions
(Real, annual percent)



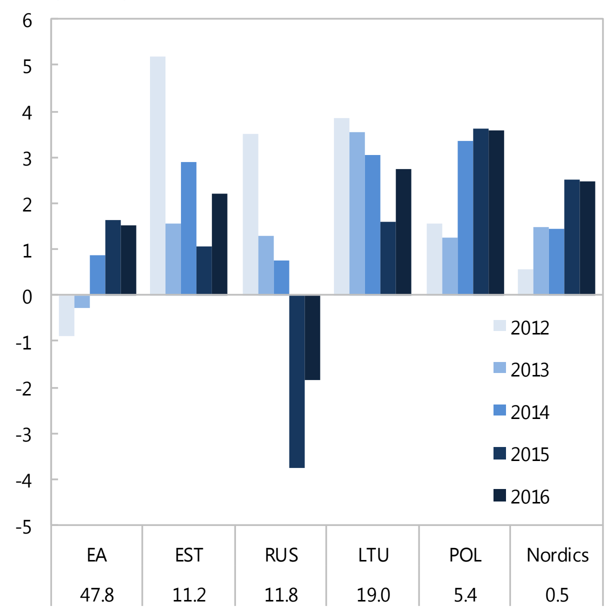
....driven by robust sentiment and strong retail sales.

Business and Consumer Confidence
(Longterm Average, 2005=100)



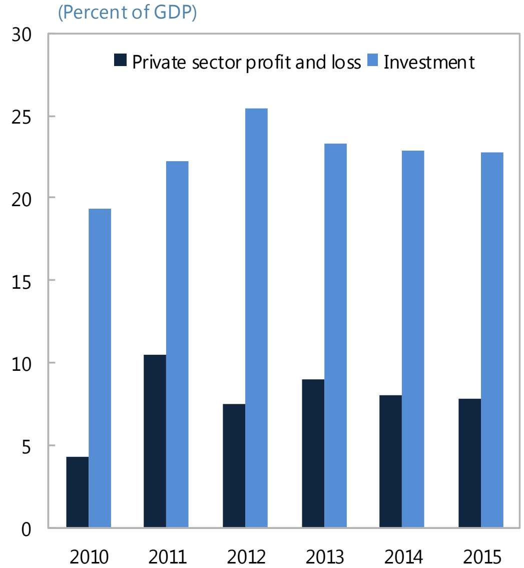
Yet, the external environment remains weak....

Annual GDP Growth of Major Partners²
(Percent)



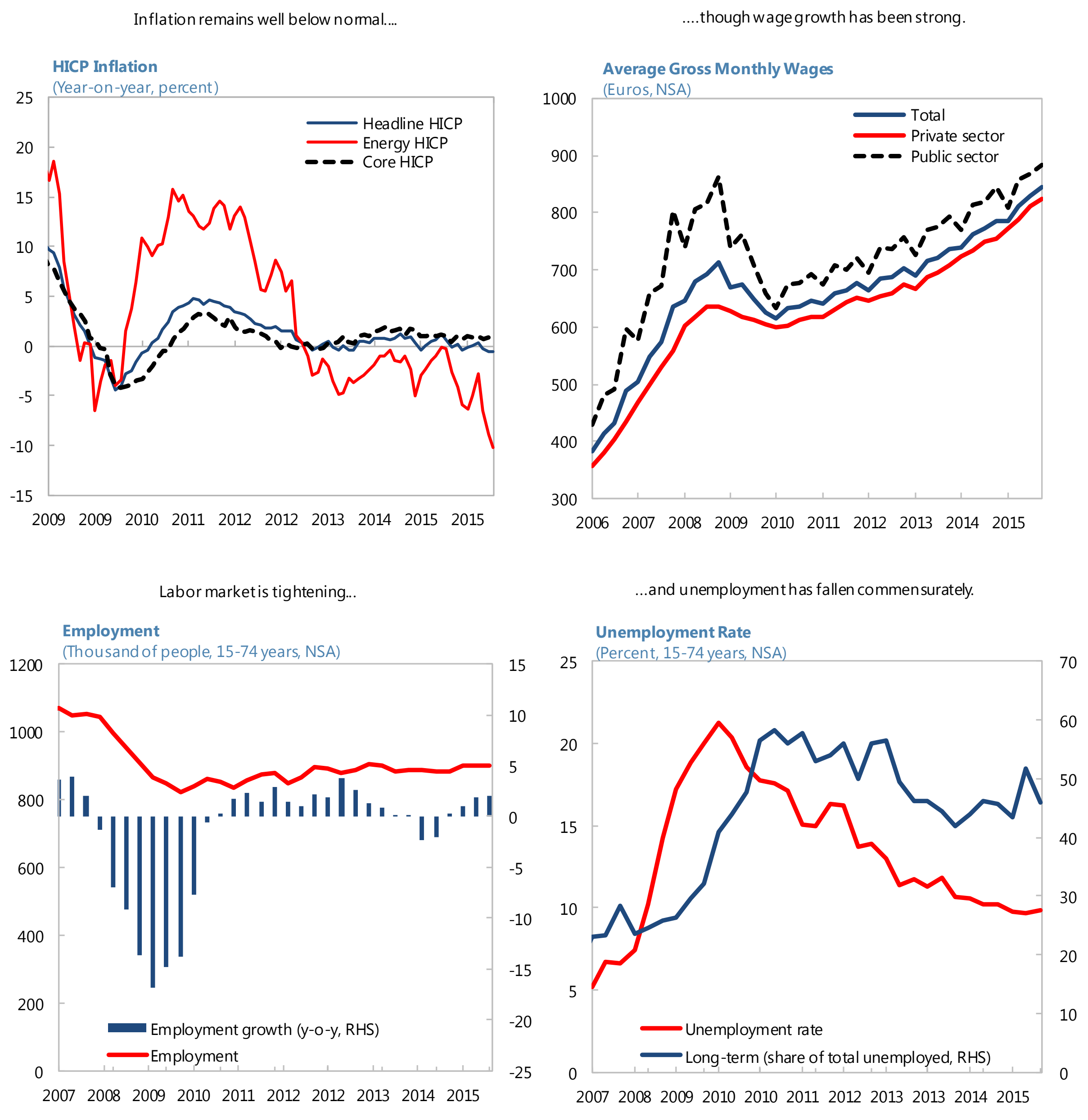
....and investment is subdued.

Private Sector Profit and Loss, and Investment
(Percent of GDP)



Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.
1/ Difference with long-term average.
2/ Numbers under country label are Latvia's export shares in 2015Q3.

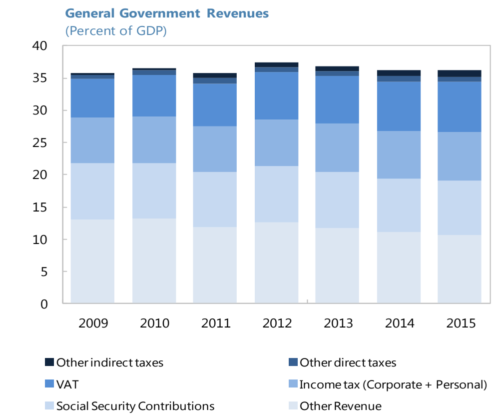
Figure 2. Republic of Latvia: Inflation and the Labor Market



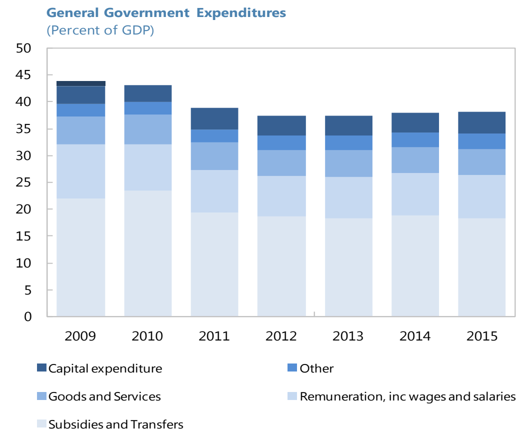
Sources: Eurostat; Haver Analytics; Latvian Central Statistical Bureau; and IMF staff calculations.

Figure 3. Republic of Latvia: Fiscal Developments

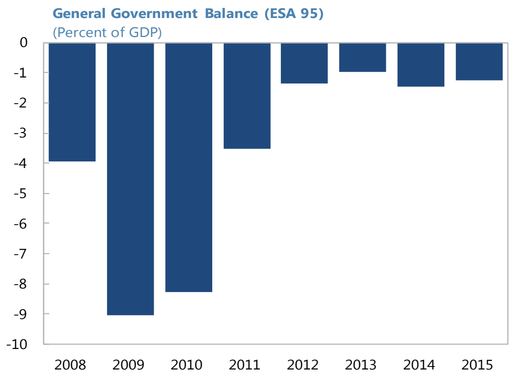
Improved administration has successfully offset past tax cuts…



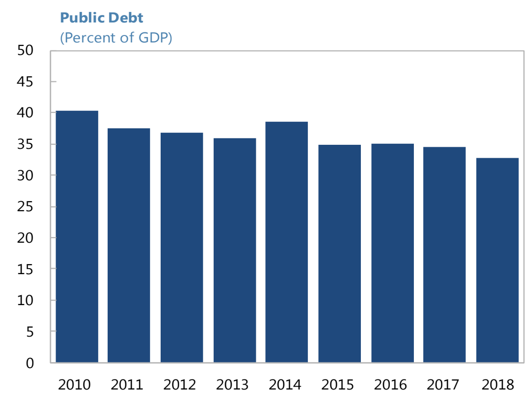
…while fiscal discipline and consolidation contained spending.



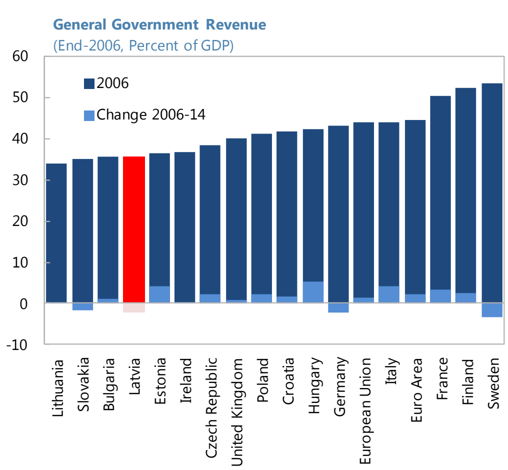
Bringing the fiscal deficit down to a sustainable level…



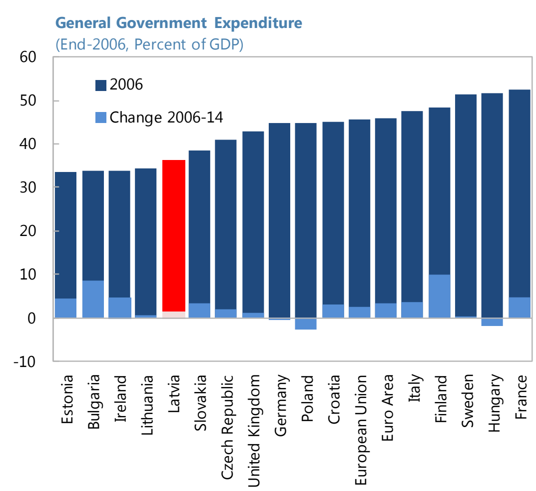
…and keeping the public debt under control.



However, more revenue may be needed…



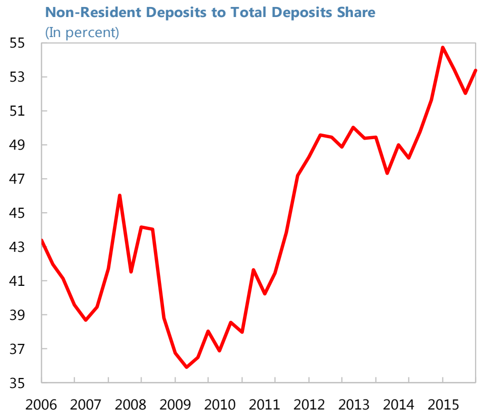
…to enhance spending on priorities.



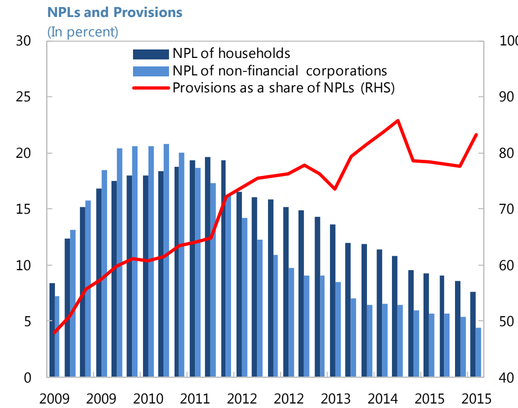
Sources: Latvian authorities, Haver Analytics; and IMF staff estimates.

Figure 4. Republic of Latvia: Banking Sector Developments

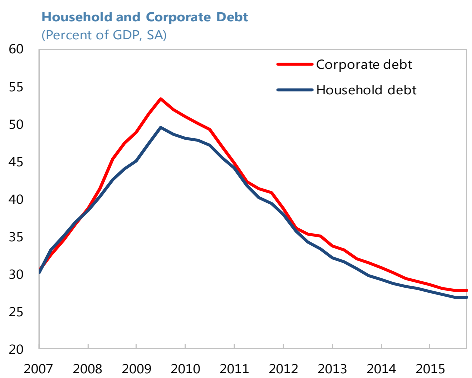
Non-resident deposit inflows have stabilized somewhat....



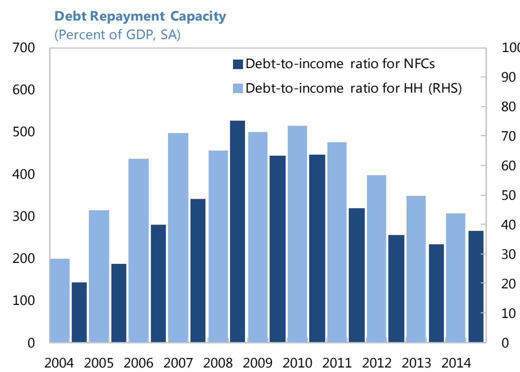
NPLs declined steadily while the coverage ratio increased.



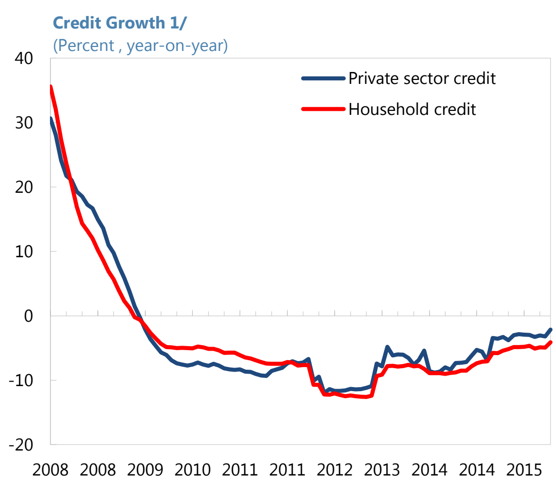
Households and firms continue to deleverage....



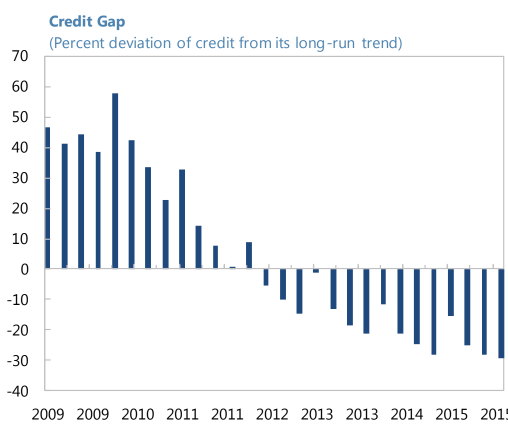
....and their debt service capacity is increasing.



Yet, credit continues to shrink, albeit at slowing rates...



....and the credit gap is highly negtive.

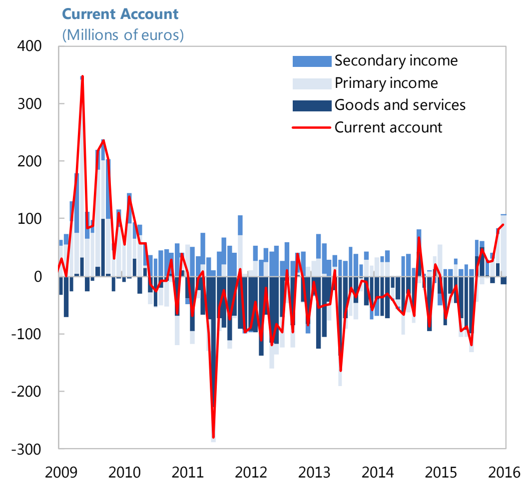


Sources: Bank of Latvia; Bloomberg; FCMC; and IMF staff calculations.

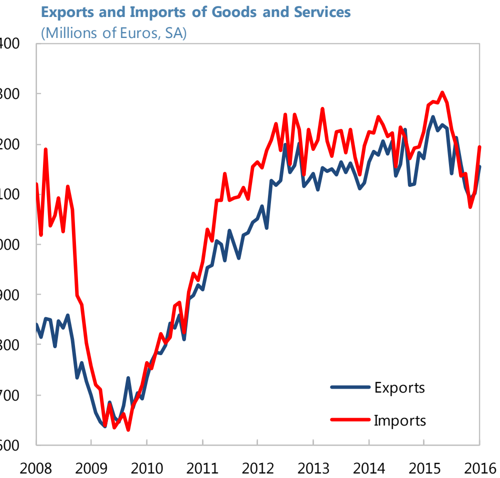
1/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

Figure 5. Republic of Latvia: Balance of Payments

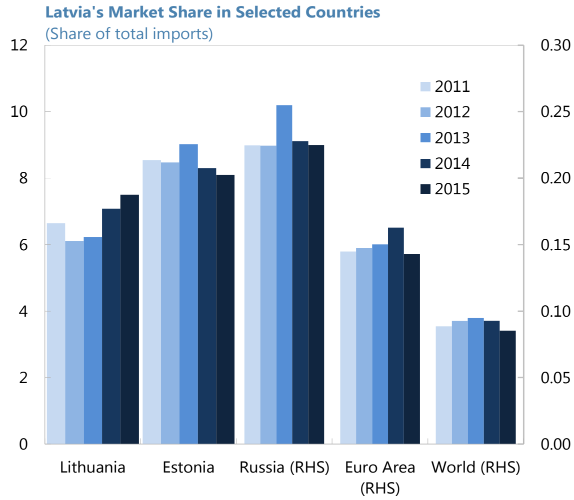
The current account is improving....



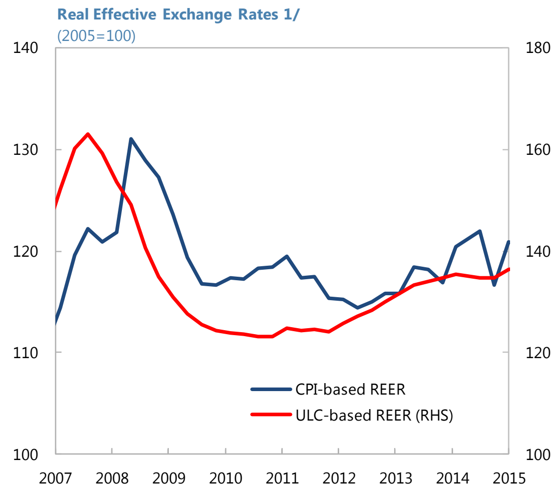
....but trade continues to lackluster amid a weak global environment.



Market shares in key export markets are no longer increasing...



....while effective exchange rates are strengthening.

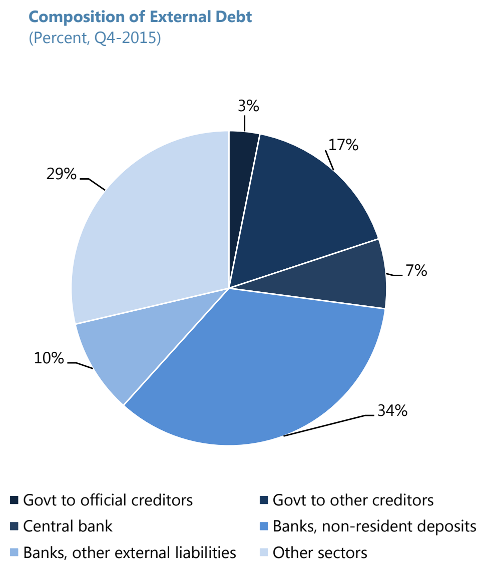


Sources: Bank of Latvia; ECB; EC; and IMF staff calculations.

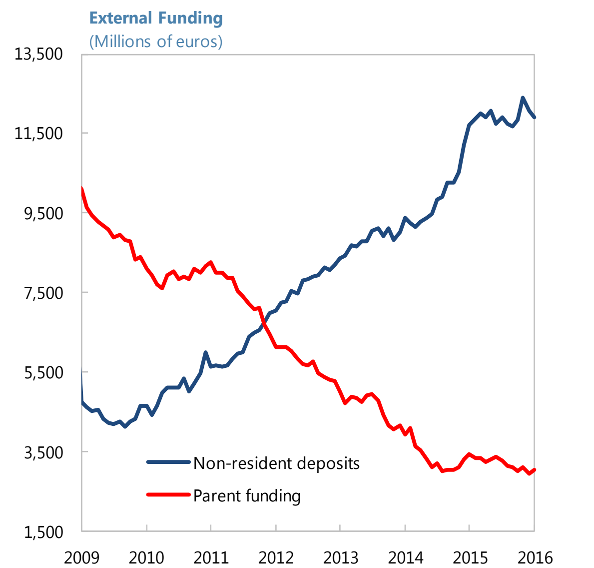
1/ Real effective exchange rates is based on IC-37 countries for ULC and IC-42 countries for CPI.

Figure 6. Republic of Latvia: External Debt and Vulnerabilities in the Banking System

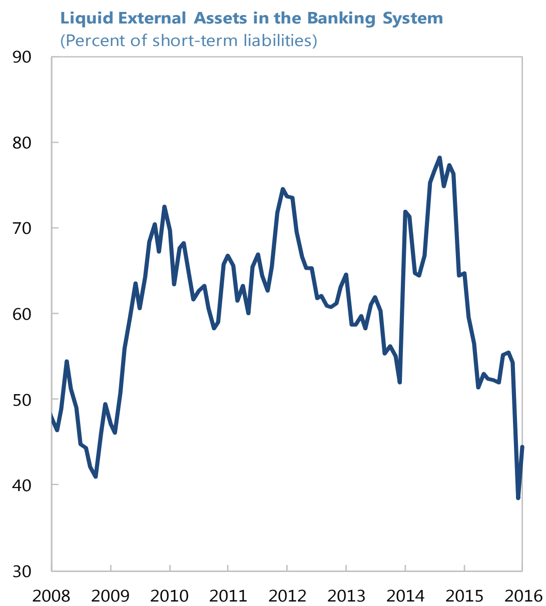
Half of external debt due to liabilities of the banking sector, with government and corporate debt modest.



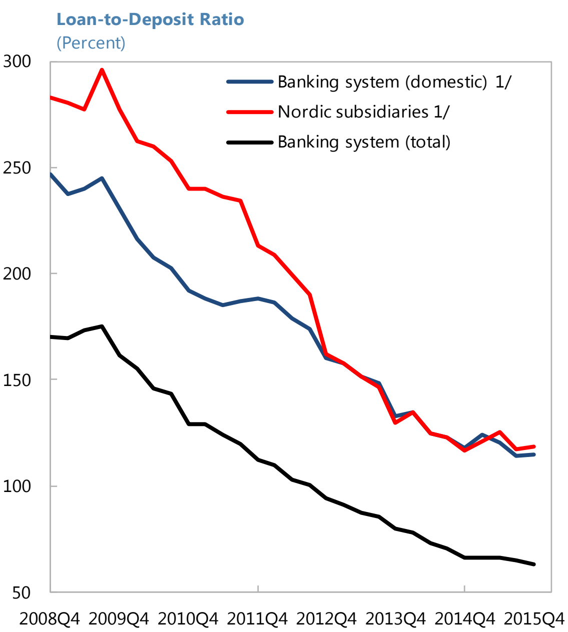
Parent bank funding has declined, while non-resident deposits have increased.



Liquidity in the banking system is adequate…



…and loan to deposit ratios have improved significantly.



Sources: Bank of Latvia; FCMC; and IMF staff calculations.
1/ Exclude foreign loans and non-resident deposits.

Table 1. Republic of Latvia: Selected Economic Indicators, 2010–16

	2010	2011	2012	2013	2014	2015	2016
							Proj.
National accounts	(Percentage change, unless otherwise indicated)						
Real GDP	-3.8	6.2	4.0	3.0	2.4	2.7	2.5
Private consumption	2.8	3.0	3.2	5.1	2.3	3.3	3.1
Public consumption	-8.1	3.0	0.3	1.6	4.9	3.1	3.1
Gross capital formation	-18.9	48.7	-1.1	-4.3	-5.5	2.1	1.2
Gross fixed capital formation	-19.8	24.1	14.4	-6.0	0.5	2.7	1.0
Exports of goods and services	13.4	12.0	9.8	1.1	3.1	1.4	0.8
Imports of goods and services	12.4	22.0	5.4	-0.2	0.8	1.8	0.9
Nominal GDP (billions of euros)	17.9	20.2	21.8	22.8	23.6	24.4	25.1
GDP per capita (thousands of euros)	8.5	9.8	10.7	11.2	11.8	12.3	12.7
Savings and Investment							
Gross national saving (percent of GDP)	21.8	22.3	22.8	21.7	21.5	20.8	19.8
Gross capital formation (percent of GDP)	19.4	25.2	26.1	24.1	23.4	22.0	21.7
Private (percent of GDP)	16.3	21.0	22.3	20.3	19.7	17.9	18.4
HICP Inflation							
Period average	-1.2	4.2	2.3	0.0	0.7	0.2	0.2
End-period	2.4	3.9	1.6	-0.4	0.3	0.4	0.8
Labor market							
Unemployment rate (LFS; period average, percent) 1/	19.5	16.2	15.0	11.9	10.8	9.9	9.4
Real gross wages	-2.2	0.0	1.5	4.5	6.1	6.7	6.3
	(Percent of GDP, unless otherwise indicated)						
Consolidated general government 1/							
Total revenue	36.6	35.7	37.5	36.8	36.2	36.2	36.1
Total expenditure	43.1	38.8	37.4	37.4	37.9	38.0	37.3
Basic fiscal balance	-6.5	-3.1	0.1	-0.6	-1.7	-1.8	-1.2
ESA balance	-8.5	-3.4	-0.8	-0.9	-1.6	-1.3	-1.1
General government gross debt	40.3	37.6	36.9	35.9	38.5	34.8	35.0
Money and credit							
Credit to private sector (annual percentage change)	-8.4	-7.4	-11.4	-5.4	-7.0	-2.2	1.8
Broad money (annual percentage change)	9.8	1.5	4.5	2.0	36.6	8.0	8.9
Balance of payments							
Current account balance	2.3	-2.8	-3.3	-2.4	-2.0	-1.2	-1.9
Trade balance	-8.3	-12.1	-11.7	-11.2	-9.6	-8.7	-7.6
Gross external debt	168.1	146.2	138.7	134.0	142.2	137.7	128.1
Net external debt 2/	55.3	47.1	39.9	36.6	32.0	25.9	11.0
Exchange rates							
U.S. dollar per euro (period average)	1.33	1.39	1.29	1.33	1.33	1.11	...
REER (period average; CPI based, 2005=100)	121.6	124.0	120.1	120.1	121.8	...	...

Sources: Latvian authorities; Eurostat; and IMF staff estimates.

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.

2/ Gross external debt minus gross external debt assets.

Table 2. Republic of Latvia: Macroeconomic Framework, 2010–21

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
									Proj.			
	(Percentage change, unless otherwise indicated)											
National accounts												
Real GDP	-3.8	6.2	4.0	3.0	2.4	2.7	2.5	3.6	3.8	3.8	3.9	4.0
Consumption	0.1	3.0	2.5	4.3	2.9	3.3	3.1	3.1	3.3	3.4	3.6	3.7
Private consumption	2.8	3.0	3.2	5.1	2.3	3.3	3.1	3.1	3.4	3.5	3.6	3.7
Public consumption	-8.1	3.0	0.3	1.6	4.9	3.1	3.1	3.0	3.0	3.0	3.5	3.5
Gross capital formation	-18.9	48.7	-1.1	-4.3	-5.5	2.1	1.2	6.0	6.0	5.0	4.5	4.5
Gross fixed capital formation	-19.8	24.1	14.4	-6.0	0.5	2.7	1.0	5.9	6.0	5.0	4.5	4.5
Exports of goods and services	13.4	12.0	9.8	1.1	3.1	1.4	0.8	3.5	4.5	4.6	4.7	4.7
Imports of goods and services	12.4	22.0	5.4	-0.2	0.8	1.8	0.9	3.6	4.6	4.4	4.5	4.4
Contributions to growth												
Domestic demand	-4.5	7.1	5.3	1.9	2.4	3.2	2.7	3.8	4.0	3.9	3.9	3.9
Net exports	0.3	-5.7	2.1	0.8	1.4	-0.3	-0.1	-0.2	-0.2	0.0	0.0	0.1
HICP inflation												
Period average	-1.2	4.2	2.3	0.0	0.7	0.2	0.2	1.7	2.0	2.0	2.0	2.0
End-period	2.4	3.9	1.6	-0.4	0.3	0.4	0.8	2.1	2.0	2.0	2.0	2.0
Labor market												
Unemployment rate (LFS, percent)	19.5	16.2	15.0	11.9	10.8	9.9	9.4	9.1	8.9	8.6	8.2	7.9
Employment (period average, percent)	-6.4	1.3	1.6	2.1	-1.0	1.3	0.4	0.2	0.1	0.0	0.1	0.0
Real gross wages	-2.2	0.0	1.5	4.5	6.1	6.7	6.3	4.2	3.7	3.8	3.8	4.0
	(Percent of GDP)											
Consolidated general government 1/												
Total revenue	36.6	35.7	37.5	36.8	36.2	36.2	36.1	36.6	37.7	37.1	36.2	35.9
Total expenditure	43.1	38.8	37.4	37.4	37.9	38.0	37.3	37.8	37.8	37.5	36.6	36.3
ESA balance	-8.5	-3.4	-0.8	-0.9	-1.6	-1.3	-1.1	-1.2	-0.9	-0.7	-0.7	-0.7
ESA structural balance	-4.7	-1.8	-0.4	-0.7	-1.0	-1.1	-1.0	-1.2	-1.0	-0.7	-0.7	-0.7
General government gross debt	40.3	37.6	36.9	35.9	38.5	34.8	35.0	34.5	32.7	31.3	29.9	28.6
Saving and investment												
Gross national saving	21.8	22.3	22.8	21.7	21.5	20.8	19.8	21.2	21.4	21.7	21.8	21.8
Private	24.6	20.7	18.4	17.8	18.4	17.3	16.1	17.1	16.3	17.2	17.4	17.5
Public 2/	-2.8	1.6	4.4	3.9	3.1	3.5	3.6	4.1	5.1	4.5	4.5	4.3
Foreign saving 3/	-2.3	2.8	3.3	2.4	2.0	1.2	1.9	1.0	1.3	1.3	1.2	1.3
Gross capital formation	19.4	25.2	26.1	24.1	23.4	22.0	21.7	22.2	22.7	22.9	23.0	23.1
Private	16.3	21.0	22.3	20.3	19.7	17.9	18.4	18.7	19.2	19.8	20.0	20.2
Public	3.1	4.1	3.8	3.8	3.7	4.1	3.2	3.5	3.5	3.2	3.1	3.0
External sector												
Current account balance	2.3	-2.8	-3.3	-2.4	-2.0	-1.2	-1.9	-1.0	-1.3	-1.3	-1.2	-1.3
Net IIP	-82.3	-74.3	-68.0	-66.6	-62.1	-59.3	-57.7	-52.3	-46.5	-41.5	-36.8	-32.7
Gross external debt	168.1	146.2	138.7	134.0	142.2	137.7	128.1	124.7	122.2	119.3	116.4	112.5
Net external debt 4/	55.3	47.1	39.9	36.6	32.0	25.9	11.0	5.8	0.2	-5.2	-10.8	-16.1
Memorandum items:												
Nominal GDP (billions of euros)	17.9	20.2	21.8	22.8	23.6	24.4	25.1	26.4	28.0	29.6	31.4	33.3

Sources: Latvian authorities; and IMF staff estimates.

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.

2/ Includes bank restructuring costs.

3/ Current account deficit

4/ Gross external debt minus gross external debt assets.

Table 3. Republic of Latvia: General Government Operations, 2010–21[1/]

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
							Projections					
						(percent of GDP)						
Total revenue and grants	36.6	35.7	37.5	36.8	36.2	36.2	36.1	36.6	37.7	37.1	36.2	35.9
Tax revenue	27.0	27.3	28.0	28.2	28.3	28.7	29.0	29.0	29.2	29.4	29.4	29.4
Direct Taxes	16.5	16.4	16.7	16.9	16.6	16.7	16.9	17.0	17.2	17.3	17.2	17.3
Corporate Income Tax	0.9	1.4	1.6	1.6	1.5	1.6	1.5	1.5	1.4	1.5	1.5	1.5
Personal Income Tax	6.2	5.6	5.7	5.9	5.9	5.9	6.0	6.2	6.2	6.3	6.3	6.3
Social Security Contributions	8.7	8.6	8.6	8.7	8.4	8.4	8.4	8.5	8.6	8.5	8.5	8.5
Real Estate and Property Taxes	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.9
Indirect Taxes	10.6	10.9	11.3	11.3	11.7	12.0	12.1	12.0	12.0	12.1	12.1	12.1
VAT	6.6	6.7	7.3	7.3	7.6	7.8	7.8	7.9	8.0	8.1	8.1	8.1
Excises	3.6	3.4	3.2	3.2	3.2	3.3	3.3	3.2	3.2	3.2	3.2	3.2
Other indirect taxes	0.4	0.8	0.8	0.8	0.9	1.0	1.0	0.8	0.8	0.8	0.8	0.8
Non Tax, self-earned and other revenue	4.8	3.8	4.0	3.7	3.3	3.3	3.3	3.2	3.2	3.0	3.0	3.0
EU and miscellaneous funds	4.8	4.7	5.5	4.9	4.5	4.1	3.8	4.4	5.3	4.7	3.8	3.5
Total expenditure 2/	43.1	38.8	37.4	37.4	37.9	38.0	37.3	37.8	37.8	37.5	36.6	36.3
Current expenditure	40.0	34.7	33.6	33.6	34.2	33.9	34.1	34.2	34.4	34.4	33.6	33.4
Remuneration	8.6	7.9	7.5	7.7	7.9	8.2	8.4	8.3	8.0	8.0	8.0	8.0
Wages and Salaries	6.7	6.2	5.9	6.0	6.1	6.3	6.4	6.4	6.2	6.2	6.2	6.2
Goods and Services	5.5	5.1	4.8	4.9	4.8	4.9	5.0	5.3	5.4	5.4	5.4	5.4
Subsidies and Transfers	23.3	19.2	18.6	18.3	18.8	18.1	18.5	18.5	18.8	18.8	18.0	17.9
Subsidies to companies and institutions	9.4	7.8	7.9	7.5	8.2	7.4	7.6	7.8	8.0	8.0	7.3	7.3
Social Support	13.9	11.3	10.5	10.5	10.4	10.6	10.7	10.5	10.6	10.7	10.6	10.5
Pensions	9.9	8.5	8.1	8.0	7.7	7.5	7.4	7.2	7.0	7.0	6.8	6.7
Other	3.9	2.8	2.4	2.6	2.7	3.1	3.4	3.4	3.6	3.8	3.8	3.7
International cooperation	0.1	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	1.0	0.9	1.0	1.2	1.2	1.0	1.1	1.1	1.1	1.1	1.1	1.1
Interest	1.4	1.4	1.5	1.4	1.5	1.8	1.2	1.1	1.1	1.0	1.0	0.9
Capital expenditure	3.1	4.1	3.8	3.8	3.7	4.1	3.2	3.5	3.5	3.2	3.1	3.0
Fiscal balance	-7.4	-3.2	0.1	-1.2	-1.7	-1.8	-1.2	-1.1	-0.1	-0.4	-0.4	-0.4
Financing (net)	7.2	3.2	-0.1	1.2	1.7	1.8	1.2	1.1	0.1	0.4	0.4	0.4
Domestic financing	1.2	0.6	-2.7	1.2	-0.8	4.5	-3.7	1.0	-0.8	-1.8	1.2	0.4
External financing	6.0	2.0	2.6	0.0	2.5	-2.7	4.9	0.1	0.9	2.2	-0.8	0.0
Errors and omissions	0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items												
ESA balance	-8.5	-3.4	-0.8	-0.9	-1.6	-1.3	-1.1	-1.2	-0.9	-0.7	-0.7	-0.7
ESA structural balance 3/	-4.7	-1.8	-0.4	-0.7	-1.0	-1.1	-1.0	-1.2	-1.0	-0.7	-0.7	-0.7
General government debt	40.3	37.6	36.9	35.9	38.5	34.8	35.0	34.5	32.7	31.3	29.9	28.6
Nominal GDP (billions of euros)	17.9	20.2	21.8	22.8	23.6	24.4	25.1	26.4	28.0	29.6	31.4	33.3

Sources: Latvian authorities; and IMF staff estimates.

1/ Fiscal accounts are on a cash basis as provided by the authorities

2/ Total expenditure excludes net acquisition of financial assets and other bank restructuring costs.

3/ Excludes one-off and unsustainable measures.

Table 4. Republic of Latvia: Medium-Term Balance of Payments, 2010–21

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
									Projections			
	(Percent of GDP, unless otherwise indicated)											
Current account	2.3	-2.8	-3.3	-2.4	-2.0	-1.2	-1.9	-1.0	-1.3	-1.3	-1.2	-1.3
Goods and services (fob)	-1.0	-4.8	-4.3	-3.4	-2.2	-1.4	-1.3	-1.6	-1.7	-1.6	-1.5	-1.3
Goods (fob)	-8.3	-12.1	-11.7	-11.2	-9.6	-8.7	-7.6	-7.8	-8.0	-8.0	-7.9	-7.7
Exports	37.1	41.0	44.2	43.1	43.2	42.2	42.3	42.3	42.5	42.8	42.9	43.1
Imports	-45.5	-53.1	-56.0	-54.3	-52.8	-50.8	-49.9	-50.2	-50.5	-50.7	-50.8	-50.8
Services	7.3	7.3	7.4	7.8	7.4	7.2	6.3	6.3	6.3	6.3	6.4	6.4
Credit	17.0	17.1	17.3	17.1	16.3	16.6	15.5	15.5	15.6	15.6	15.7	15.8
Debit	-9.8	-9.8	-9.8	-9.3	-8.9	-9.3	-9.2	-9.2	-9.3	-9.3	-9.3	-9.3
Primary Income	1.1	0.0	-0.6	-0.3	-0.2	-0.3	-1.3	-0.3	-0.5	-0.6	-0.7	-0.9
Compensation of employees	2.4	2.3	2.4	2.3	2.8	2.6	2.5	2.4	2.4	2.4	2.4	2.4
Investment income	-2.7	-3.5	-4.3	-3.8	-3.7	-3.7	-3.5	-3.5	-3.7	-3.6	-3.7	-3.9
Secondary Income	2.3	1.9	1.6	1.3	0.4	0.5	0.7	0.8	0.9	0.9	1.0	0.9
Capital and financial account	-4.2	2.5	2.3	1.5	-0.2	3.4	2.0	1.2	1.5	1.5	1.4	1.5
Capital account	2.0	2.1	3.0	2.5	3.2	2.8	4.5	3.7	4.5	3.9	3.7	3.5
Financial account	-6.1	0.4	-0.7	-1.0	-3.4	0.6	-2.5	-2.5	-3.0	-2.4	-2.3	-2.0
Direct investment	1.5	4.9	3.3	1.6	1.0	2.3	2.6	2.9	3.3	3.7	4.2	4.7
Portfolio investment and financial derivatives	-2.9	-1.8	4.8	0.1	-0.2	-9.2	-2.4	-7.0	-5.5	-3.8	-5.3	-6.2
of which: general government net issuance	-0.1	1.2	7.4	-0.3	6.9	-0.7	5.2	0.4	1.8	3.0	1.1	0.0
Other investment	-0.8	-7.2	-5.1	-1.0	-4.6	8.8	-2.7	1.7	-0.7	-2.4	-1.2	-0.5
Reserve assets	-4.0	4.5	-3.6	-1.7	0.5	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.8	0.3	1.0	0.8	2.2	-2.2	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
	(Percent change, unless otherwise indicated)											
Goods and Services												
Export value (fob)	18.9	21.3	13.9	2.2	2.3	2.1	1.4	5.2	6.4	6.4	6.4	6.5
Import value (fob)	19.8	28.7	12.7	0.9	0.6	0.8	1.2	5.7	6.6	6.3	6.1	6.1
Export volume	13.4	12.0	9.8	1.1	3.1	1.4	0.8	3.5	4.5	4.6	4.7	4.7
Import volume	12.4	22.0	5.4	-0.2	0.8	1.8	0.9	3.6	4.6	4.4	4.5	4.4
Gross reserves (billions of euros)	5.8	4.9	5.7	5.8	2.7	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Gross external debt (percent of GDP)	168.1	146.2	138.7	134.0	142.2	137.7	128.1	124.7	122.2	119.3	116.4	112.5
Medium and long term (percent of GDP)	114.5	100.7	88.2	78.9	77.6	70.6	74.4	71.4	70.4	69.0	67.6	66.7
Short term (percent of GDP)[1]	53.5	45.5	50.5	55.1	63.9	65.6	67.0	66.9	66.3	65.6	64.7	61.0
Net external debt (percent of GDP)[2]	55.3	47.1	39.9	36.6	32.0	25.9	11.0	5.8	0.2	-5.2	-10.8	-16.1
Memo items												
Nominal GDP (billions of euros)	17.9	20.2	21.8	22.8	23.6	24.4	25.1	26.4	28.0	29.6	31.4	33.3
U.S. dollar per euro (period average)	1.33	1.39	1.29	1.33	1.33	1.11	...	...	...	...	...	...

Sources: Latvian authorities; and IMF staff estimates.

[1] Based on detailed data until 2013. Extrapolated for debt outside the public sectors and MFIs starting 2014.

[2] Gross external debt minus gross external debt assets.

Table 5. Republic of Latvia: Financial Soundness Indicators, 2006–15

(in percent, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Commercial banks										
Capital Adequacy										
Regulatory capital to risk-weighted assets	10.2	11.1	11.80	14.6	14.6	17.4	17.60	18.9	21.0	22.7
Regulatory Tier I capital to risk-weighted assets 1/	8.8	9.8	10.50	11.5	11.5	14.2	15.20	17.3	18.3	19.7
Capital and reserves to assets	7.6	7.9	7.30	7.4	7.3	7.5	9.36	9.9	9.9	10.4
Asset Quality										
Annual growth of bank loans	56.2	37.2	11.2	-7.0	-7.1	-8.1	-10.9	-6.5	-6.1	0.1
Annual growth of bank loans to residents	47.1	30.3	15.8	67.2	-8.7	-8.3	-10.5	-6.2	-7.6	-1.5
Annual growth of bank loans to companies	52.5	36.3	16.9	-6.5	-8.0	-7.6	-9.0	-5.6	-9.6	-1.6
Sectoral distribution of loans (in % of total loans, stock)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture, hunting and related service activities	1.8	1.6	1.7	1.6	1.6	2.0	2.4	3.2	2.8	2.8
Construction and real estate activities	18.9	18.8	19.6	20.8	20.4	20.0	18.6	18.1	17.9	17.3
Industry and trade	22.0	21.6	23.1	22.3	22.0	22.0	24.3	24.2	22.7	23.3
Financial intermediation	8.0	6.0	6.0	4.5	3.2	2.8	2.7	3.6	4.7	5.1
Households	39.4	40.0	38.4	39.3	39.8	40.0	39.1	38.4	37.8	36.2
Non-residents	9.9	12.1	11.2	11.4	13.1	13.2	12.9	12.6	14.0	15.4
Loans past due over 90 days	0.5	0.8	3.6	16.4	19.0	17.5	11.1	8.3	6.9	6.4
Loans to households			4.7	16.8	18.4	19.3	15.2	12.0	9.5	7.6
Loans to corporations			2.8	18.5	20.8	16.2	9.7	7.0	5.9	4.4
Earnings and Profitability										
ROA (after tax)	2.1	2.0	0.3	-3.5	-1.6	-0.9	0.6	0.9	1.1	1.3
ROE (after tax)	25.6	24.3	4.6	-41.6	-20.4	-11.2	5.6	8.7	11.1	12.5
Liquidity										
Liquid assets to total assets	23.9	25.0	21.6	21.1	27.3	27.4	32.3	36.5	39.9	40.2
Liquid assets to short term liabilities	51.1	55.7	52.8	62.8	67.9	63.9	59.8	64.4	63.1	66.7
Customers deposits to (non-interbank) loans	71.3	68.2	58.8	61.9	77.5	84.1	106.3	124.9	151.3	158.5
Sensitivity to Market Risk										
FX deposits to total deposits 2/		70.7	69.4	74.5	72.6	73.5	76.2	75.9	40.3	43.1
FX loans to total loans 2/		81.8	85.0	87.1	88.9	86.3	84.5	88.5	13.0	13.8
Memorandum Items										
Share of non-resident deposits to total deposits	39.6	41.7	44.0	38.0	41.6	47.2	48.9	47.3	51.7	53.4

Source: CSB, BoL, FCMC, Latvian Leasing Association, staff calculations

1/ Regulatory Tier 1 capital to risk weighted assets as from Dec 2009 is calculated as Tier 1 capital (including deduction)/risk-weighted assets

2/ Euro-denominated positions are included in and before 2013, but not in 2014.

3/ Banks dealing with residents (non-residents) are defined as banks in which non-resident non-MFI deposits are below (above) 20 percent of their assets.

Table 6. Republic of Latvia: Indicators of Fund Credits, 2009–17
(Millions of SDRs)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Stock, existing	713.8	982.2	982.2	0.0	0.0	0.0	0.0	0.0	0.0
Obligations, existing	11.2	21.8	26.9	1003.0	1.6	0.0	0.0	0.0	0.0
Repurchase	0.0	0.0	0.0	982.2	0.0	0.0	0.0	0.0	0.0
Charges	11.2	21.8	26.9	20.8	1.6	0.0	0.0	0.0	0.0
Stock of existing Fund credit									
In percent of quota	502.3	691.2	691.2	0.0	0.0	0.0	0.0	0.0	0.0
In percent of GDP	4.2	6.3	5.5	0.0	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and ser	9.7	11.6	9.5	0.0	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	16.1	19.7	23.3	0.0	0.0	0.0	0.0	0.0	0.0
Obligations to the Fund from existing Fund drawings									
In percent of quota	7.8	15.3	18.9	705.9	1.1	0.0	0.0	0.0	0.0
In percent of GDP	0.1	0.1	0.2	5.5	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and ser	0.2	0.3	0.3	8.9	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	0.3	0.4	0.6	20.7	0.0	0.0	0.0	0.0	0.0

Source: IMF staff estimates.

Annex I. Public Debt Sustainability Analysis (DSA)

Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

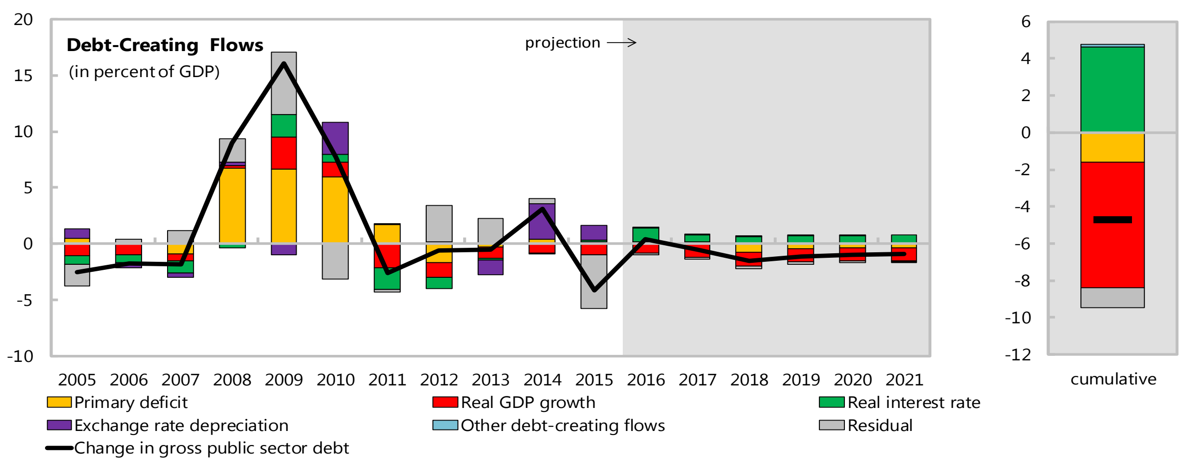
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	24.4	38.6	34.5	34.9	34.4	32.8	31.7	30.7	29.8
Public gross financing needs	4.2	3.7	11.0	4.8	6.8	4.2	5.6	6.4	3.1
Real GDP growth (in percent)	2.7	2.4	2.7	2.5	3.6	3.8	3.8	3.9	4.0
Inflation (GDP deflator, in percent)	6.2	1.2	0.6	0.5	1.5	1.9	1.9	2.0	2.0
Nominal GDP growth (in percent)	9.6	3.6	3.4	3.0	5.2	5.8	5.9	6.0	6.1
Effective interest rate (in percent) [4/]	5.1	4.3	4.8	4.1	3.5	4.0	4.2	4.4	4.8

As of March 10, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		0
5Y CDS (bp)		80
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A-	A-
Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.5	3.1	-4.1	0.4	-0.6	-1.5	-1.1	-1.0	-0.9	-4.7	
Identified debt-creating flows	1.5	2.6	0.6	0.6	-0.4	-1.4	-0.9	-0.8	-0.8	-3.7	
Primary deficit	2.1	0.4	0.2	0.2	0.2	-0.8	-0.4	-0.4	-0.4	-1.6	-0.4
Primary (noninterest) revenue and gra	35.2	36.0	36.0	35.9	36.4	37.6	37.0	36.0	35.8	218.8	
Primary (noninterest) expenditure	37.3	36.4	36.2	36.1	36.6	36.8	36.5	35.7	35.4	217.1	
Automatic debt dynamics [5/]	-0.6	2.3	0.4	0.4	-0.6	-0.6	-0.5	-0.5	-0.4	-2.2	
Interest rate/growth differential [6/]	-0.7	-0.9	-0.9	0.4	-0.6	-0.6	-0.5	-0.5	-0.4	-2.2	
Of which: real interest rate	-0.4	-0.1	0.1	1.2	0.6	0.6	0.7	0.7	0.8	4.6	
Of which: real GDP growth	-0.3	-0.8	-1.0	-0.8	-1.2	-1.2	-1.2	-1.2	-1.2	-6.8	
Exchange rate depreciation [7/]	0.1	3.2	1.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.1	
Privatization/Drawdown of Deposits (	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.1	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.0	0.4	-4.7	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1	-1.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

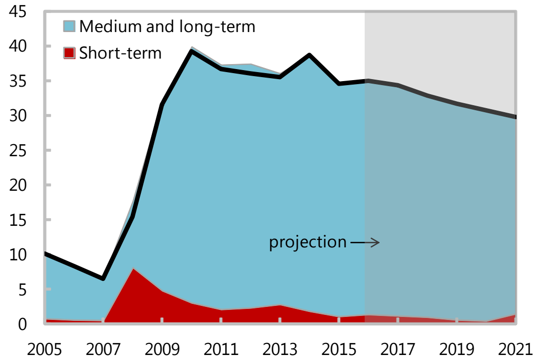
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

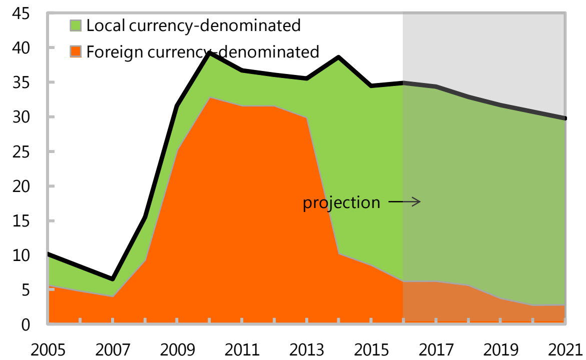
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

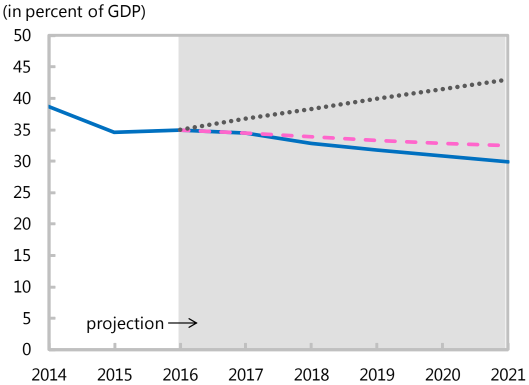


Alternative Scenarios

Baseline Historical Constant Primary Balance

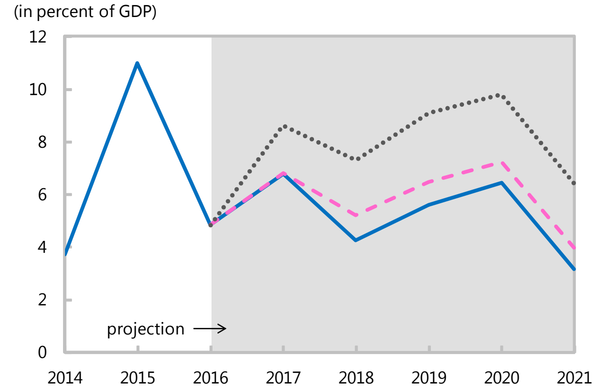
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.5	3.6	3.8	3.8	3.9	4.0
Inflation	0.5	1.5	1.9	1.9	2.0	2.0
Primary Balance	-0.2	-0.2	0.8	0.4	0.4	0.4
Effective interest rate	4.1	3.5	4.0	4.2	4.4	4.8
Constant Primary Balance Scenario						
Real GDP growth	2.5	3.6	3.8	3.8	3.9	4.0
Inflation	0.5	1.5	1.9	1.9	2.0	2.0
Primary Balance	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Effective interest rate	4.1	3.5	4.0	4.2	4.3	4.8

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.5	1.8	1.8	1.8	1.8	1.8
Inflation	0.5	1.5	1.9	1.9	2.0	2.0
Primary Balance	-0.2	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	4.1	3.5	3.6	3.5	3.4	3.5

Source: IMF staff.

Debt Sustainability Framework, 2011–21
(in percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2011	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
1 Baseline: External debt	146.2	138.7	134.0	142.2	137.7			128.1	124.7	122.2	119.3	116.4	112.5	-9.7
2 Change in external debt	-21.8	-7.5	-4.7	8.2	-4.5			-9.6	-3.4	-2.5	-2.9	-2.9	-3.9	
3 Identified external debt-creating flows (4+8+9)	-22.6	-5.8	-6.6	-3.4	2.4			-3.8	-6.1	-6.3	-6.7	-7.2	-7.7	
4 Current account deficit, excluding interest payments	-2.4	-1.0	-0.8	-1.1	-1.3			0.4	-0.5	-0.2	-0.2	-0.2	0.0	
5 Deficit in balance of goods and services	4.8	4.3	3.4	2.2	1.4			1.3	1.6	1.7	1.6	1.5	1.3	
6 Exports	58.1	61.5	60.2	59.5	58.8			57.8	57.8	58.1	58.4	58.6	58.9	
7 Imports	62.9	65.8	63.6	61.8	60.2			59.1	59.4	59.8	60.0	60.1	60.2	
8 Net non-debt creating capital inflows (negative)	-3.8	-2.2	-1.9	-0.7	-2.4			-2.4	-2.7	-3.1	-3.5	-4.0	-4.5	
9 Automatic debt dynamics 1/	-16.4	-2.5	-3.8	-1.6	6.2			-1.8	-2.9	-3.0	-3.0	-3.0	-3.1	
10 Contribution from nominal interest rate	5.2	4.3	3.2	3.1	2.5			1.5	1.5	1.5	1.4	1.4	1.3	
11 Contribution from real GDP growth	-8.7	-5.9	-3.9	-3.0	-4.5			-3.3	-4.4	-4.5	-4.4	-4.3	-4.4	
12 Contribution from price and exchange rate changes 2/	-12.9	-0.9	-3.2	-1.6	8.2			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	0.8	-1.7	1.9	11.6	-7.0			-5.8	2.7	3.8	3.8	4.2	3.7	
External debt-to-exports ratio (in percent)	251.5	225.6	222.5	239.0	234.3			221.5	215.8	210.3	204.3	198.5	191.1	
Gross external financing need (in billions of US dollars) 4/	20.4	20.0	22.2	22.4	23.0			20.0	21.4	21.5	22.3	23.6	24.6	
in percent of GDP	71.9	71.3	73.3	71.5	85.1	10-Year	10-Year	71.8	72.5	68.7	66.8	66.4	65.3	
Scenario with key variables at their historical averages 5/								128.1	126.0	124.6	123.3	122.5	120.2	-10.7
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	6.2	4.0	3.0	2.4	2.7	3.8	9.2	2.5	3.6	3.8	3.8	3.9	4.0	
GDP deflator in US dollars (change in percent)	12.5	-5.1	4.6	1.3	-16.0	6.7	13.3	0.6	2.3	2.1	2.4	2.7	1.8	
Nominal external interest rate (in percent)	3.7	2.9	2.5	2.4	1.5	3.7	2.3	1.1	1.3	1.3	1.3	1.2	1.2	
Growth of exports (US dollar terms, in percent)	28.2	4.4	5.6	2.4	-14.8	16.4	18.5	1.5	6.0	6.6	6.9	7.1	6.3	
Growth of imports (US dollar terms, in percent)	36.1	3.3	4.2	0.6	-15.9	52.6	111.6	1.3	6.5	6.8	6.8	6.8	6.0	
Current account balance, excluding interest payments	2.4	1.0	0.8	1.1	1.3	-3.7	9.2	-0.4	0.5	0.2	0.2	0.2	0.0	
Net non-debt creating capital inflows	3.8	2.2	1.9	0.7	2.4	2.8	1.6	2.4	2.7	3.1	3.5	4.0	4.5	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

External Debt Sustainability Framework, 2011–21

(in percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2011	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
1 Baseline: External debt	146.2	138.7	134.0	142.2	137.7			128.1	124.7	122.2	119.3	116.4	112.5	-9.7
2 Change in external debt	-21.8	-7.5	-4.7	8.2	-4.5			-9.6	-3.4	-2.5	-2.9	-2.9	-3.9	
3 Identified external debt-creating flows (4+8+9)	-22.6	-5.8	-6.6	-3.4	2.4			-3.8	-6.1	-6.3	-6.7	-7.2	-7.7	
4 Current account deficit, excluding interest payments	-2.4	-1.0	-0.8	-1.1	-1.3			0.4	-0.5	-0.2	-0.2	-0.2	0.0	
5 Deficit in balance of goods and services	4.8	4.3	3.4	2.2	1.4			1.3	1.6	1.7	1.6	1.5	1.3	
6 Exports	58.1	61.5	60.2	59.5	58.8			57.8	57.8	58.1	58.4	58.6	58.9	
7 Imports	62.9	65.8	63.6	61.8	60.2			59.1	59.4	59.8	60.0	60.1	60.2	
8 Net non-debt creating capital inflows (negative)	-3.8	-2.2	-1.9	-0.7	-2.4			-2.4	-2.7	-3.1	-3.5	-4.0	-4.5	
9 Automatic debt dynamics 1/	-16.4	-2.5	-3.8	-1.6	6.2			-1.8	-2.9	-3.0	-3.0	-3.0	-3.1	
10 Contribution from nominal interest rate	5.2	4.3	3.2	3.1	2.5			1.5	1.5	1.5	1.4	1.4	1.3	
11 Contribution from real GDP growth	-8.7	-5.9	-3.9	-3.0	-4.5			-3.3	-4.4	-4.5	-4.4	-4.3	-4.4	
12 Contribution from price and exchange rate changes 2/	-12.9	-0.9	-3.2	-1.6	8.2			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	0.8	-1.7	1.9	11.6	-7.0			-5.8	2.7	3.8	3.8	4.2	3.7	
External debt-to-exports ratio (in percent)	251.5	225.6	222.5	239.0	234.3			221.5	215.8	210.3	204.3	198.5	191.1	
Gross external financing need (in billions of US dollars) 4/	20.4	20.0	22.2	22.4	23.0			20.0	21.4	21.5	22.3	23.6	24.6	
in percent of GDP	71.9	71.3	73.3	71.5	85.1			71.8	72.5	68.7	66.8	66.4	65.3	
Scenario with key variables at their historical averages 5/								128.1	126.0	124.6	123.3	122.5	120.2	-10.7
Key Macroeconomic Assumptions Underlying Baseline						10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	6.2	4.0	3.0	2.4	2.7	3.8	9.2	2.5	3.6	3.8	3.8	3.9	4.0	
GDP deflator in US dollars (change in percent)	12.5	-5.1	4.6	1.3	-16.0	6.7	13.3	0.6	2.3	2.1	2.4	2.7	1.8	
Nominal external interest rate (in percent)	3.7	2.9	2.5	2.4	1.5	3.7	2.3	1.1	1.3	1.3	1.3	1.2	1.2	
Growth of exports (US dollar terms, in percent)	28.2	4.4	5.6	2.4	-14.8	16.4	18.5	1.5	6.0	6.6	6.9	7.1	6.3	
Growth of imports (US dollar terms, in percent)	36.1	3.3	4.2	0.6	-15.9	52.6	111.6	1.3	6.5	6.8	6.8	6.8	6.0	
Current account balance, excluding interest payments	2.4	1.0	0.8	1.1	1.3	-3.7	9.2	-0.4	0.5	0.2	0.2	0.2	0.0	
Net non-debt creating capital inflows	3.8	2.2	1.9	0.7	2.4	2.8	1.6	2.4	2.7	3.1	3.5	4.0	4.5	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

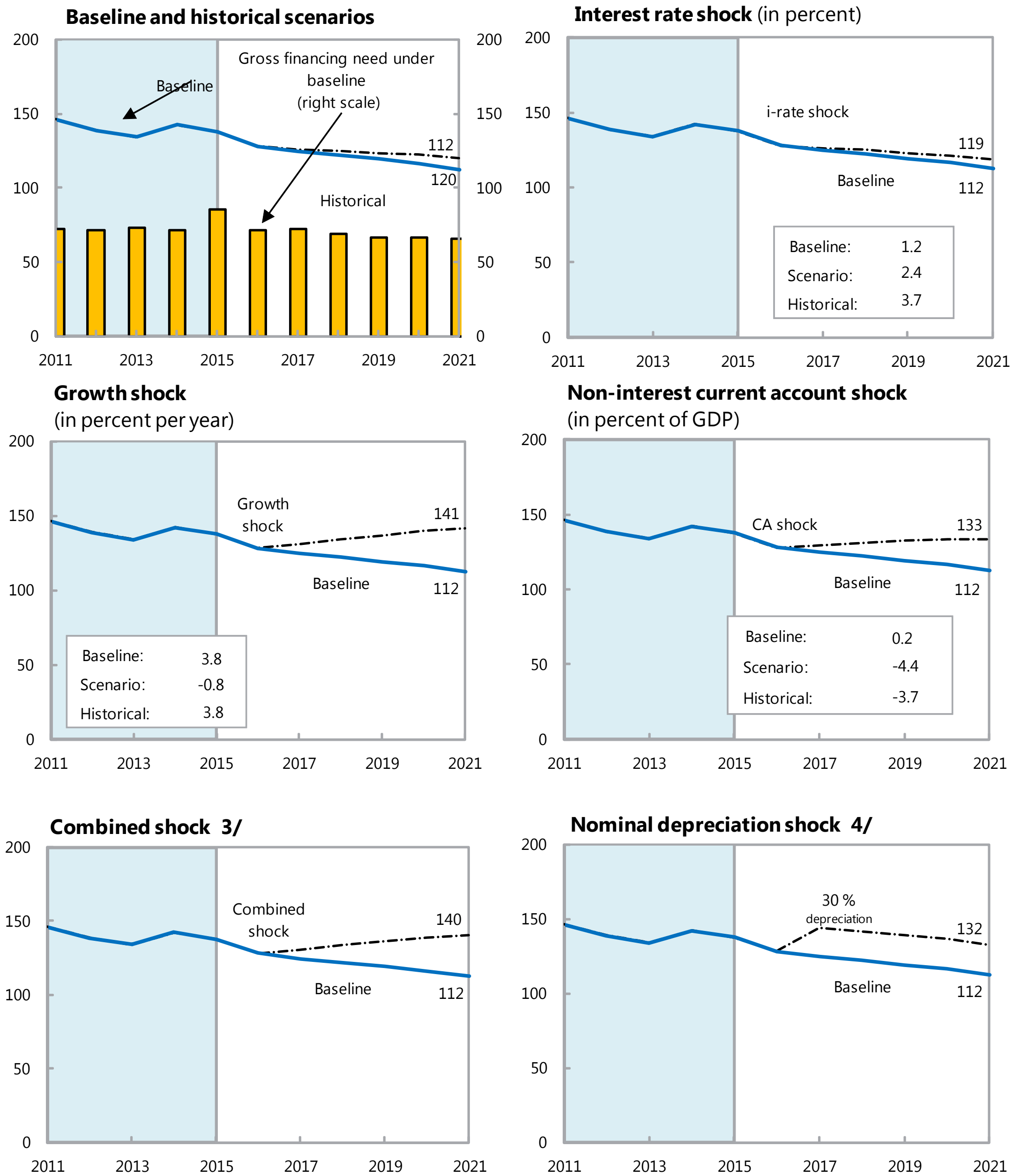
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

External Debt Sustainability: Bound Tests 1/ 2/

(External debt percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time nominal depreciation of 30 percent occurs in 2016.

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 17, 2016

Prepared By

European Department

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FUND RELATIONS

(As of February 29, 2016)

Membership Status: Joined May 19, 1992; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	332.30	100.00
Fund holdings of currency (Exchange Rate)	332.26	99.99
Reserve Tranche Position	0.06	0.02

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	120.82	100.00
Holdings	120.82	100.00

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Dec 23, 2008	Dec 22, 2011	1,521.63	982.24
Stand-By	Apr 20, 2001	Dec 19, 2002	33.00	0.00
Stand-By	Dec 10, 1999	Apr 09, 2001	33.00	0.00

Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2016	**2017**	**2018**	**2019**	**2020**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Exchange Rate Arrangement:

As of January 1, 2014, the currency of Latvia is the euro, which floats freely and independently against other currencies. Prior to 2014, the currency of Latvia was the lat, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ±1 percent band. On January 1, 2005, the lat was re-pegged to the euro at the rate 1 euro = 0.702804 lats, and on April 29, 2005, Latvia entered ERM II, maintaining the previous band width. Latvia maintains an exchange system free of restrictions on the payments or transfers for current international transactions. Exchange restrictions maintained for security reasons have been notified to the Fund for approval most recently in January 2013 (see EBD/13/3, January 28, 2013).

Previous Article IV Consultation:

Latvia is on the 12-month consultation cycle. The last Article IV consultation was concluded on May 4, 2015 (IMF Country Report No. 15/110). The Executive Board assessment is available at http://www.imf.org/external/pubs/ft/scr/2015/cr15110.pdf.

Safeguards Assessment:

The safeguards assessment completed on July 8, 2009 concluded that the Bank of Latvia (BoL) operates robust internal audit and control systems. The assessment recommended clarifying the respective roles of the BoL and the Treasury in holding, managing, and reporting to the Fund audited international reserves data. It also recommended amendments to the mandate of the BoL's audit committee and improvements to the financial statements' disclosures. The authorities have already taken steps to implement these recommendations, notably by establishing a formal arrangement between the BoL and the Treasury, revising the audit committee charter and expanding the existing accounting framework.

FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) during February 14–28, 2001. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (Country Report No. 02/10). An AML/CFT assessment mission took place during March 8–24, 2006, and the report was sent to the Board on May 23, 2007. A joint IMF-World Bank mission conducted an FSAP Update during February 27–March 9, 2007. A World Bank mission conducted an FSAP development module during November 8–18, 2011. Moneyval conducted a follow-up assessment during May 9–13, 2011, and the mutual evaluation report was adopted on July 5, 2012.

ROSC Modules

Standard/Code assessed	Issue date
Code of Good Practices on Fiscal Transparency	March 29, 2001
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002
Basel Core Principles for Effective Banking Supervision	January 2, 2002
CPSS Core Principles for Systemically Important Payment Systems	January 2, 2002
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002
IAIS Core Principles	January 2, 2002
OECD Corporate Governance Principles	January 2, 2002
Data Module	June 23, 2004

Republic of Latvia: Technical Assistance (2007–12):				
Dept.	**Project**	**Action**	**Timing**	**Counterpart**
FAD	Expenditure Policy	Mission	June 2007	Ministry of Finance
FAD	Tax Policy	Mission	March 2008	Ministry of Finance
FAD	Revenue Administration	Mission	January 2009	Ministry of Finance
MCM	Bank Resolution	Mission	January 2009	FCMC, Bank of Latvia
FAD	Public Financial Management	Mission	March 2009	Ministry of Finance
MCM/ LEG	Debt Restructuring	Mission	March 2009	Ministry of Finance, FCMC
LEG	Legal Aspects of P&A Transactions	Mission	Feb-March 2009	FCMC
MCM	Bank Intervention Procedures and P&A	Mission	March 2009	FCMC
FAD	Public Financial Management	Mission	April-May 2009	Ministry of Finance
FAD	Revenue Administration	Mission	July 2009	Ministry of Finance
FAD	Public Financial Management	Resident Advisor	July 2009- June 2010	Ministry of Finance
FAD	Cash Management	Mission	July-August 2009	Ministry of Finance
MCM	Mortgage and Land Bank	Mission	Sept. 2009	Ministry of Finance
MCM	Deposit Insurance	Mission	Sept. 2009	FCMC
MCM	Liquidity Management	Mission	November 2009	Bank of Latvia
LEG	Bank Resolution Legal Framework	Mission	January 2010	FCMC
FAD	Tax Policy	Mission	February 2010	Ministry of Finance
LEG	Bank Resolution Legal Framework	Mission	February 2010	FCMC
LEG	Corporate and Personal Insolvency Law	Mission	March 2010	Ministry of Justice
FAD	Public Financial Management	Mission	April 2010	Ministry of Finance
LEG	Corporate and Personal Insolvency Law	Mission	April 2010	Ministry of Justice
MCM	Stress Testing	Mission	June 2010	Bank of Latvia
FAD	Expenditure Policy	Mission	August 2010	Ministry of Finance
FAD	Revenue Administration	Mission	Sept. 2010	Ministry of Finance
LEG	Legal Framework for Foreclosure Procedures	Missions	November 2010	Ministry of Justice
FAD	Public Financial Management	Mission	Feb-March 2011	Ministry of Finance
FAD	Tax Administration	Mission	June 2011	Ministry of Finance
MCM	Bank Resolution	Mission	July 2012	FCMC
FAD	Expenditure Rationalization	Mission	October 2012	Ministry of Finance

Resident Representative Post: Mr. David Moore was appointed Resident Representative from June 11, 2009 to June 11, 2013.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund for surveillance purposes is classified as adequate (A). Latvia is a subscriber of the SDDS (Special Data Dissemination Standard) and a link to Latvia's metadata is available at the IMF's website for the DSBB (Dissemination Standards Bulletin Board).

National Accounts: The CSB compiles and publishes quarterly national accounts with the production and expenditure approaches on a regular and timely basis. Since September 2011, national accounts are calculated with the NACE rev. 2 classifications, determined by the European Commission. However, there are discrepancies between the GDP estimates based on production and those based on expenditure. The statistical discrepancy is included in changes in inventories on the expenditure side.

The underlying data for the production approach are obtained primarily through a survey of businesses and individuals, and are supplemented by data from labor force surveys and administrative sources. The CSB believes that the basic data understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.

Government finance statistics: Fund staff is provided quarterly with monthly information on revenues and expenditures of the central and local governments and special budgets. With some limitations, the available information permits the compilation of consolidated accounts of the general government. The Government Finance Statistics database in the IMF's eLibrary website contains cash data in the GFSM 2001 format. Quarterly general government data on an accrual basis are provided through Eurostat for the International Financial Statistics on a timely basis.

Monetary statistics: Monetary statistics could provide more detail in the liabilities of depository corporations by subsectors of the general government in line with international standards.

Balance of payments: The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000. The data collection program is a mixed system, with surveys supplemented by monthly information from the international transactions reporting system (ITRS), and administrative sources. Contrary to international standards—but similar to a number of other EU countries—the BoL includes provisions for expected losses of foreign-owned banks. Between Q4 2008–Q2 2010, this treatment led to the recording of negative reinvested earnings (i.e., losses) of foreign-owned banks as negative outflows. These "inflows" in the income account of the balance of payments thus gave a positive contribution to the current account.

Data Standards and Quality: Latvia is a participant in the IMF's Special Data Dissemination Standard since November 1, 1996. A Data ROSC was published in June 2004.

Reporting to STA: The authorities are reporting data for the Fund's International Financial Statistics, Government Finance Statistics Yearbook, the Direction of Trade Statistics, and the Balance of Payments Statistics Yearbook.

Republic of Latvia: Table of Common Indicators Required for Surveillance

As of May 17, 2016

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological Soundness[8]	Data Quality – Accuracy and Reliability[9]
Exchange Rates	03/31/2016	04/29/2016	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/21/2016	04/25/2016	M	M	M		
Reserve/Base Money	03/31/2016	04/28/2016	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	03/31/2016	04/28/2016	M	M	M		
Central Bank Balance Sheet	03/31/2016	04/28/2016	M	M	M		
Consolidated Balance Sheet of the Banking System	03/31/2016	04/28/2016	M	M	M		
Interest Rates[2]	04/28/2016	04/28/2016	M	M	M		
Consumer Price Index	04/30/2016	05/8/2016	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	12/31/2015	04/24/2016	M	Q	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	12/31/2015	04/24/2016	M	Q	M		

Republic of Latvia: Table of Common Indicators Required for Surveillance (concluded)

As of May 17, 2016

Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/31/2015	04/24/2016	M	Q	M		
External Current Account Balance	2/29/2016	3/13/2016	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	2/29/2016	3/13/2016	M	M	M		
GDP/GNP	Q4 2015	04/4/2016	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q4 2015	04/4/2016	Q	Q	Q		
International Investment Position[6]	Q4 2015	04/4/2016	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

[2] Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability position vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC published in July 2004, the findings of the mission that took place during September 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
June 10, 2016

1. **This statement provides information that has become available since the Staff Report was circulated to the Executive Board on May 18, 2016**. The information does not alter the thrust of the staff appraisal.

2. **Q1 GDP data confirm the economy is slowing, broadly in line with staff estimates.** 2016Q1 GDP growth in Latvia came in at 2.1 percent year on year, stronger than the flash estimate of 1.8, and broadly in line with staff estimates. While representing a deceleration from the 2.7 percent year on year growth in the last quarter of 2015, on a quarter on quarter seasonally adjusted basis GDP increased by 0.1 percent in 2016Q1 after decreasing by 0.4 percent in 2015Q4. Annual GDP growth remained driven by private consumption growth of 3.7 percent, with government consumption rising 2.2 percent. The slowdown primarily reflects a 16.4 percent decline in gross fixed capital formation. Imports rose 4.6 percent, supported by higher consumption, while exports fell by 2.9 percent due to weakness in key trade partners.

3. **Amendments to the Credit Institutions Law were passed by Parliament.** The amendments, passed on June 2, strengthen the AML/CFT framework, providing for bigger fines in the event of breaches of anti-money laundering or combatting terrorist financing requirements.

4. **Prime Minister Kučinskis signed the Agreement on Accession of Latvia to the Organisation for Economic Cooperation and Development (OECD) on June 2.** Following ratification of the agreement by Parliament, which is expected in mid-June, Latvia will become the 35th member of the organization.

Statement by Thomas Ostros, Executive Director for Republic of Latvia and Agnija Jekabsone, Advisor to Executive Director June 10, 2016

On behalf of the Latvian authorities I would like to thank staff for the candid and productive discussions during the Article IV mission in Riga. The authorities highly value staff's contributions. The external expertise provided by the Fund always plays a significant role in Latvian policy discussions. The report and the accompanying Selected Issues papers appropriately reflect the current state of the Latvian economy highlighting key growth bottlenecks of the economy. The authorities agree with the thrust of staff appraisal, but would also like to offer some comments on issues raised in the report.

Outlook

Despite the difficulties, the Latvian economy is making headway, and doing it in a balanced manner. Against the backdrop of continuing geopolitical tensions and sluggish growth outlook in the EU, the 2.7 percent GDP growth rate posted in 2015 can be considered good news. In particular, since this growth rate was achieved with the current account balance in line with fundamentals, and public and private debt dynamics causing no concern.

Growth slowdown in last two quarters, however, provides some food for thought about the prospects of convergence with Western Europe. Over the last two quarters – the last quarter of 2015 and the first of 2016 – GDP growth has slowed and turned negative. Although this deceleration was mostly due to temporary factors, reflecting a combination of delays in the absorption of EU funds and problems in one large steel manufacturer, staff rightly points out that medium-term growth will hinge on the ability to implement meaningful structural reforms.

An average growth of 4 percent is indeed attainable, but it would require effort on the part of the authorities to set off additional sources of growth. The last time the economy's growth rates reached or exceeded 4.0 percent was in 2011-2012, rebounding from a more than 20 percent drop during the crisis. In the absence of structural reforms and stronger credit expansion, growth rates of such magnitude seem challenging.

Labor Competitiveness

The authorities share staff's concerns about rising wage pressures. Some of the increase is indeed offsetting the long period of wage restraint after the crisis. Also, it contains some measurement error due to tax evasion. However, that can only explain part to the rise; the other part points to renewed pressures in the labor market. Minimum wage increases in excess of labor productivity growth could potentially hurt competitiveness and should be avoided in the future.

Further reforms in vocational and higher education remain a core part of our strategy to strengthen competitiveness. In order to improve labor flexibility, work on revising the Guaranteed Minimum Income law, allowing for a gradual tapering of benefits, as advised by staff, is ongoing. Also, the authorities plan to introduce measures aimed at improving regional labor mobility. However, free movement of labor within the EU imposes limits to how much can be achieved by measures containing wage pressures. Against this backdrop, the authorities see measures aimed at building a more skilled workforce – namely improvements in higher and vocational education – as key to guaranteeing future growth.

Financial sector

Overall, the analysis on the reasons for low credit is in line with the authorities' views – sluggish credit growth is likely hampering growth. Both demand and supply factors are hindering growth, albeit for different groups. While for larger enterprises and more established enterprises demand factors matter, credit supply for SMEs and households remain tight.

Lending by Nordic subsidiaries could indeed be better attuned to Latvian circumstances. The analysis in the Selected Issues paper clearly sets out the reasons for sluggish growth and can serve as a good ground for a discussion. The suggestion to use the benchmarking exercise conducted with their European partners to review banks' internal risk models is worth considering.

However, the role of other, domestic, factors should not be underestimated. In the report, staff highlights the importance of the insolvency process. It is indeed vital to continue progress in this area; however, the authorities see that a broader approach, focusing not only on the insolvency process, but strengthening the whole legal environment and judiciary system is necessary. Strengthening the authorities' investigative capacity, combating and preventing corruption, as well as maintaining high standards of ethics and business culture among all stakeholders – particularly state authorities and insolvency administrators – are of paramount importance. As in other policy areas, grey economy remains an important factor holding back credit recovery.

The authorities acknowledge the importance of vigilant supervision and mitigating of risks in the NRD sector. The FCMC has taken important steps to mitigate anti-money laundering and terrorism financing (AML/CFT) risks. In this context, independent reviews of AML/CFT compliance in NRD banks have been carried out by competent US consultancy firms in April and May.

As a minor point, the authorities do not share the view that limited lending of the NRD sector to the domestic economy implies that a large part of the economy has limited access to credit (as Selected Issues, p.27, Paragraph 17 seems to indicate). Given the volatile nature of the main funding sources of NRD banks, their engagement in lending for residents might be unwelcome from the financial stability perspective. It is the resident-servicing banking sector that is essential in this process.

Fiscal policy

The fiscal position remains sustainable. The 2015 fiscal deficit was 1.3 percent and in 2016 it is envisaged at 1.1 percent. Public debt remains low by EU standards and is projected to trend downwards over the medium term.

Additional fiscal space will be needed to support reforms in the education and health sectors and to strengthen the social safety net in the coming years. The authorities' envisaged review of tax and expenditures provides an opportunity to examine options for opening fiscal space. At the same time, one should be realistic about what can be achieved at the current stage of development. While social spending is among the lowest in EU and should gradually be increased, the EU is a rather high-bar reference group in this respect. As can be inferred from the chart on page 17 of the report, social spending has a tendency to correlate with GDP per capita. Latvia still remains one of the poorest countries in the EU in need of setting the right conditions for catching-up. That said, the authorities are aware of the need to increase targeted social spending, in addition to health care and education reform, and plan to do it in the coming years.

Concerning options for opening fiscal space, the authorities see more potential in combating the grey economy and less in recalibrating the tax burden. The authorities have doubts that some of the measures suggested by staff (like the PIT surtax on high income) would constitute a 'growth friendly taxation'. High share of grey economy implies that any re-calibration aimed at taxing the higher income share of population would fall disproportionally on the shoulders of remaining non-grey economy high wage earners. Also, it would increase the relative costs (vis-à-vis similar countries) of attracting high-skilled employees. Combating the grey economy remains the authorities' main priority. Over the last few years, the authorities have been fairly successful in this area and will continue to implement measures strengthening the taxation framework and the capacity of tax authorities. Moreover, the ongoing tax system review will assist the authorities in developing a medium-term tax strategy focusing on policy goals such as maintaining the competitiveness of the tax system, analyzing options to improve equality and identifying options to increase government revenues to finance increased spending needs.