Rabobank

Country report **LATVIA**

Summary

Latvia's economy has gradually recovered from its 2008/10 recession, when GDP fell by about 20%. Last year, driven by strongly rising investments and exports, as well as recovering private consumption, the local economy expanded by 5.5%. Economic growth is expected to come in at about 3% in 2012 and 2013. Following last year's elections, a new center-right government remains generally committed to its predecessor's austerity policies and also started to precipitately repay loans related to a 2008 IMF Standby-agreement. Recent years' prudent policies and lessons learned from Latvia's foreign-debt fuelled credit bubble bode well for continuous fiscal and macro-economic discipline. Meanwhile, Latvia's social situation is expected to remain relatively stable, in spite of high unemployment and lingering tensions between ethnic Latvians and Russians. Notwithstanding a major improvement of the balance of payments, Latvia's very high external debt level and its dependence on foreign banks to refinance this burden is worrisome. Yet, given that most external debt is denominated in euros, the anticipated accession to the single currency area in 2014 provides some comfort.

What could trigger rating changes

+ Lower external debt load and continued fiscal prudence
+ Euro area accession
- Faltering commitment by foreign banks
- Relapse into recession

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Latvia

National facts	
Type of government	Parliamentary republic
Capital	Riga
Surface area (thousand sq km)	65
Population (millions)	2.3
Main languages	Latvian (58%)
	Russian (38%)
Main religions	Lutheran (20%)
	Orthodox (15%)
	Unspecified (65%)
Head of State (president)	Andris Bērziņš
Head of Government (prime-minister)	Valdis Dombrovskis
Monetary unit	Lat (LVL)

Economy		2011
Economic size	*bn USD*	*% World total*
Nominal GDP	28	0.04
Nominal GDP at PPP	35	0.04
Export value of goods and services	16	0.07
IMF quotum (in mln SDR)	142	0.07
Economic structure	*2011*	*5-year av.*
Real GDP growth	5.5	-0.1
Agriculture (% of GDP)	4	4
Industry (% of GDP)	25	25
Services (% of GDP)	70	72
Standards of living	*USD*	*% World av.*
Nominal GDP per head	12671	117
Nominal GDP per head at PPP	15751	127
Real GDP per head	7284	89

Social and governance indicators	rank / total
Human Development Index (rank)	43 / 187
Ease of doing business (rank)	21 / 185
Economic freedom index (rank)	56 / 179
Corruption perceptions index (rank)	61 / 183
Press freedom index (rank)	50 / 178
Gini index (income distribution)	36.6
Population below $1.25 per day (PPP)	0%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Germany	8	Germany	12
Sweden	6	Lithuania	9
UK	3	Russia	5
Lithuania	2	Estonia	4
Main export products (%)			
Timber products			17
Metals			15
Machinery & equipment			13
Chemicals			7
Main import products (%)			
Mineral products			17
Machinery & equipment			17
Metals			11
Chemicals			10
Openness of the economy			
Export value of G&S (% of GDP)			53
Import value of G&S (% of GDP)			54
Inward FDI (% of GDP)			1.5

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

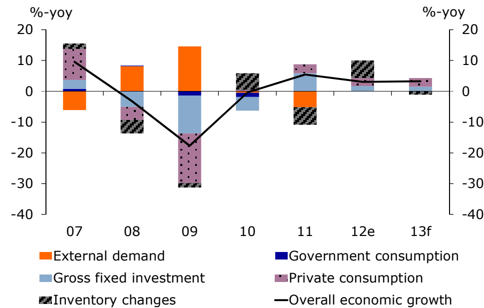
Economic structure and growth

Latvia is a small Baltic economy with a nominal GDP of USD 28bn. It has a population of 2.3m, and its nominal GDP per capita amounted to USD 12,671, or USD 15,751 in PPP terms, in 2011. Together with Bulgaria and Romania, Latvia is still one of the poorest EU-member states. The country mainly produces low-value added products, ranging from timber and food-related produce to machinery and electric equipment. Germany, Sweden and neighboring Lithuania rank among Latvia's main trading partners, both in terms of exports and imports. Timber products constituted about a-fifth of Latvia's exports in 2011, followed by machinery and equipment, as well as metals. Reflecting intra-industry trade, machines also constitute the most important import category, as do mineral imports (partly Russian oil and gas) and chemicals.

Latvia's economy gradually recovers from its very deep three-year recession that began in 2008 and brought about a 20% contraction of output, when a foreign-debt financed credit bubble burst. While output still declined by 0.3% in 2010, it increased by 5.5% last year, promoting Latvia to one of Europe's top-performers in terms of growth. Economic growth was mainly driven by recovering foreign direct investments and exports, as Latvia's favorable business climate and low wages (17% of Swedish labor costs) once again attracted foreign companies after a few years in which foreign direct investment had almost dried up. Notwithstanding the strong decline in consumer credit and stagnating real wages, private consumption growth returned to positive

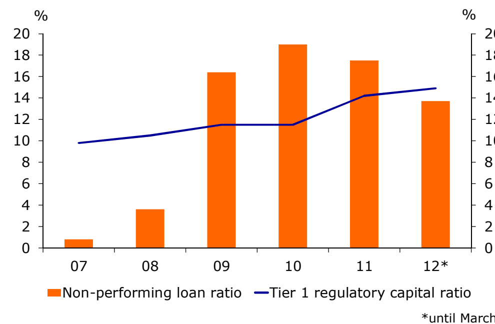
territory. Barring a major deterioration of the euro area sovereign debt crisis, this and next year's economic growth is expected to come in at about 3%, respectively.

Figure 1: Growth performance



Source: EIU

Figure 2: Banking sector



Source: IMF

Latvia's financial sector is largely foreign-owned. Nordic banks, mainly from Sweden, dominate the sector and provide it with the implicit backing of the AAA-rated Swedish sovereign. Given that the local banking sector's heavy reliance on external financing and the collapse of the domestic Krajbank were the main drivers of the very deep 2008-2010 recession, the continued involvement of Nordic banks, which also included large recapitalizations, has helped the sector recover from its deep crisis. Still, funding by Nordic parent banks has declined considerably since 2009 amid efforts to downsize the sector, which has reduced its vulnerability to external risks. As most of Latvia's external debt is denominated in euros, the country's significantly improved chances of joining the single currency area in 2014 should lead to a further reduction in vulnerability over the medium-term. Notwithstanding, given a loan-to-deposit ratio of about 120%, external financing remains essential. Meanwhile, benefitting from Latvia's economic recovery asset quality has improved gradually, as the sector-wide non-performing loan ratio declined from 19% in 2009 to a still elevated 13.7% in March 2012. Moreover, the sector's Tier 1-ratio has improved from 11.5% to 14.9% during the same period. Consequently, compared to its critical shape in 2009, the sector's resilience has increased considerably, but it remains dependent on the ongoing commitment by Nordic banks.

Political and social situation

Latvia is currently governed by a center-right three-party government under the leadership of Valdis Dombrovskis. The current government assumed office after the extraordinary September 2011 elections that followed the dissolution of parliament by former President Zatler. His decision came in response to the parliament's refusal to finish anti-corruption investigations involving the leader of the center-right Latvian Way party. The current coalition government comprises the prime minister's center-right Unity Alliance, former president Valdis Zatler's Reform Party, and the conservative nationalist National Alliance. The government currently only controls 50 out of the 100 seats of the Latvian parliament (Saeima), but so far enjoys the support of six members of Mr Zatler's party that have left the party recently. Due to the absence of a parliamentary majority, the possible further erosion the Reform Party, and the lingering risk of public disenchantment with ongoing austerity measures, we do not expect the government to last until the next elections that will be held in October 2015. Still, in spite of frequent changes in governments, we note a considerable degree of policy continuity in Latvia, which should bode well for the country's economic recovery and possible euro accession in 2014.

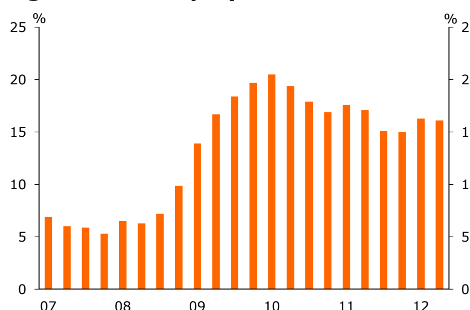
While Latvia's social climate is generally peaceful, in spite of elevated unemployment levels and recent considerable austerity measures, lingering tensions with the country's sizeable Russian minority remain a source of conflict. As non-Latvian speaking Russians do not possess the right to vote, recurrent efforts to change this situation could increase tensions, particularly so as the mainly-Russian Harmony Center-party won the September 2011 elections, and Latvia's secret service perceives Russian influence as an emerging security threat.

Reflecting ongoing tensions with neighboring Russia, Latvia is a major proponent of strong transatlantic links, while accession to the euro area in 2014 is planned. Even as the recent exclusion of the Harmony Center party from the government was ill-received by Russia, bilateral relations should remain workable. However, the country could be exposed to a sudden disruption of Russian energy supplies if relations were to worsen.

Economic policy

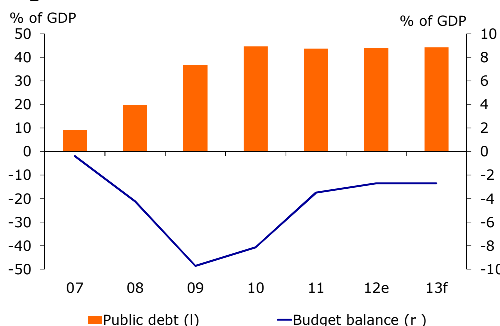
Benefitting from considerable austerity measures and strongly improving tax revenues on the back of the economic recovery, Latvia's public finances have improved markedly since the budget deficit almost reached double-digit levels in 2009. Following a budget deficit of 3.5% of GDP last year, this year's deficit is expected to come in at 2.7%. This projection includes limited spending increases on infrastructure, healthcare and social projects, which were part of a supplementary budget adopted by parliament in late August of 2012. Prior to these measures, the top value-added tax rate had already been cut by 1 percentage point from 23% to 22%. Since a budget surplus in the first half of 2012 had provided the government with sufficient fiscal space to implement these measures, they do not represent a deviation from Latvia's fiscal consolidation course to which the government remains firmly committed amid lingering risks of renewed turmoil on European sovereign bond markets. The government's prudent stance is also reflected in this year's prepayment of USD 486m (1.7% of GDP) to the IMF to complete 45% of the repayment of Latvia's 2008 Standby-Agreement in order avoid repayment peaks in 2013. Even though the supplementary budget projects a budget deficit of 1.4% of GDP in 2013, a stabilization of this year's deficit seems more likely amid a challenging external environment. Meanwhile, Latvia's public debt ratio is expected to remain stable at about 44% of GDP.

Figure 3: Unemployment rate



Source: Latvijas Statistika

Figure 4: Public finances



Source: EIU

As Latvia's currency, the Lat, is pegged to the euro, the Bank of Latvia's (BoL) monetary policy is determined by the European Central Bank (ECB). In line with the recent interest rate cut by the ECB and headline inflation coming in at a low 1.7% in August, the BoL lowered its policy rate and overnight lending rates recently. Yet, due to widespread use of the euro, the impact on the local economy will likely be limited. Given considerable progress in rebalancing the Latvian economy,

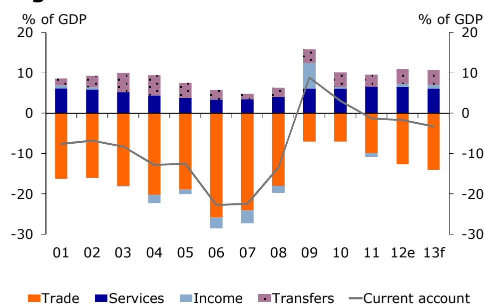
increased pressure on the peg, even in the event of a gradual disintegration of the euro area, is unlikely, which should reduce repayment risks related to the country's very large and mostly euro-denominated external debt exposure.

Thanks to Latvia's low inflation and fiscal discipline in recent years, the country meets the Maastricht criteria for accession to the euro area and its government remains committed to the introduction of the common currency. Even though Latvia's sovereign bond yields have fallen strongly this year, they might not converge sufficiently with the yields of the euro area's best performers, but given the latter's particularly low levels amid the euro area debt crisis, this criterion for euro accession might be waived. Recent comments made by the EU Economic and Monetary Affairs Commissioner Olli Rehn suggesting that Latvia could become the euro area's 18th member in 2014 point into this direction, since they can be interpreted as an official approval of Latvia's euro area membership. While Latvia has not yet filed an application procedure, it will likely do so in early 2013. Provided that the country continues on its current path of fiscal prudence and low inflation and populist policies do not rise if the euro area debt crisis were to worsen, the country will likely introduce the euro in 2014.

Balance of Payments and External Position

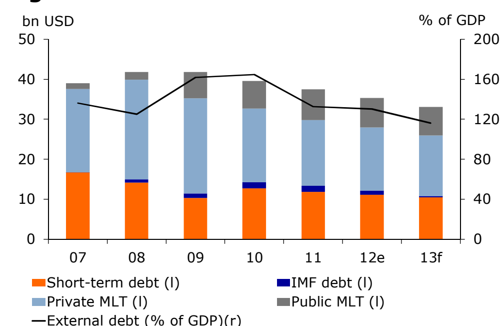
Following a major turnaround in 2009, when collapsing imports and losses by foreign owned firms contributed to a 8.8% of GDP current account surplus via improvements of the trade and income balances, respectively, gradually recovering domestic demand drove the current account back into deficit last year (-1.3% of GDP). However, given more prudent fiscal policies, negative credit growth, and a general increase in global risk aversion, a return to pre-crisis double-digit current account deficits is rather unlikely. Amid relatively weak external demand, Latvia's very large trade balance deficit will continue to drive near- to medium-term current account deficits. Notwithstanding, rising inflows of EU funds on the back of Latvia's improving capacity to contribute necessary co-funding should lead to a stabilization of the current account deficit at about 4% of GDP in the coming years. While Latvia's pre-crisis current account deficits had been largely debt-financed, the post-crisis deficits have been completely financed by foreign direct investments. This trend will likely continue in the coming years, even as the current account deficits are expected to increase moderately.

Figure 5: Current account



Source: EIU

Figure 6: External debt



Source: EIU

In contrast to the positive development of the balance of payments, Latvia's external position still suffers from the considerable pre-crisis debt build-up. External debt, though on a downward trend, still amounted to about 130% of GDP last year. Amid ongoing deleveraging efforts by banks and households, a gradual improvement to 117% of GDP is expected for next year. About a quarter of

external debt is short-term, while private medium- to long-term debt, largely related to Latvia's foreign-owned banking sector, represents almost half of its total external debt load. We caution that the sustainability of Latvia's large foreign debt exposure depends on the continuous commitment of foreign banks to support their Latvian subsidiaries. Also, given that most of Latvia's external debt is denominated in euros, the external debt position is exposed to the risk of a devaluation of the lat against the euro. Accession to the single currency area in 2014 would therefore reduce some of the associated risks.

Latvia's liquidity position is relatively weak, as foreign exchange reserves merely cover 5 months of imports and slightly more than 30% of debt service costs this year. In this regard, the ongoing commitment of Swedish banks to finance their Latvian subsidiaries provides some comfort, but we note that the lingering tensions in the euro area and a possible increase in risk aversion would argue for higher FX reserves levels. Still, thanks to Latvia's positive performance under the recent IMF standby-agreement, the prepayment of associated repayments, and possible financial support from the ECB, external assistance, if needed, should be available.

Latvia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	9.6	-3.3	-17.7	-0.3	5.5	3.1	3.3
Consumer prices (average % change pa)	10.1	15.4	3.5	-1.1	4.4	2.5	2.6
Current account balance (% of GDP)	-22.4	-13.4	8.8	3.0	-1.3	-1.7	-3.3
Total foreign exchange reserves (m USD)	5553	5028	6632	7256	5997	6500	6900
Economic growth							
GDP (% real change pa)	9.6	-3.3	-17.7	-0.3	5.5	3.1	3.3
Gross fixed investment (% real change pa)	7.9	-13.8	-37.4	-18.1	27.9	6.5	5.5
Private consumption (real % change pa)	14.3	-5.8	-22.6	0.7	4.4	3.9	4.1
Government consumption (% real change pa)	4.9	1.6	-9.4	-7.9	1.1	0.8	1.0
Exports of G&S (% real change pa)	10.0	2.0	-14.1	11.5	12.6	4.6	4.9
Imports of G&S (% real change pa)	16.1	-10.8	-33.3	11.5	20.7	4.1	4.4
Economic policy							
Budget balance (% of GDP)	-0.4	-4.2	-9.7	-8.1	-3.5	-2.7	-2.7
Public debt (% of GDP)	9	20	37	45	44	44	44
Money market interest rate (%)	5.1	4.1	3.9	0.7	0.3	1.0	2.0
M2 growth (% change pa)	14	-4	-3	11	0	3	7
Consumer prices (average % change pa)	10.1	15.4	3.5	-1.1	4.4	2.5	2.6
Exchange rate LCU to USD (average)	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Recorded unemployment (%)	5.7	5.3	12.1	15.6	12.8	14.3	12.8
Balance of payments (m USD)							
Current account balance	-6426	-4493	2283	731	-363	-460	-940
Trade balance	-6898	-6014	-1822	-1692	-2794	-3430	-3980
Export value of goods and services	8227	9634	7387	9107	12032	12490	13020
Import value of goods and services	15125	15648	9209	10799	14826	15920	17000
Services balance	1002	1348	1566	1467	1841	1750	1730
Income balance	-909	-596	1655	85	-276	220	270
Transfer balance	379	769	884	871	866	990	1050
Net direct investment flows	1945	1092	151	349	1464	1100	1280
Net portfolio investment flows	-653	-214	605	-73	-1135	-100	-100
Net debt flows	12474	3657	-97	-135	-177	-1770	-1870
Other capital flows (negative is flight)	-6092	-552	-1283	-173	-1011	1780	1920
Change in international reserves	1249	-510	1659	699	-1223	540	300
External position (m USD)							
Total foreign debt	39040	41847	41822	39555	37490	35340	33100
Short-term debt	16705	14144	10295	12723	11848	11100	10450
Total debt service due, incl. short-term debt	15059	22825	21718	20842	22445	21170	20090
Total foreign exchange reserves	5553	5028	6632	7256	5997	6500	6900
International investment position	-22731	-25673	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	24548	24653	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	47279	50325	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-24.1	-18.0	-7.0	-7.0	-9.9	-12.6	-14.0
Current account balance (% of GDP)	-22.4	-13.4	8.8	3.0	-1.3	-1.7	-3.3
Inward FDI (% of GDP)	8.1	4.1	0.4	1.5	5.5	4.6	5.3
Foreign debt (% of GDP)	136	125	162	165	133	130	116
Foreign debt (% of XGSIT)	253	231	288	254	192	173	154
International investment position (% of GDP)	-79.3	-76.7	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	98	126	149	134	115	104	93
Interest service ratio incl. arrears (% of XGSIT)	10	10	7	6	9	6	5
FX-reserves import cover (months)	4.4	3.9	8.6	8.1	4.9	4.9	4.9
FX-reserves debt service cover (%)	37	22	31	35	27	31	34
Liquidity ratio	91	75	94	95	89	93	96

Source: EIU, IMF

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