



# REPUBLIC OF LATVIA

May 2015

## 2015 ARTICLE IV CONSULTATION—STAFF REPORT; INFORMATIONAL ANNEX; AND PRESS RELEASE

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 2015 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on March 2, 2015, 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 April 9, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Press Release**

The document listed below has been or will be separately released

Selected Issues Paper

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# REPUBLIC OF LATVIA

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

April 9, 2015

### KEY ISSUES

**Context.** Latvia has made remarkable economic progress since the crisis: the output gap is now largely closed, the current account deficit has been reduced to sustainable levels, and unemployment continues to fall. However, the economy has recently slowed considerably in the face of a deteriorating external environment, weak investment, and persistently shrinking bank credit.

**Challenges.** Subdued economic growth is expected to continue in 2015 due to continued weakness in trade partners, particularly Russia. An escalation of geo-political tensions or protracted low growth in the Euro Area poses further downside risks. Rapid productivity growth will be needed over the medium term if per capita income is to converge to core Euro Area levels.

#### **Staff views.**

- The continued contraction of bank credit is likely to constrain investment going forward. Recent efforts to catalyze SME lending and improve the implementation of insolvency procedures are welcome.
- Over the medium term efforts are needed to increase the revenue envelope to ensure that necessary capital and social expenditures can be accommodated.
- Although geopolitical tensions do not appear to have significantly affected the inflow of non-resident deposits (NRDs) to date, continued vigilant supervision and regulation of the NRD banking sector is needed.
- Structural reforms are needed in several areas—such as education, infrastructure, labor markets and the judicial system—to maintain competitiveness over time in the Euro Area currency union.

**Authorities' views.** The authorities were in broad agreement with staff recommendations, notwithstanding some differences on tax and benefit policies. They agreed to explore ways to build fiscal space over the medium-term to accommodate essential expenditures. They also concurred with the need for higher prudential standards and intensive monitoring of risks associated with NRD banking sector.

Approved By  
**Philip Gerson (EUR)**  
**and Mark Flanagan (SPR)**

Discussions were held in Riga during February 19-March 2, 2015. The team comprised Mr. Aiyar (head), Messrs. Srouf and Lian (all EUR), and Ms. Diouf (SPR). Mr. Rutkaste (OED) also joined the discussions.

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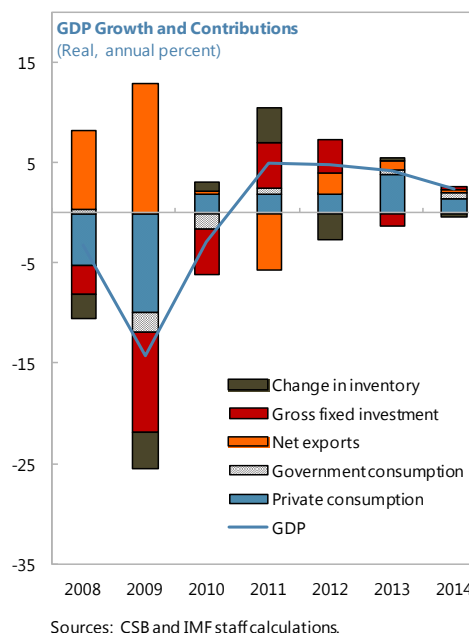
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## CONTEXT

**1. Latvia has made remarkable economic progress since the financial crisis.** The output gap has almost closed; unemployment, although still high, is now mainly structural in nature; and the real effective exchange rate is broadly in line with fundamentals. The current account—which was more than 20 percent of GDP in deficit just before the output collapse—is close to balance. Fiscal policy is prudent, and public debt is among the lowest in Europe. The country experienced a smooth entry into the Euro Area. Going forward, policy continuity is likely, as the incumbent center-right coalition remains in power following parliamentary elections last October.

**2. The 2014 Article IV consultation commended the authorities for prudent macroeconomic policies, but argued for an extensive medium-term agenda of structural reforms.** The staff appraisal recommended gradual fiscal consolidation in line with the Fiscal Discipline Law (FDL); measures to reduce inequality and strengthen the social safety net; structural reforms to boost productivity; and close supervision of non-resident deposits (NRDs) in the banking system. Policy making has broadly reflected these recommendations. Fiscal policy has been in line with the FDL, and some measures, such as raising the minimum non-taxable allowance under the income tax, have targeted vulnerable sections of society. The electricity sector has been liberalized, and close supervision of NRD-specialized banks continues.



## RECENT ECONOMIC DEVELOPMENTS

**3. The recovery slowed considerably in 2014 amid a deteriorating external environment.** GDP growth fell from 4.2 percent in 2013 to an estimated 2.4 percent, reflecting the prolonged closure of a large steel manufacturer Liepajas Metalurgs (LM), and weak economic performance in the Euro Area (EA) and Russia amid rising geopolitical tensions. Despite the decline, the GDP growth rate remained well above the Euro Area average of 0.9 percent. To date the direct impact of the Russia-Ukraine conflict, including sanctions, is estimated to be relatively small (Box 1). However, the conflict—together with the lingering economic malaise in the Euro Area—has raised uncertainty and likely been a key factor in holding back domestic demand.

**4. Consumption growth decelerated strongly, and the anticipated investment recovery was modest.** Private consumption growth was only 2.3 percent in 2014, much lower than 6.3 percent in 2013, as the uncertain economic climate led to more precautionary savings. Gross fixed investment increased by a sluggish 1.6 percent, belying expectations of a strong rebound from the 5.2 percent contraction of 2013. Apart from weak external conditions, controversy over

proposed amendments to the insolvency law likely contributed to an uncertain domestic environment. Exports remained subdued due to tepid growth among trading partners and the full-year impact of the closure of LM in mid-2013, while the depreciation of the ruble against the euro had a negative impact on export receipts, especially in the last quarter. The current account deficit widened slightly to about 3 percent of GDP.

**5. The labor market continued to tighten.** Real wages increased 6.3 percent and the increases were broad-based, resulting from both a higher minimum wage (320 euros per month, up from the previous level of 280 euros) and competition for higher skilled workers. It is unlikely that the rapid wage growth signals an overheating labor market at this juncture: few companies reported labor shortages as an important obstacle to businesses, and part of the recorded wage increase probably reflects successful tax compliance measures, which have led to more accurate reporting and reduced under-the-table “envelope wages”. The unemployment rate declined further to about 10.5 percent in December 2014, down from 11.3 percent a year ago, while the participation rate stayed constant.

**6. Inflation recovered slightly on the back of robust core inflation.** Headline inflation averaged only 0.7 percent, following zero price growth the previous year. Despite a significant increase in core inflation to 1.5 percent (from 0.2 percent the previous year), reflecting strong wage growth, the continued decline in food and energy prices held back headline inflation. In comparison, core inflation in the Euro Area was 0.7 percent in 2014.

**7. Banks continued to repair their balance sheets.** Bank profitability improved further, while the overall NPL ratio declined to 6.8 percent in December 2014 from 8.3 percent a year earlier. However, deleveraging continues, with the stock of bank credit to the private sector declining by about 7.6 percent (y-on-y) in December 2014. Moreover, the issuance of new loans actually decreased in 2014. The shrinking stock of domestic credit—extended primarily by large Nordic subsidiary banks—was matched by the repatriation of funds to parent banks. Asset prices continued their gradual recovery (Figure 6), although both stock prices and property prices remain well under the levels reached just prior to the financial crisis.

**8. There is little evidence that geopolitical tensions have disrupted the flow of NRDs into Latvia.** NRD growth was stable in 2014 and accelerated slightly towards the end of the year. Excluding exchange rate effects, which were substantial due to the depreciation of the euro against the US dollar, the stock of NRDs increased by 14 percent year-on-year in December 2014, broadly in line with the average rate of growth over the last three years.

**9. The general government deficit widened by about ½ percentage point to around 1.4 percent of GDP in 2014.** While this exceeded the nominal budget target of 0.9 percent of GDP, the breach was largely accounted for by a one-off payment related to the sale of Citadele bank (see below). The negative budgetary impact of the economic slowdown was largely offset by revenue gains from improved tax compliance and higher wages. With the output gap still negative, staff estimate that the structural deficit, excluding the one-off cost, remains just under 1 percent of GDP.

## OUTLOOK AND RISKS

**10. Lackluster economic growth is expected to continue this year.** This reflects the adverse impact of the anemic external environment, particularly Russia's sharp slowdown, on exports and investment. This will be mitigated but not fully offset by higher disposable income due to lower oil prices and robust real wages, which would tend to support private consumption. LM has now reopened and is gradually ramping-up production, but is not expected to reach full capacity until the fourth quarter. Given abundant liquidity in the banking system, the accommodative monetary stance of the ECB is unlikely to exercise much impact except through a weaker euro and expectations of a more robust recovery in the Euro Area. While inflation is expected to fall in 2015, reflecting the sharply lower oil price forecast, the liberalization of electricity tariffs will support prices to some extent.<sup>1</sup>

**11. Over time, growth is expected to accelerate as the external climate improves and investment picks-up, but this is predicated on strong reform efforts.** Annual medium-term growth of around 4 percent—higher than in core economies—should be achievable as the economy converges towards Euro Area average income levels. This is conditional on measures to enhance competitiveness, and continued prudent macroeconomic management. Adverse demographics, including continuing emigration, will tend to reduce the labor force, so reforms aimed at reducing high structural unemployment will be needed simply to keep employment constant. Robust growth will depend on capital accumulation—underpinned by a resumption of credit supply—and TFP growth (see selected issues paper on Latvia's medium-term growth). International evidence shows that while several countries at a similar level of development have been able to increase labor productivity rapidly and converge towards frontier income levels, others have failed to do so: the key is to attract sufficient investment, especially in industries with high investment multipliers, and lay the foundations for rapidly improving productivity, including by building infrastructure and through reforms to education.

**12. The outlook is subject to significant downside risks (RAM).** A prolonged slowdown in Russia and the Euro Area would further dampen confidence and thwart a pick-up in economic activity, while a further escalation of sanctions and counter-sanctions could disrupt trade settlements. A sharp supply-driven rise in oil prices would remove an important factor supporting projected growth, especially in the near-term. Resurgent sovereign stress arising from events in Greece could spill over to higher bond yields in Latvia. A failure to tackle the structural reform agenda would impede productivity growth and diminish competitiveness over the medium term; indeed the external assessment (Box 2) shows that there are already some signs of eroding competitiveness due to recently rising unit labor costs (although so far these losses are minor

<sup>1</sup> From January 1st, 2015, smaller enterprises and households—which had hitherto bought electricity from the state-owned JSC Latvenergo at subsidized rates—shifted to purchasing electricity on the free market (with some exemptions for special groups such as poor households or households with many children). This reform—long advocated by the European commission—was originally scheduled for April, 2014 but was delayed to develop a proper compensation mechanism for low income households.

compared to the gains made from internal devaluation since the crisis). The external assessment also shows that Latvia is vulnerable to a severe growth or current account shock, which could reverse the projected medium-term trend of a gradually falling debt-to-GDP ratio. The authorities broadly concurred with these risks, but noted that while sovereign stress arising in the European periphery might increase somewhat the cost of the government's external financing from the current extremely low rates, Latvia's low public debt and sound macroeconomic fundamentals make it very unlikely to be rationed from credit markets. Indeed, ratings agencies have repeatedly upgraded the country's sovereign rating over the last three years. The authorities also noted that—partly as a result of the ECB's unconventional policy actions—there were upside risks from a stronger-than-expected recovery in the Euro Area.

## POLICY DISCUSSIONS

### A. Fiscal Policy

**13. The 2015 budget is broadly neutral.** A 1 percentage point cut in the personal income tax (PIT) rate to 23 percent, which will result in an estimated revenue loss of  $\frac{1}{4}$  percent of GDP, is expected to be offset by growth of the tax base, as tax compliance continues to improve and wages rise (including through a further 40 euros increase in the minimum wage), and by a cut in capital spending. The structural deficit target of 1 percent of GDP is in line with the authorities' Fiscal Discipline Law (FDL), and strikes an appropriate balance between the need to rebuild fiscal space over the cycle and that of avoiding fiscal drag in a weak economic environment.<sup>2</sup> The authorities agreed with staff that, given the unusually large uncertainties regarding external conditions, the budget should be implemented flexibly in accordance with the FDL. Automatic stabilizers should be allowed to operate fully in case economic growth falls below the forecast.

**14. Staff urged further measures targeted at reducing inequality and strengthening the social safety net.** At less than one fifth the EU average (per inhabitant) social protection benefits in Latvia remain among the lowest in Europe. At the same time, income inequality (as reflected for instance in the ratio of the highest to the lowest income quintile) is among the highest. The authorities have recently taken some measures to alleviate these problems, such as the 2014 increase in the non-taxable minimum allowance, but more is needed. In particular, the cuts to Latvia's Guaranteed Minimum Income (GMI) benefit in 2013, and the de-centralization of the scheme's financing should be reversed, in line with the recommendations of the World Bank study.

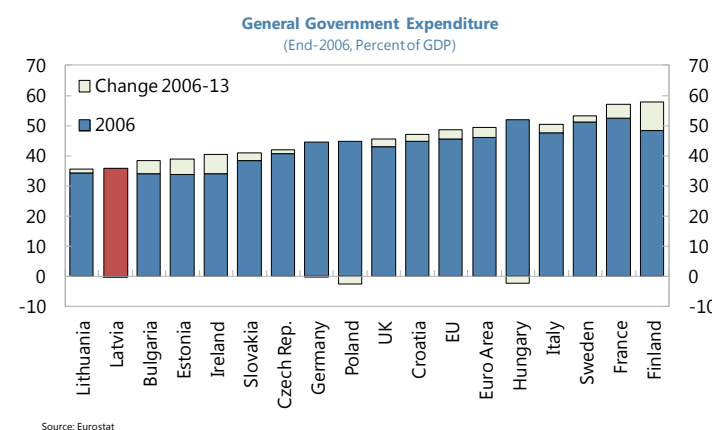
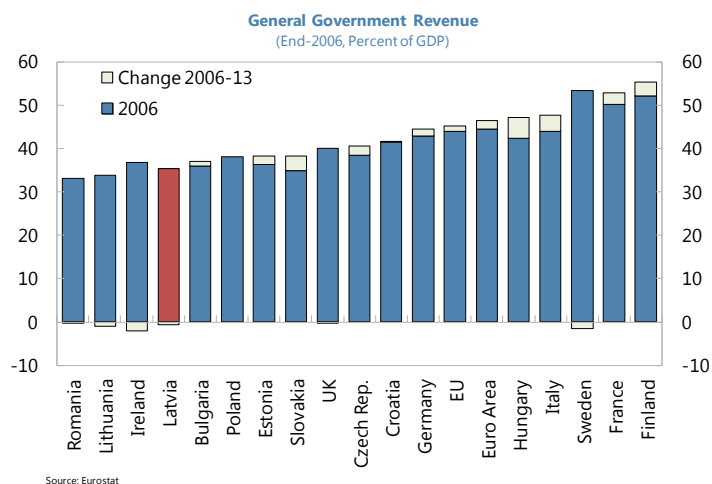
**15. Current fiscal policies could significantly reduce the budget envelope and constrain priority spending over the medium term.** Planned declines in the PIT rate and SOEs' payout ratio, together with increases in tax allowances and cuts in social contributions, are estimated to reduce

<sup>2</sup> The FDL sets a medium-term objective (MTO) of 0.5 percent of GDP, but permits deviations from this target for revenue transfers to the privately managed Pillar II pension fund. The FDL is designed to be compatible with Latvia's commitments under the Stability and Growth Pact (SGP).



revenue by over three percentage points of GDP between 2013 and 2017.<sup>3</sup> Staff estimate that additional revenue measures equivalent to 0.6 percent of GDP in 2016 and 2017 will be needed to safeguard priority investment, particularly infrastructure investment (thus keeping public capital expenditure above a historical low of about three percent of GDP), and social spending, including on improving social exclusion benefits and introducing progressive tax allowances. Alternatively, sizable expenditure reductions would be required in other areas, but staff and the authorities agreed that there was limited scope for substantial permanent cuts in other parts of the budget, given the already low level of public expenditures in Latvia (see text chart).

**16. Several options could be considered to open fiscal space while reducing inequality.**<sup>4</sup> First the PIT rate cut should be reconsidered. While the authorities view the PIT cut as a measure to improve work incentives, a more targeted way to achieve this goal would be to further expand the non-taxable minimum allowance, and to introduce a more gradual phasing-out of the GMI benefit, which currently falls one-to-one with income. Second, property tax revenue, which currently amounts to less than 0.8 percent of GDP, (well below European and OECD average levels) should be expanded. Staff urged the authorities to enable local municipalities to raise the real estate tax rate



Measures	2016	2017
Maintain PIT rate at the 2015 rate of 23 percent	0.21	0.20
Increase property tax rate by 0.5 ppt on buildings and land	0.22	0.22
Improve cadastral revenue	0.08	0.08
Reverse ceiling introduced on social contributions for incomes above 48,600	0.14	0.14
Better-targeted tax allowances 1/	0.20	0.20
Increase CIT from current 15 to 16%	0.10	0.10
Remove excise exemptions on gazoil for agriculture	0.14	0.14
<b>Total</b>	<b>1.1</b>	<b>1.1</b>
<i>Memorandum items</i>		
Structural deficit: authorities' target	-0.8	-0.7
Structural deficit: staff estimate without measures	-1.5	-1.3
<b>Gap</b>	<b>-0.6</b>	<b>-0.6</b>

Source: Latvian authorities and staff calculations  
1/ Including lower tax allowances for pensioners, lower tax allowances for dependents and elimination of non-taxable threshold for high-income individuals.

<sup>3</sup> The PIT rate is scheduled to be lowered by one percentage point in 2015 and again in 2016, while SOE payout ratios are to be cut from the current 90 percent level to 70 percent in 2016 and to 27 percent in 2017.

<sup>4</sup> The measures considered here have a permanent effect on revenue, i.e., if enacted in 2016 a measure would entail a gain in 2017 and future years as well (provided it is not reversed).

on high-valued land and buildings above the current 1.5 percent ceiling. This should go hand-in-hand with cadastral reform to remove substantial discrepancies in property valuation, for instance between old and renovated or new buildings and to correct inconsistent valuation of agricultural land; such discrepancies damage both tax collection and credibility. Third, the cap on social security contributions could be removed (while maintaining the cap on benefits). The combined effect of these measures should suffice to close the revenue gap estimated under current policies. Moreover, other options exist should the authorities choose not to fully implement the measures above. For example, the minimum non-taxable threshold for pensioners and the tax allowance for dependents could be reduced, and excises on fuel used in agriculture raised, in conjunction with better-targeted direct support for low- and middle-income households. Alternatively, the corporate income tax rate, which is among the lowest in the EU, could be raised.

**17. The authorities recognized the need for enhancing revenue over the medium term and reducing inequality.** They emphasized ongoing measures for combating the grey economy, noting the significant gains achieved to-date, and agreed that revenues from property taxes could be improved. They were not amenable to reversing and decentralizing the cuts to the GMI benefit this year, but noted that medium-term plans are under consideration for increasing GMI benefits within an integrated social benefit system (under which a minimum level of combined benefits—comprising the GMI, unemployment insurance, parental benefits, etc—would be defined relative to the economy’s median wage). They will also consider introducing progressive minimum non-taxable thresholds in the future, which would help ameliorate inequality.

## B. Financial Supervision

**18. Latvia’s three largest banks comfortably passed the ECB’s Comprehensive Assessment.** The wider banking system is also well capitalized and liquid, with an average CET1 ratio of about 18 percent and a liquidity ratio of around 64 percent, substantially higher than regulatory minimum requirements of 8 percent and 30 percent respectively. Citadele, the “good bank” created upon the dissolution of Parex, was sold to a consortium of international investors within the timetable set by DG Competition.<sup>5</sup> The sale triggered the exercise of a put-option equivalent to about 0.4 percent of GDP compensating the EBRD for its injection of equity capital in Parex at the outset of the crisis.

**19. Banking supervision is now shared between the Latvian regulator (the FCMC) and the SSM.** The SSM directly supervises Latvia’s three largest banks, accounting for about 42 percent of the banking system by assets. The Joint Supervisory Teams (JSTs) for these banks are led by an ECB official and include Latvian representation. On the other hand, the Colleges of Supervisors for the large banking groups—two of which are subsidiaries of Swedish parent banks and are among Latvia’s three largest banks— are chaired by the Swedish supervisory authorities and include representatives from the ECB , while Latvia’s FCMC has observerstatus. The authorities report that information sharing and cooperation among these supervisory bodies has so far been good. They

<sup>5</sup> Latvia’s economic crisis was sparked by a run on the country’s largest domestic bank, Parex, in 2008.

agreed with staff that open communication channels among the ECB, the Swedish regulators and the FCMC will remain essential going forward, especially when capital and liquidity conditions are less benign than at present.

**20. Ongoing geopolitical tensions and the deep economic downturn in Russia highlight potential risks stemming from the high level of NRDs in Latvia’s banking system.** NRDs, over 80 percent of which are estimated to originate from Russia and other CIS countries, currently account for about half of the banking sector’s total deposits, and could therefore be vulnerable to a sudden stop or flow reversal. Moreover, since NRDs are covered by the country’s deposit guarantee scheme, they represent a significant contingent fiscal liability.<sup>6</sup> That said, to date there are few signs of NRD inflows being impeded due to geopolitical events (Box 1). Risks to the domestic economy are mitigated by various factors. NRD banks hold the major share of their assets abroad in liquid instruments such as European and US government securities, and bank deposits.<sup>7</sup> They are already subject to higher capital and liquidity requirements, in line with past staff advice. Moreover, the FCMC plans to impose a “business model risk” add-on to NRD banks’ contributions to Latvia’s deposit guarantee scheme, ensuring that NRD banks pay more into the scheme per dollar of deposits.

**21. The authorities remain keenly aware of the need for vigilant supervision of the NRD banking sector.** AML / CFT supervision is being strengthened and made more risk-based. The Latvian bank regulator, the FCMC, reported that it conducts frequent offsite and onsite bank inspections, and that customer due diligence guidelines have been strengthened since the Moneyval report in 2012. The authorities noted that the Financial Intelligence Unit responsible for fighting money laundering and other financial crimes now receives greater budgetary support—which it has used to expand staff, undertake more training programs and invest in more sophisticated risk-assessment software—and works in cooperation with the State Revenue Service and foreign regulators.

## C. Resuscitating Bank Credit

**22. Bank deleveraging reflects both demand and supply factors.** The debt overhang and uncertain outlook continue to hold back credit growth and investment in an environment of tightened lending standards. Discussions with bank representatives suggest that SMEs and low income households in particular face hurdles accessing funding because of the higher risks they represent and their lack of collateral. The credit contraction has persisted well past the point in the cycle when most countries see a resumption of credit growth.<sup>8</sup> It is particularly worrying in the

<sup>6</sup> As a recent example, the bankruptcy of Latvijas Krajbanka—which in September 2011 accounted for about 1½ percent of Latvia’s NRDs and 8 percent of domestic deposits—required the Deposit Guarantee Fund to pay out about 336 million lats (about 2.2 percent of GDP) to cover insured deposits, of which 200 million lats came from a treasury loan.

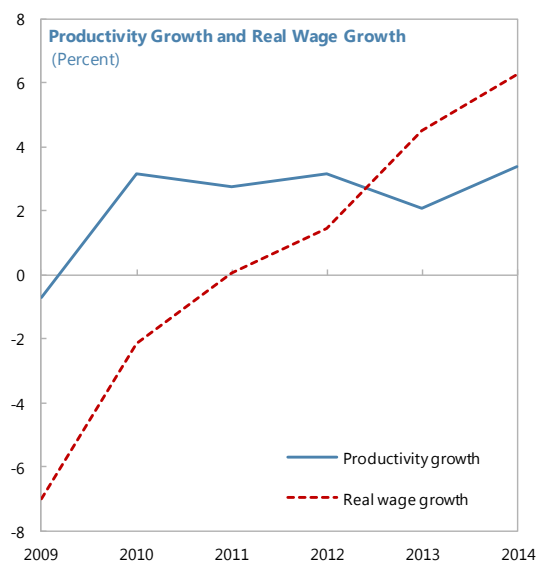
<sup>7</sup> See Appendix I, 2012 Article IV Consultation with Latvia.

<sup>8</sup> See Baltic Cluster Report, 2014, IMF Country Report No. [ISCR/14/116](#).

context of a tightening labor market and high real wage growth. For several years after the trough of the crisis, firms were able to finance investment through retained profits, since productivity growth outstripped wages. But now the lack of credit is likely to be a binding constraint on investment.

**23. The authorities have few direct levers to encourage credit supply, given the dominance of Nordic subsidiaries in Latvia's domestic economy.**

ECB quantitative easing is unlikely to have an impact on bank lending, since Nordic subsidiaries depend on parent banks for funding rather than wholesale markets, while the parent banks themselves are not liquidity constrained. The subsidiary banks note that, while they have indeed tightened lending standards since the crisis, the main reason for anemic lending is lack of demand. The reduction in their loan book over the last few years has created excess cash holdings, which in turn have been repatriated to the parent banks; thus the observed increase in the percentage of local deposit funding for the subsidiaries is not a conscious change in business model but rather a consequence of excess liquidity.



Sources: CSB and IMF staff calculations.

**24. The recently created Single Development Institute (SDI) is appropriately taking a more active role in supporting SME lending.**<sup>9</sup> The SDI has introduced a number of programs designed to catalyze private bank lending, including loan guarantee schemes and a program to reduce credit risk for private lenders by providing subordinated loans. The authorities also pointed to recent efforts to develop credit bureaus to make available potential borrowers' credit related information in a standardized way, which would help banks to screen borrowers and reduce informational asymmetries in the loan market. Staff encouraged all these initiatives, while noting that care is needed to ensure that the SDI is genuinely addressing market failures rather than supporting unviable businesses.

**25. Policy measures to reduce the still high debt overhang would increase demand for credit while improving perceptions of credit risk on the supply side.** While earlier legal amendments have already strengthened the insolvency regime, its administration and implementation could be further improved. Banks report that insolvency procedures can be very lengthy and insolvency administrators obstructive. The authorities pointed to various measures being planned, or already implemented, to reduce the backlog of pending cases, such as a greater number of courts and better specialization and allocation of judges across courts. A new law makes

<sup>9</sup> As described in previous staff reports, the SDI is a new institution formed through the merger of the Latvian Guarantee Agency, the Rural Development Fund and the Mortgage and Land Bank.

insolvency administrators state officials, subjecting them to greater income disclosure and stricter supervision. And reforms are underway to encourage mediation or arbitration as an alternative to much lengthier regular court procedures.

**26. A compromise has been reached on the implementation of recent amendments to the insolvency law which could have had the unintended consequence of further dampening credit supply.** The amendments—passed by Parliament last year—limited the liability of mortgage borrowers to collateral and reduced the discharge period for debtors from 3.5 years to 1 year after declaring insolvency. While the amendments did not apply retroactively, thus limiting the immediate impact on bank balance sheets, they created further uncertainty amid an already weak lending environment. Several banks responded by charging higher mortgage down payments and rationing credit to low-income households and households that live outside major cities, despite the amendments not having taken effect. Staff therefore welcomed the recent compromise which requires banks to offer customers a choice between a “regular” mortgage and a limited-recourse mortgage of the type prescribed by the amendments (which can be priced differently).

## D. Structural Reforms

**27. Latvia’s most important medium-term challenge is to maintain competitiveness within the Euro Area currency union.** The substantial real depreciation following the crisis allowed the country to make rapid competitiveness gains, but now that the exchange rate is broadly in line with fundamentals (see External Assessment), the focus must shift to structural reforms. In order for Latvia to consistently exceed average Euro Area growth and thereby close the income gap with core economies, productivity growth must be supported by appropriate policies. Over the last two years, wages have grown rapidly as labor market slack has diminished, and this is reflected in a slight erosion of competitiveness as measured by unit labor costs. Against this background—and in the context of large increases to the minimum wage in 2014 and 2015—staff recommended that future increases should not exceed productivity growth. The authorities concurred that future changes to the minimum wage would need to take account of economic developments.

**28. Labor market reforms to improve work incentives should be implemented.** A system of in-work tax credits and benefits should be considered because empirical evidence suggests that these have proven effective in increasing employment of lower skilled workers. Active labor market policies (ALMPs) should continue to be strengthened. The coverage ratio of ALMPs has improved substantially, from 42 percent in 2012 to 62 percent in 2014, partly due to the decline in the unemployment rate. The authorities pointed to several active projects targeted at various segments of the unemployed population, including an active ageing project as well as measures to improve internal mobility.

**29. Upgrading public infrastructure and improving state-owned enterprise (SOE) governance are important elements of strengthening competitiveness.** Improving public infrastructure could also help attract FDI and associated technological knowhow. Moreover, the current juncture is propitious for well-planned projects to attract centralized funding from the

Juncker plan. An important area where reforms are both necessary and well-identified is ports: Riga and Ventspils ports both remain overly dependant on low-value added bulk traffic and face strong competition, especially from Russian ports. Staff urged speedy implementation of the recommendations of the World Bank study on ports, which made several specific suggestions to increase capacity and enhance connectivity to land transport, while improving governance and accountability. On a related front, centralizing SOE management while divesting non-core activities—in line with long-planned reforms—would improve efficiency and accountability, contributing to an improvement in the business environment. The authorities noted that a working group has been set up to consider the World Bank recommendations on ports, while a framework law to strengthen SOE governance was passed in October 2014. The latter will require a centralized SOE manager to be established, and independent boards and annual reporting will be re-introduced for largest SOEs.

**30. Reforms to higher and vocational education would help reduce skills mismatches and structural unemployment.** The authorities—in conjunction with European partners—have already developed an ambitious reform agenda. Plans include introducing quality-based accreditation of study fields, consolidation of higher education institutions (which are currently too numerous) and better targeting of public funds to universities (shifting resources from social sciences to STEM fields). A new financing model for higher education that seeks to reward quality is being prepared in cooperation with World Bank experts. These measures, together with the promotion of EU foreign (i.e. not Latvian) languages in teaching, would build a more skilled workforce. Meanwhile, reforms to vocational education could help reduce skills mismatches and hence alleviate structural unemployment in the medium-term. Efforts should continue to expand vocational training from a pilot program encompassing 6 institutions to a wider base of institutions, and to include a council of social partners and sector experts. The authorities agreed with staff that unwavering implementation of the education reform agenda would be crucial over the next few years.

## STAFF APPRAISAL

**31. Latvia's economic slowdown is expected to persist this year.** GDP growth is estimated to have decelerated to about 2.4 percent in 2014, reflecting the prolonged closure of steel manufacturer Liepajas Metalurgs, and weak economic performance in the Euro Area and Russia amid rising geopolitical tensions. In 2015 the anemic external environment—particularly the sharp recession in Russia—will continue to weigh on exports and investment. This is expected to be somewhat mitigated by higher disposable income due to lower oil prices and robust real wages, the reopening of LM, and the accommodative monetary stance of the ECB.

**32. Faster medium-term growth will be necessary if Latvia is to close the income gap with the rest of the Euro Area, but this cannot be taken for granted.** Medium-term growth of around 4 percent should be feasible. But adverse demographic trends will exert a downward pull on the growth trajectory, so robust growth depends on reforms to reduce still-high structural unemployment, and on boosting capital accumulation and labor productivity. Moreover, the near-

term forecast is subject to several downside risks, most importantly a prolonged slowdown in important trading partners such as Russia and the Euro Area.

**33. While the 2015 budget is broadly appropriate, fiscal space needs to be built-up over the medium-term.** Automatic stabilizers should be allowed to operate fully this year, given the weak and uncertain external environment. Over the medium-term, various factors, such as planned reductions to the personal income tax (PIT) rate, could constrain the budget's capacity for necessary capital and social expenditure. The authorities should explore ways to increase the revenue envelope, for example by reconsidering future PIT rate cuts, greater land taxation in conjunction with cadastre reform, the removal of the cap on social security contributions, and better targeting of a number of tax allowances. Such measures would complement the welcome focus on shrinking the grey economy through better tax compliance.

**34. The continuing contraction of bank credit is increasingly likely to constrain investment.** Staff supports recent public sector initiatives to catalyze SME lending, including by providing loan guarantees, taking subordinated positions and encouraging the development of credit bureaus. Reforms to insolvency procedures and the court system are needed to encourage writedowns and accelerate the reduction in private sector debt. This would provide a spur to new lending from both the demand and supply side.

**35. So far there have been no significant disruptions to NRD flows arising from geopolitical tensions.** But the Russia-Ukraine conflict highlights the need for maintaining vigilant supervision of NRD banks, which account for almost half of all deposits in the banking system. In this context, the authorities are encouraged to continue their efforts to strengthen and effectively implement the AML/CFT framework. Appropriately, the Financial Intelligence Unit responsible for combating money laundering and financial terrorism has been strengthened. Minimum capital and liquidity requirements are higher for NRD banks, in line with previous staff advice; and the authorities plan to impose on NRDs proportionately higher contributions to the deposit guarantee fund.

**36. Latvia's most important medium-term challenge is to maintain competitiveness within the Euro Area currency union.** Future increases to the minimum wage should not exceed productivity growth. In order for Latvia to consistently exceed average Euro Area growth and thereby close the income gap with core economies, productivity growth must be supported by appropriate structural policies. Reforms are needed in a number of areas such as labor markets, higher and vocational education, infrastructure, and SOE management.

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



### Box 1. Republic of Latvia: Russia Linkages

**Latvia is strongly linked to Russia through both trade and finance.** Russia accounted for around 11 percent of Latvia's exports of goods and services in 2013. Trade linkages have strengthened in the past decade due to the faster growth of the Russian economy compared to Latvia's other trading partners. As a regional banking centre, Latvia also 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. Latvia's linkages with Ukraine are much weaker: Ukraine accounted for only 1 percent of Latvia's exports in 2013.

**Latvia is currently fully dependent on Russia for gas imports.** Supply has so far been reliable, and in any event Latvia has a large gas storage facility in Incukalna. A new LNG terminal at the port of Klaipeda, Lithuania, capable of meeting most of the Baltic countries' gas needs, will become operational this year. With Lithuania upgrading its pipelines to Latvia, natural gas imported through the LNG terminal can be supplied to Latvia.

**Slower Russian GDP growth is expected to lower Latvia's growth directly through the trade channel and through second round effects.** Every 1 percent decline in Russia's GDP growth is estimated to directly reduce Latvia's export growth by 0.4 percent and GDP growth by 0.2 percent. Persistently weaker Russian demand for Latvian goods and services may negatively affect Latvian GDP through second round effects, increasing precautionary savings (hence reducing consumption) and dampening investment sentiment. The recent crash in oil price is expected to pull down Russian GDP growth in 2015 by around 3–4 percent, which is expected to slow down Latvia's growth by around 0.6–0.8 percent.

**Russian counter-sanctions have had only a marginal impact on Latvia's economy.** The Russian measures were directed at Latvian food exports, but food exports to Russia as a share of Latvian GDP are small. Moreover, Latvian food exporters are expected to find new markets to substitute the loss of the Russian market. On the other hand, counter-sanctions may exert a downward pull on food prices and inflation. Moreover, if geopolitical tensions and the cycle of sanctions and counter-sanctions were to escalate, the effect on Latvia could be much more serious.

**So far the Russia-Ukraine conflict has had little discernible impact on the Latvian banking system.** Although some small banks experienced large drops in NRDs after sanctions against Russia were announced, overall there was no disruption of NRD inflows. In fact NRD deposit growth in 2014 was more robust than in the previous year: after correcting for valuation effects from the euro's movement against the dollar the growth rate of NRDs reached 14 percent (y-on-y) in December 2014, compared to 8.3 percent in December 2013.

**Russian FDI to Latvia somewhat surprisingly accelerated in the first half of 2014.** Russia's share in inward FDI was stable at around 6 percent in the first and second quarters of 2014, 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. Republic of Latvia: External Sector Assessment

The macroeconomic imbalances of the pre-crisis period have been largely addressed, and the current account is close to balance. Model-based assessments suggest that the exchange rate is broadly in line with fundamentals. However, the substantial competitiveness gains that accrued to Latvia from correcting its overvalued real exchange rate have now been exhausted, and the focus will need to shift to generating sustained improvements in productivity.

**Exchange rate assessments based on CGER methodologies conclude that the REER is broadly in line with fundamentals (Table A).** The external sustainability (ES) and the macroeconomic balance (MB) approaches indicate that the Latvia's REER is close to equilibrium. The equilibrium real exchange rate (ERER) points to a higher misalignment than the other two methodologies, showing a moderate overvaluation. In Latvia, where there have been profound structural changes over the last decade, the former two estimates are likely more reliable, producing results very close to one another, and consistent with external sector developments.

**Table A. Latvia: 2015 Real Exchange Rate Assessment Using CGER Methodology**

Approach	Current Account Balance		REER (in logs)		
	Norm	Underlying	Equilibrium	Actual	Misalignment <sup>1</sup>
External Sustainability	-3.5	-2.2	...	...	-2.6
Macroeconomic Balance	-2.8	-2.2	...	...	-1.2
Equilibrium Real Exchange Rate	...	...	4.9	5.0	10.3

Source: IMF staff estimates.

<sup>1</sup> A positive number indicates overvaluation.

**The EBA-lite methodology concludes that Latvia's policies are broadly appropriate, but finds an unrealistically large real exchange rate undervaluation.** A small policy gap of 1 percent is estimated, suggesting that Latvia's fiscal, external (reserves and capital account), and financial policies are appropriate. But the current account norm is estimated as -5.5 percent of GDP, much larger than the actual 2014 CA deficit of -3.1 percent. This result should be interpreted with caution, as it seems inconsistent with the country's still high negative net international investment position, 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: 2015 Exchange Rate Assessment using EBA-lite Methodology Summary Table

CA-Actual	-3.1%	CA-Fitted	-4.5%
CA-Norm	-5.5%	Residual	1.4%
<b>CA-Gap</b>	<b>2.4%</b>	Policy gap	1.0%
Elasticity	-0.36		
<b>Real Exchange Rate Gap</b>	<b>-6.5%</b>	Cyclical Contributions	-0.6%
		Cyclically adjusted CA	-2.5%
		Cyclically adjusted CA Norm	-4.9%

**An examination of REER time-series (Panel 6) suggests that there have been very substantial gains in competitiveness since the crisis, but recent developments present a more mixed picture.** The HIPC-based REER has appreciated modestly by 2.5 percent since 2013, reflecting NEER appreciation somewhat mitigated by a decline in Latvia's HIPC relative to its main trading partners—many of which, such as the Nordics and CIS countries, are outside the Euro Area. Real wage growth continued to be strong in 2014, and this is reflected in a simple index of export profitability—the ratio of the export deflator to nominal ULCs—

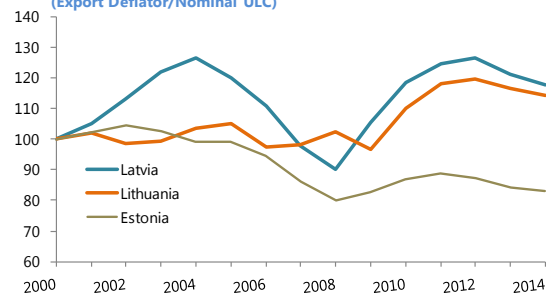
### Box 2. Republic of Latvia: External Sector Assessment (concluded)

whose continuing decline suggests that profit margins in Latvia are being squeezed relative to Euro Area countries, and more sharply than in the other Baltic countries.

**Accelerating the development of the export sector will require structural reforms to improve competitiveness.**

Since the crisis, export growth has been supported by the large internal devaluation. Latvia has successfully diversified its export base, both in terms of product mix and trade partners.<sup>1</sup> But the weak external environment, notably in Russia and main trading partners in Euro Area, will pose challenges to export expansion, despite mitigating effects from the euro depreciation and the recent drop in oil prices. Now that Latvia has joined the Euro Area and the severe wage restraint of the crisis period is being unwound, the focus must shift to generating productivity improvements that consistently exceed wage growth. A major effort should be made, inter alia, on reforms to upgrade the country's infrastructure, reduce skills mismatches in the labor market, improve work incentives, speed up the judicial process and reform SOE governance.

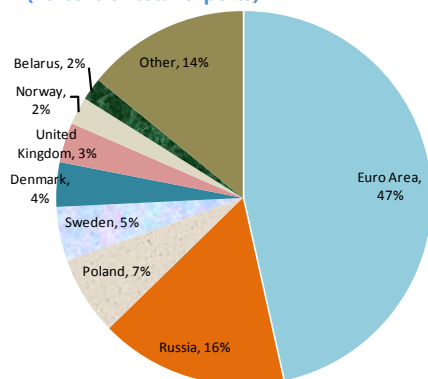
Latvia: Export Profitability Compared to Euro Area, 2000-14 (Export Deflator/Nominal ULC)



Sources: European Commission and IMF staff calculations.

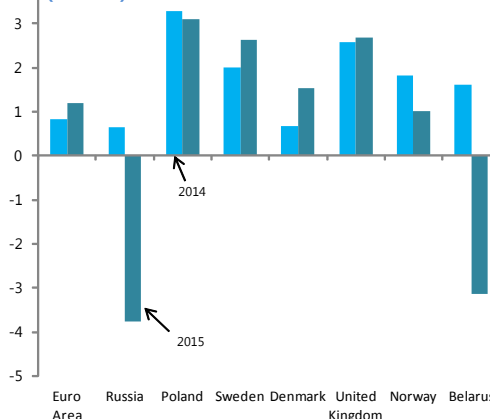
#### Growth Prospects in Main Trading Partners

Export Shares<sup>1</sup> (Percent of total exports)



Sources: Direction of Trade Statistics and IMF staff calculations.  
<sup>1</sup> Based on exports of goods in 2013.

Real GDP Growth in Main Trading Partners, 2014-15 (Percent)



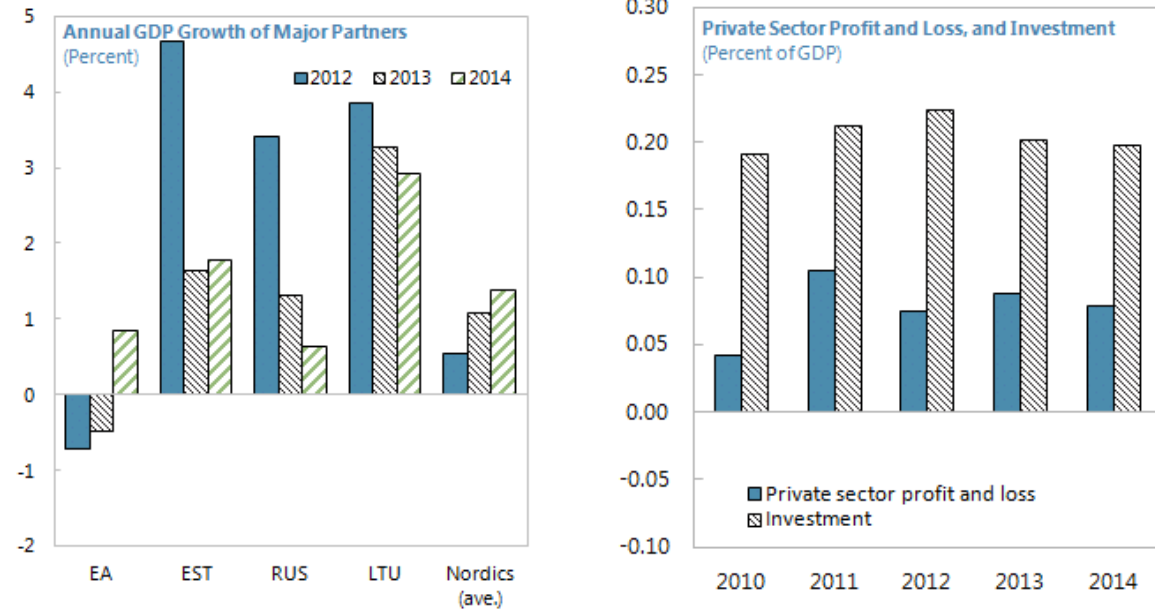
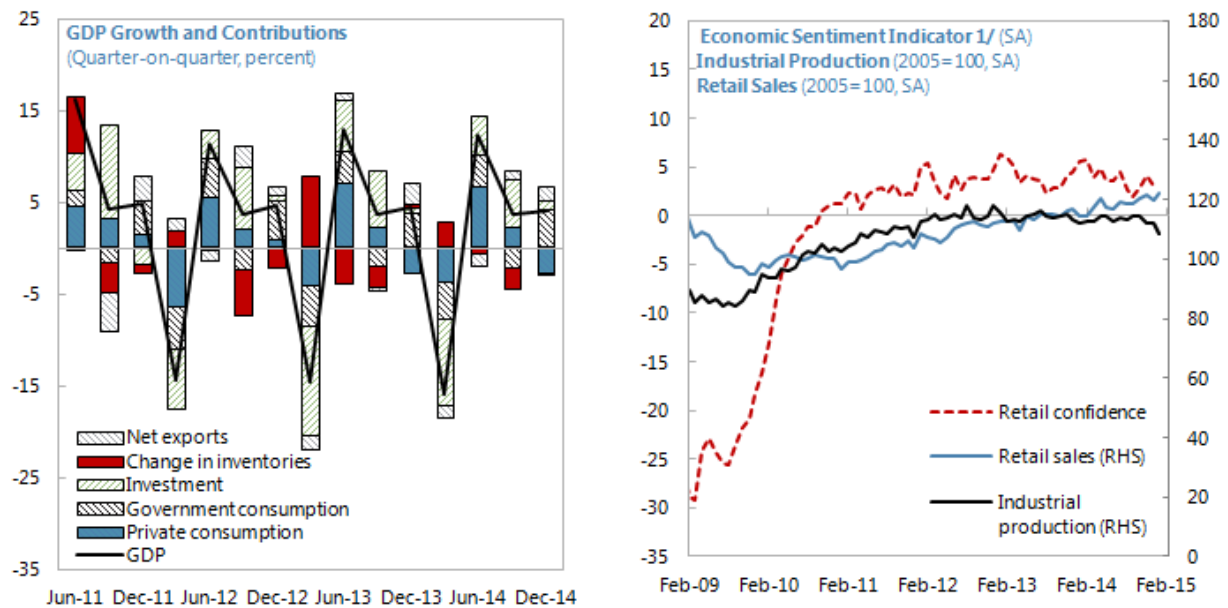
**External debt increased slightly in 2014, owing to government Eurobond issuances and exchange rate developments, but remains contained.** The government issued 2 billion of Eurobonds in 2014 partly to amortize European Commission loans. In addition, the euro value of dollar-denominated debt, estimated at 39.4 percent of GDP or 28.1 percent of total debt, has increased following the depreciation of the euro against the dollar. However the largest share of dollar-denominated debt is owed by banks, mostly by NRD-banks, the majority of whose assets are held abroad in liquid instruments, and which face restrictions on currency mismatches. Over the medium-term external debt is expected to resume its post-crisis downward trend, decreasing by more than 10 percentage points by the end of the projection period. Capital flows are expected to be stable and sufficient to cover the modest CA deficit, as they have been for the past few years. The main components of capital flows are government bond issuances, Nordic parent bank funding, and NRDs.

<sup>1/</sup> See Baltic Cluster Report, 2014, IMF Country Report No. [ISCR/14/116](#)

### Box 3. Republic of Latvia: Risk Assessment Matrix <sup>1/</sup>

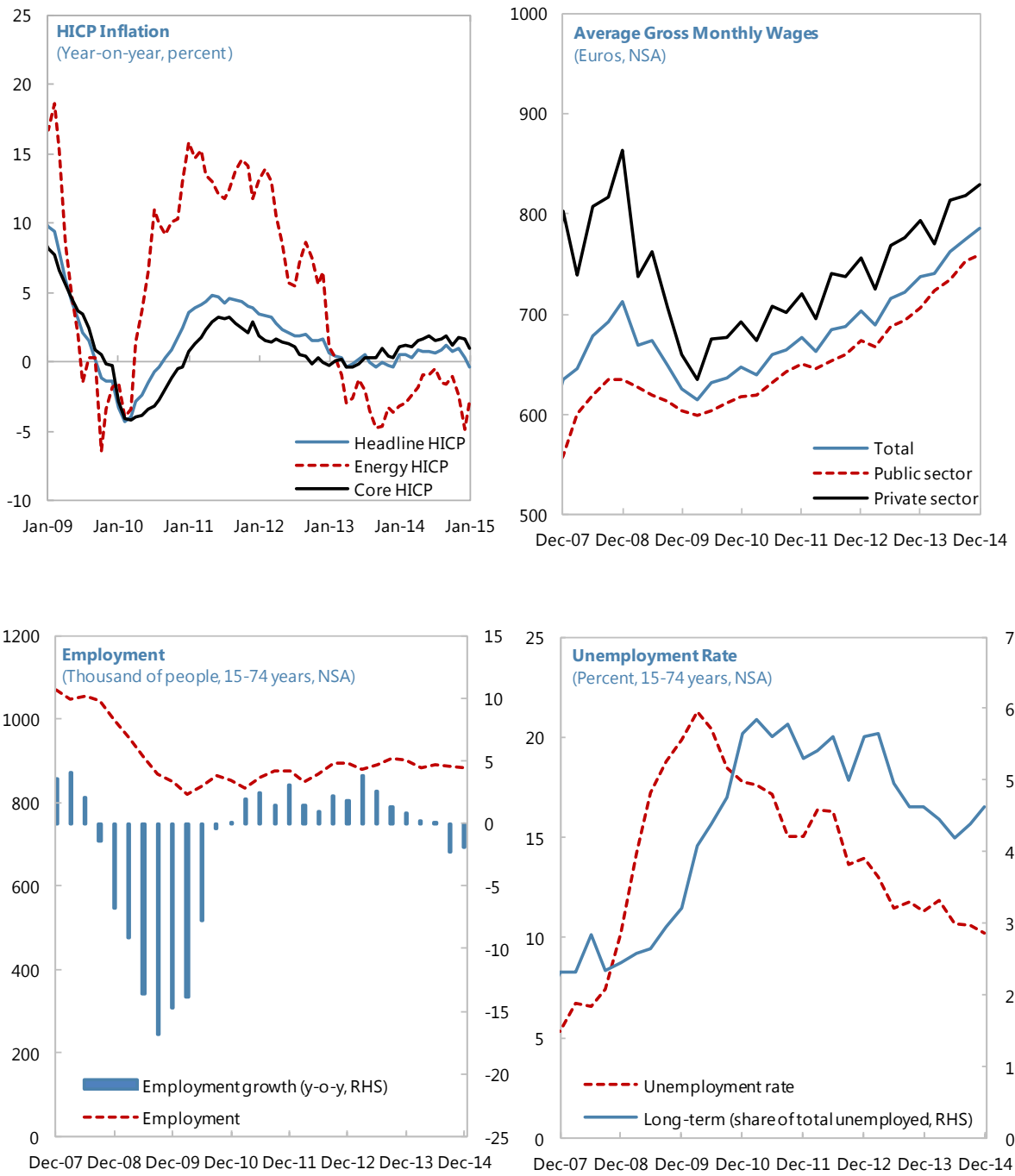
Risk	Relative Likelihood	Impact if Realized
<p><b>Side-effects from global financial conditions.</b></p> <ul style="list-style-type: none"> <li>• <b>A surge in financial volatility:</b> As investors reassess underlying risk and move to safe-haven assets given slow and uneven growth as well as asymmetric monetary exit, with poor market liquidity amplifying the effect on volatility.</li> </ul>	<b>High</b>	<p style="text-align: center;"><b>Low/Medium</b></p> <p>Could lower funding for Nordic parent banks reliant on wholesale funding, further hindering credit growth.</p>
<p><b>Protracted period of slower growth in advanced and emerging economies.</b></p> <ul style="list-style-type: none"> <li>• <b>Euro Area and Japan:</b> Weak demand and persistently low inflation from a failure to fully address crisis legacies and appropriately calibrate macro policies, leading to “new mediocre” rate of growth.</li> <li>• <b>Emerging markets:</b> Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.</li> </ul>	<p style="text-align: center;"><b>High</b></p> <p style="text-align: center;"><b>Medium</b></p>	<p style="text-align: center;"><b>High</b></p> <p>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.</p>
<p><b>Geopolitical fragmentation that erodes the globalization process and fosters inefficiency.</b></p> <ul style="list-style-type: none"> <li>• <b>Russia/Ukraine:</b> The mounting conflict depresses business confidence and heightens risk aversion, amid disturbances in global financial, trade and commodity markets.</li> <li>• <b>Heightened risk of fragmentation/ state failure/security dislocation in the Middle East and some countries in Africa,</b> leading to a sharp rise in oil prices, with negative global spillovers.</li> </ul>	<p style="text-align: center;"><b>Medium</b></p> <p style="text-align: center;"><b>Medium</b></p>	<p style="text-align: center;"><b>High</b></p> <p>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.</p> <p style="text-align: center;"><b>Medium</b></p> <p>A sharp supply-driven rise in oil prices would remove an important factor supporting projected growth, especially in the near-term.</p>
<p><b>Bond market stress from a reassessment in sovereign risk.</b></p> <ul style="list-style-type: none"> <li>• <b>Euro Area:</b> Sovereign stress re-emerges due to policy uncertainty, faltering reforms, and political and social upheaval, particularly in Greece.</li> </ul>	<b>Medium</b>	<p style="text-align: center;"><b>Medium</b></p> <p>A rise in sovereign spreads would raise the price of external financing, but is unlikely to cause credit to be rationed, given the lack of macroeconomic imbalances and low public debt.</p>
<p><b>Failure to advance on structural reforms.</b></p>	<b>Medium</b>	<p style="text-align: center;"><b>High</b></p> <p>In the absence of structural reforms productivity growth and the business environment would suffer, harming competitiveness and employment.</p>
<p><sup>1/</sup> 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.</p>		

Figure 1. Republic of Latvia: Real Sector, 2009–14



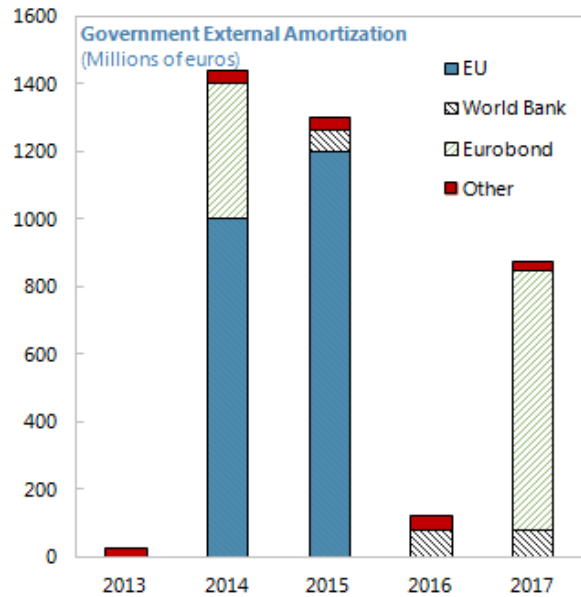
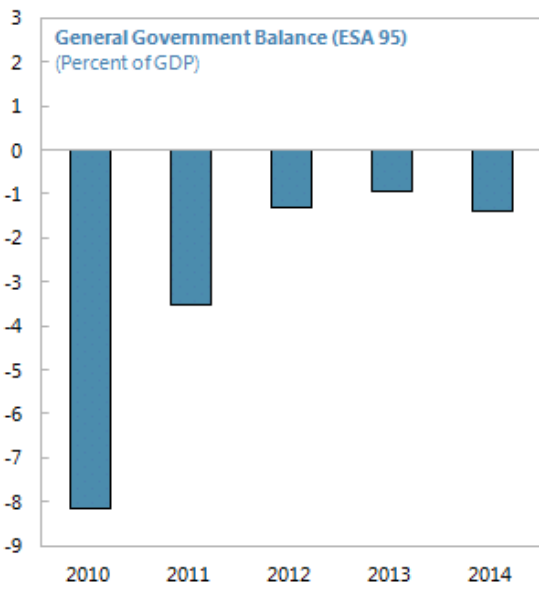
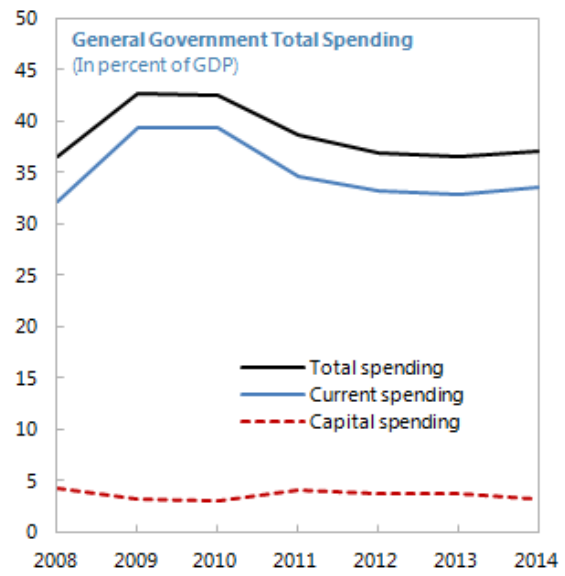
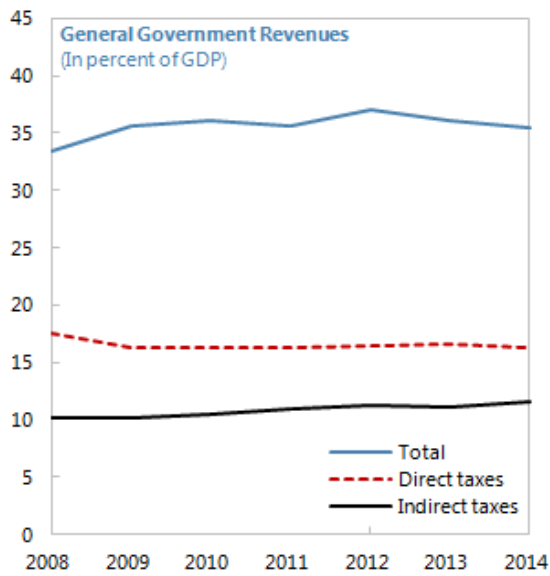
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.  
 1/ Difference with long-term average.

**Figure 2. Republic of Latvia: Inflation and the Labor Market, 2007–14**



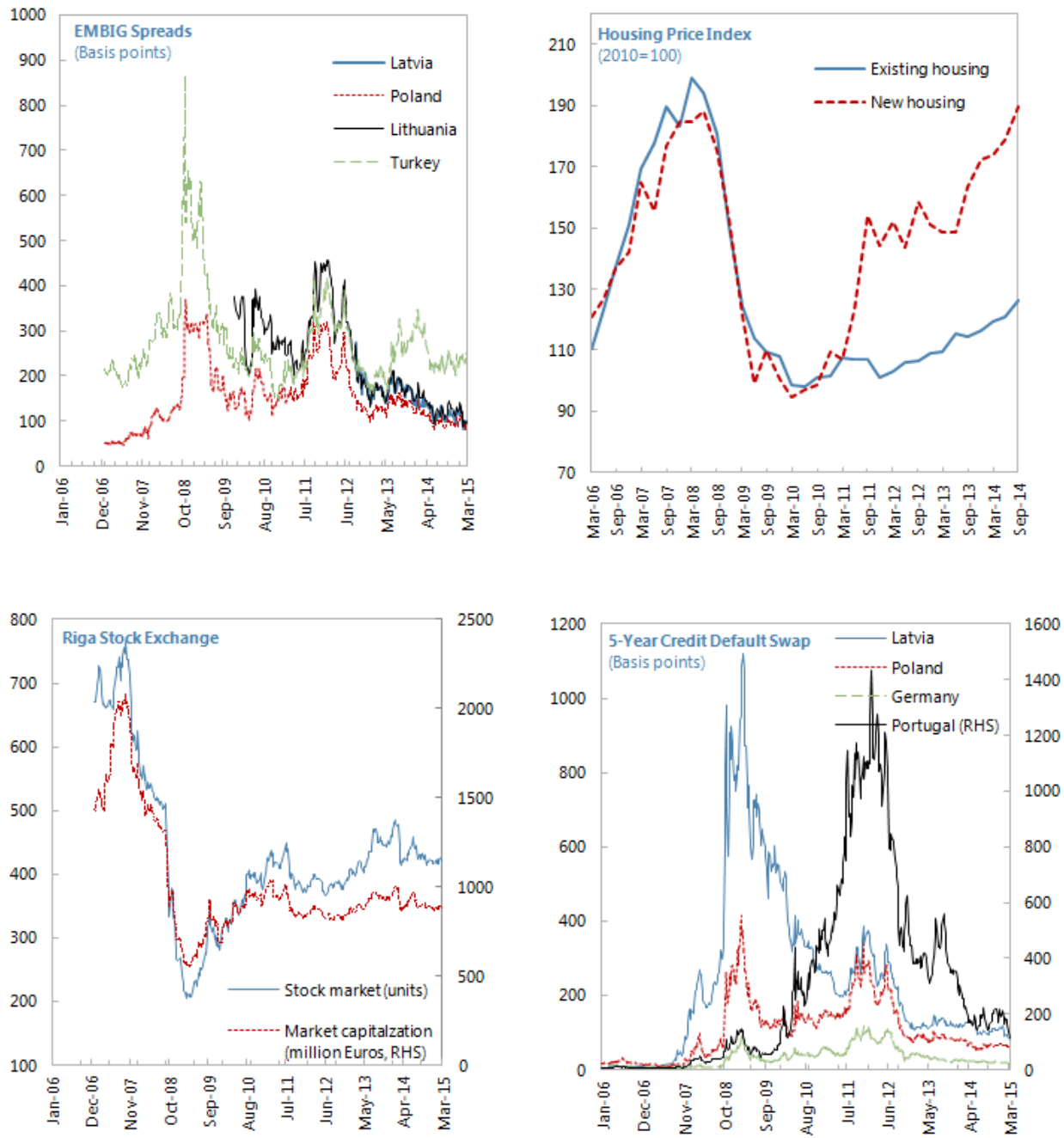
Sources: Eurostat; Haver Analytics; Latvian Central Statistical Bureau; and IMF staff calculations.

**Figure 3. Republic of Latvia: Fiscal Developments, 2008–14**



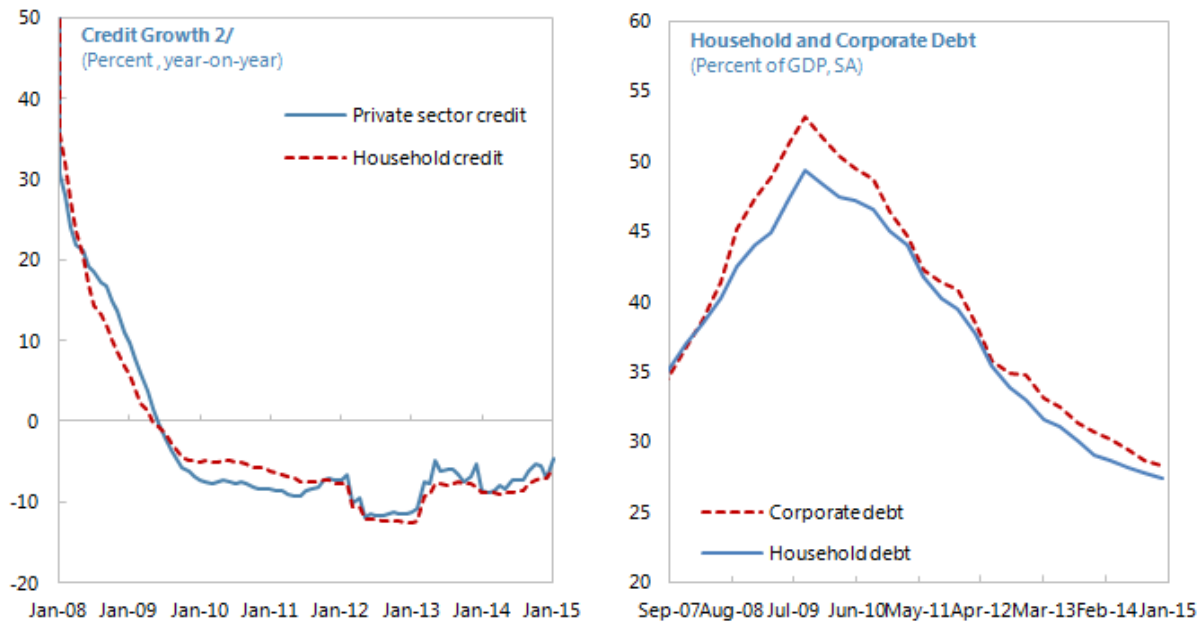
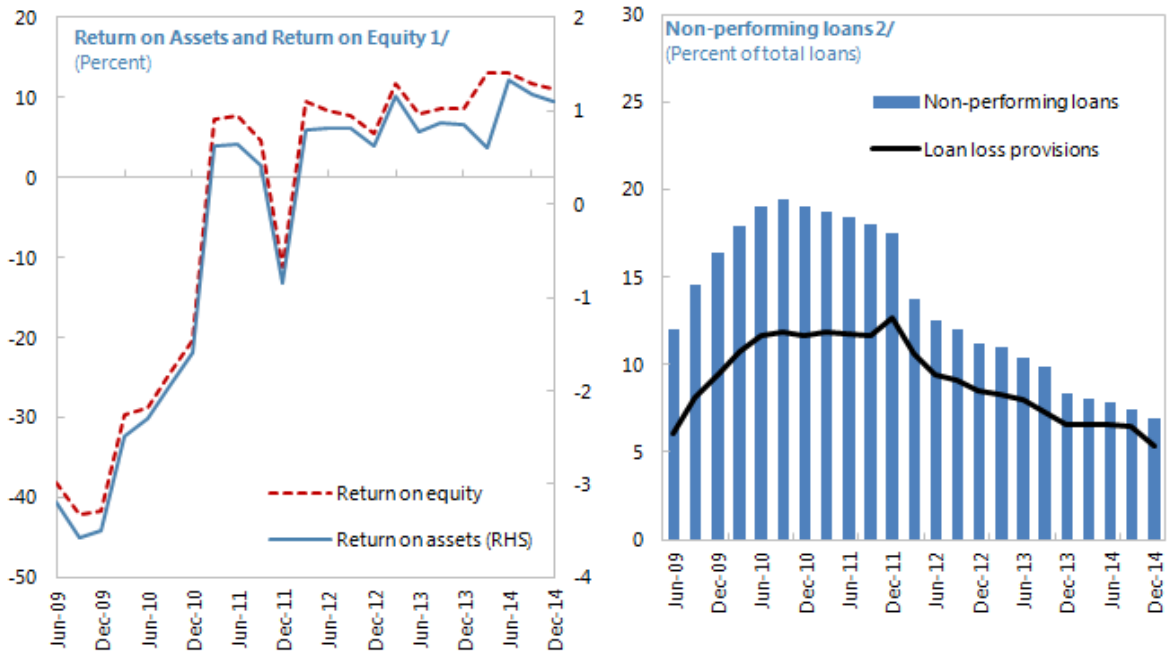
Sources: Latvian authorities; and IMF staff estimates.

**Figure 4. Republic of Latvia: Financial Market Developments, 2006–15**



Sources: Bank of Latvia; Bank for International Settlements; Bloomberg; and IMF staff calculations.

**Figure 5. Republic of Latvia: Banking Sector Development, 2007–14**



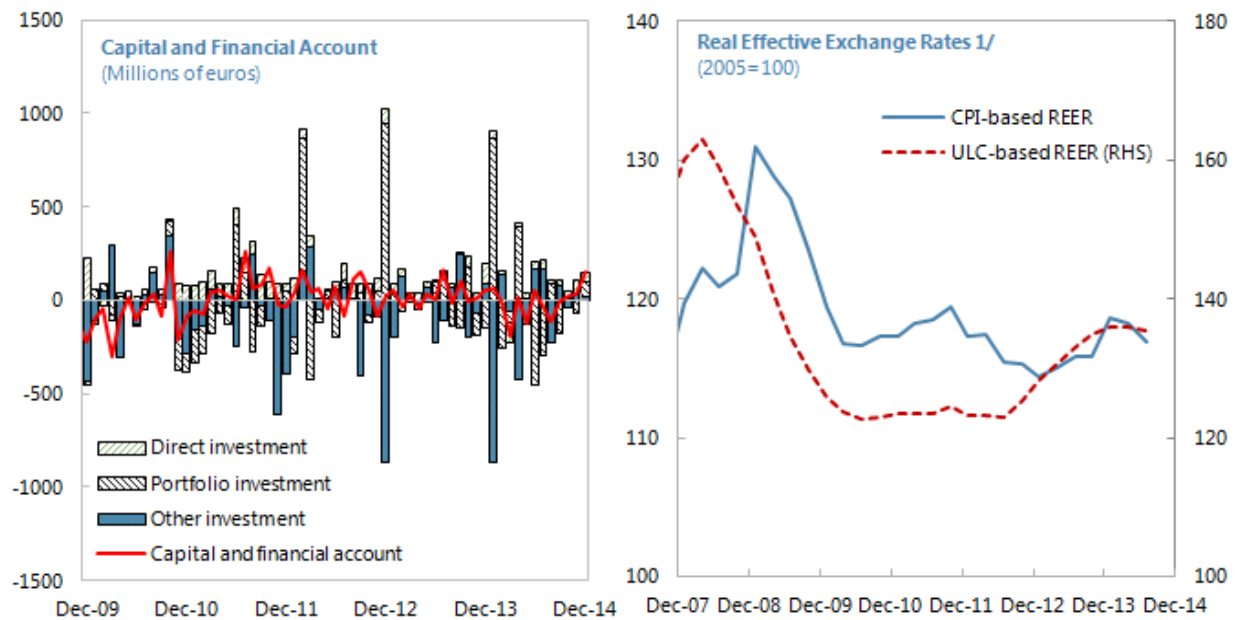
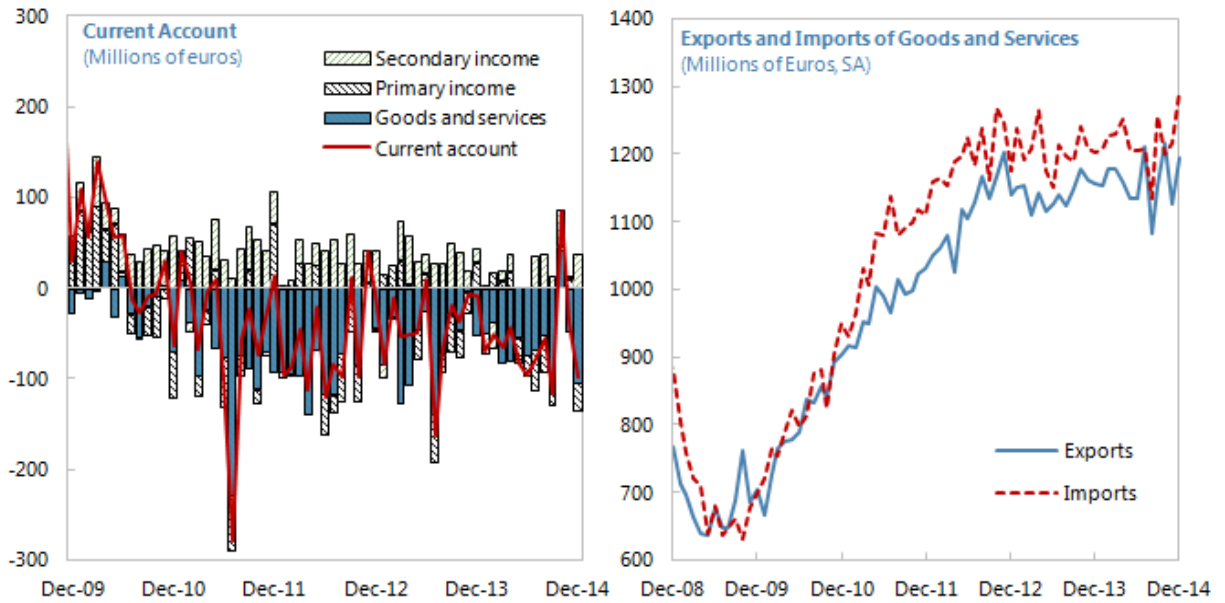
Source: Bank of Latvia; Bloomberg; FCMC; and IMF staff calculations.

1/ Data from January 2012 onwards exclude Parex Bank, which lost its banking license in March 2012, and Latvijas Krajbanka, which was suspended in November 2011 and lost its banking licence in May 2012.

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



**Figure 6. Republic of Latvia: Balance of Payments, 2007–14**

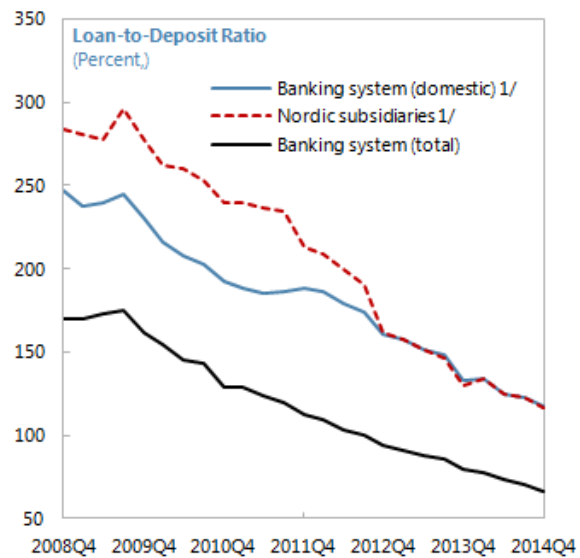
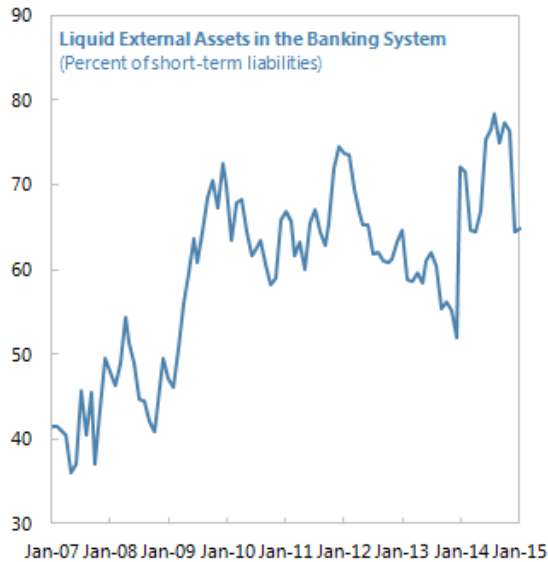
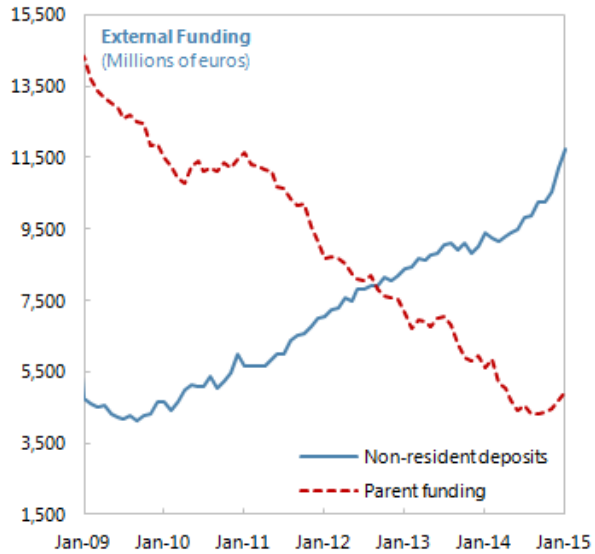
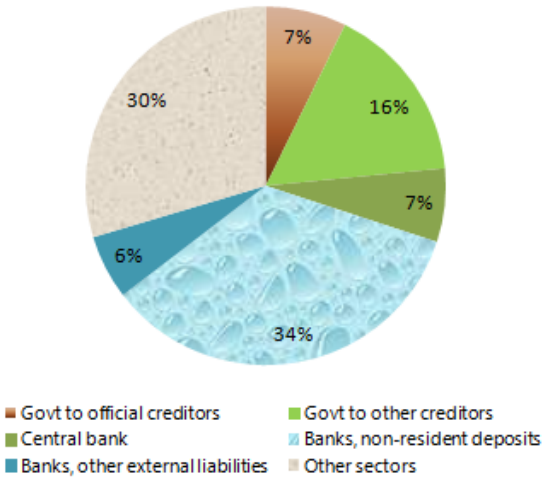


Sources: Bank of Latvia; ECB; EC; and IMF staff calculations.

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

**Figure 7. Republic of Latvia: External Debt and Vulnerabilities in the Banking System**

**Composition of External Debt**  
(Percent, Q4-2014)



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, 2008–15**

	2008	2009	2010	2011	2012	2013	2014	2015
							Est.	Proj.
(Percentage change, unless otherwise indicated)								
<b>National accounts</b>								
Real GDP	-3.2	-14.2	-2.9	5.0	4.8	4.2	2.4	2.3
Private consumption	-8.0	-16.2	3.1	2.9	3.0	6.2	2.3	2.9
Gross fixed capital formation	-9.2	-33.3	-20.0	24.2	14.5	-5.2	1.6	-0.4
Exports of goods and services	2.4	-12.9	13.4	12.0	9.8	1.4	1.9	1.2
Imports of goods and services	-10.7	-31.7	12.4	22.0	5.4	-0.2	1.5	1.1
Nominal GDP (billions of euros)	24.4	18.9	18.2	20.3	22.0	23.2	24.1	25.1
GDP per capita (thousands of euros)	11.1	8.7	8.6	9.8	10.8	11.4	11.8	12.4
<b>Savings and Investment</b>								
Gross national saving (percent of GDP)	21.7	29.4	21.7	21.5	22.7	21.1	20.8	21.6
Gross capital formation (percent of GDP)	34.0	21.4	19.4	24.3	26.0	23.4	23.9	23.7
Private (percent of GDP)	29.7	18.1	16.3	20.2	22.2	19.7	20.3	20.7
<b>HICP Inflation</b>								
Period average	15.4	3.5	-1.1	4.4	2.3	0.0	0.7	0.5
End-period	10.5	-1.2	2.5	4.1	1.6	-0.3	0.3	1.6
<b>Labor market</b>								
Unemployment rate (LFS definition; period average, percent) 1/	7.5	16.9	18.7	16.2	15.0	11.9	10.8	10.4
Real gross wages	4.5	-7.0	-2.2	0.0	1.5	4.5	6.3	3.5
(Percent of GDP, unless otherwise indicated)								
<b>Consolidated general government 1/</b>								
Total revenue	33.4	35.7	36.1	35.6	37.1	36.1	35.5	35.1
Total expenditure	36.5	42.6	42.5	38.7	37.0	36.6	37.1	36.5
Basic fiscal balance	-3.1	-7.0	-6.4	-3.1	0.1	-0.6	-1.7	-1.4
ESA balance	-3.9	-9.0	-8.2	-3.5	-1.3	-1.0	-1.4	-1.2
General government gross debt	16.1	32.3	39.8	37.5	36.5	35.2	37.8	37.7
<b>Money and credit</b>								
Credit to private sector (annual percentage change)	11.0	-6.9	-8.4	-7.4	-11.4	-5.4	-7.0	-1.0
Broad money (annual percentage change)	-3.9	-1.9	9.8	1.5	4.5	2.0	4.1	4.3
EMBIG (Percent) 3/	...	...	...	...	1.60	1.39	1.18	1.08
Money market rate (one month, eop, percent) 4/	13.30	2.67	0.61	1.06	0.30	0.25	0.13	...
<b>Balance of payments</b>								
Current account balance	-12.3	8.0	2.3	-2.8	-3.3	-2.3	-3.1	-2.1
Trade balance	-17.2	-8.1	-8.2	-12.0	-11.6	-10.9	-10.1	-9.3
Gross external debt	122.0	154.7	165.8	145.8	137.2	131.3	138.7	132.6
Net external debt 2/	53.8	58.1	54.6	47.0	39.5	35.9	31.1	29.2
<b>Exchange rates</b>								
U.S. dollar per euro (period average)	1.47	1.39	1.33	1.39	1.29	1.33	1.33	...
REER (period average; CPI based, 2005=100)	123.2	130.1	121.5	123.9	119.9	119.9	121.7	...
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.								
3/ Latest data as of March 2015.								
4/ Refers to the European Central Bank money market rate from 2014 onwards.								

Table 2. Republic of Latvia: Macroeconomic Framework, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Est.			Proj.			
	(Percentage change, unless otherwise indicated)										
<b>National accounts</b>											
Real GDP	-2.9	5.0	4.8	4.2	2.4	2.3	3.3	3.7	3.9	3.9	4.0
Consumption	0.4	3.0	2.4	5.5	2.6	3.0	3.9	3.5	3.5	3.5	3.5
Private consumption	3.1	2.9	3.0	6.2	2.3	2.9	4.1	4.0	4.0	4.0	4.0
Public consumption	-8.1	3.1	0.4	2.9	3.6	3.1	3.1	1.6	1.6	1.6	1.6
Gross capital formation	-16.2	42.1	2.6	-4.0	0.2	0.0	7.4	4.0	4.5	5.0	5.0
Gross fixed capital formation	-20.0	24.2	14.5	-5.2	1.6	-0.4	7.3	4.0	4.5	5.0	5.0
Stockbuilding	1.0	3.5	-2.6	0.3	-0.3	0.1	0.1	0.0	0.0	0.1	0.1
Exports of goods and services	13.4	12.0	9.8	1.4	1.9	1.2	2.6	4.9	4.8	4.7	4.7
Imports of goods and services	12.4	22.0	5.4	-0.2	1.5	1.1	4.9	4.6	4.5	4.5	4.5
Contributions to growth											
Domestic demand	-3.3	10.6	2.6	3.3	2.1	2.4	4.8	3.8	3.9	4.0	4.0
Net exports	0.3	-5.6	2.1	1.0	0.2	0.0	-1.5	0.0	0.0	-0.1	-0.1
<b>HICP inflation</b>											
Period average	-1.1	4.4	2.3	0.0	0.7	0.5	1.7	2.3	2.2	2.0	2.0
End-period	2.5	4.1	1.6	-0.3	0.3	1.6	1.7	2.3	2.2	2.0	2.0
<b>Labor market</b>											
Unemployment rate (LFS definition; period average, percent)	18.7	16.2	15.0	11.9	10.8	10.4	10.2	9.8	9.6	9.4	9.3
Employment (period average, percent change)	-5.8	2.2	1.6	2.1	-1.0	0.3	0.1	0.0	0.0	0.1	0.0
Real gross wages	-2.2	0.0	1.5	4.5	6.3	3.5	3.2	3.7	3.8	3.9	3.9
	(Percent of GDP)										
<b>Consolidated general government 1/</b>											
Total revenue	36.1	35.6	37.1	36.1	35.5	35.1	33.9	32.7	33.6	33.4	32.7
Total expenditure	42.5	38.7	37.0	36.6	37.1	36.5	34.9	34.5	34.1	33.7	33.2
ESA balance	-8.2	-3.5	-1.3	-1.0	-1.4	-1.2	-0.9	-0.8	-0.5	-0.5	-0.5
ESA structural balance	-2.8	-1.6	-0.1	-0.8	-0.9	-1.0	-0.8	-0.7	-0.5	-0.5	-0.5
General government gross debt	39.8	37.5	36.5	35.2	37.8	37.7	37.0	36.6	35.0	33.5	31.9
<b>Saving and investment</b>											
Gross national saving	21.7	21.5	22.7	21.1	20.8	21.6	21.9	22.0	22.4	22.6	22.9
Private	24.5	19.9	18.4	17.3	17.8	18.8	18.4	19.0	18.2	18.2	18.5
Public 2/	-2.8	1.6	4.4	3.8	3.0	2.8	3.5	3.0	4.2	4.4	4.4
Foreign saving 3/	-2.3	2.8	3.3	2.3	3.1	2.1	2.8	2.7	2.4	2.3	2.2
Gross capital formation	19.4	24.3	26.0	23.4	23.9	23.7	24.6	24.7	24.8	24.9	25.1
Private	16.3	20.2	22.2	19.7	20.3	20.7	21.6	21.5	21.6	21.7	21.9
Public	3.1	4.1	3.8	3.7	3.6	3.0	3.1	3.1	3.2	3.2	3.2
<b>External sector</b>											
Current account balance	2.3	-2.8	-3.3	-2.3	-3.1	-2.1	-2.8	-2.7	-2.4	-2.3	-2.2
Net IIP	-81.2	-74.1	-67.3	-65.3	-61.2	-57.4	-55.2	-53.0	-50.2	-47.8	-45.5
Gross external debt	165.8	145.8	137.2	131.3	138.7	132.6	135.0	131.1	129.1	126.9	124.6
Net external debt 4/	54.6	47.0	39.5	35.9	31.1	29.2	27.2	25.2	22.4	19.2	15.9
<b>Memorandum items:</b>											
Nominal GDP (billions of euros)	18.2	20.3	22.0	23.2	24.1	25.1	26.3	27.9	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, 2010–20<sup>1/</sup>**

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	
						Projections						
	(percent of GDP)											
Total revenue and grants	36.1	35.6	37.1	36.1	35.5	35.1	33.9	32.7	33.6	33.4	32.7	
Tax revenue	26.7	27.2	27.7	27.7	27.8	27.5	27.0	26.8	26.8	26.8	26.7	
Direct Taxes	16.2	16.3	16.5	16.6	16.2	16.0	15.5	15.4	15.4	15.4	15.4	
Corporate Income Tax	0.9	1.4	1.6	1.6	1.5	1.5	1.4	1.4	1.4	1.4	1.4	
Personal Income Tax	6.1	5.6	5.6	5.7	5.8	5.6	5.4	5.5	5.5	5.5	5.5	
Social Security Contributions	8.6	8.6	8.5	8.5	8.2	8.1	7.8	7.8	7.8	7.8	7.7	
Real Estate and Property Taxes	0.7	0.8	0.8	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.7	
Indirect Taxes	10.4	10.9	11.2	11.1	11.5	11.5	11.5	11.4	11.4	11.4	11.3	
VAT	6.5	6.7	7.2	7.2	7.5	7.5	7.6	7.6	7.6	7.6	7.6	
Excises	3.6	3.4	3.2	3.1	3.1	3.1	3.0	2.9	2.9	2.9	2.8	
Other indirect taxes	0.4	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
Non Tax, self-earned and other revenue	4.7	3.8	3.9	3.6	3.3	3.3	3.2	2.9	3.1	3.1	3.1	
EU and miscellaneous funds	4.7	4.7	5.5	4.8	4.5	4.3	3.7	3.0	3.7	3.4	2.9	
Total expenditure 2/	42.5	38.7	37.0	36.6	37.1	36.5	34.9	34.5	34.1	33.7	33.2	
Current expenditure	39.4	34.6	33.2	32.9	33.5	33.8	32.5	31.9	31.9	31.4	30.8	
Remuneration	8.5	7.9	7.4	7.6	7.7	7.9	7.6	7.4	7.4	7.4	7.4	
Wages and Salaries	6.6	6.2	5.8	5.9	6.0	6.1	5.9	5.7	5.7	5.7	5.7	
Goods and Services	5.4	5.1	4.7	4.8	4.7	5.1	4.6	4.5	4.5	4.5	4.5	
Subsidies and Transfers	23.0	19.2	18.4	17.9	18.4	18.2	17.8	17.6	17.4	17.2	16.7	
Subsidies to companies and institutions	9.2	7.8	7.9	7.4	8.1	7.8	7.6	7.7	7.6	7.4	7.0	
Social Support	13.7	11.3	10.4	10.3	10.2	10.2	10.0	9.8	9.7	9.7	9.5	
Pensions	9.8	8.5	8.0	7.8	7.6	7.4	7.2	7.0	6.7	6.5	6.3	
Other	3.9	2.8	2.4	2.5	2.6	2.8	2.8	2.8	3.0	3.2	3.2	
International cooperation	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	
Payments to EU budget	1.0	0.9	1.0	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	
Other	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Interest	1.4	1.4	1.5	1.4	1.5	1.4	1.2	1.2	1.4	1.1	1.1	
Capital expenditure	3.1	4.1	3.8	3.7	3.6	3.0	3.1	3.1	3.2	3.2	3.2	
Measures to be identified	0.0	0.0	0.0	0.0	0.0	0.3	0.6	0.6	1.0	0.9	0.9	
Restructuring costs	0.9	0.1	-0.1	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Fiscal balance	-7.3	-3.2	0.1	-1.2	-1.7	-1.4	-1.0	-1.7	-0.5	-0.4	-0.4	
Financing (net)	7.1	3.2	-0.1	1.2	1.7	1.4	1.0	1.7	0.5	0.4	0.4	
Domestic financing	1.1	0.6	-2.7	1.2	-0.8	4.0	-3.6	2.3	-0.3	-1.7	1.2	
External financing	5.9	2.0	2.6	0.0	2.4	-2.6	4.6	-0.6	0.8	2.0	-0.8	
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	
Memorandum items												
ESA balance	-8.2	-3.5	-1.3	-1.0	-1.4	-1.2	-0.9	-0.8	-0.5	-0.5	-0.5	
ESA structural balance 3/	-2.8	-1.6	-0.1	-0.8	-0.9	-1.0	-0.8	-0.7	-0.5	-0.5	-0.5	
Nominal GDP (billions of euros)	18.2	20.3	22.0	23.2	24.1	25.1	26.3	27.9	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, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	
					Est.			Projections				
	(Percent of GDP, unless otherwise indicated)											
Current account	2.3	-2.8	-3.3	-2.3	-3.1	-2.1	-2.8	-2.7	-2.4	-2.3	-2.2	
Goods and services (fob)	-1.0	-4.7	-4.3	-3.3	-2.9	-2.1	-3.6	-3.5	-3.2	-3.1	-2.9	
Goods (fob)	-8.2	-12.0	-11.6	-10.9	-10.1	-9.3	-10.5	-10.4	-10.3	-10.1	-10.0	
Exports	36.6	40.9	43.8	42.2	42.1	40.4	40.1	40.3	40.4	40.5	40.6	
Imports	-44.8	-52.9	-55.4	-53.2	-52.2	-49.7	-50.6	-50.8	-50.7	-50.6	-50.6	
Services	7.2	7.3	7.4	7.6	7.3	7.2	6.9	7.0	7.0	7.1	7.1	
Credit	16.8	17.1	17.1	16.8	16.0	15.7	15.6	15.7	15.7	15.8	15.8	
Debit	-9.6	-9.8	-9.7	-9.2	-8.7	-8.5	-8.7	-8.7	-8.7	-8.7	-8.7	
Primary Income	1.0	0.0	-0.6	-0.3	-0.8	-0.9	-1.0	-1.0	-1.3	-1.5	-1.7	
Compensation of employees	2.4	2.3	2.3	2.2	2.3	2.3	2.3	2.3	2.2	2.2	2.2	
Investment income	-2.6	-3.4	-4.2	-3.8	-3.8	-3.9	-3.9	-3.9	-4.1	-4.2	-4.4	
Secondary Income	2.3	1.9	1.6	1.3	0.5	0.9	1.8	1.8	2.2	2.2	2.3	
of which: from EU	4.7	4.7	5.5	4.8	4.5	4.3	3.7	3.0	3.7	3.4	3.2	
Capital and financial account	-4.1	2.5	2.3	1.5	-1.0	2.1	2.8	2.7	2.4	2.3	2.2	
Capital account	1.9	2.1	3.0	2.5	3.0	3.4	2.3	1.8	2.0	1.9	1.8	
Financial account	-6.1	0.4	-0.7	-1.0	-4.0	-1.4	0.5	0.9	0.3	0.4	0.4	
Direct investment	1.5	4.9	3.2	1.6	1.1	1.9	2.1	2.4	2.7	3.1	3.6	
Portfolio investment and financial derivatives	-2.8	-1.8	4.7	0.1	-0.5	0.4	2.8	-2.1	-0.3	1.2	-0.7	
of which: general government net issuance	-0.1	1.2	7.3	-0.3	6.8	2.4	4.9	-0.3	1.7	2.9	1.0	
Other investment	-0.7	-7.2	-5.1	-1.0	-5.0	-3.7	-4.4	0.7	-2.1	-4.0	-2.5	
Reserve assets	-4.0	4.5	-3.6	-1.7	0.5	0.0	0.0	0.0	0.0	0.0	0.0	
Errors and omissions	1.8	0.3	1.0	0.8	4.1	0.0	0.0	0.0	0.0	0.0	0.0	
	(Percent change, unless otherwise indicated)											
Goods and Services												
Export value (fob)	18.9	21.3	13.9	2.2	1.8	0.7	4.1	6.7	6.5	6.1	6.3	
Import value (fob)	19.8	28.7	12.7	0.9	1.2	-0.4	6.8	6.5	6.1	5.8	6.0	
Export volume	13.4	12.0	9.8	1.4	1.9	1.2	2.6	4.9	4.8	4.7	4.7	
Import volume	12.4	22.0	5.4	-0.2	1.5	1.1	4.9	4.6	4.5	4.5	4.5	
Gross reserves (billions of euros)	5.8	4.9	5.7	5.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	
Gross external debt (percent of GDP)	165.8	145.8	137.2	131.3	138.7	132.6	135.0	131.1	129.1	126.9	124.6	
Medium and long term (percent of GDP)	113.0	100.4	87.2	77.3	76.0	68.7	71.0	67.7	66.5	65.1	63.7	
Short term (percent of GDP) <sup>1</sup>	52.8	45.4	50.0	54.0	62.7	63.9	64.0	63.4	62.6	61.8	60.9	
Net external debt (percent of GDP) <sup>2</sup>	54.6	47.0	39.5	35.9	31.1	29.2	27.2	25.2	22.4	19.2	15.9	
<i>Memo items</i>												
Nominal GDP (billions of euros)	18.2	20.3	22.0	23.2	24.1	25.1	26.3	27.9	29.6	31.4	33.3	
U.S. dollar per euro (period average)	1.33	1.39	1.29	1.33	1.33	...	...	...	...	...	...	

Sources: Latvian authorities; and IMF staff estimates.

<sup>1</sup> Based on detailed data until 2013. Extrapolated for debt outside the public sectors and MFIs starting 2014.<sup>2</sup> Gross external debt minus gross external debt assets.

**Table 5. Republic of Latvia: Financial Soundness Indicators, 2006–14**

(in percent, unless otherwise indicated)

	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14
<b>Commercial banks</b>									
<i>Capital Adequacy</i>									
Regulatory capital to risk-weighted assets 1/	10.2	11.1	11.80	14.6	14.6	17.4	17.60	18.9	17.9
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	17.9
Capital and reserves to assets	7.6	7.9	7.30	7.4	7.3	7.5	9.36	9.9	9.9
<i>Asset Quality</i>									
Annual growth of bank loans	56.2	37.2	11.2	-7.0	-7.1	-8.1	-10.9	-6.5	-6.1
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
Agriculture, hunting and related service activities	1.8	1.6	1.7	1.6	1.6	2.0	2.4	3.2	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
Industry and trade	22.0	21.6	23.1	22.3	22.0	22.0	24.3	24.2	22.0
Financial intermediation	8.0	6.0	6.0	4.5	3.2	2.8	2.7	3.6	4.7
Households	39.4	40.0	38.4	39.3	39.8	40.0	39.1	38.4	37.8
Non-residents	9.9	12.1	11.2	11.4	13.1	13.2	12.9	12.6	14.0
Loans past due over 90 days	0.5	0.8	3.6	16.4	19.0	17.5	11.1	8.3	6.9
Loans to households			4.7	16.8	18.4	19.3	15.2	12.0	9.5
Loans to corporations			2.8	18.5	20.8	16.2	9.7	7.0	5.9
<i>Earnings and Profitability</i>									
ROA (after tax)	2.1	2.0	0.3	-3.5	-1.6	-0.9	0.6	0.9	1.1
ROE (after tax)	25.6	24.3	4.6	-41.6	-20.4	-11.2	5.6	8.7	11.1
<i>Liquidity</i>									
Liquid assets to total assets	23.9	25.0	21.6	21.1	27.3	27.4	32.3	36.5	39.9
Liquid assets to short term liabilities	51.1	55.7	52.8	62.8	67.9	63.9	59.8	64.4	63.1
Customers deposits to (non-interbank) loans	71.3	68.2	58.8	61.9	77.5	84.1	106.3	124.9	158.4
<i>Sensitivity to Market Risk</i>									
FX deposits to total deposits 2/		70.7	69.4	74.5	72.6	73.5	76.2	75.9	40.3
FX loans to total loans 2/		81.8	85.0	87.1	88.9	86.3	84.5	88.5	13.0
<i>Memorandum Items</i>									
Number of banks dealing with residents 3/	9.0	9.0	14.0	15.0	15.0	17.0	13.0	13.0	11.0
Number of banks dealing with non-residents 3/	14.0	14.0	13.0	12.0	14.0	13.0	16.0	15.0	15.0
Assets of banks dealing with residents/Total banking system assets 3/	51.1	60.8	63.9	78.4	66.6	63.3	54.5	54.8	49.2
Assets of banks dealing with non-residents/Total banking system assets 3/	48.9	39.2	36.1	21.6	33.4	36.7	45.5	45.2	50.8

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

Regulatory capital to risk-weighted assets and Regulatory Tier 1 capital to risk-weighted assets in the column of Dec 2014 uses data from Sep 2014.

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, 2009–16**

(Million of SDRs)

	2009	2010	2011	2012	2013	2014	2015	2016
Stock, existing	713.8	982.2	982.2	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
Repurchase	0.0	0.0	0.0	982.2	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
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
In percent of GDP	4.2	6.2	5.5	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and services	9.7	11.6	9.5	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
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
In percent of GDP	0.1	0.1	0.2	5.4	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.2	0.3	0.3	8.9	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

Source: IMF staff estimates.



## Annex I. Public Debt Sustainability Analysis (DSA) \*/

### Republic of Latvia: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

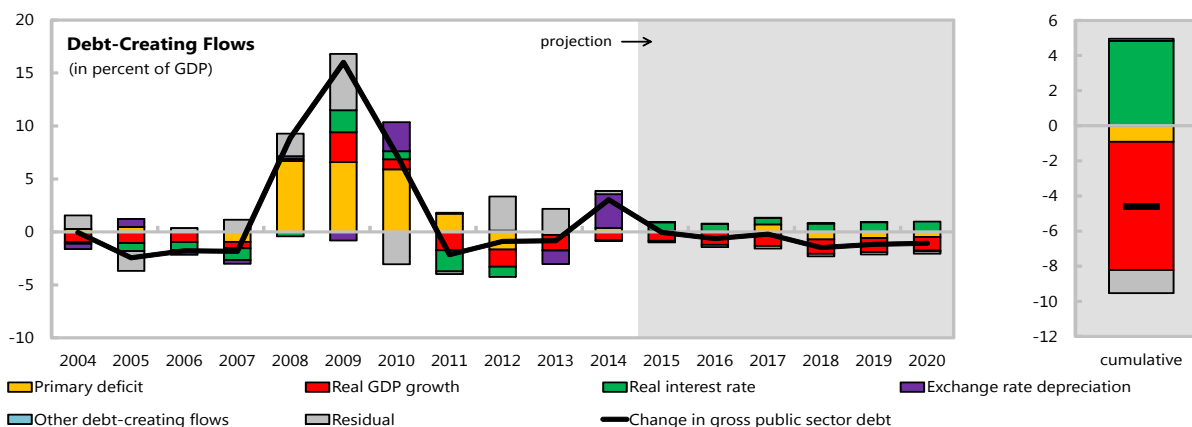
(in percent of GDP unless otherwise indicated)

#### Debt, Economic and Market Indicators <sup>1/</sup>

	Actual			Projections						As of March 10, 2015		
	2004-2012 <sup>2/</sup>	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads EMBIG (bp) <sup>3/</sup>		
Nominal gross public debt	21.7	34.9	37.9	37.8	37.2	37.0	35.5	34.4	33.3		1	
Public gross financing needs	4.4	0.6	3.6	10.7	6.2	9.8	6.0	5.9	10.7	5Y CDS (bp)	92	
Real GDP growth (in percent)	3.3	4.2	2.4	2.3	3.3	3.7	3.9	3.9	4.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	6.9	1.1	1.2	1.8	1.6	2.2	2.2	2.0	2.1	Moody's	A3	A3
Nominal GDP growth (in percent)	10.9	5.3	3.6	4.2	5.0	6.0	6.2	6.0	6.1	S&Ps	A-	A-
Effective interest rate (in percent) <sup>4/</sup>	5.3	4.2	4.3	4.1	3.7	4.0	4.6	4.9	5.2	Fitch	A-	A-

#### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020		
Change in gross public sector debt	2.6	-0.8	3.0	0.0	-0.6	-0.2	-1.5	-1.2	-1.1	-4.6	
Identified debt-creating flows	1.6	-3.0	2.7	0.1	-0.4	0.0	-1.2	-0.9	-0.8	-3.3	
Primary deficit	2.1	-0.3	0.4	0.1	0.0	0.7	-0.7	-0.6	-0.5	-0.9	
Primary (noninterest) revenue and grants	34.5	36.1	35.3	34.9	33.7	32.5	33.4	33.2	32.6	200.4	
Primary (noninterest) expenditure	36.7	35.8	35.7	35.0	33.7	33.3	32.7	32.6	32.1	199.5	
Automatic debt dynamics <sup>5/</sup>	-0.5	-2.8	2.3	0.0	-0.5	-0.7	-0.6	-0.4	-0.3	-2.5	
Interest rate/growth differential <sup>6/</sup>	-0.7	-1.5	-0.8	0.0	-0.5	-0.7	-0.6	-0.4	-0.3	-2.5	
Of which: real interest rate	-0.4	-0.1	0.0	0.8	0.7	0.6	0.8	0.9	1.0	4.8	
Of which: real GDP growth	-0.3	-1.4	-0.8	-0.8	-1.2	-1.3	-1.4	-1.3	-1.3	-7.3	
Exchange rate depreciation <sup>7/</sup>	0.2	-1.3	3.2	...	...	...	...	...	...	...	
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 (+ r) <sup>0</sup>	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 Euroare) <sup>0</sup>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes <sup>8/</sup>	0.9	2.2	0.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-1.3	



Source: IMF staff.

\*/ Latvia is characterized as a low-scrutiny country despite financing needs marginally exceed the 10 percent threshold in two years, 2015 and 2020. The excess in 2020 is marginal, while financing needs in 2015 are already mostly covered. Latvia has been very successful in accessing markets recently and have been repeatedly upgraded by rating agencies.

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  $[(r - \pi(1+g) - g + ae(1+r)] / (1+g+\pi+gn)$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = 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  $r - \pi(1+g)$  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.

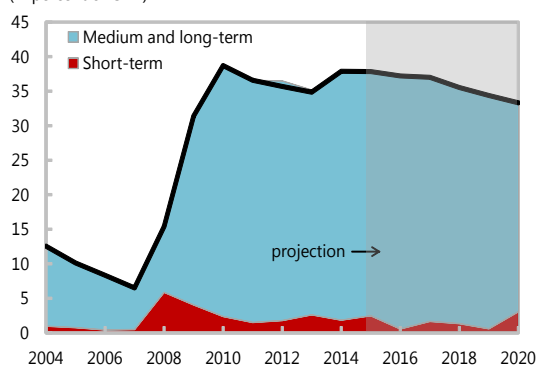
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

## Republic of Latvia: Public DSA—Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

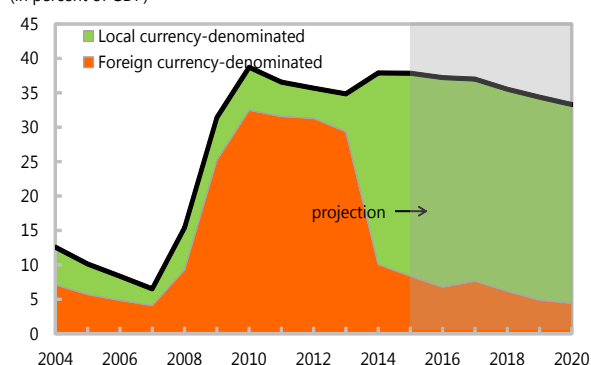
#### By Maturity

(in percent of GDP)



#### By Currency

(in percent of GDP)



### Alternative Scenarios

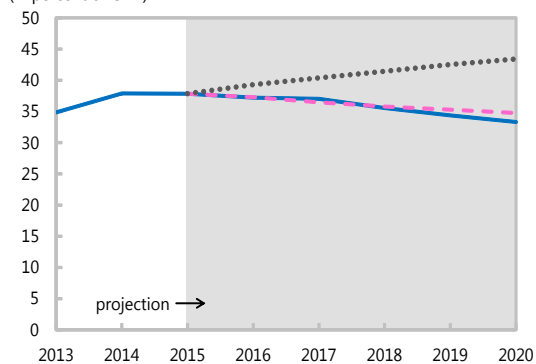
Baseline

..... Historical

--- Constant Primary Balance

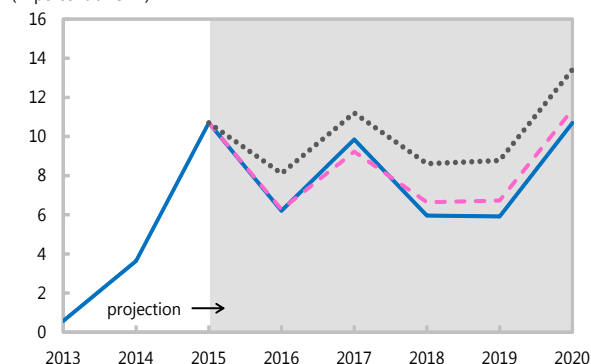
#### Gross Nominal Public Debt

(in percent of GDP)



#### Public Gross Financing Needs

(in percent of GDP)



### Underlying Assumptions

(in percent)

#### Baseline Scenario

	2015	2016	2017	2018	2019	2020
Real GDP growth	2.3	3.3	3.7	3.9	3.9	4.0
Inflation	1.8	1.6	2.2	2.2	2.0	2.1
Primary Balance	-0.1	0.0	-0.7	0.7	0.6	0.5
Effective interest rate	4.1	3.7	4.0	4.6	4.9	5.2

#### Historical Scenario

	2015	2016	2017	2018	2019	2020
Real GDP growth	2.3	2.8	2.8	2.8	2.8	2.8
Inflation	1.8	1.6	2.2	2.2	2.0	2.1
Primary Balance	-0.1	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	4.1	3.7	3.5	3.4	3.3	3.2

#### Constant Primary Balance Scenario

	2015	2016	2017	2018	2019	2020
Real GDP growth	2.3	3.3	3.7	3.9	3.9	4.0
Inflation	1.8	1.6	2.2	2.2	2.0	2.1
Primary Balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	4.1	3.7	4.0	4.6	4.8	5.1

Source: IMF staff.

**Republic of Latvia: External Debt Sustainability Framework, 2009–19**  
(in percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -7.5
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Baseline: External debt	154.7	165.8	145.8	137.2	131.3	138.7	132.6	135.0	131.1	129.1	126.9	
Change in external debt	32.7	11.1	-20.0	-8.6	-5.9	7.3	-6.1	2.4	-3.9	-2.0	-2.2	
Identified external debt-creating flows (4+8+9)	38.7	10.7	-25.4	0.6	-11.0	-1.7	-3.4	-3.3	-4.2	-4.9	-5.4	
Current account deficit, excluding interest payments	-16.5	-8.4	-2.4	-1.0	-0.8	0.1	-1.1	-0.3	-0.5	-0.8	-0.8	
Deficit in balance of goods and services	0.5	1.0	4.7	4.3	3.3	2.9	2.1	3.6	3.5	3.2	3.1	
Exports	43.2	53.4	58.0	60.8	59.0	58.0	56.1	55.7	56.0	56.2	56.2	
Imports	43.7	54.5	62.7	65.1	62.3	60.9	58.2	59.2	59.5	59.4	59.3	
Net non-debt creating capital inflows (negative)	2.2	-1.1	-3.9	-2.2	-2.2	-1.8	-2.0	-1.9	-2.2	-2.5	-2.9	
Automatic debt dynamics 1/	53.0	20.3	-19.0	3.8	-8.0	0.0	-0.2	-1.1	-1.5	-1.6	-1.7	
Contribution from nominal interest rate	8.5	6.1	5.3	4.3	3.1	3.0	3.1	3.1	3.2	3.1	3.1	
Contribution from real GDP growth	23.6	4.9	-7.1	-7.0	-5.3	-3.0	-3.4	-4.2	-4.7	-4.7	-4.7	
Contribution from price and exchange rate changes 2/	20.9	9.3	-17.2	6.5	-5.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-5.9	0.4	5.4	-9.2	5.1	9.0	-2.8	5.8	0.3	2.9	3.2	
External debt-to-exports ratio (in percent)	357.9	310.3	251.5	225.6	225.5	239.0	236.2	242.6	234.0	229.8	225.6	
Gross external financing need (in billions of US dollars) 4/ in percent of GDP	18.8 71.6	19.7 81.7	20.4 72.3	20.0 70.6	22.2 71.9	10-Year 71.2	10-Year 73.1	21.4 67.5	23.7 69.7	24.3 66.7	25.9 66.2	
Scenario with key variables at their historical averages 5/						138.7	116.8	115.9	111.8	109.9	107.6	-8.9
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation					
Real GDP growth (in percent)	-14.2	-2.9	5.0	4.8	4.2	3.4	8.0	2.4	2.3	3.3	3.7	3.9
GDP deflator in US dollars (change in percent)	-14.6	-5.7	11.6	-4.3	4.4	8.5	13.7	1.3	-8.1	2.1	3.3	3.4
Nominal external interest rate (in percent)	5.1	3.6	3.7	2.9	2.5	4.7	2.6	2.4	2.1	2.5	2.5	2.6
Growth of exports (US dollar terms, in percent)	-21.3	13.2	27.2	5.3	5.6	18.2	18.8	1.9	-9.1	4.6	7.8	7.8
Growth of imports (US dollar terms, in percent)	-38.1	14.1	34.9	4.1	4.2	71.0	172.9	1.3	-10.1	7.3	7.6	7.4
Current account balance, excluding interest payments	16.5	8.4	2.4	1.0	0.8	-2.5	11.1	-0.1	1.1	0.3	0.5	0.8
Net non-debt creating capital inflows	-2.2	1.1	3.9	2.2	2.2	2.4	2.2	1.8	2.0	1.9	2.2	2.5

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.

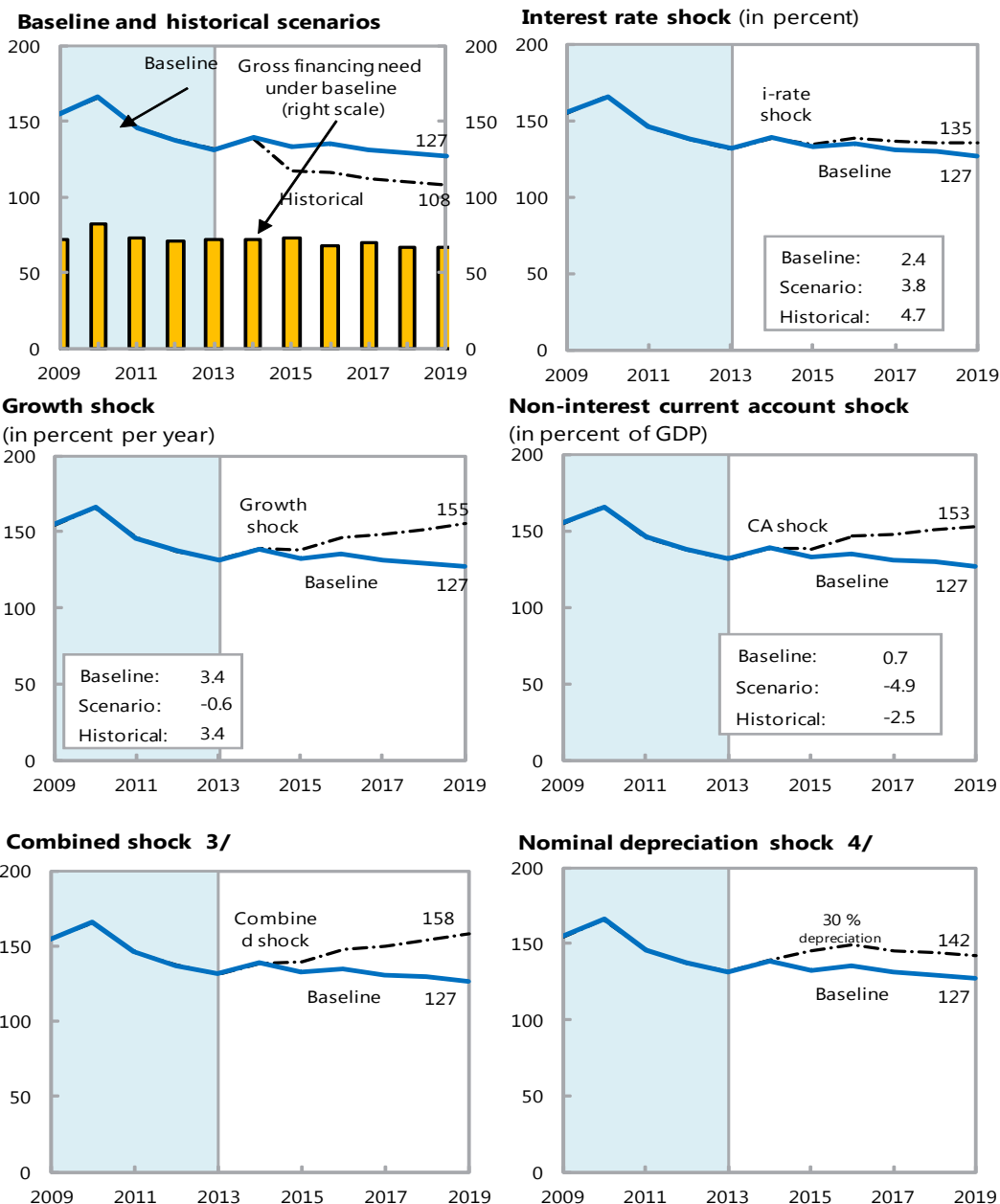
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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.

## Republic of Latvia: External Debt Sustainability: Bound Tests <sup>1/ 2/</sup>

(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 2010.



# REPUBLIC OF LATVIA

April 9, 2015

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department

### CONTENTS

FUND RELATIONS	2
STATISTICAL ISSUES	6

## FUND RELATIONS

(As of April 9, 2015)

**Membership Status:** Joined May 19, 1992; Article VIII

### General Resources Account:

	SDR Million	Percent of Quota
Quota	142.10	100.00
Fund holdings of currency (Exchange Rate)	142.06	99.97
Reserve Tranche Position	0.06	0.04

### 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				
	2014	2015	2016	2017	2018
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  $\pm 1$  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 2, 2014 (IMF Country Report No. 14/115). The Executive Board assessment is available at <http://www.imf.org/external/np/sec/pr/2014/pr14205.htm>.

**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):**

<b>Dept.</b>	<b>Project</b>	<b>Action</b>	<b>Timing</b>	<b>Counterpart</b>
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 November 30, 2012

	Date of Latest Observation	Date Received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of Publication <sup>7</sup>	Memo Items:	
						Data Quality – Methodological Soundness <sup>8</sup>	Data Quality – Accuracy and Reliability <sup>9</sup>
Exchange Rates	02/28/2014	03/01/2014	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	02/28/2014	03/01/2014	M	M	M		
Reserve/Base Money	02/28/2014	03/15/2014	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	02/28/2014	03/15/2014	M	M	M		
Central Bank Balance Sheet	02/28/2014	03/01/2014	M	M	M		
Consolidated Balance Sheet of the Banking System	02/28/2014	03/15/2014	M	M	M		
Interest Rates <sup>2</sup>	02/28/2014	03/15/2014	M	M	M		
Consumer Price Index	02/28/2014	03/15/2014	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	12/31/2013	02/28/2014	M	Q	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	12/31/2013	02/28/2014	M	Q	M		

Republic of Latvia: Table of Common Indicators Required for Surveillance (concluded)							
As of November 30, 2012							
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	12/31/2013	02/28/2014	M	Q	M		
External Current Account Balance	9/30/2013	12/4/2013	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	9/30/2013	12/4/2013	M	M	M		
GDP/GNP	Q4 2013	03/15/2014	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q3 2013	12/4/2013	Q	Q	Q		
International Investment Position <sup>6</sup>	Q3 2013	12/4/2013	Q	Q	Q		
<p><sup>1</sup> Any reserve assets that are pledged or 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</p> <p><sup>2</sup> Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.</p> <p><sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.</p> <p><sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.</p> <p><sup>5</sup> Including currency and maturity composition.</p> <p><sup>6</sup> Includes external gross financial asset and liability position vis-à-vis nonresidents.</p> <p><sup>7</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).</p> <p><sup>8</sup> 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).</p> <p><sup>9</sup> 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.</p>							



INTERNATIONAL MONETARY FUND



Press Release No. 15/186  
FOR IMMEDIATE RELEASE  
May 04, 2015

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

### **IMF Executive Board Concludes 2015 Article IV Consultation with the Republic of Latvia**

On April 24, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with the Republic of Latvia, and considered and endorsed the staff appraisal without a meeting.<sup>2</sup>

Latvia's strong recovery has recently slowed in the face of sluggish growth in the euro area and deteriorating economic conditions in Russia amid rising geopolitical tensions. GDP growth decelerated to 2.4 percent in 2014 reflecting weak demand and the prolonged closure of a steel manufacturer (Liepajas Metalurgs). Low food and energy prices held consumer price inflation around 0.7 percent despite rising real wages.

The 2014 general government deficit of about 1.4 percent of GDP was higher than expected due mainly to a one-off payment related to the sale of Citadele bank. The negative budgetary impact of the economic slowdown was largely offset by revenue gains from improved tax compliance and higher wages.

Bank balance sheets continued to strengthen. Profitability increased and the ratio of non-performing loans declined. But credit continued to contract. Growth of non-resident deposits (NRDs) in the banking system was stable.

In 2015, the weak external environment, particularly the sharp slowdown in Russia, will continue to weigh on exports and investment. This is expected to be mitigated, but not fully offset, by higher disposable income due to lower oil prices and robust real wages, the reopening of the steel manufacturer, and the accommodative monetary stance of the ECB. Over time, growth would rise to around 4 percent.

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<sup>1</sup> 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.

<sup>2</sup> The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

## Executive Board Assessment

In concluding the 2015 Article IV consultation with the Republic of Latvia, Executive Directors endorsed staff's appraisal, as follows:

Latvia's economic slowdown is expected to persist this year. GDP growth is estimated to have decelerated to about 2.4 percent in 2014, reflecting the prolonged closure of steel manufacturer Liepajas Metalurgs, and weak economic performance in the euro area and Russia amid rising geopolitical tensions. In 2015 the anemic external environment—particularly the sharp recession in Russia—will continue to weigh on exports and investment. This is expected to be somewhat mitigated by higher disposable income due to lower oil prices and robust real wages, the reopening of LM, and the accommodative monetary stance of the ECB.

Faster medium-term growth will be necessary if Latvia is to close the income gap with the rest of the euro area, but this cannot be taken for granted. Medium-term growth of around 4 percent should be feasible. But adverse demographic trends will exert a downward pull on the growth trajectory, so robust growth depends on reforms to reduce still-high structural unemployment, and on boosting capital accumulation and labor productivity. Moreover, the near-term forecast is subject to several downside risks, most importantly a prolonged slowdown in important trading partners such as Russia and the euro area.

While the 2015 budget is broadly appropriate, fiscal space needs to be built-up over the medium-term. Automatic stabilizers should be allowed to operate fully this year, given the weak and uncertain external environment. Over the medium-term, various factors, such as planned reductions to the personal income tax (PIT) rate, could constrain the budget's capacity for necessary capital and social expenditure. The authorities should explore ways to increase the revenue envelope, for example by reconsidering future PIT rate cuts, greater land taxation in conjunction with cadastre reform, the removal of the cap on social security contributions, and better targeting of a number of tax allowances. Such measures would complement the welcome focus on shrinking the grey economy through better tax compliance.

The continuing contraction of bank credit is increasingly likely to constrain investment. Staff supports recent public sector initiatives to catalyze SME lending, including by providing loan guarantees, taking subordinated positions and encouraging the development of credit bureaus. Reforms to insolvency procedures and the court system are needed to encourage writedowns and accelerate the reduction in private sector debt. This would provide a spur to new lending from both the demand and supply side.

So far there have been no significant disruptions to NRD flows arising from geopolitical tensions. But the Russia-Ukraine conflict highlights the need for maintaining vigilant supervision of NRD banks, which account for almost half of all deposits in the banking system. In this context, the authorities are encouraged to continue their efforts to strengthen and effectively

implement the AML/CFT framework. Appropriately, the Financial Intelligence Unit responsible for combating money laundering and financial terrorism has been strengthened. Minimum capital and liquidity requirements are higher for NRD banks, in line with previous staff advice; and the authorities plan to impose on NRDs proportionately higher contributions to the deposit guarantee fund.

Latvia's most important medium-term challenge is to maintain competitiveness within the euro area currency union. Future increases to the minimum wage should not exceed productivity growth. In order for Latvia to consistently exceed average euro area growth and thereby close the income gap with core economies, productivity growth must be supported by appropriate structural policies. Reforms are needed in a number of areas such as labor markets, higher and vocational education, infrastructure, and SOE management.

### Republic of Latvia: Selected Economic Indicators, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
							Est.	Proj.
National accounts	(Percentage change, unless otherwise indicated)							
Real GDP	-3.2	-14.2	-2.9	5.0	4.8	4.2	2.4	2.3
Private consumption	-8.0	-16.2	3.1	2.9	3.0	6.2	2.3	2.9
Gross fixed capital formation	-9.2	-33.3	-20.0	24.2	14.5	-5.2	1.6	-0.4
Exports of goods and services	2.4	-12.9	13.4	12.0	9.8	1.4	1.9	1.2
Imports of goods and services	-10.7	-31.7	12.4	22.0	5.4	-0.2	1.5	1.1
Nominal GDP (billions of euros)	24.4	18.9	18.2	20.3	22.0	23.2	24.1	25.1
GDP per capita (thousands of euros)	11.1	8.7	8.6	9.8	10.8	11.4	11.8	12.4
Savings and Investment								
Gross national saving (percent of GDP)	21.7	29.4	21.7	21.5	22.7	21.1	20.8	21.6
Gross capital formation (percent of GDP)	34.0	21.4	19.4	24.3	26.0	23.4	23.9	23.7
Private (percent of GDP)	29.7	18.1	16.3	20.2	22.2	19.7	20.3	20.7
HICP Inflation								
Period average	15.4	3.5	-1.1	4.4	2.3	0.0	0.7	0.5
End-period	10.5	-1.2	2.5	4.1	1.6	-0.3	0.3	1.6
Labor market								
Unemployment rate (LFS definition; period average, percent) 1/	7.5	16.9	18.7	16.2	15.0	11.9	10.8	10.4
Real gross wages	4.5	-7.0	-2.2	0.0	1.5	4.5	6.3	3.5
	(Percent of GDP, unless otherwise indicated)							
Consolidated general government 1/								
Total revenue	33.4	35.7	36.1	35.6	37.1	36.1	35.5	35.1
Total expenditure	36.5	42.6	42.5	38.7	37.0	36.6	37.1	36.5
Basic fiscal balance	-3.1	-7.0	-6.4	-3.1	0.1	-0.6	-1.7	-1.4
ESA balance	-3.9	-9.0	-8.2	-3.5	-1.3	-1.0	-1.4	-1.2
General government gross debt	16.1	32.3	39.8	37.5	36.5	35.2	37.8	37.7
Money and credit								
Credit to private sector (annual percentage change)	11.0	-6.9	-8.4	-7.4	-11.4	-5.4	-7.0	-1.0
Broad money (annual percentage change)	-3.9	-1.9	9.8	1.5	4.5	2.0	4.1	4.3
EMBIG (Percent) 3/	...	...	...	...	1.60	1.39	1.18	1.08
Money market rate (one month, eop, percent) 4/	13.30	2.67	0.61	1.06	0.30	0.25	0.13	...
Balance of payments								
Current account balance	-12.3	8.0	2.3	-2.8	-3.3	-2.3	-3.1	-2.1
Trade balance	-17.2	-8.1	-8.2	-12.0	-11.6	-10.9	-10.1	-9.3
Gross external debt	122.0	154.7	165.8	145.8	137.2	131.3	138.7	132.6
Net external debt 2/	53.8	58.1	54.6	47.0	39.5	35.9	31.1	29.2
Exchange rates								
U.S. dollar per euro (period average)	1.47	1.39	1.33	1.39	1.29	1.33	1.33	...
REER (period average; CPI based, 2005=100)	123.2	130.1	121.5	123.9	119.9	119.9	121.7	...

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.

3/ Latest data as of March 2015.

4/ Refers to the European Central Bank money market rate from 2014 onwards.