



REPUBLIC OF LATVIA

September 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LATVIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its August 31, 2018 consideration of the staff report that concluded the Article IV consultation with the Republic of Latvia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on August 31, 2018, following discussions that ended on July 2, 2018, 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 July 27, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Latvia

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

Selected Issues

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IMF Executive Board Concludes 2018 Article IV Consultation with the Republic of Latvia

On August 31, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Republic of Latvia.

Growth in 2017 rebounded with a strong, broad-based upswing, supported by increasing wages, a recovery of private investment, and accelerated absorption of EU funds. Nominal gross wages rose by 7.8 percent, the unemployment rate declined to 8.2 percent—the lowest rate since 2008—and the average inflation rate reached 2.9 percent. With import volumes rising by 9.5 percent, the current account swung into a moderate deficit of 0.8 percent of GDP. Real GDP growth is projected to moderate to 3.7 percent in 2018, driven by continued strong domestic demand.

Government revenues overperformed in 2017, buoyed by strong economic activity and wage growth. Nonetheless, the 2017 general government structural balance recorded a deficit of 0.8 percent of GDP (ESA definition), which resulted in a positive fiscal impulse rendering fiscal policy procyclical.

Despite the suspension of activities of Latvia's third largest bank on money laundering concerns, the banking system remains well capitalized and liquid, with capital-to-risk-weighted assets of 22.4 percent and liquid assets exceeding 80 percent of short-term liabilities at end-March 2018. Deleveraging of both households and nonfinancial corporations (NFCs) continued, with household debt to income now at half of its pre-crisis levels, and corporate debt to GDP down by more than a quarter from its peak in 2010.

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

Executive Board Assessment²

Executive Directors commended the continuing buoyant growth in Latvia in the context of strong macroeconomic fundamentals and the authorities' commitment to maintaining prudent fiscal balances and public debt levels. At the same time, they considered that the medium-term outlook is challenging, with risks tilted to the downside, especially on the domestic front. Directors emphasized the need to address the risk of overheating and to tackle policy challenges by focusing reforms on three key areas: easing labor market constraints and improving productivity, reviving domestic credit to support investment, and strengthening the enforcement of the AML/CFT framework to safeguard financial sector stability.

Directors noted that labor market constraints and demographic headwinds pose significant challenges to the medium and long-term outlook. They advised the authorities to focus on structural reforms that support labor market participation, reduce structural unemployment, and raise labor productivity. Reform measures could include the use of skill-matching and skill-building policies, better access to housing, revisiting the minimum wage structure, improving labor participation of targeted groups, and encouraging appropriate labor immigration.

Directors commended the authorities for setting ambitious fiscal objectives. They underlined that upfront consolidation will be needed, especially given the current procyclicality of fiscal policy. Directors encouraged the authorities to use the favorable macroeconomic conditions to mitigate overheating risks and build fiscal buffers. They noted that the ongoing tax reform would help reduce the high tax wedge and improve progressivity of the tax system, and urged the authorities to increase revenue mobilization to mitigate the upfront cost of the reform. Directors emphasized that more should be done to improve the growth friendliness and inclusiveness of the fiscal policy mix, including by reallocating spending toward better targeted social protection programs and productive investments.

Directors welcomed the authorities' efforts to enhance regulation and lending standards that have helped improve banks' balance sheets and supported financial sector stability. They also stressed that, over the medium term, the financial system needs to become more supportive of investment. In this regard, Directors recommended that reforms address risks from the insolvency framework and the shadow economy.

Directors expressed concern about the possible reputational impact on the financial system from money laundering allegations involving banks servicing foreign clients (BSFCs), and concurred that steadfast actions are needed to restore its reputation. Directors urged the authorities to ensure effective enforcement of AML/CFT regulations, focusing on mitigating risks from non-resident deposits and opaque companies. They also noted that changes in the banking legislation, alongside harmonization at the EU level, should provide more adequate tools to liquidate banks deemed to be failing or likely to fail. Directors stressed that such reforms, and careful management of the refocusing of BSFCs, will be key to minimize financial sector stability risks.

It is expected that the next Article IV consultation with Latvia will be held on the standard 12-month cycle.

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

Latvia: Selected Economic Indicators, 2013–19							
	2013	2014	2015	2016	2017	2018	2019
	Projections						
National accounts	(Percentage change, unless otherwise indicated)						
Real GDP	2.4	1.9	3.0	2.2	4.5	3.7	3.3
Private consumption	5.1	1.4	2.5	3.3	5.1	4.3	3.5
Public consumption	1.6	1.9	1.9	2.7	4.1	4.4	3.5
Gross capital formation	-5.2	-8.9	2.7	0.2	17.5	13.4	6.5
Gross fixed capital formation	-6.0	0.1	-0.5	-15.0	16.0	14.0	6.5
Exports of goods and services	1.1	6.0	3.0	4.1	4.8	3.2	3.1
Imports of goods and services	0.4	1.2	2.1	4.5	9.5	7.1	4.5
Nominal GDP (billions of euros)	22.8	23.6	24.3	24.9	26.9	28.9	30.6
GDP per capita (thousands of euros)	11.3	11.8	12.2	12.7	13.8	14.9	15.8
Savings and Investment							
Gross national saving (percent of GDP)	21.6	20.9	21.8	21.0	20.7	20.8	21.0
Gross capital formation (percent of GDP)	24.3	22.7	22.2	19.6	21.5	23.1	23.6
Private (percent of GDP)	20.5	19.0	18.5	16.9	17.9	19.6	20.4
HICP Inflation							
Period average	0.0	0.7	0.2	0.1	2.9	2.7	2.4
End-period	-0.4	0.3	0.4	2.1	2.2	2.7	2.4
	(Percent of GDP, unless otherwise indicated)						
Labor market							
Unemployment rate (LFS; period average, percent)1/	11.9	10.8	9.9	9.6	8.7	8.2	8.1
Real gross wages	4.6	6.1	6.6	4.9	4.8	5.1	4.3
Consolidated general government 1/							
Total revenue	36.7	36.1	36.2	36.4	35.8	36.6	36.0
Total expenditure	37.3	37.8	37.8	36.8	36.7	37.8	37.0
Basic fiscal balance	-0.6	-1.7	-1.5	-0.4	-0.8	-1.2	-1.0
ESA balance	-1.2	-1.5	-1.4	0.1	-0.5	-0.9	-1.0
General government gross debt 3/	35.8	38.5	34.9	37.4	36.3	35.0	34.2
Money and credit							
Credit to private sector (annual percentage change)	-6.6	-7.4	-2.3	3.5	1.2	...	...
Broad money (annual percentage change)	2.0	35.5	7.5	6.6	2.7	...	...
Balance of payments							
Current account balance	-2.7	-1.7	-0.5	1.4	-0.8	-2.4	-2.6
Trade balance	-11.5	-10.1	-9.1	-7.7	-9.7	-10.9	-11.1
Gross external debt	133.9	144.1	143.6	148.8	140.8	136.6	136.8
Net external debt 2/	36.6	33.7	29.3	28.8	24.4	30.1	31.6
Exchange rates							
U.S. dollar per euro (period average)	1.33	1.33	1.11	1.11	1.13	...	...
REER (period average; CPI based, 2005=100)	120.3	122.2	120.8	121.9	122.9	...	...
Terms of trade (annual percentage change)	0.6	-1.2	0.7	2.8	0.7	1.6	0.6
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/ Gross public debt of the general government consistent with the cash deficit.							



REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

July 20, 2018

KEY ISSUES

Context. The economy has gained momentum amidst sound fundamentals. Growth in 2017 surprised with a strong and broad-based upswing driven by a recovery in investment and a supportive external environment, and the outlook is favorable. Fiscal and current account deficits remain at prudent levels, as does the public debt burden. The financial system remains stable.

Challenges. In the short term, the authorities need to prevent further inflationary pressures and risks to competitiveness due to rapid wage growth and EU investment fund flows. Risks related to banks servicing nonresidents also pose regulatory challenges. Demographic headwinds and weak credit growth to support investment pose a challenge to long-term growth and living standards.

Staff Views.

- The policy mix needs to be calibrated to ensure that the economy smoothly navigates the cyclical upswing and is on a path of sustainable long-term growth. The authorities should keep the reform momentum, focusing on supporting labor market participation, reducing structural unemployment, raising labor productivity, and increasing investment.
- Fiscal policy has become procyclical as the inflow of EU investment funds has accelerated, and the new tax reform has taken effect. Given policy constraints within the currency union, the authorities need to carefully balance fiscal policy priorities to prevent the accumulation of imbalances, while improving the growth-friendliness and inclusiveness of government spending.
- The financial sector remains stable, but credit growth is still anemic. Reforms need to address supply and demand constraints such as the credit risks stemming from the insolvency regime and the shadow economy. Strengthening the enforcement of AML/CFT regulations, enhancing regulatory tools, and swiftly refocusing the business model of banks servicing nonresidents will be key to minimize financial sector stability risks.

Approved By
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and Johannes Wiegand (SPR)

Discussions were held in Frankfurt on June 18 and in Riga during June 20–July 2. The team comprised Iva Petrova (Head), Karina Garcia, Andrew Jewell, Andreas Tudyka (all EUR), Oleksandr Pysaruk (MCM), and Jonathan Pampolina (LEG). Ms. Jekabsone (OED) also joined the discussions. Nhu Nguyen and Hannah Jung supported the mission from headquarters.

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CONTEXT

1. Latvia's economy has gained momentum, but is facing constraints. Consumption growth, utilization of EU structural funds, and a favorable external environment allowed the Latvian economy to reach a growth peak in 2017. However, structural headwinds loom ahead. A shrinking labor force has exacerbated labor market tightness across all sectors. Weak credit growth is limiting the scope for sustained investment, which alongside high capacity utilization, poses constraints to increasing productivity further. Reforms are thus needed to sustain the growth momentum, increase productivity and support long-term growth and Latvia's income convergence in the euro area.

2. The banking system is stable, but recent developments have, once again, dented its reputation. Of 21 banks operating in the Latvian economy at end-2017w, about half are actively engaged in domestic activity. The rest are tailored toward non-resident business. Despite a 50 percent outflow of non-resident deposits since end-2015, banks servicing foreign clients (BSFC) have failed to refocus their business model, amidst remaining gaps in the enforcement of AML/CFT regulations. Money laundering allegations involving BSFCs have put at risk the credibility of the financial system. Corruption allegations against the Bank of Latvia's governor and his suspension have also tarnished the reputation of the system and raised concerns about central bank independence.

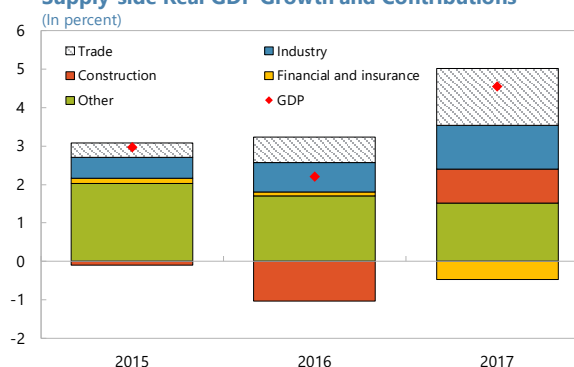
3. The upcoming elections are unlikely to cause a change in policy course. Parliamentary elections are scheduled to take place on October 6, 2018. Latvia has enjoyed policy continuity, and the current election cycle is not expected to put pressure on the government budget or put at risk reform implementation. Nonetheless, with lingering uncertainties about the costs and impact of the ongoing tax and health reforms, prudent fiscal policies will be critical for preserving Latvia's sound public finances.

4. Recent policies broadly reflect the 2017 Article IV recommendations. The implementation of the tax reform has aimed to address several staff recommendations, including lowering the tax burden on labor, enhancing equity, reducing the grey economy, and mitigating the fiscal cost of the reform. The authorities have also introduced new measures to improve SMEs' access to finance. Efforts to improve the insolvency and judicial regime are ongoing.

RECENT ECONOMIC DEVELOPMENTS

5. Growth rebounded with a strong, broad-based upswing. Domestic demand growth tripled from 2.5 percent in 2016 to 7.5 percent in 2017 (Figure 1). Private consumption continued to increase its contribution to overall growth, supported by increasing wages and strong consumer confidence. Investment recovered on the back of an accelerated absorption of EU funds, and implementation of private sector investment projects.¹ Growth in construction peaked to over 19 percent, more than offsetting a 17 percent decline in financial and insurance services, while growth in manufacturing and retail trade picked up.

Supply-side Real GDP Growth and Contributions



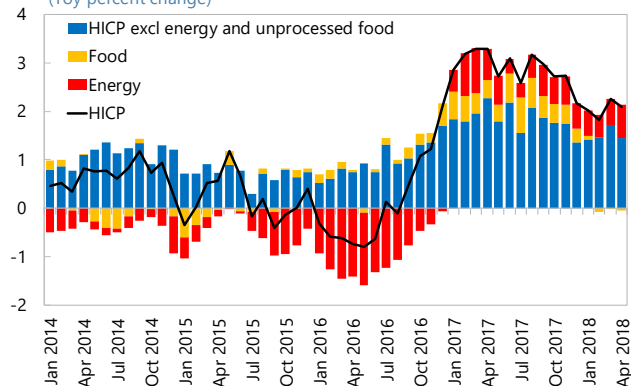
Sources: Latvian Central Statistical Bureau; and IMF staff calculations.

6. Fiscal policy in 2017 was expansionary. Government revenues overperformed, mainly due to higher income taxes and social security contributions, buoyed by strong economic activity and wage growth (Figure 2). EU-funded investment and a one-off advance payment to green electricity producers raised government spending.² The 2017 budget deficit of 0.5 percent of GDP was about ¼ percent below staff's projections. However, with a larger-than-projected positive output gap, this translated into a structural deficit of 0.8 percent of GDP and an expansionary fiscal impulse broadly in line with projections. During the first quarter of 2018, the general government recorded a cash surplus, supported by a strong increase in income tax revenues, VAT, and social security contributions.

7. Gross wages increased significantly as the labor market continued to tighten.

Nominal gross wages rose by 7.8 percent in 2017 with private sector wages growing at 8.3 percent, about 1 percentage point higher than public sector wages (Figure 3). Wage pressures were the highest in sectors requiring higher-skilled labor, and in and around Riga. The unemployment rate declined significantly to 8.2 percent at end-2017—the lowest rate since 2008, and the labor force participation rate increased to an all-time high. However, this

HICP Inflation (Yoy percent change)



Sources: Statistics Latvia; and staff calculations

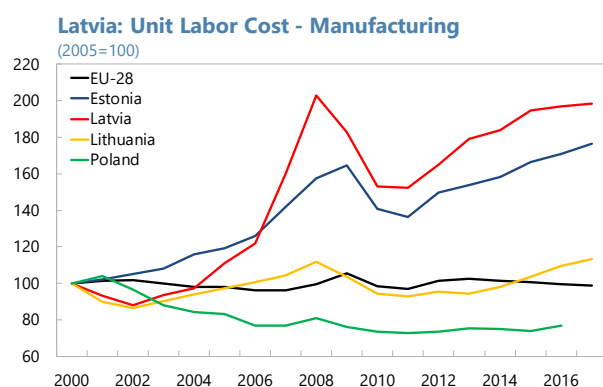
¹ Latvia was allocated €5.63 billion of European Structural and Investment Funds for the period 2014–20, including €1.16 billion for infrastructure, €782 million for environment protection, and €764 million in support of SMEs.

² A reduction of *Latvenergo's* capital (a public enterprise) was used in lieu of a one-off compensation for the State's liabilities related to the subsidization of green energy generation.

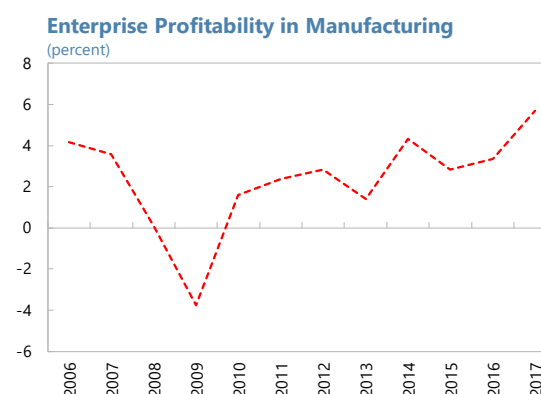
is largely a result of emigration, with employment having remained flat since the crisis. Against this backdrop, the labor market continued to tighten, with the job vacancy rate approaching its pre-crisis peak and labor shortages increasing in the industry, construction, and service sectors.

8. Inflationary pressures have thus picked up. Average headline inflation reached 2.9 percent in 2017. Energy and food price inflation contributed about 0.6 and 0.5 percentage points respectively, partly driven by base effects that faded out toward year-end. Average core inflation has approached 2 percent, as wages have put pressure on service prices (Figure 4).

9. And while signs of weakening have emerged, competitiveness has held up. With import volumes rising by 9.5 percent, the current account swung into a moderate deficit of 0.8 percent of GDP in 2017 (Figure 5). Wage growth drove unit labor costs (ULCs) to pre-crisis highs, and export shares in neighboring markets—where ULC growth has been more moderate—have started weakening. Nonetheless, goods and services export volumes expanded by 4.8 percent, and world export shares edged up, reflecting a successful diversification of export markets. Profitability in export-oriented sectors also remained robust. The external sector position is assessed to be stronger than implied by medium-term fundamentals, with EU fund inflows and improved terms of trade contributing about 0.4 percentage points to the lower CA deficit (Annex I). Latvia’s policy gap of about 1.5 percent mostly reflects the average—accommodative—fiscal stance of the rest of the world.



Sources: Haver Analytics and IMF staff calculations.

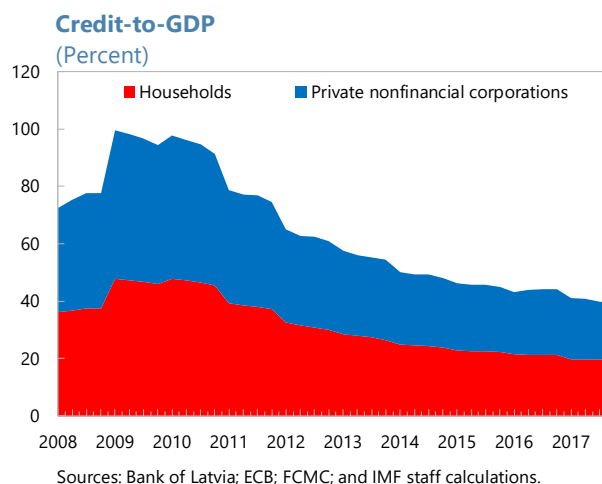


Sources: Statistics Latvia; Haver; and IMF Staff Calculations.

10. The financial system remained stable despite pressures from the suspension of activities of Latvia’s third largest bank. In February 2018, the US Treasury’s financial intelligence unit proposed blacklisting ABLV Bank—Latvia’s third largest bank—on money laundering concerns. As ABLV’s liquidity situation deteriorated rapidly, the ECB subsequently determined that the bank was failing or likely to fail (Annex II). The suspension of ABLV’s activities put pressure on non-resident deposits, which declined by more than a third (Figure 6). Nonetheless, the banking system remains well capitalized and liquid, with capital-to-risk-weighted assets of 22.4 percent and liquid assets exceeding 80 percent of short-term liabilities at end-March, 2018.

11. Despite favorable macroeconomic conditions, credit growth is still subdued.

Deleveraging of both households and nonfinancial corporations (NFCs) continued, with household debt to income now at half of its pre-crisis levels and corporate debt to GDP down by more than a quarter from its peak in 2010. The decline in credit to households leveled off, while credit to NFCs expanded modestly in 2017. Lending standards remained tight—an indication that banks are still cautious, as they continue to improve the quality of their lending portfolios. Non-performing loans have declined to 4 percent (Figure 7, Annex III). Non-bank credit notably to households, increased sharply after changes to the regulatory framework in 2016 led to lower non-bank lending rates, but remains at only 2 percent of GDP.



12. Public and external debt have remained stable. Low spreads supported by Latvia's investment-grade credit rating have created favorable financing conditions and allowed the authorities to refinance existing government debt at lower interest costs and longer maturities.

OUTLOOK AND RISKS

13. The medium-term growth outlook is favorable, but increasingly binding constraints loom.

Real GDP growth is projected to moderate to 3.7 percent in 2018, with a positive output gap of 1.2 percent of GDP. While strong domestic demand will continue to drive growth, supported by EU structural funds and rising wages, external demand has weakened. Investment growth is projected to moderate in the second half of the year. The downsizing of BSFC activity is also projected to weigh on growth by about ½ percentage point of GDP in 2018. Over the medium term, growth is projected to gradually converge to its potential rate of 3 percent, as EU investment funds level off and capacity constraints become increasingly binding, thereby driving a slowdown in wages.

Medium-term Outlook
(percent change)

	2017	2018	2019	2023
GDP	4.5	3.7	3.3	3.0
Consumption	4.9	4.3	3.2	3.2
Gross investment	17.5	13.4	6.5	5.0
Exports	4.8	3.2	3.1	3.0
Imports	9.5	7.1	4.5	4.0

14. Fiscal policy is projected to remain procyclical in 2018, against staff's advice. The 2018 budgeted fiscal position is expected to remain at a deficit of 1 percent of GDP, as the new tax and healthcare reforms take effect along with a peak in EU-funded investment. Over the medium term, however, a deceleration in EU fund disbursements and a gradual consolidation of about 0.6 percent of GDP will ease domestic demand pressures and help close the output gap. Public debt is projected to remain at prudent levels and declining (Annex IV).

15. The labor market will continue to exert pressure on inflation. The inflow of EU funds will increase demand for labor in 2018, particularly in the construction sector, which attracts a significant share of these funds. The 13 percent increase in the minimum wage will put additional pressure on overall wages in 2018–19.³ With wage and excise tax increases taking effect, inflation is expected to peak at over 3 percent in mid-2018. Over the medium term, wage pressures are projected to remain strong, but ease up as capacity constraints deplete profitability and firms seek to align wage growth with productivity.⁴ Nonetheless, inflation will remain above 2 percent due to catch-up effects relative to the euro area.

16. Risks to the baseline are tilted to the downside. The key near-term risks to the outlook stem from domestic factors, especially excessive tightening of the labor market and a deepening of fiscal pro-cyclicality, which could trigger an accumulation of imbalances and overheating pressures. Failure to further advance structural reforms, particularly those that could ease labor market conditions, could undermine competitiveness and weaken the medium-term outlook. Failure to enforce AML/CFT regulations and/or a failure of the BSFC sector to refocus its business model could undermine confidence and put at risk financial sector stability (Annex II). External risks are related to trade channels and financial conditions. Potentially weaker growth in advanced economies, and a retreat from cross-border integration, could dent export growth; this is somewhat mitigated by Latvia's high degree of diversification. An abrupt reversal of risk appetite in Europe and/or tighter global financial conditions could raise the cost of public debt financing. Spillovers from a significant retreat in the Nordic mortgage market—via parent bank funding—could halt the credit growth recovery in the medium-term. Upside risks to the outlook stem from a potential large stimulus to investment from the CIT reform and a faster-than-projected recovery of credit growth.

Authorities' Views

17. The authorities broadly agreed with staff's assessment of the outlook and risks. They recognized that EU structural funds will continue to have a strong positive impact on growth in 2018, especially in the construction sector, while the downsizing of the BSFC sector would dampen prospects somewhat. They considered that on balance domestic and external factors pose equal risks, as both could affect confidence negatively.

POLICY DISCUSSIONS: STRENGTHENING FOUNDATIONS WHILE RIDING THE UPSWING

Policy discussions focused on the need to stem overheating risks and use the cyclical recovery to redouble reform efforts to address risks to medium and long-term growth. Reforms should focus on fostering labor supply and lowering structural unemployment; enhancing productivity growth to mitigate the impact of adverse demographics; improving the growth-friendliness of fiscal policies and

³ IMF Country Report 16/151. Each percentage point increase in the minimum wage results in about 0.12–0.17 percentage point increase in firms' wages.

⁴ IMF, 2018, "Regional Economic Outlook Europe". *European Wage Dynamics and Labor Market Integration*. The study finds that in Latvia productivity gains are translated into similar real wage increases in the long run.

increasing fiscal buffers. Efforts are also needed to address lingering crisis legacies in the financial sector that prevent efficient financial intermediation and sustainable credit growth, and pose risks to financial stability.

A. Macro-structural Policies: Preserving Strong Growth

Mitigating Labor Market Risks

18. Labor market constraints pose significant challenges to the medium-term outlook.

Emigration continues to deplete the country of needed skills while reducing the size of the labor force. Since Latvia regained independence in 1990, the country has lost about 1/4 of its population, of which about 60 percent was caused by emigration. Latvia lost an estimated 1 percentage point of annual growth during the period 1999–2014 due to emigration and the resulting deterioration of skills.⁵ The loss of skilled labor is driving up wages and dampening productivity gains, and could discourage FDI.

19. **Labor supply has been squeezed by structural factors.** Labor force participation is at a historical high, but nevertheless trails participation rates in neighboring countries. Participation rates in Latvia are comparatively low for the youth (15–24) and for older workers who have struggled to update their skills. Skills mismatches and skills shortages are among the highest in the EU, contributing to high structural unemployment. Wage differentials with the euro area continue to trigger outward migration, while inward migration is not encouraged enough.⁶

20. **Progress in addressing these challenges is ongoing.** The authorities have implemented a set of policies that could address some of the labor market tightness. In particular, the implementation of the recent tax reform is projected to effectively reduce the tax wedge from 42 percent in 2016 below 40 percent (Annex VI).⁷ The ongoing public administration reform—which should be expanded to municipalities and SOEs—is also expected to increase the availability of skilled labor in the private sector. Recent reforms have improved the quality of vocational education and training (VET). Larger VET schools have been upgraded and modernized, and the law on vocational education was amended in 2017 to provide more flexibility in offered VET programs.

21. **Steadfast efforts are needed to improve skills matching and encourage higher labor force participation and mobility.** Relying solely on productivity-enhancing measures would not be sufficient to protect competitiveness. While such measures would be critical to support long-term growth, they are unlikely to yield quick results and prevent rising wages from eroding profitability. Several labor market policy options could ease capacity constraints over the medium term:

⁵ IMF, 2016, “Emigration and Its Economic Impact on Eastern Europe,” IMF Staff Discussion Note 16/07.

⁶ See “Labor Market Challenges,” *Republic of Latvia: Selected Issues*, International Monetary Fund, 2018.

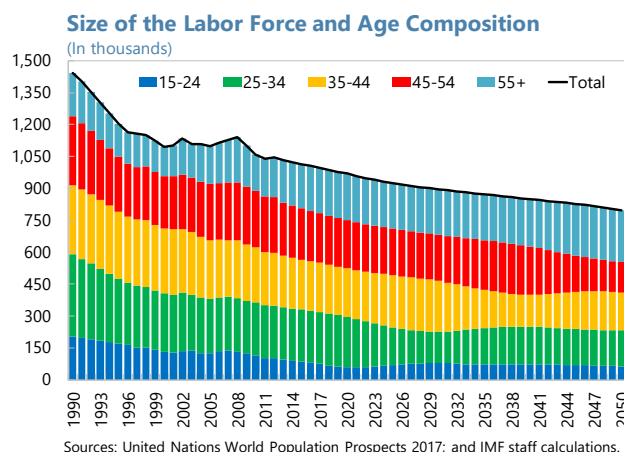
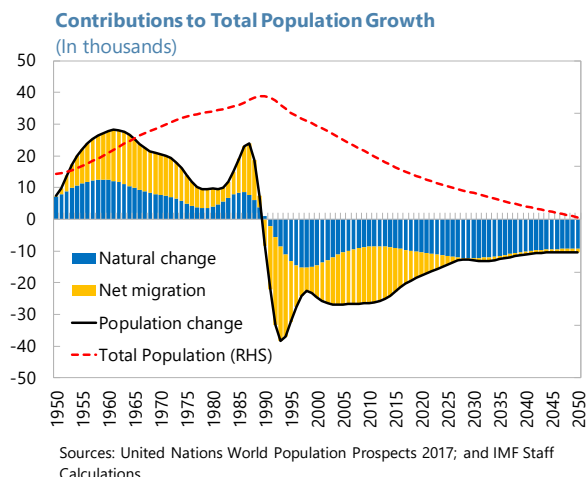
⁷ Estimates for single workers earning 67 percent of the average wage.

- **Increase participation in active labor market policies (ALMPs).** While Latvia has made progress improving the effectiveness of ALMPs, participation remains low, and spending on ALMPs is among the lowest in the EU. ALMPs and training should be aimed at reducing skills mismatches and helping the long-term unemployed find jobs.
- **Continue to reform vocational education and training, and encourage lifelong learning.** Improving links with employers, including by expanding workplace-based learning, would make Latvia's VET system more effective. Lifelong learning programs should be more accessible and tailored to both employers' needs and employees' circumstances.
- **Improve access to housing.** Current rental regulations discourage investment in rental housing. Below-market rents are common—a legacy of Soviet-era rental agreements—and rental dispute resolution mechanisms are time consuming and costly. More rental housing would facilitate labor mobility and help stem emigration.
- **Employ more foreign workers.** Latvia could do more to attract skilled labor from abroad. Workers from outside the EU are not covered by public health insurance, and students from outside the EU, who finish their studies in Latvia, cannot easily integrate into the Latvian labor market.
- **Revisit the minimum wage structure.** Unlike in many countries, Latvia has a unified statutory minimum wage, with no differentiation by region or group of workers. A generous minimum wage that applies across the board risks pricing first-time labor market entrants and other low productivity workers out of formal employment. Age-specific and regional-specific minimum wage provisions, by contrast, could help reduce unemployment.
- **Increase participation rates of targeted groups.** This could be achieved by further increasing the retirement age, linking it to life expectancy, and limiting early retirement options. Providing more flexible work arrangements, including increased part-time work, for workers transitioning to retirement can also enable longer working lives for an aging workforce.

Addressing Adverse Demographics

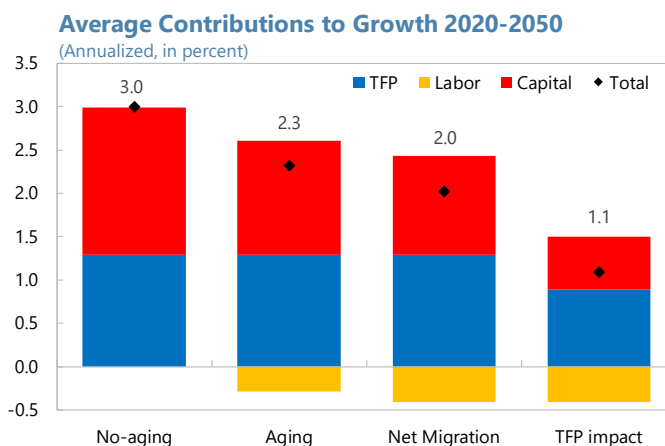
22. Latvia's labor market and growth outlook face difficult challenges over the long term.

Latvia's population and workforce are projected to decline and age rapidly. By 2050, the population is projected to decline by one quarter and the labor force by about 20 percent, with the share of workers aged 55 years or older rising from about 20 percent in 2015 to 30 percent in 2050. Fewer workers produce less, which, if not offset by more capital or higher productivity, will reduce potential output. If shrinking and aging coincide, a higher dependency ratio can translate into lower per-capita GDP. Aging may also affect productivity due to depreciating skills and physical capabilities. In addition, population aging will pose severe challenges to government finances, as fewer workers provide social security contributions for old-age pensions, health and long-term care. The resulting financing need may lead to a substitution away from growth-friendly capital to current spending.



23. Demographic shifts could decrease long-run growth by 1–2 percentage points.

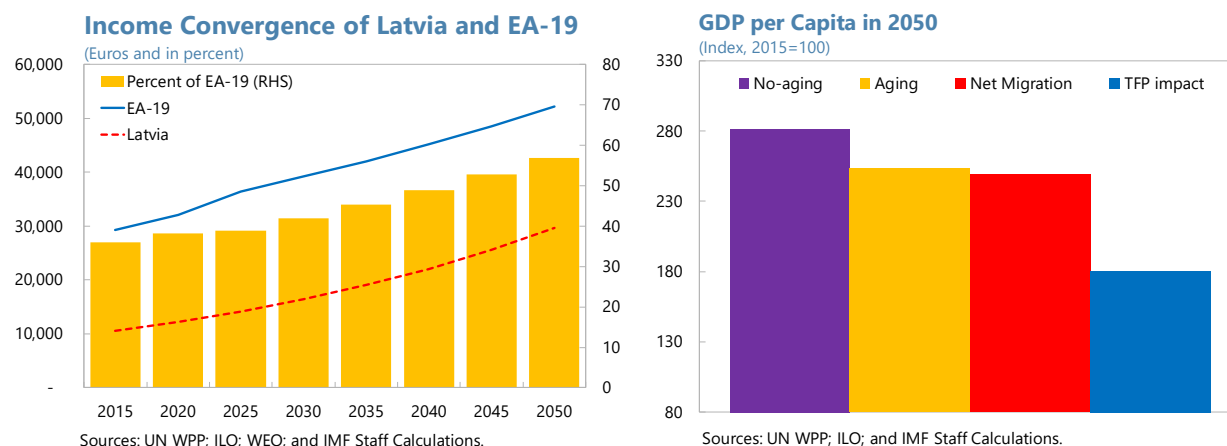
Under a no-aging scenario that assumes an unchanged population and labor force structure, TFP growth following historical trends, and capital accumulation on a balanced growth path, Latvia’s long-run growth is estimated at 3 percent.⁸ Allowing for the projected natural population change in 2020–50 (i.e. births and deaths), and the corresponding population aging, but abstracting from projected migration, long-term growth could be lower by about 0.7 percentage points due to the projected decline in labor. Projected net migration trends could cut an additional 0.3 percentage points. Finally, the diminishing productivity of the aging workforce could reduce growth through a negative impact on TFP to about 1.1 percent on average in 2020–50—half as high as under the aging scenario. Consequently, absent any policy changes, demographic shifts can potentially turn into strong headwinds for Latvia in the coming decades.



24. Latvia’s income convergence with the euro area may slow as demographic headwinds take hold.

Under the no aging scenario, per-capita income is projected to reach almost 60 percent of the EA-19 average by 2050—about 2.8 times higher than in 2015. As Latvia’s population declines and ages faster than the euro area’s, this likely presents an upper bound absent any reforms. Adding the projected natural population change as well as net migration to the underlying population dynamics could result in an income that is only about 2.5 times higher by 2050. Including the productivity-restraining effect of workforce aging would yield a per-capita income that is about 1.8 times higher by 2050. Consequently, swift implementation of policies to arrest the labor force decline and increase productivity will be paramount to counter these effects.

⁸ See IMF Country Report No. 17/194 and “Demographic Headwinds to Convergence,” *Republic of Latvia: Selected Issues*, International Monetary Fund, 2018.



25. Structural reforms supporting TFP growth will be critical to mitigate the demographic impact on potential growth in the long run. Alongside the labor market reforms mentioned above, addressing structural and institutional obstacles that prevent the efficient use of available technologies, or lead to inefficient allocation of resources, will be key to reaching this goal. The largest efficiency gains are likely to come from improving the quality of institutions (such as protection of property rights and upgrading legal systems) and increasing access to financial services (especially for small, but productive firms).⁹ Furthermore, reducing the regulatory burden and red tape for businesses and further improving corporate governance of state-owned enterprises would foster competition and efficient resource allocation, as would greater technology diffusion.¹⁰ Fiscal structural reforms, aimed at improving efficiency in the tax system, can also boost firm-level productivity by reducing resource misallocation.¹¹ Structural reforms in the areas of R&D and education would also help boost productivity and reduce costs.

Authorities' Views

26. The authorities recognized that reducing structural unemployment could mitigate the risks that stem from the tight labor market. However, they expressed concerns about introducing administrative complexity in the minimum wage framework and skepticism about the effectiveness of work-based training due to the small size of Latvian companies. They also questioned whether rental market policies were hindering labor market mobility. They were well-aware of the significant implications that adverse demographic trends could have for long-term growth and income convergence, but stressed the difficulty of designing effective policies to address the labor force decline and the strong political sensitivities to relaxing immigration for non-EU workers. They thus agreed that efforts should focus on productivity-enhancing measures.

⁹ See IMF, 2016, "Regional Economic Issues: Central, Eastern and Southeastern Europe," and IMF Country Report No. 16/172.

¹⁰ See OECD, 2015, "Policy areas for increasing productivity in Latvia," *OECD Economics Department Working Papers*, No 1255.

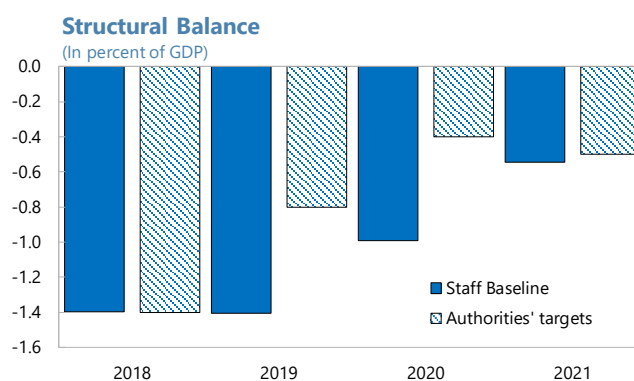
¹¹ See IMF, 2017, *Fiscal Monitor*, April.

B. Fiscal Policy: Toward a More Inclusive and Growth-Friendly Policy Mix

27. Given Latvia's position in the cycle, a stronger fiscal position is warranted to reverse procyclicality and build adequate fiscal buffers over the medium term.

Inflationary pressures from fast wage growth and EU investment fund inflows have emerged during the cyclical upswing. Further pressures could arise if fiscal uncertainties stemming from the ongoing tax and healthcare reforms materialize. Given policy constraints within the currency union, carefully calibrated fiscal policies need to

protect the economy from an accumulation of imbalances while providing room for growth-enhancing reforms. Seeking to balance these objectives, the authorities have set ambitious fiscal targets in the 2018 Stability Program. In staff's assessment, these targets would allow public debt to remain firmly on a downward path and to regain buffers but will require policies that yield significant frontloaded savings of $\frac{1}{2}$ – $\frac{3}{4}$ percent of GDP. Raising new permanent revenue of this amount and safeguarding growth-enhancing spending will help achieve these targets in a way that strengthens fiscal sustainability without compromising social sustainability.



The difference between the staff baseline and authorities' projections is due to the difference in assessment of the tax reform cost, which staff assesses as permanent.

Source: MoF and IMF staff calculations.

28. The recently-adopted tax reform should help reduce inequality and enhance growth, but will further constrain fiscal space.

The change to the PIT structure is an important initial step to reduce Latvia's high labor tax wedge and income inequality, while changes to the CIT system could improve corporate balance sheet transparency and investment incentives. The medium-term impact of these changes will largely depend on whether they succeed in boosting labor force participation and corporate investment. Staff simulations suggest that the reform could have a positive impact on the economy over the medium term. In a scenario with the most favorable assumptions, in which corporates fully invest additional income provided by the CIT reform, the PIT and CIT reforms could increase real GDP by about 1.5 percent over the medium term. However, tax revenues will be permanently lower. Revenue-balancing measures would prevent further constraining fiscal space (Annex VI).

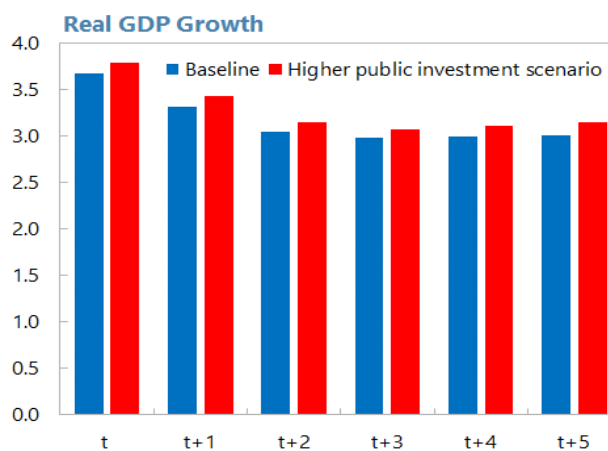
29. With limited flexibility in the budget and lingering uncertainties about revenues, room for policy maneuver will be constrained.

Latvia has many spending needs to advance the country toward income convergence with the euro area, reduce the existing high levels of poverty and inequality, and address spending pressures related to the projected adverse demographic trends. The fiscal policy mix thus needs to combine more efficient and growth-friendly spending with better revenue mobilization.

30. There is scope for reallocating spending to improve growth and income equality.

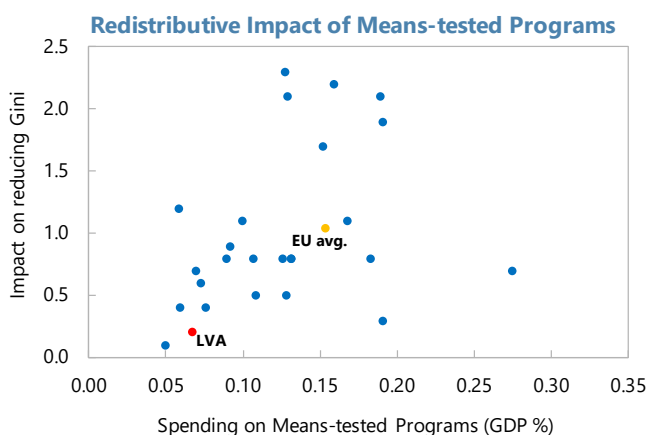
Efforts should focus on increasing investment and social protection spending, while streamlining government consumption:¹²

- **Investment.** Given Latvia’s relatively low capital-output ratio in comparison with advanced economies, greater investment is needed to support long-term growth.¹³ Staff estimates suggest that a permanent increase in capital expenditure of 0.5 percent of GDP per year—upon the deceleration of EU-funded investment—financed by a reduction in government consumption, could gradually add about 0.7 percentage points to cumulative real GDP growth over the medium term.



Sources: Latvian Authorities; and IMF staff calculations.

- **Health and education.** While there is significant uncertainty about the magnitude of the potential gains, cross country-studies suggest that efficient healthcare and education spending can directly reduce market income inequality, and increase human capital and labor productivity.¹⁴ Savings could be secured by streamlining institutions with high teacher-student ratios and reallocating resources to fewer institutions to help improve the quality of education.
- **Social protection.** Latvia spends significantly less than other EU countries on social protection, especially on means-tested (MT) programs. Experience from other countries suggests that significant gains in reducing inequality and poverty can be achieved by relying more on properly designed MT programs. With relatively high levels of income inequality, the case for relying on targeted programs is more compelling in Latvia, and thus strengthening the guaranteed minimum income and social housing programs would be a step in the right direction. Further savings and efficiency gains can be secured by reducing the size of the wage bill, recalibrating the design of existing safety nets, and improving administrative capacity in the implementation of existing programs.



Sources: FAD Expenditure Assessment tool; and IMF staff calculations.

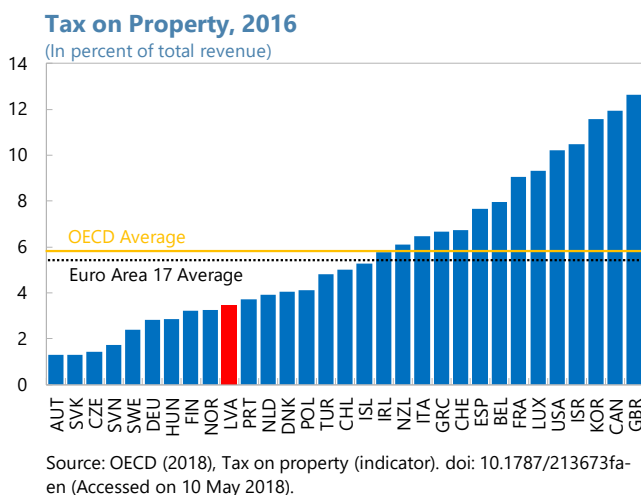
¹² See “Efficient Government Spending,” *Republic of Latvia: Selected Issues*, International Monetary Fund, 2018.

¹³ See IMF Country Report No. 17/195.

¹⁴ IMF, 2017, *Fiscal Monitor*, “Tackling Inequality.”

31. Achieving the targeted fiscal path and development goals requires new and stable sources of revenue.

While there is some scope to improve spending efficiency, the savings would be minimal given that Latvia is already close to the efficiency frontier in many areas. Given Latvia's low intake from property taxes compared to EU peer countries, raising property revenues is a growth-friendly alternative to securing needed savings. There is also scope to reduce VAT tax expenditures by simplifying the VAT rate structure and to further reduce VAT noncompliance by strengthening the tax administration. These measures could provide additional revenue, while promoting fairness among taxpayers and a level playing field for companies.



Authorities' Views

32. The authorities agreed that reversing fiscal procyclicality would be necessary to mitigate overheating risks and build fiscal buffers. However, they expressed reservations about the need to raise additional savings in 2019–20, given that fiscal policies remain consistent with their EU stability pact commitments and domestic fiscal rules. They considered their fiscal objectives to be achievable under current policies as the stimulus impact of the tax reform would gradually compensate for the revenue loss. Nonetheless, they agreed that structural reforms to boost productivity, particularly those related to improving the quality of healthcare and infrastructure, would require fiscal space. They thus emphasized their commitment to strengthening the revenue administration and saw merit in reforming the property tax as sources of additional permanent revenue.

C. Macro-financial Policies: Ensuring Efficient Financial Intermediation

Restoring Credit Growth

33. Credit growth has been slow to recover, as supply and demand constraints are not easing. On the supply side, this has partly been a result of continuing regulatory efforts to repair banks' balance sheets and preserve financial stability, including through macroprudential policies aimed at building safer capital cushions (Annex III). Furthermore, banks' lending standards remain tight in the face of weak borrower collateral and equity, lengthy insolvency procedures, and the shadow economy. On the demand side, while there are some indications that loan demand has increased, nearly three quarters of SMEs report no need for credit, either because they have no plans to expand or because they intend to finance their investments with internal resources. The

pickup in non-bank credit—mainly due to businesses tapping EU funds—has not been sufficient to resuscitate the overall timid credit growth.

34. Healthy credit growth is needed to support investment and the economy in the medium term. Given the shrinking labor force, investment will be an important component for supporting medium-term growth. Structural and regulatory reforms will be particularly important to prepare the banking system to extend credit as EU funds decelerate. The completion of the ongoing ambitious reform of the insolvency regime to address concerns about abuse and lack of transparency should also help unlock credit, especially if it results in shortening the length of insolvency procedures and improving creditors' recovery rates. Further efforts are also needed to bring more of Latvia's economic activities into the formal economy and to encourage voluntary income and asset disclosure. This requires improving public trust in government institutions, including through the ongoing efforts to strengthen Latvia's tax administration, Financial Intelligence Unit (FIU) and the Corruption Prevention and Combating Bureau. The rollout of new instruments to support credit (e.g. financial and non-financial support for startups) as well as regional cooperation in developing capital markets are also welcome steps to further deepen financial intermediation.

Strengthening the AML/CFT Framework and Refocusing the BSFC Sector

35. The suspension of activities of Latvia's third largest bank has highlighted important deficiencies in the existing regulatory and supervisory framework. These deficiencies cut across several areas of supervision of BSFCs. While Latvia has made improvements to its AML/CFT legislation in recent years, ABLV's proposed designation as an institution of primary money laundering concern exposed serious shortfalls in the implementation of AML/CFT preventive measures in the BSFC sector. It also raised doubts as to the capacity of the supervisors to effectively identify and address AML/CFT compliance breaches. Furthermore, allowing ABLV to proceed with a voluntary liquidation after the ECB's determination of the bank as "failing or likely to fail"—and the SRB's decision not to resolve the bank for lack of public interest—demonstrates weaknesses in a legal framework that does not provide sufficient powers for compulsory liquidation in such cases. Ineffective application of AML/CFT controls in the liquidation process could also lead to payouts to depositors without sufficient customer due diligence checks. ABLV's case highlights the limitations arising from the absence of a common EU-wide AML/CFT supervision framework, and from fragmentation in the bank resolution regime within the euro area.

36. A multi-pronged strategy is needed to address these deficiencies. The focus needs to be on developing more effective AML/CFT enforcement, preventing high-risk activities of BSFCs, and repairing bank governance.

- **Strengthening AML/CFT enforcement and implementation.** The authorities need to ensure that financial institutions apply preventive measures (including verification of the beneficial owner), particularly in relation to high-risk customers. AML/CFT supervision needs to more stringently evaluate banks' risk mitigation models, ensure that customer due diligence requirements are properly followed, and apply corrective actions and sanctions when

deficiencies are identified. Information sharing could be improved through enhanced cooperation mechanisms among key stakeholders (i.e., FCMC, FIU, tax administration, corporate registry, and law enforcement agencies). Furthermore, the authorities are encouraged to swiftly implement the actions recommended by the AML/CFT assessment adopted by Moneyval in July 2018. Finally, establishing a regional AML/CFT supervisory arrangement could enhance convergence of supervisory practices, improve the quality of domestic AML/CFT supervision through training and capacity building, and minimize regulatory arbitrage.¹⁵

- **Refocusing the BSFC sector.** In view of the high reputational and governance risks, it is critical to reassess the sustainability of business models involving opaque entities. Although new legislation now prohibits banks from engaging with some narrowly-defined types of shell companies, further measures are needed to ensure the transparency of Latvian companies and identify the customer's beneficial owners. The FCMC should carefully oversee the voluntary liquidation of ABLV, the payout of insured deposits, and the consolidation of the BSFC sector to mitigate the risks of payments to entities associated with money laundering, and the potential impact on confidence and financial stability. Furthermore, the FCMC should ensure that new BSFC activities do not increase financial stability risks or create contingent liabilities for the government.
- **Upgrading the banking and insolvency framework.** The national authorities should have adequate legal tools to liquidate a bank that has been deemed "failing or likely to fail". Efforts to strengthen the integrity, accountability, and qualification requirements of insolvency administrators are welcome. Upgrades are also needed to the domestic banking and insolvency legislation, alongside harmonization within the EU, to include clear requirements for the FCMC to impose compulsory liquidation upon a bank that has been determined as "failing or likely to fail" by the ECB, but will not be resolved by the SRB. Continued vigilant application of fit-and-proper rules, including strengthening the assessment of the reputation of bank owners and senior managers should also be pursued.

Authorities' Views

37. The authorities emphasized the financial stability gains that resulted from conservative lending policies after the 2008 crisis. Nonetheless, they concurred that restoring credit growth is a medium-term priority and addressing deficiencies in insolvency administration and combating the shadow economy would be critical in this effort. They also agreed that legal amendments to enhance the regulatory tools and powers, alongside harmonization within the EU, would be useful. National authorities emphasized their commitment to work toward minimizing risks to financial stability related to ABLV's liquidation and the refocusing of the BSFC sector. Finally, they recognized the need for enhanced enforcement of AML/CFT regulations and considered the new legislation on shell companies as one of the appropriate ways to manage the high risks. They also expressed strong support for a regional AML/CFT supervisory arrangement, and for further domestic efforts to improve information sharing and supervisory capacity.

¹⁵ See IMF, 2018, Euro Area—Financial System Stability Assessment.

STAFF APPRAISAL

38. Latvia's economy has continued to recover since the crisis, but the path toward income convergence remains challenging. Consumption growth, utilization of EU structural funds, and a favorable external environment allowed the economy to reach a growth peak in 2017, and are projected to support strong growth in 2018. The external sector position is stronger than implied by medium-term fundamentals. However, the economy is facing increasingly binding constraints. A shrinking labor force exacerbates labor market tightness, driving up wages and eroding competitiveness, while labor force aging is likely to dampen productivity in the long run. Weak credit growth limits the scope for sustained investment and poses constraints to increasing productivity further. The challenge is thus to smoothly navigate the ongoing cyclical upswing, while setting the stage for robust and inclusive growth in the medium and long term.

39. The policy mix needs to be calibrated to mitigate overheating risks and keep the economy on a path of sustainable long-term growth. To prevent excessive tightening of the labor market, which could result in rapid loss of competitiveness and higher inflation, reforms need to focus on easing labor market constraints by encouraging greater labor force participation and reducing structural unemployment. These reforms include greater use of skill-matching and skill-building policies, better access to housing, revisiting the minimum wage structure, improving labor participation of targeted groups, and encouraging labor immigration. Productivity-enhancing reforms will also be critical for the economy to face demographic headwinds to growth in the long run.

40. Near-term fiscal policy priorities need to prevent the accumulation of imbalances. The procyclicality of fiscal policies raises near-term risks of overheating, especially as uncertainties linger about the economic impact of the recent tax reform. Given policy constraints within the currency union, a stronger fiscal position would be warranted to reverse procyclicality and build fiscal buffers. The authorities' fiscal objectives are appropriate, but will require steadfast implementation supported by upfront consolidation. Greater revenue mobilization, including to mitigate the costs of the recent tax reform, would support these objectives.

41. Improving the growth-friendliness and inclusiveness of the fiscal policy mix has long-term benefits. Despite dampening revenues, the recently adopted income tax reform is a step in the direction of reducing the high tax wedge, improving progressivity of the tax system, and encouraging firms' investment. Reallocating government spending toward productive investment will help the economy weather the gradual deceleration of EU structural funds in the medium term. More efficient health and education spending and better targeted social protection programs would help build human capital, improve labor productivity, and address Latvia's high poverty and inequality rates.

42. The financial system needs to become more supportive of investment in the medium term. Tight macroprudential regulations and lending standards since the crisis have helped improve banks' balance sheets and have supported financial sector stability. But in the medium and long term, robust investment will be needed to raise Latvia's capital-output ratio. The financial system could become more supportive of investment as reforms address risks stemming from the insolvency framework and the shadow economy. In particular, completing the reform of the insolvency regime and the licensing of insolvency administrators would help improve creditors' recovery rates, while efforts to encourage voluntary income and asset disclosure would help reduce credit risk.

43. Steadfast actions are necessary to restore the reputation of Latvia's financial system. Effective enforcement of AML/CFT regulations should focus on mitigating risks from non-resident depositors and opaque companies. Changes in banking legislation, alongside harmonization at the EU level, should provide more adequate tools to liquidate banks deemed to be failing or likely to fail. More vigilant application of fit and proper rules, including assessment of the reputation of bank owners and managers, would help improve bank governance and business models. These reforms, and careful management of the refocusing of BSFCs, will be key to minimize financial sector stability risks.

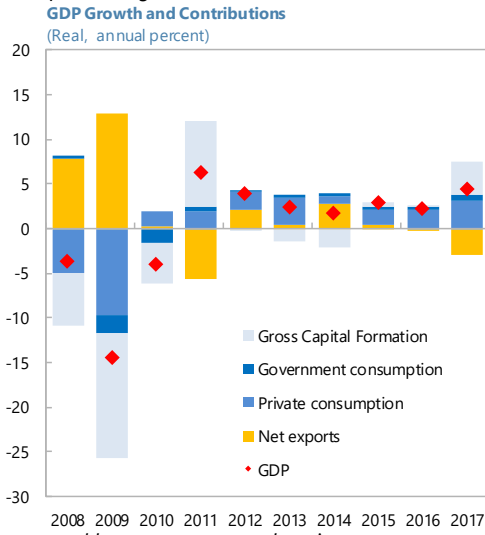
44. The next Article IV Consultation is expected to be completed on the standard 12-month cycle.

Box 1. Risk Assessment Matrix¹

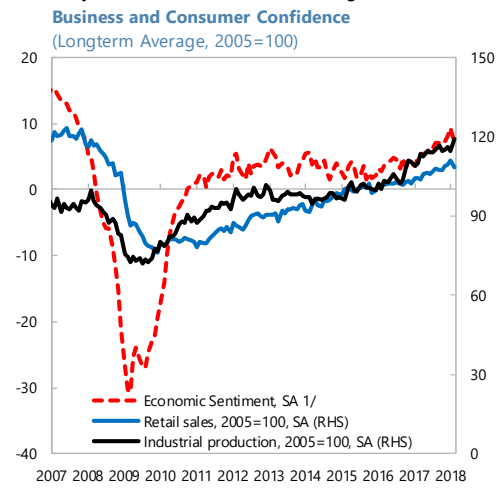
Source of Risk and Likelihood	Impact if Realized	Policy Recommendations Mitigation/Response
<p>Medium</p> <p>Retreat from cross-border integration: Fraying consensus about the benefits of globalization leads to protectionism and economic isolationism, resulting in reduced global and regional policy and regulatory collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.</p>	<p>High</p> <p>As a small open economy, Latvia could be significantly impacted mainly through trade and confidence channels.</p>	<p>Pursue structural policies that enhance productivity.</p> <p>Continue to diversify product and export markets.</p> <p>Participate in coordinated policy response at the European level.</p>
<p>High</p> <p>Structurally weak growth in key advanced and emerging economies. Low productivity growth (U.S., euro area and Japan), high debt, and failure to fully address crisis legacies by undertaking structural reforms amidst persistently low inflation (euro area and Japan) undermine medium-term growth.</p>	<p>High</p> <p>The euro area remains Latvia's single largest trade partner. A protracted slowdown would have a direct impact on exports while also eroding business and consumer confidence.</p>	<p>Participate in coordinated policy response at the European level.</p> <p>Allow automatic stabilizers to operate.</p> <p>If the shock is of sufficient magnitude, discretionary fiscal action could be considered.</p>
<p>High/Medium</p> <p>Tighter global financial conditions. (High) Continued monetary policy normalization and increasingly stretched valuations across asset classes, an abrupt change in global risk appetite, could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns.</p> <p>Significant retreat in the Nordic mortgage market. (Medium)</p>	<p>Medium</p> <p>Could raise the public cost of debt financing. Domestically, sharp increases to interest rate could further hinder credit growth.</p> <p>Could lower funding for Nordic banks reliant on wholesale funding, raising cost of financing and hindering credit growth</p>	<p>Perception of Latvia as a safe asset and the issuance of long-term sovereign debt are mitigating factors.</p> <p>Continue implementing prudent debt management and macroprudential policies and build fiscal buffers.</p> <p>High bank capitalization and liquidity are mitigating factors.</p>
<p>High/Medium</p> <p>Delays in the enforcement of AML standards (High)</p> <p>Failure to refocus the business model of the BSFC sector and/or fast consolidation of the BSFC sector, including due to intensification of sanctions on Russia. (Medium)</p>	<p>High/Medium</p> <p>Could result in further actions taken by foreign regulators, affecting financial sector stability and growth.</p> <p>Rapid downsizing of deposits could undermine confidence and have a larger-than-expected impact on growth.</p>	<p>Maintain strict AML/CFT regulations and improve their enforcement.</p> <p>Reassess the sustainability of a business model involving opaque entities. Closely monitor and manage the withdrawal of nonresident deposits to minimize spillovers and costs.</p>
<p>Medium</p> <p>Failure to advance structural reforms, including those that ease the labor market and pose risks of overheating. (Medium)</p> <p>Deepening of fiscal pro-cyclicality (Medium)</p>	<p>High</p> <p>Could lead to overheating labor market, harming competitiveness. Delay in other reforms could undermine productivity growth and the business environment.</p> <p>Could trigger an accumulation of imbalances and overheating pressures</p>	<p>Focus on improving the labor market, business environment, infrastructure, and human capital.</p> <p>Reduce the structural balance faster to avoid procyclicality.</p>
<p>¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.</p>		

Figure 1. Latvia: Real Sector

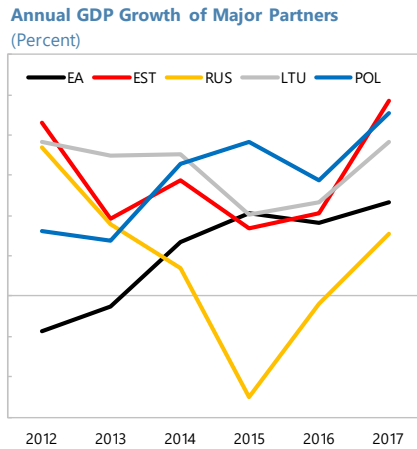
Consumption-led growth accelerated in 2017



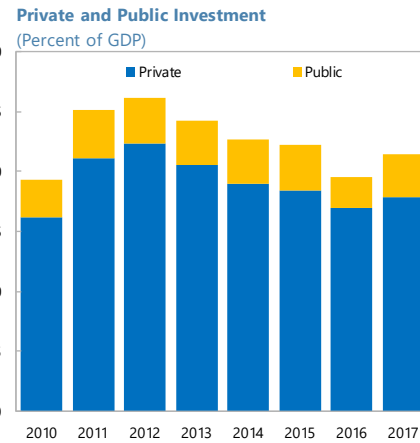
...driven by robust sentiment and strong retail sales



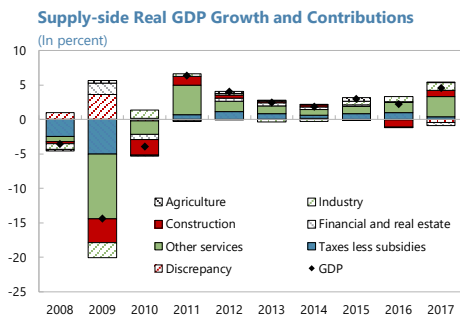
... supported by a strong external environment



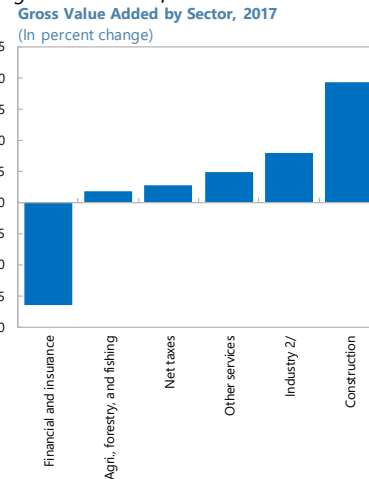
...and a recovery in investment.



Growth in industry, retail services, and construction accelerated...



...weathering the decline in financial services.

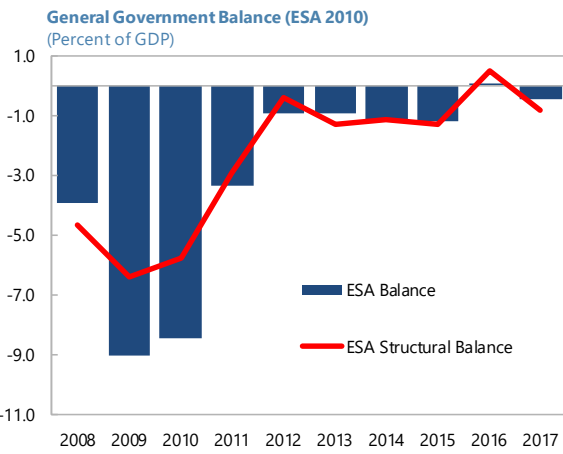


Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

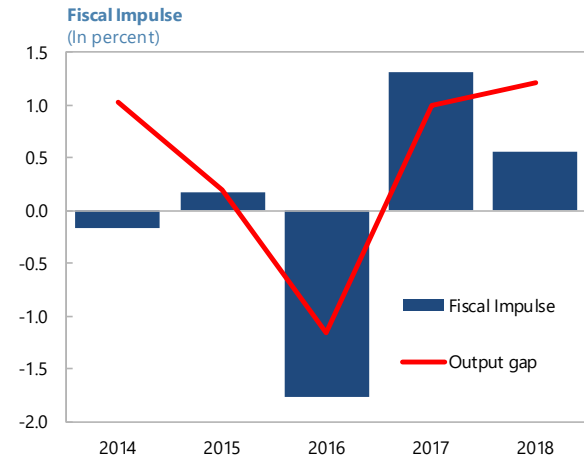
1/ Difference with long-term average.
2/ Mining, manufacturing, and electricity.

Figure 2. Latvia: Fiscal Developments

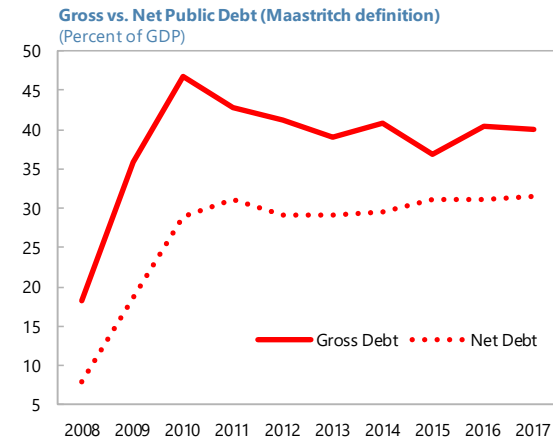
After a significant fiscal consolidation since the crisis,...



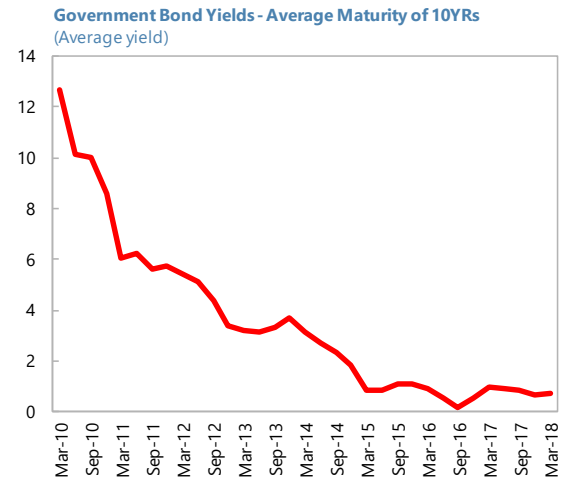
...fiscal policy has turned procyclical and expansionary.



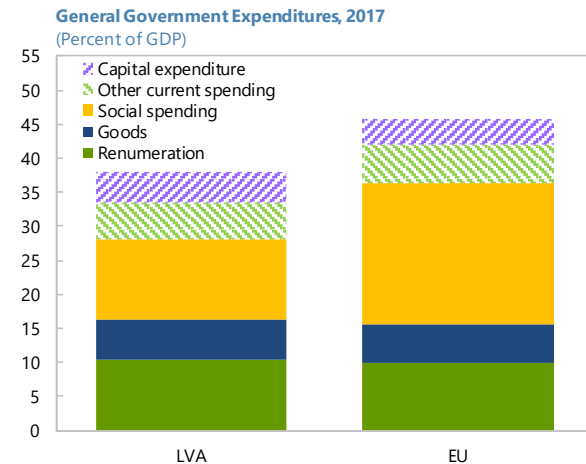
Public debt has leveled off..



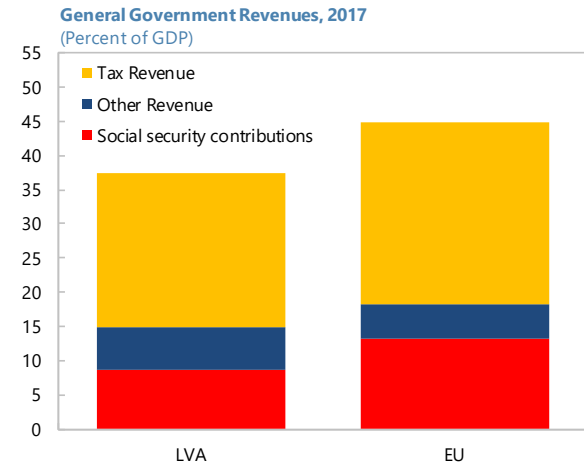
as low interest rates have allowed refinancing at long maturities.



Latvia's social spending lags behind peers...



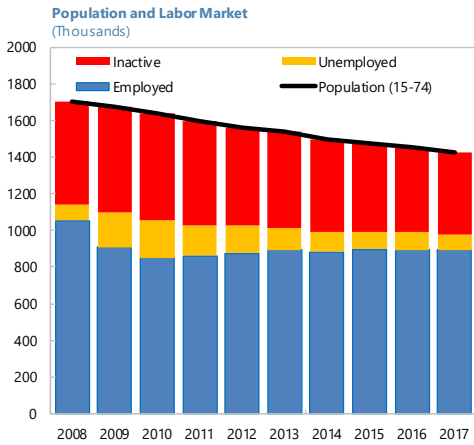
...constrained by a low revenue ratio.



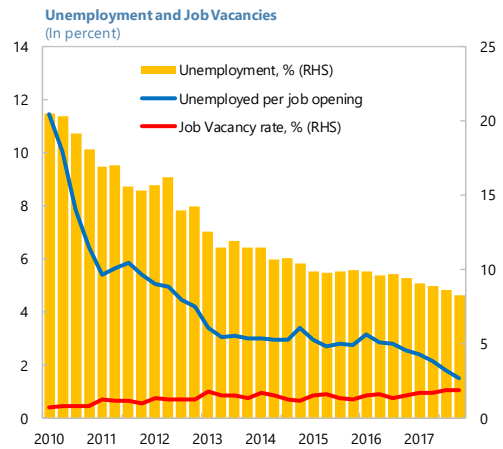
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 3. Latvia: Labor Market

A declining working age population



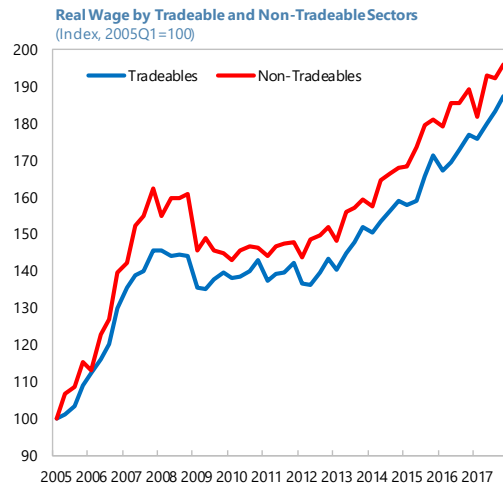
...has resulted in low unemployment



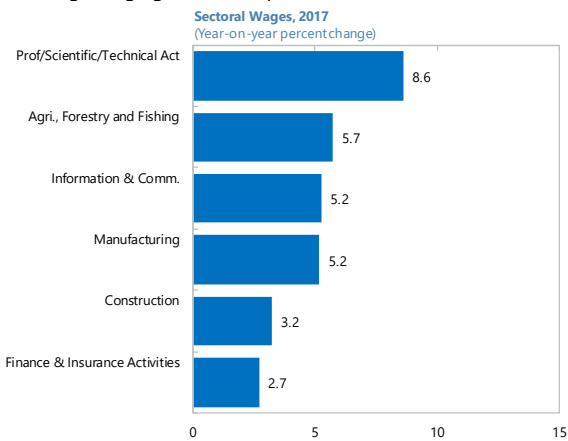
...and a tightening labor market



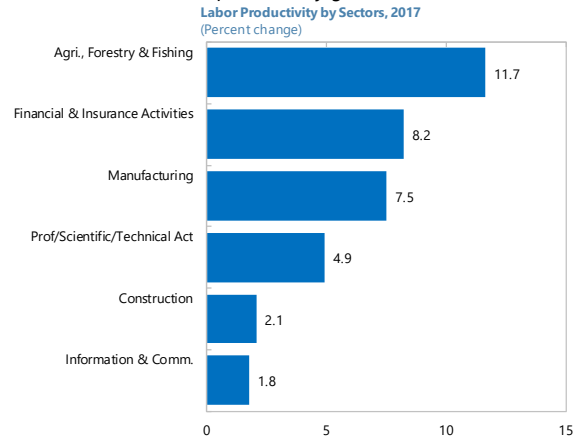
...with rapidly rising wages



...although wage growth in export-oriented sectors



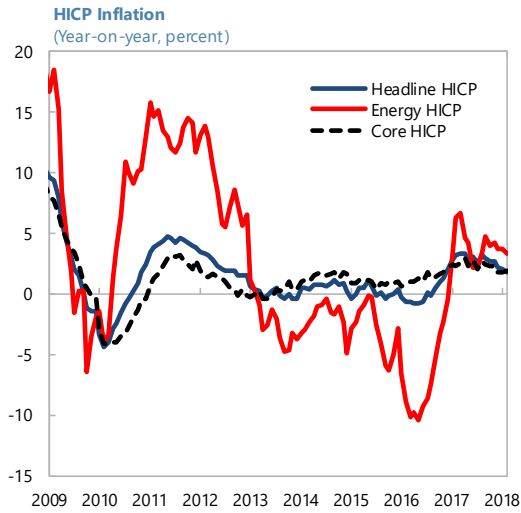
...has remained below productivity growth.



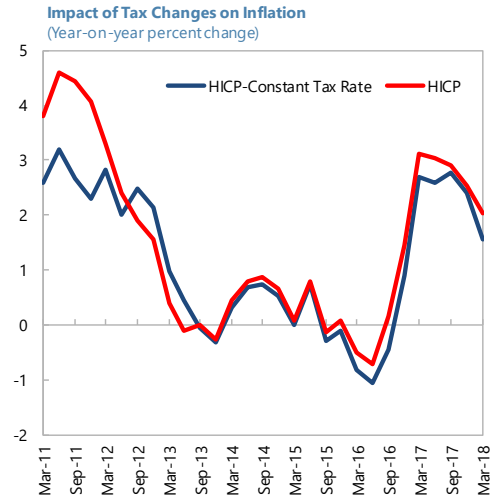
Sources: Latvian authorities, Haver Analytics; and IMF staff estimates.

Figure 4. Latvia: Inflation

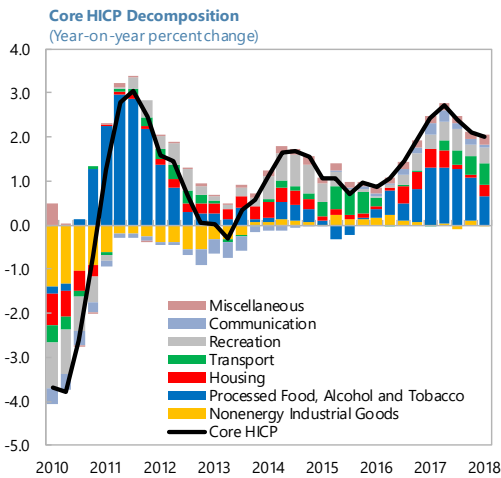
Headline inflation peaked due to energy prices...



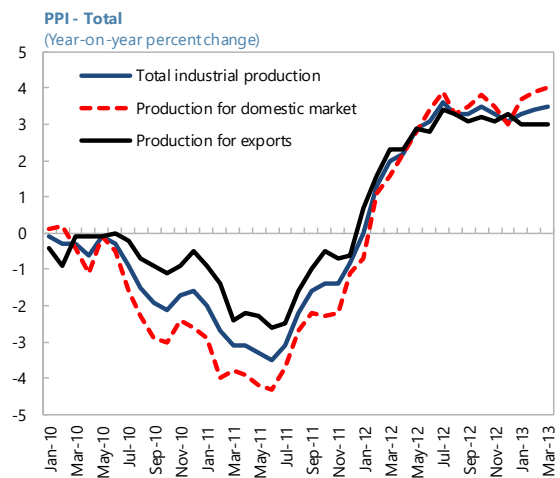
...and indirect tax hikes.



... while core inflation remained below 2 percent...



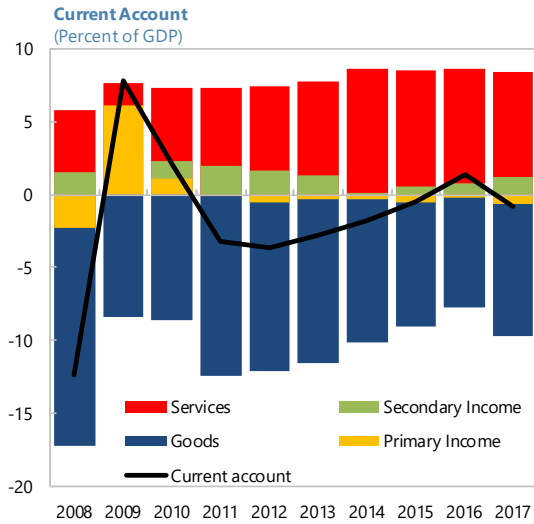
...despite faster-rising producer prices.



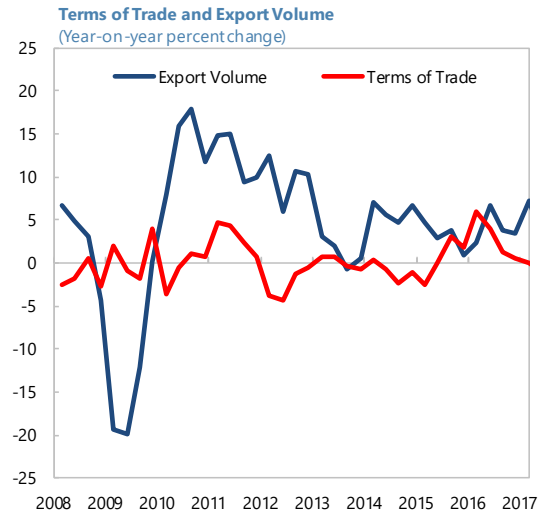
Sources: Eurostat; Haver Analytics; Latvian Central Statistical Bureau; and IMF staff calculations.

Figure 5. Latvia: Balance of Payments

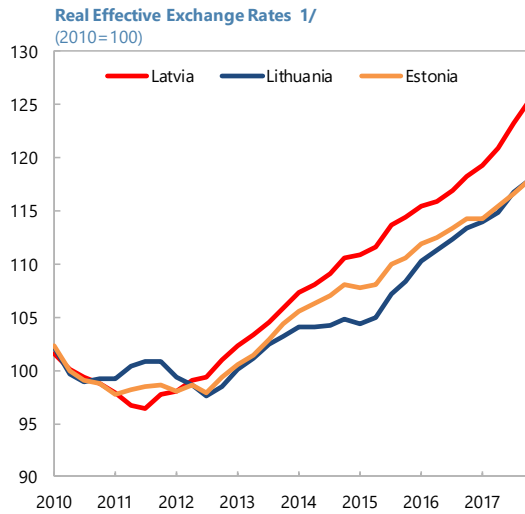
The current account is near a balance...



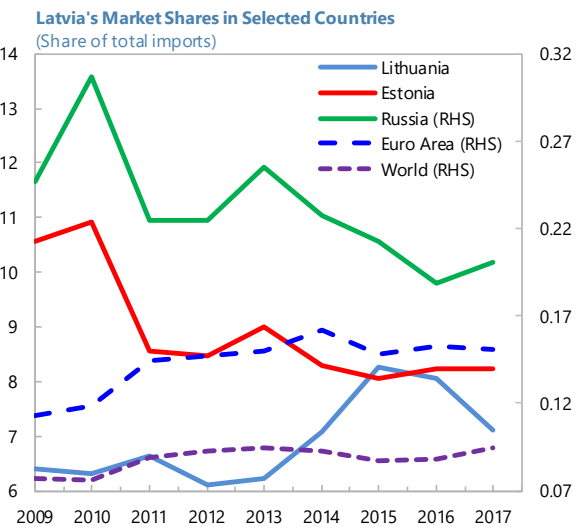
...with exports driven by a favorable global environment.



While the REER has appreciated relative to peers...



...Latvia has managed to diversify exports and sustain market shares



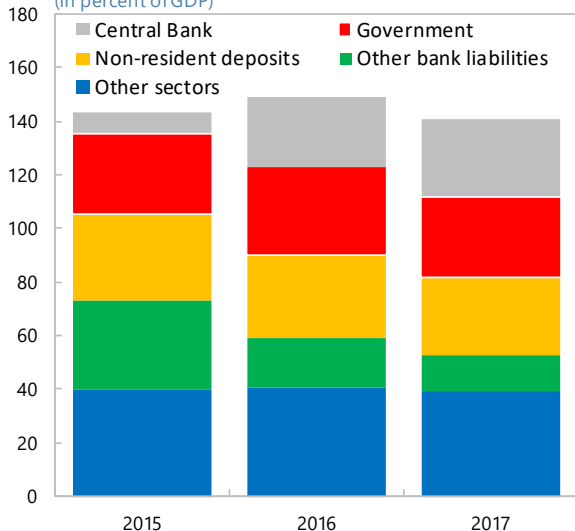
Sources: Bank of Latvia; ECB; EC; and IMF staff calculations.

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

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

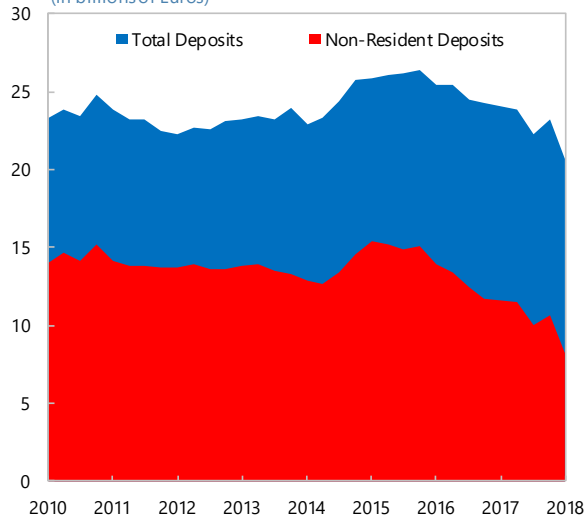
While shrinking, the share of banks' liabilities in external debt remains the largest.

Composition of External Debt
(In percent of GDP)



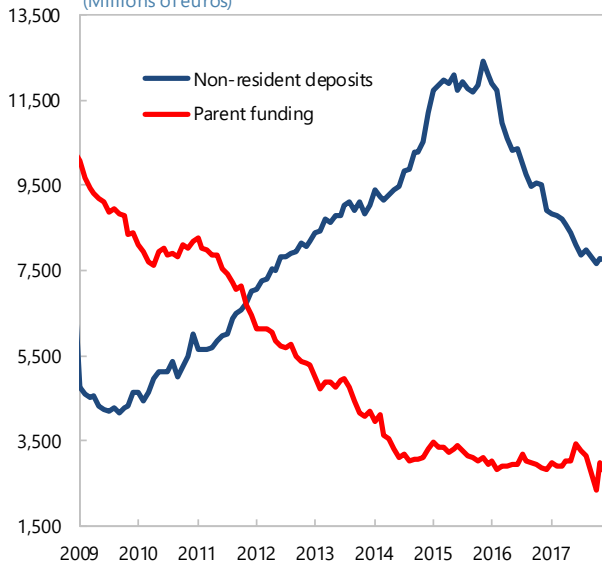
Non-resident deposits have nearly halved since 2015.

Total Deposits and Non-Resident Deposits
(In billions of Euros)



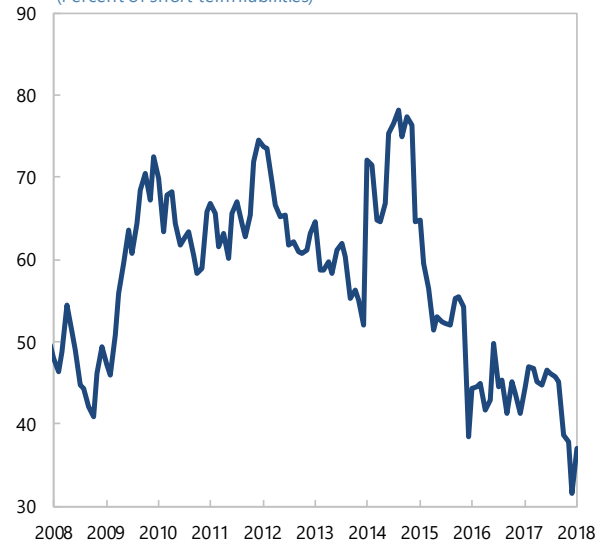
While parent-bank funding has remained stable...

External Funding
(Millions of euros)



...liquid external assets have declined after ABLV's blacklisting.

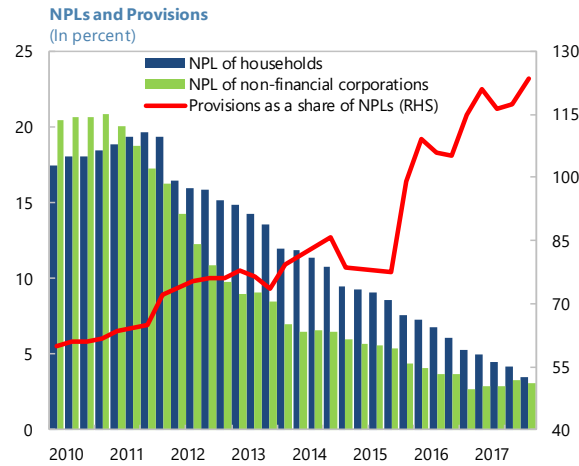
Liquid External Assets in the Banking System
(Percent of short-term liabilities)



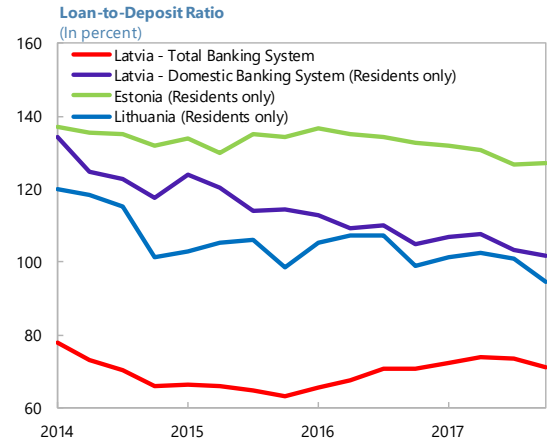
Sources: Bank of Latvia; FCMC; and IMF staff calculations.

Figure 7. Latvia: Banking Sector Developments

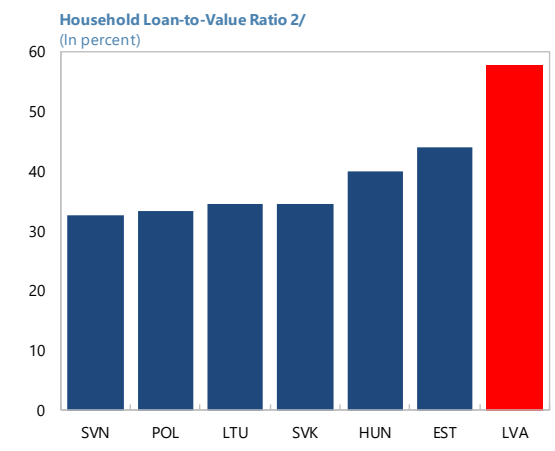
Banks' credit portfolios continue improving...



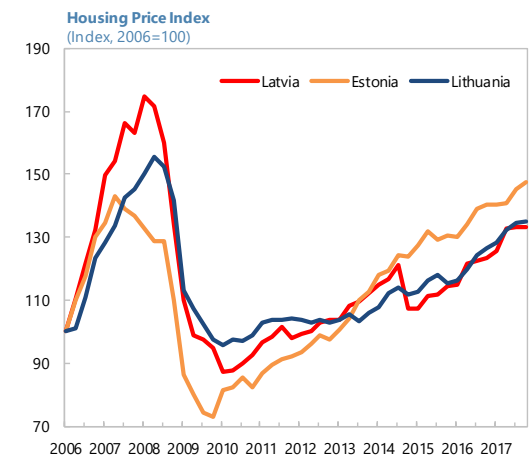
...with loans financed by a greater share of (domestic) deposits.



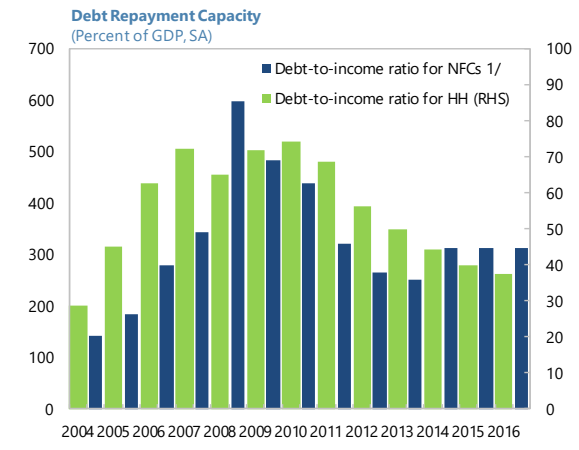
While loan-to-value ratios are higher than peers'...



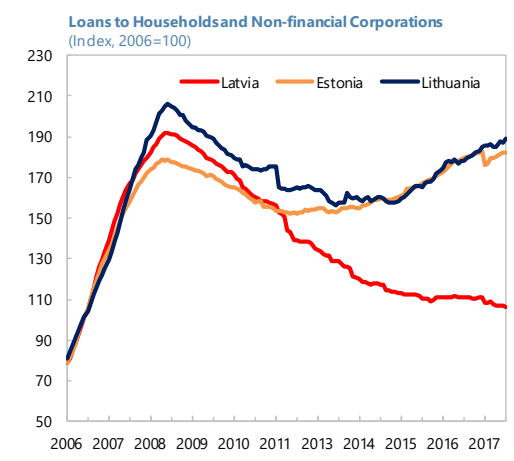
...housing prices have leveled off...



...debt repayment capacity has improved...



...and deleveraging continues.



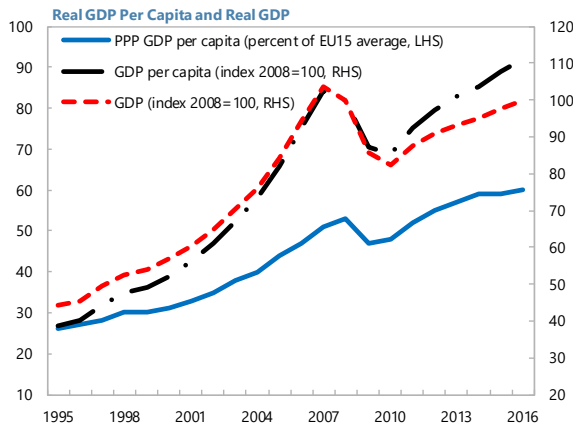
Source: Bank of Latvia; ECB; FCMC; and IMF staff calculations.

1/ Data for non-financial corporation debt-to-income ratio for 2015 and 2016 is 2014 data.

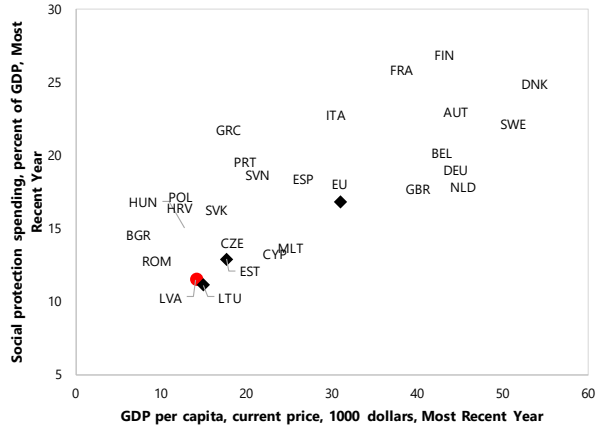
2/ European Central Bank— Household Finance and Consumption Survey, April 2017.

Figure 8. Latvia: Inequality and Poverty

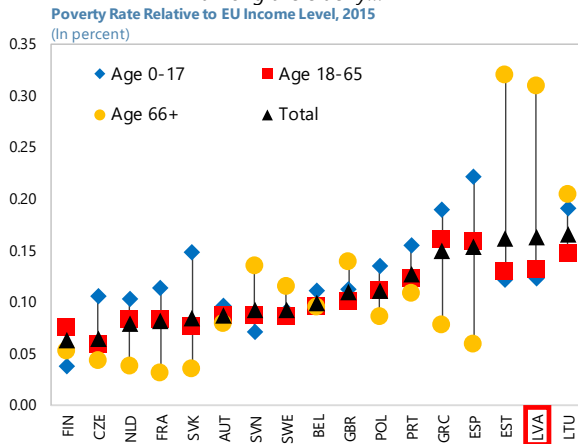
Latvia's GDP per capita remains well below the euro area...



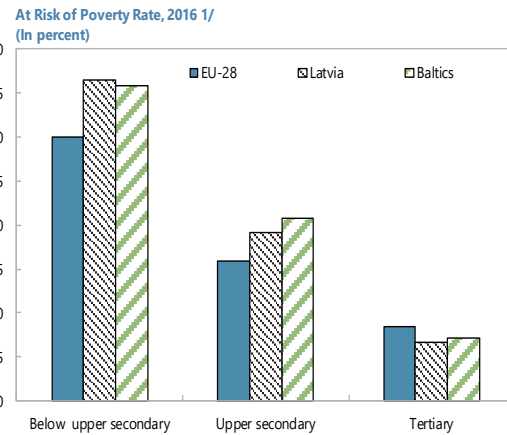
...and spending on social protection is among the lowest.



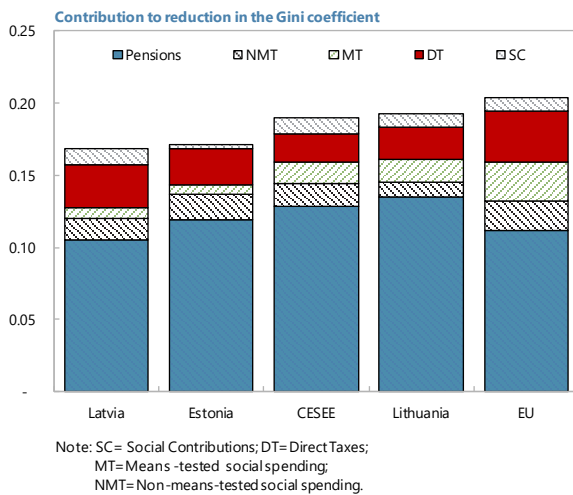
Poverty rates are some of the highest in the EU, especially among the elderly...



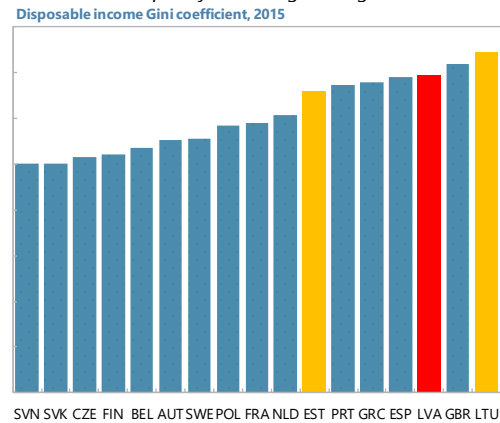
...and those with a low level of education.



Fiscal policy has a small redistributive impact...



...and income inequality is among the highest in the EU.



Source : OECD (2018), Poverty rate (indicator). doi: 10.1787/0fe1315d-en (Accessed on 12 April 2018); Eurostat; Statistics Latvia; IMF FAD; and IMF staff calculations.

1/ Active population aged 25-64.

Table 1. Latvia: Selected Economic Indicators, 2013–19

	2013	2014	2015	2016	2017	2018	2019
						Proj.	
(Percentage change, unless otherwise indicated)							
National accounts							
Real GDP	2.4	1.9	3.0	2.2	4.5	3.7	3.3
Private consumption	5.1	1.4	2.5	3.3	5.1	4.3	3.5
Public consumption	1.6	1.9	1.9	2.7	4.1	4.4	3.5
Gross capital formation	-5.2	-8.9	2.7	0.2	17.5	13.4	6.5
Gross fixed capital formation	-6.0	0.1	-0.5	-15.0	16.0	14.0	6.5
Exports of goods and services	1.1	6.0	3.0	4.1	4.8	3.2	3.1
Imports of goods and services	0.4	1.2	2.1	4.5	9.5	7.1	4.5
Nominal GDP (billions of euros)	22.8	23.6	24.3	24.9	26.9	28.9	30.6
GDP per capita (thousands of euros)	11.3	11.8	12.2	12.7	13.8	14.9	15.8
Savings and Investment							
Gross national saving (percent of GDP)	21.6	20.9	21.8	21.0	20.7	20.8	21.0
Gross capital formation (percent of GDP)	24.3	22.7	22.2	19.6	21.5	23.1	23.6
Private (percent of GDP)	20.5	19.0	18.5	16.9	17.9	19.6	20.4
HICP Inflation							
Period average	0.0	0.7	0.2	0.1	2.9	2.7	2.4
End-period	-0.4	0.3	0.4	2.1	2.2	2.7	2.4
Labor market							
Unemployment rate (LFS; period average, percent) 1/	11.9	10.8	9.9	9.6	8.7	8.2	8.1
Real gross wages	4.6	6.1	6.6	4.9	4.8	5.1	4.3
(Percent of GDP, unless otherwise indicated)							
Consolidated general government 1/							
Total revenue	36.7	36.1	36.2	36.4	35.8	36.6	36.0
Total expenditure	37.3	37.8	37.8	36.8	36.7	37.8	37.0
Basic fiscal balance	-0.6	-1.7	-1.5	-0.4	-0.8	-1.2	-1.0
ESA balance	-1.2	-1.5	-1.4	0.1	-0.5	-0.9	-1.0
General government gross debt 3/	35.8	38.5	34.9	37.4	36.3	35.0	34.2
Money and credit							
Credit to private sector (annual percentage change)	-6.6	-7.4	-2.3	3.5	1.2	...	...
Broad money (annual percentage change)	2.0	35.5	7.5	6.6	2.7	...	...
Balance of payments							
Current account balance	-2.7	-1.7	-0.5	1.4	-0.8	-2.4	-2.6
Trade balance	-11.5	-10.1	-9.1	-7.7	-9.7	-10.9	-11.1
Gross external debt	133.9	144.1	143.6	148.8	140.8	136.6	136.8
Net external debt 2/	36.6	33.7	29.3	28.8	24.4	30.1	31.6
Exchange rates							
U.S. dollar per euro (period average)	1.33	1.33	1.11	1.11	1.13	...	...
REER (period average; CPI based, 2005=100)	120.3	122.2	120.8	121.9	122.9	...	...
Terms of trade (annual percentage change)	0.6	-1.2	0.7	2.8	0.7	1.6	0.6

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/ Gross public debt of the general government consistent with the cash deficit.

Table 2. Latvia: Macroeconomic Framework, 2013–23

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
								Proj.			
(Percentage change, unless otherwise indicated)											
National accounts											
Real GDP	2.4	1.9	3.0	2.2	4.5	3.7	3.3	3.1	3.0	3.0	3.0
Consumption	4.3	1.5	2.4	3.2	4.9	4.3	3.5	3.3	3.2	3.2	3.2
Private consumption	5.1	1.4	2.5	3.3	5.1	4.3	3.5	3.3	3.2	3.2	3.2
Public consumption	1.6	1.9	1.9	2.7	4.1	4.4	3.5	3.2	3.0	3.0	3.0
Gross capital formation	-5.2	-8.9	2.7	0.2	17.5	13.4	6.5	5.0	5.0	5.0	5.0
Gross fixed capital formation	-6.0	0.1	-0.5	-15.0	16.0	14.0	6.5	5.0	5.0	5.0	5.0
Exports of goods and services	1.1	6.0	3.0	4.1	4.8	3.2	3.1	3.0	3.0	3.0	3.0
Imports of goods and services	0.4	1.2	2.1	4.5	9.5	7.1	4.5	4.0	4.0	4.0	4.0
Contributions to growth											
Domestic demand	2.0	-1.0	2.5	2.5	7.5	6.6	4.5	4.0	3.9	3.9	4.0
Net exports	0.4	2.8	0.5	-0.3	-3.0	-2.7	-1.2	-0.9	-0.9	-1.0	-1.0
HICP inflation											
Period average	0.0	0.7	0.2	0.1	2.9	2.7	2.4	2.4	2.4	2.3	2.3
End-period	-0.4	0.3	0.4	2.1	2.2	2.7	2.4	2.4	2.4	2.3	2.3
Labor market											
Unemployment rate (LFS, percent)	11.9	10.8	9.9	9.6	8.7	8.2	8.1	8.0	7.9	7.8	7.8
Employment (period average, percent)	2.1	-1.0	1.3	-0.3	0.2	0.2	0.0	0.0	0.0	0.0	0.0
Real gross wages	4.6	6.1	6.6	4.9	4.8	5.1	4.3	4.0	3.7	3.4	3.0
(Percent of GDP)											
Consolidated general government 1/											
Total revenue	36.7	36.1	36.2	36.4	35.8	36.6	36.0	36.3	35.8	35.6	35.2
Total expenditure	37.3	37.8	37.8	36.8	36.7	37.8	37.0	36.9	36.3	36.1	35.7
ESA balance	-1.2	-1.5	-1.4	0.1	-0.5	-0.9	-1.0	-0.8	-0.4	-0.4	-0.4
ESA structural balance	-1.5	-1.4	-1.4	0.5	-0.9	-1.4	-1.4	-1.0	-0.5	-0.4	-0.4
General government gross debt 5/	35.8	38.5	34.9	37.4	36.3	35.0	34.2	33.1	32.0	31.0	30.0
Saving and investment											
Gross national saving	21.6	20.9	21.8	21.0	20.7	20.8	21.0	21.3	21.1	21.2	21.3
Private	18.1	18.1	18.5	17.6	17.0	17.4	17.7	17.7	17.4	17.5	17.6
Public 2/	3.5	2.8	3.2	3.3	3.7	3.4	3.3	3.6	3.7	3.7	3.8
Foreign saving 3/	2.7	1.7	0.5	-1.4	0.8	2.4	2.6	2.6	3.1	3.3	3.4
Gross capital formation	24.3	22.7	22.2	19.6	21.5	23.1	23.6	23.8	24.2	24.5	24.8
Private	20.5	19.0	18.5	16.9	17.9	19.6	20.4	20.8	21.2	21.5	21.8
Public	3.8	3.7	3.8	2.7	3.6	3.5	3.2	3.0	3.0	3.0	3.0
External sector											
Current account balance	-2.7	-1.7	-0.5	1.4	-0.8	-2.4	-2.6	-2.6	-3.1	-3.3	-3.4
Net IIP	-66.5	-66.1	-63.9	-58.9	-56.5	-55.7	-54.5	-53.4	-53.0	-52.7	-52.3
Gross external debt	133.9	144.1	143.6	148.8	140.8	136.6	136.8	137.0	132.3	131.5	130.8
Net external debt 4/	36.6	33.7	29.3	28.8	24.4	30.1	31.6	32.5	34.1	36.1	37.7
Memorandum items:											
Nominal GDP (billions of euros)	22.8	23.6	24.3	24.9	26.9	28.9	30.6	32.3	34.1	35.9	37.8
Output gap (percent)	1.1	1.0	0.2	-1.2	1.0	1.2	1.0	0.5	0.2	0.0	0.0
Potential output growth (percent)	1.6	1.9	3.8	3.6	2.3	3.5	3.6	3.6	3.2	3.2	3.0
Terms of trade (annual percentage change)	0.6	-1.2	0.7	2.8	0.7	1.6	0.6	0.3	0.1	0.0	0.0
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.											
5/ Gross public debt of the general government consistent with the cash deficit.											

Table 3. Latvia: General Government Operations, 2013–23¹

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	Projections										
	(percent of GDP)										
Total revenue and grants	36.7	36.1	36.2	36.4	35.8	36.6	36.0	36.3	35.8	35.6	35.2
Tax revenue	28.2	28.3	28.8	29.8	29.8	29.6	29.1	29.7	29.7	29.7	29.8
Direct Taxes	16.9	16.5	16.7	17.2	17.4	16.7	16.1	16.3	16.3	16.3	16.3
Corporate Income Tax	1.6	1.5	1.6	1.7	1.6	0.8	0.8	1.1	1.1	1.1	1.1
Personal Income Tax	5.8	5.9	5.9	6.1	6.3	6.0	5.4	5.3	5.2	5.2	5.2
Social Security Contributions	8.7	8.4	8.4	8.4	8.4	8.8	8.8	8.9	8.9	8.9	8.9
Real Estate and Property Taxes	0.8	0.8	0.8	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Indirect Taxes	11.3	11.7	12.1	12.5	12.5	12.9	13.1	13.4	13.4	13.4	13.5
VAT	7.3	7.6	7.8	8.1	8.1	8.4	8.5	8.7	8.8	8.8	8.8
Excises	3.2	3.2	3.3	3.5	3.4	3.5	3.6	3.7	3.7	3.7	3.7
Other indirect taxes	0.8	0.9	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9	1.0
Non Tax, self-earned and other revenue	3.6	3.3	3.3	3.6	3.3	3.2	3.0	2.8	2.7	2.5	2.4
EU and miscellaneous funds	4.9	4.5	4.1	3.0	2.7	3.8	3.8	3.9	3.4	3.3	3.0
Total expenditure 2/	37.3	37.8	37.8	36.8	36.7	37.8	37.0	36.9	36.3	36.1	35.7
Current expenditure	33.5	34.1	34.0	34.1	33.1	34.3	33.8	33.9	33.3	33.1	32.7
Remuneration	7.7	7.9	8.2	8.4	8.5	8.6	8.4	8.3	8.2	8.0	7.9
Wages and Salaries	6.0	6.1	6.3	6.5	6.5	6.6	6.4	6.4	6.3	6.2	6.1
Goods and Services	4.9	4.8	4.8	4.8	4.9	5.3	5.2	5.2	5.1	5.0	5.0
Subsidies and Transfers	18.2	18.7	18.2	18.6	17.7	18.5	18.3	18.4	18.1	18.1	18.0
Subsidies to companies and institutions	7.5	8.2	7.4	7.6	7.1	7.5	7.2	7.3	6.9	6.9	6.8
Social Support	10.5	10.4	10.6	10.8	10.5	10.8	10.9	11.0	11.0	11.0	11.0
Pensions	8.0	7.7	7.5	7.5	7.2	7.3	7.4	7.5	7.5	7.5	7.5
Other	2.6	2.7	3.1	3.4	3.3	3.5	3.5	3.5	3.5	3.5	3.5
International cooperation	0.2	0.2	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	1.2	1.2	1.0	1.0	0.8	1.0	1.1	1.1	1.1	1.1	1.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	1.4	1.5	1.8	1.2	1.1	1.0	0.9	1.0	0.9	0.8	0.8
Capital expenditure	3.8	3.7	3.8	2.7	3.6	3.5	3.2	3.0	3.0	3.0	3.0
Fiscal balance	-1.2	-1.7	-1.5	-0.4	-0.8	-1.2	-1.0	-0.6	-0.6	-0.5	-0.5
Financing (net)	1.2	1.7	1.5	0.4	0.8	1.2	1.0	0.6	0.6	0.5	0.5
Domestic financing	2.4	-5.4	6.5	-2.9	1.4	1.2	-1.9	-2.0	3.0	-0.7	-0.8
External financing	-1.2	7.1	-4.9	3.3	-0.6	0.0	2.9	2.6	-2.5	1.2	1.3
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items											
ESA balance	-1.2	-1.5	-1.4	0.1	-0.5	-0.9	-1.0	-0.8	-0.4	-0.4	-0.4
ESA structural balance 3/	-1.5	-1.4	-1.4	0.5	-0.9	-1.4	-1.4	-1.0	-0.5	-0.4	-0.4
General government debt 4/	35.8	38.5	34.9	37.4	36.3	35.0	34.2	33.1	32.0	31.0	30.0
Nominal GDP (billions of euros)	22.8	23.6	24.3	24.9	26.9	28.9	30.6	32.3	34.1	35.9	37.8

Sources: Latvian authorities; and IMF staff estimates.

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

2/ The bank restructuring costs are calculated in accordance with ESA 95 definitions.

3/ In computing structural balances part of the bank restructuring costs are treated as one-offs.

4/ Gross public debt of the general government consistent with the cash deficit.

Table 4. Latvia: Medium-Term Balance of Payments, 2013–23

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
						Projections					
	(Percent of GDP, unless otherwise indicated)										
Current account	-2.7	-1.7	-0.5	1.4	-0.8	-2.4	-2.6	-2.6	-3.1	-3.3	-3.4
Goods and services (fob)	-3.7	-1.4	-0.5	0.9	-1.3	-2.7	-3.1	-3.5	-4.0	-4.5	-5.0
Goods (fob)	-11.5	-10.1	-9.1	-7.7	-9.7	-10.9	-11.1	-11.3	-11.6	-11.8	-12.1
Exports	43.1	43.4	42.5	41.7	42.3	42.5	41.8	41.0	40.5	39.7	38.9
Imports	-54.5	-53.4	-51.6	-49.4	-51.9	-53.4	-52.9	-52.3	-52.0	-51.5	-51.0
Services	7.8	8.6	8.5	8.6	8.4	8.2	8.0	7.8	7.6	7.3	7.1
Credit	17.1	17.4	17.9	18.4	18.2	18.3	18.0	17.7	17.4	17.1	16.8
Debit	-9.3	-8.7	-9.4	-9.8	-9.8	-10.1	-10.0	-9.9	-9.9	-9.8	-9.7
Primary Income	-0.3	-0.4	-0.6	-0.2	-0.7	-0.9	-0.6	-0.2	-0.1	0.2	0.7
Compensation of employees	2.3	2.8	2.5	2.2	1.9	1.8	1.8	1.8	1.8	1.8	1.8
Investment income	-3.8	-3.8	-3.9	-3.7	-3.6	-3.6	-3.3	-3.0	-2.9	-2.5	-2.0
Secondary Income	1.3	0.1	0.6	0.7	1.2	1.1	1.1	1.1	1.0	1.0	0.8
Capital and financial account	1.5	0.4	3.4	-0.8	0.0	2.4	2.6	2.6	3.1	3.3	3.4
Capital account	2.5	3.2	2.8	1.0	0.8	1.2	1.2	1.1	1.1	1.0	1.0
Financial account	-1.0	-2.8	0.6	-1.8	-0.7	1.2	1.4	1.5	2.0	2.3	2.4
Direct investment	1.6	1.2	2.6	0.0	2.1	0.8	0.7	1.2	0.8	0.7	0.8
Portfolio investment and financial derivatives	0.1	-0.5	-9.5	-4.5	-6.5	-4.3	2.5	1.6	-3.3	0.1	0.2
of which: general government net issuance	-0.3	6.9	-0.6	3.9	0.1	0.3	4.9	2.7	-2.4	1.4	1.3
Other investment	-1.0	-4.1	8.8	3.2	7.0	4.7	-1.7	-1.3	4.6	1.5	1.5
Reserve assets	-1.7	0.5	-1.3	-0.5	-3.3	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.2	1.3	-2.9	-0.6	0.7	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent change, unless otherwise indicated)										
Goods and Services											
Export value (fob)	2.2	4.6	2.4	1.9	8.5	8.3	4.2	3.6	4.0	3.3	3.1
Import value (fob)	0.9	0.9	0.9	-0.5	12.6	10.6	5.0	4.3	4.9	4.3	4.1
Export volume	1.1	6.0	3.0	4.1	4.8	3.2	3.1	3.0	3.0	3.0	3.0
Import volume	0.4	1.2	2.1	4.5	9.5	7.1	4.5	4.0	4.0	4.0	4.0
Gross reserves (billions of euros)	5.8	2.7	3.2	3.3	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Gross external debt (billions of euros)	30.5	34.0	34.9	37.1	37.8	39.4	41.9	44.3	45.1	47.2	49.3
Medium- and long-term (billions of euros)	18.0	18.7	17.2	18.2	18.0	18.2	19.2	20.2	19.6	20.3	21.1
Short term (billions of euros) ¹	12.5	15.3	17.7	18.9	19.9	21.3	22.6	24.0	25.4	26.8	28.2
Net external debt (billions of euros) ²	8.3	8.0	7.1	7.2	6.6	8.6	9.4	10.1	11.2	12.5	13.8
Gross external debt (percent of GDP)	133.9	144.1	143.6	148.8	140.8	136.6	136.8	136.9	132.2	131.4	130.7
Medium and long term (percent of GDP)	78.8	79.4	70.9	73.1	66.9	62.9	62.8	62.6	57.6	56.6	55.9
Short term (percent of GDP) ¹	55.1	64.7	72.7	75.7	73.9	73.6	74.0	74.3	74.6	74.8	74.8
Net external debt (percent of GDP) ²	36.6	33.7	29.3	28.8	24.4	29.7	30.8	31.4	32.8	34.8	36.7
<i>Memo items</i>											
Nominal GDP (billions of euros)	22.8	23.6	24.3	24.9	26.9	28.9	30.6	32.3	34.1	35.9	37.8
U.S. dollar per euro (period average)	1.33	1.33	1.11	1.11	...	...	...	...	...	...	...

Sources: Latvian authorities; and IMF staff estimates.

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

2/ Gross external debt minus gross external debt assets.

Table 5. Latvia: Financial Soundness Indicators, 2007–17

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Commercial banks											
<i>Capital Adequacy</i>											
Regulatory capital to risk-weighted assets 1/	11.1	11.80	14.6	14.6	17.4	17.60	18.9	21.0	22.8	21.5	21.4
Regulatory Tier 1 capital to risk-weighted assets 1/	9.8	10.50	11.5	11.5	14.2	15.20	17.3	18.3	19.8	18.2	19.0
Capital and reserves to assets	7.9	7.30	7.4	7.3	7.5	9.36	9.9	9.9	10.4	10.1	11.1
<i>Asset Quality</i>											
Annual growth of bank loans	37.2	11.2	-7.0	-7.1	-8.1	-10.9	-6.5	-6.1	0.1	3.1	-4.6
Annual growth of bank loans to residents	30.3	15.8	67.2	-8.7	-8.3	-10.5	-6.2	-7.6	-1.5	3.1	-2.8
Annual growth of bank loans to companies	36.3	16.9	-6.5	-8.0	-7.6	-9.0	-5.6	-9.6	-1.6	1.6	-7.6
Sectoral distribution of loans (in % of total loans, stock)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture, hunting and related service activities	1.6	1.7	1.6	1.6	2.0	2.4	3.2	2.8	2.8	2.8	2.8
Construction and real estate activities	18.8	19.6	20.8	20.4	20.0	18.6	18.1	17.9	17.3	17.9	17.3
Industry and trade	21.6	23.1	22.3	22.0	22.0	24.3	24.2	22.7	23.3	22.7	23.3
Financial intermediation	6.0	6.0	4.5	3.2	2.8	2.7	3.6	4.7	5.1	4.7	5.1
Households	40.0	38.4	39.3	39.8	40.0	39.1	38.4	37.8	36.2	37.8	36.2
Non-residents	12.1	11.2	11.4	13.1	13.2	12.9	12.6	14.0	15.4	14.0	15.4
Loans past due over 90 days	0.8	3.6	16.4	19.0	17.2	11.1	8.3	6.9	6.0	4.4	4.1
Loans to households	...	4.7	16.8	18.4	19.3	15.2	12.0	9.5	7.6	5.3	3.5
Loans to corporations	...	2.8	18.5	20.8	16.2	9.7	7.0	5.9	4.4	2.7	3.1
<i>Earnings and Profitability</i>											
ROA (after tax)	2.0	0.3	-3.5	-1.6	-0.9	0.6	0.9	1.1	1.3	1.5	0.9
ROE (after tax)	24.3	4.6	-41.6	-20.4	-11.2	5.6	8.7	11.1	12.5	14.3	7.6
<i>Liquidity</i>											
Liquid assets to total assets	25.0	21.6	21.1	27.3	27.4	32.3	36.5	39.9	40.2	33.8	37.4
Liquid assets to short term liabilities	55.7	52.8	62.8	67.9	63.9	59.8	64.4	63.1	66.7	61.9	59.5
Customers deposits to (non-interbank) loans	68.2	58.8	61.9	77.5	84.1	106.3	124.9	151.3	158.5	141.2	140.3
<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	43.1	34.2	29.1
FX loans to total loans 2/	81.8	85.0	87.1	88.9	86.3	84.5	88.5	13.0	13.8	12.5	8.4
<i>Memorandum Items</i>											
Share of non-resident deposits to total deposits	41.7	44.0	38.0	41.6	47.2	48.9	47.3	51.7	53.4	42.8	39.7

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.

Annex I. External Sector Assessment

1. Foreign assets and liabilities. The NIIP has improved gradually and stood at around -56 percent of GDP by end 2017, compared to -58 percent at end-2016; it is projected to continue declining to about -48 percent of GDP over the medium term. Gross assets stood at 133 percent of GDP in 2017, while gross liabilities stood at 189 percent. Debt securities comprised only 24 percent of these liabilities. At the same time, net external debt stood at 24 percent of GDP at the end of 2017.

2. Current account. The current account moved to a deficit of 0.8 percent of GDP in 2017, driven by a notable uptick in goods imports, as investment and consumption growth accelerated. The current account is projected to further deteriorate in 2018 and 2019 as investment and consumption continue to be strong. The EBA-lite CA model results suggest a CA gap of around 2.5 percent of GDP in 2017, of which about 1.5 percentage points can be attributed to the policy gap. This in turn mostly reflects the average fiscal stance of the rest of the world, which is assessed overly accommodative at this juncture. The remainder of the CA gap is unexplained by the model and may represent other distortions that affect the external sector, including exchange rate misalignment. Overall, the current account position is assessed stronger than implied by fundamentals and desirable policies.

ESA Summary Table	
EBA-lite CA model	
CA-Actual	-0.8%
CA-Norm	-3.3%
CA-Gap	2.5%
o/w Policy gap	1.5%
Elasticity	-0.45
Implied REER Gap	-5.6%
CA-Fitted	-1.9%
Residual	1.1%
EBA-lite Index REER model	
ln(REER)-Actual	4.61
ln(REER)-Norm	4.62
REER-Gap	-0.8%
o/w policy gap	-0.8%

3. Real exchange rate. The REER appreciated by about 0.8 percent between 2016 and 2017. The EBA-lite CA model suggests an undervaluation of 5.6 percent using standard trade elasticities. As Latvia is still a catching-up economy, continued strong investment and consumption should bring down the balance without the need for an exchange rate adjustment. The EBA-lite Index REER model finds a small undervaluation.

4. Capital and financial accounts. The capital account is dominated by EU structural fund inflows, which slowed in 2017, as funds are primarily aimed at supporting current expenditure on structural measures. FDI inflows, at 3.7 percent of GDP in 2017, rebounded to their highest level since the GFC, portfolio and other investment flows remain the main drivers of the financial account. High foreign holdings of government bonds and cross-border linkages of the banking sector in the region indicate potential vulnerabilities.

5. FX intervention and reserves level. The Euro has the status of a global reserve currency. As such, reserves held by euro area economies are typically low to standard metrics, but the currency is free floating.

6. The external position in 2017 was stronger than implied by medium-term fundamentals and desirable policies. A widening of the current account deficit from 2018 onwards is expected, on the back of a pick-up in investment and unwinding of terms-of-trade gains.

Annex II. Recent Developments in the BSFC Sector

1. **Foreign authorities have alleged that Latvian BSFCs have been involved in money laundering.** On February 13, the Financial Crimes Enforcement Network of the U.S. Department of the Treasury (FinCEN) named Latvia's ABLV Bank an institution of primary money laundering concern. FinCEN issued a proposal under the U.S. Patriot Act, seeking to prohibit ABLV from engaging in dollar transactions with correspondent banks. FinCEN's report found that the bank orchestrated money laundering schemes, obstructed regulatory enforcement, engaged in bribery, and conducted illicit activities linked to North Korea, Russia, and Ukraine. In 2017, Rietumu Bank, also one of Latvia's largest banks, was fined €80 million for being involved in a tax avoidance scheme in France; Rietumu is currently appealing the French court ruling.
2. **ABLV's Failure.** FinCEN's report triggered a rapid deterioration of ABLV's liquidity situation. Deposit withdrawals amounted to nearly a quarter of ABLV's total deposits (2 percent of GDP) within two days of FinCEN's announcement. In response, the FCMC—upon ECB's instructions—imposed restrictions on payments made by ABLV until the bank's liquidity situation was stabilized. As ABLV was unable to secure sufficient liquidity to withstand stressed outflows within the set deadline, the ECB determined ABLV, and its Luxembourg subsidiary, to be "failing or likely to fail".
3. **Liquidation process.** The Single Resolution Board (SRB) established that resolution of ABLV and its subsidiary was not in the public interest, as the banks did not provide critical functions in the economy and the financial system, and their failure was not expected to have a significant adverse impact on financial stability. The banks' liquidation was thus expected to take place under national legislation; however, the Luxembourg court found the local subsidiary to be solvent and refused the request for its liquidation. Moreover, the FCMC did not find legal grounds for a compulsory liquidation of the bank in Latvia, or to revoke its license.¹ A voluntary liquidation plan submitted by ABLV's shareholders was subsequently approved by the FCMC. The shareholders have also filed a case against the ECB and SRB's decision with the Court of Justice of the European Union.
4. **Deposit insurance.** On March 3, payouts commenced to about 23,000 insured depositors in ABLV. The payouts are expected to be fully backed by ABLV's funds without the use of the additional funds of Latvia's Deposit Guarantee Fund. By end-April, about 25 percent of ABLV's €480 million insured deposits were paid out. Of concern is the potential disregard for provisions of the Deposit Guarantee Law that prohibit payouts to depositors who have not been identified as required under the provisions of the Money Laundering Prevention Law.
5. **Regulatory response.** On April 26, parliament approved a bill limiting banks' activities with customers deemed to be of high-risk. This bill aims to reduce the engagement between Latvian banks and shell companies, while also enhancing the information exchange between financial institutions and law enforcement agencies. However, it does not improve the oversight by all relevant authorities involved in company registration and formation, or bolster the ability of

¹ Pursuant to Article 27 of the Credit Institutions Law, a credit institution's license may be cancelled if it fails to comply with laws governing the activities of the credit institution, which includes the AML/CFT Law.

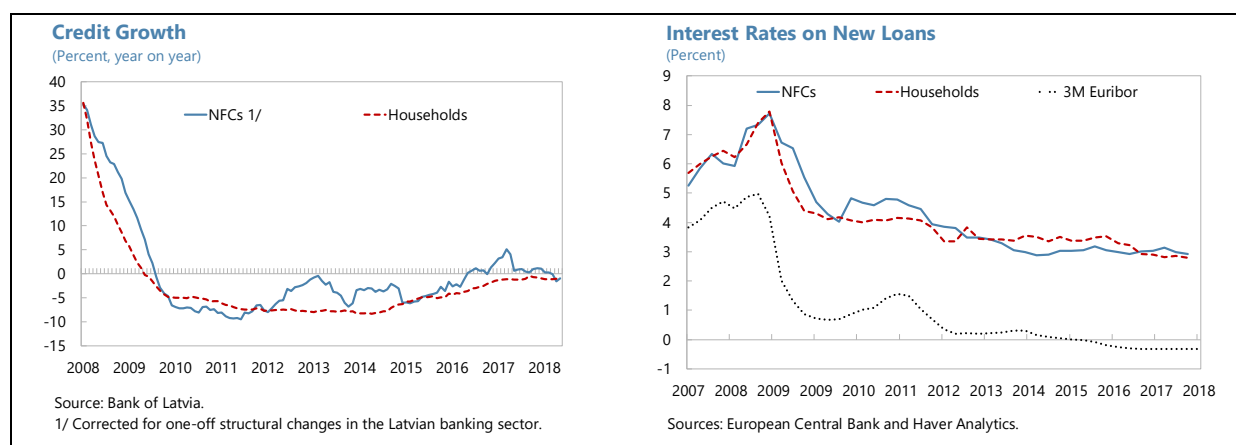
authorities to access ownership information, so as to enhance the transparency of legal persons established in Latvia.

6. Impact on the financial system. These events and the measures taken by FCMC have resulted in a significant drop in deposits. Since the FinCEN report, deposits in the BSFC sector have declined by more than a third. Spillovers to banks servicing domestic clients have so far been limited, with their deposits growing slightly since February. Gross value added of financial services declined by 27 percent y/y during the first quarter of 2018 but was fully offset by growth in other sectors. This limited impact could be in part due to the relatively little engagement of BSFCs with the domestic economy, with only 10–12 percent of their total deposits and loans targeting domestic clients. Furthermore, the BSFC sector has been consolidating since end-2015, after the withdrawal of U.S. correspondent banks from the Latvian market and strengthening of the AML/CFT regulations. Non-resident deposits declined by about 35 percent in 2015–17. Correspondent banking relations have not been affected negatively. In early 2018, Citadele bank restored correspondent banking relations in US dollar transactions.

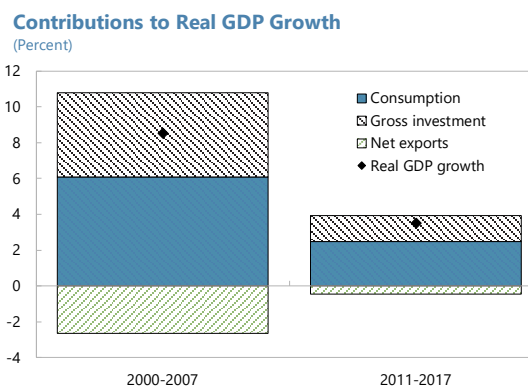
7. Risks to the outlook. The failure of ABLV and the ongoing efforts to strengthen implementation of AML/CFT regulations may result in a fast consolidation of the BSFC sector. The extent and speed at which it will consolidate is yet unclear, but it could have a tangible impact on the economy. The market exit of ABLV alone could reduce growth by 0.5 percentage points. Under the extreme assumption that the BSFC would be fully consolidated, the loss of value added could reduce growth by about 1 percentage point. Second round effects are difficult to quantify, but given the limited role of the BSFC sector in the domestic economy, they are expected to be much smaller, unless they result in significant deterioration in confidence.

Annex III. Impediments to Credit

1. Despite Latvia's ongoing economic recovery and record low interest rates, credit growth has remained anemic. Credit growth slowed sharply during the crisis and turned negative in 2009. In the years that followed, credit continued to contract even as the economy emerged from a recession and accommodative monetary policy lowered the cost of borrowing. With the economy now in its eighth year of expansion and borrowing costs at record lows, credit has recovered only slowly. The decline in lending to households has leveled off, while credit to non-financial corporations (NFCs) began to grow modestly in 2017 before turning negative again in 2018.¹ Although the credit cycle has turned, the credit-to-GDP gap remains deeply negative.



2. Creditless recoveries are not rare, representing about one-fifth of all recoveries.² They are likely to occur when an unsustainable credit boom unwinds, resulting in a recession and a banking crisis, as was the case in Latvia. Creditless recoveries are typically weaker than recoveries with credit, with output growth about a third lower on average. Investment tends to have a smaller contribution to growth in creditless recoveries, although consumption is also affected. A recovery can be creditless because credit is not available (lack of supply) or because it is not needed (lack of demand). While it is difficult to pinpoint with certainty, the main drivers behind the lack of credit growth in Latvia, evidence suggests that both supply and demand factors are at play.



¹ NFC credit growth turned negative in 2017 due to structural changes in the banking sector, notably the transfer of Nordea Bank's loan portfolio to its parent bank in Sweden prior to its merger with DNB. Excluding these one-off effects, however, NFC credit growth remained positive throughout 2017.

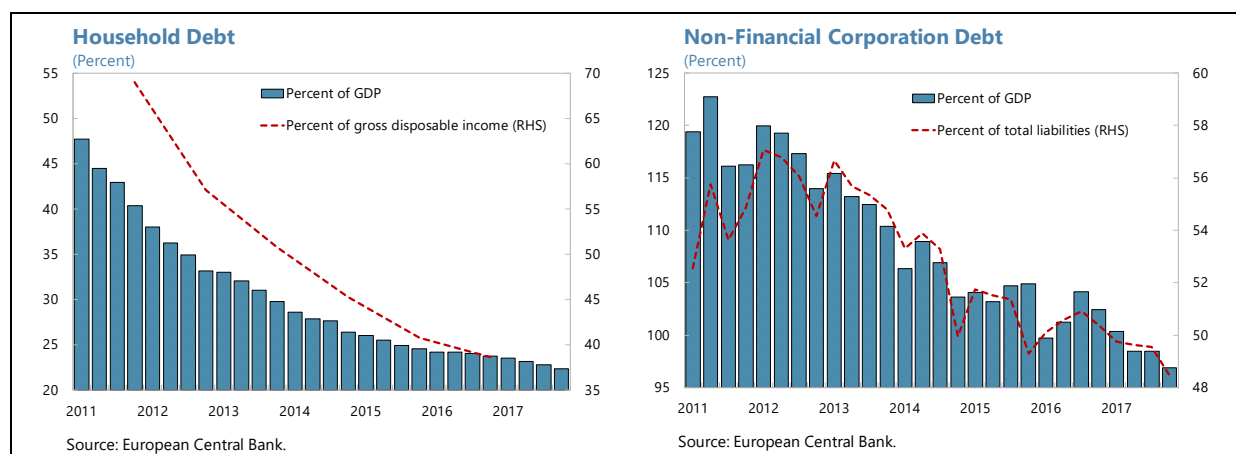
² See Abiad, A., G. Dell'Ariccia, and B. Li, "Creditless Recoveries," IMF Working Paper 11/58. A creditless recovery is defined as an episode where real credit growth is negative in the first three years following a recession.

Supply-side Factors

3. Bank lending to households and NFCs has remained sluggish even though the banking sector is healthy, and private sector balance sheets have improved. Capital and liquidity ratios comfortably exceed required levels. The ratio of non-performing loans has declined considerably from its 2010 peak and is in line with the EU average. Loan-loss provisioning is high and profitability is strong. Stress tests performed by the Bank of Latvia indicate that credit institutions' capacity to absorb a potential increase in credit risks due to shocks is good and continues to improve, thanks to the improving quality of their loan portfolio and their high level of capitalization. Both NFC and household debt-to-GDP ratios have declined steadily from their post-crisis peaks.

Banking Sector Indicators, Q4 2017			
	Latvia	EU average	Minimum requirement
Tier 1 capital ratio	19.0	16.2	8
Total capital ratio	21.4	19.0	11
Liquidity ratio ¹	59.5		30
Liquidity coverage ratio	313.3	148.5	
Leverage ratio	9.8	5.3	
Loan-to-deposit ratio	71.3	116.7	
Excluding foreign deposits	103.0		
NPL ratio	4.1	4.0	
NPL coverage ratio	93.2	44.5	
Return on equity (percent)	7.6	6.1	
Return on assets (percent)	0.9	0.4	

Sources: Financial and Capital Market Commission; European Banking Authority.
1/ Liquid assets/current liabilities with maturity up to 30 days.



4. Banks' capital buffers have been increased several times since the crisis. A capital add-on was introduced in 2012 for banks with lending to foreign clients exceeding 5 percent of total assets, and all banks became subject to a capital conservation buffer starting in 2014. The FCMC in 2015 identified six "other systemically important institutions" (O-SIIs), with capital surcharges phased in over 2017–18.

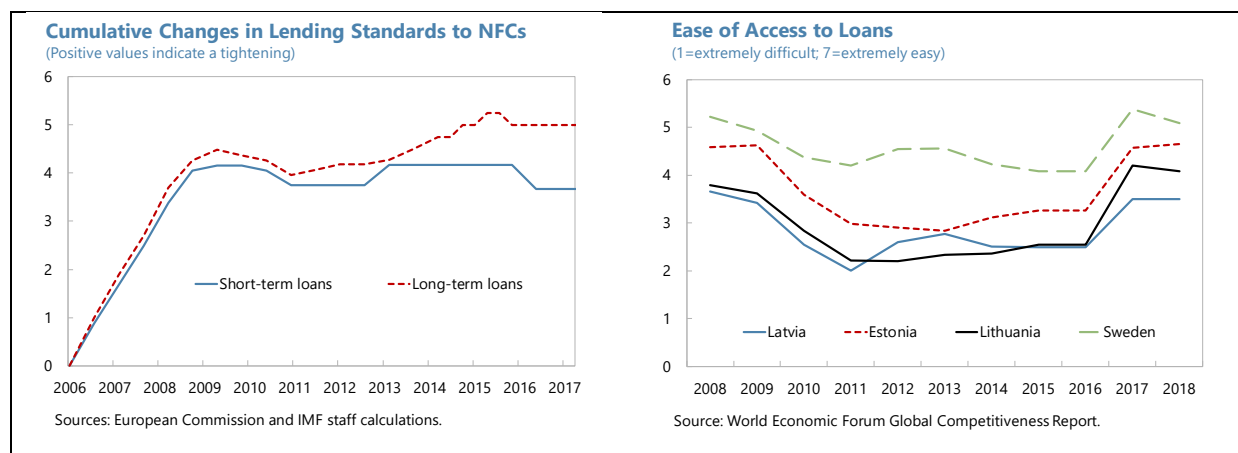
Summary of Macprudential Measures in Latvia	
LTV cap	Effective June 12, 2007, maximum LTV of 90 percent. Effective September 18, 2014, LTV may reach 95 percent if loans are guaranteed by the State.
Countercyclical capital buffer	Set to 0 on February 1, 2016. All credit institutions covered. Rate is reviewed quarterly by the FCMC and has not changed.
Capital conservation buffer	Effective May 28, 2014, all credit institutions are required to maintain a capital conservation buffer of Common Equity Tier I capital equal to 2.5 percent of total risk exposure.
Pillar 1 add-on	Effective April 30, 2012, banks must maintain additional capital if lending to foreign clients exceeds 5 percent of total assets. Capital add-on depends on the share and growth rate of foreign clients' loans in bank's assets.
Capital surcharges for systemically important institutions	On December 30, 2015, the FCMC identified six institutions as "other systemically important institutions" (O-SIIs). The following capital buffer rates were set on November 7, 2016, with a phase-in period: Effective June 30, 2017, the capital buffer was set to 1 percent for ABLV Bank, Swedbank, and SEB banka, and to 0.75 percent for Rietumu Banka, Citadele banka, and DNB banka. Effective June 30, 2018, the capital buffer rises to: 2 percent from 1 percent for ABLV Bank, Swedbank, and SEB banka; to 1.75 percent from 0.75 percent for Rietumu Banka; and to 1.50 percent from 0.75 percent for Citadele banka and DNB banka.
Other measures to mitigate structural systemic risk	Effective January 1, 2011, credit institutions were subject to a financial stability levy equal to 0.036 percent of their liabilities, after certain adjustments. The levy was increased to 0.072 percent effective January 1, 2012. The purpose of the levy is to finance measures that may be needed to promote financial stability.

5. Moreover, Swedish banks operating in Latvia have been affected by tighter capital requirements back home.

Domestically active banks in Latvia are dominated by branches and subsidiaries of Nordic banks—primarily Swedish banks. The latter have likely reduced their credit supply in Latvia as a result of tighter capital requirements introduced in Sweden in the last five years and applied on a consolidated basis.

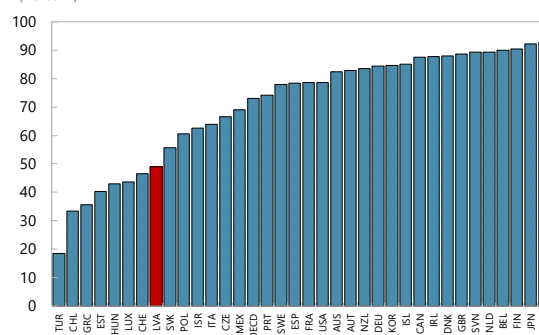
Sweden: Capital Requirements, 2013–17 (In percent unless otherwise indicated)					
	2013	2014	2015	2016	2017
Capital conservative buffer (CCoB)		2.5	2.5	2.5	2.5
Countercyclical capital buffer (CCyB)				1.5	2
Systemic risk buffer (SRB)			3.0	3.0	3.0
Pillar II capital add-on			2.0	2.0	2.0
Risk weight floor					
Residential	15	25	25	25	25
Commercial		100	100	100	100
Source: IMF Country Report No. 17/350					

6. Lending standards, which were tightened during the crisis, have remained strict amid lingering credit risk concerns. Banks cite insufficient collateral, excessive leverage, insufficient profitability or cash flow, shortcomings in the legal framework; and the shadow economy as reasons for rejecting loan applications. In this context, household credit is directed mainly to high-income households: the highest quintile accounts for 61 percent of outstanding household loans. Businesses report that access to credit is improving, but remains difficult relative to other countries in region.



7. Concerns about the insolvency system may also be restraining credit growth. According to a study by Deloitte and Touche, creditors lost between €580–750 million as a result of abuses in insolvency proceedings over the period 2008–14. In 2017, five insolvency administrators were placed under criminal arrest and/or suspended by the Latvian Insolvency Administration following allegations of extortion and money laundering. Several of these administrators were implicated in the liquidation proceedings of Trasta Komercbanka. The recovery rate of creditors’ claims on firms in liquidation is low by international standards, and insolvency proceedings can be excessively long and complicated. To address these concerns, the authorities have embarked on wide-ranging reforms to strengthen the insolvency regime.

Recovery Rate of Debt of Insolvent Firms, 2016
(Percent)



Source: OECD.

Box 1. Insolvency Administration Reforms

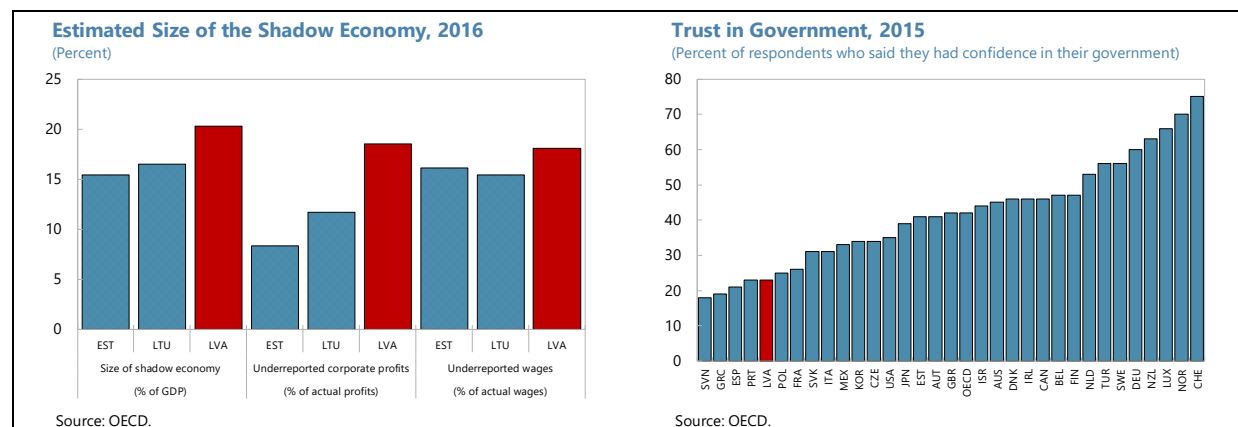
In 2017, the Latvian authorities issued Insolvency Policy Development Guidelines. The guidelines aim to encourage businesses to use reorganization or restructuring proceedings to restore solvency, maximize the value of recovered assets from insolvency proceedings, ensure that insolvency administrators are well-qualified, and improve the supervision and regulation of insolvency administration.

Progress has been made in enacting regulations and legislative amendments to strengthen insolvency administration. Abuses by insolvency administrators have been a matter of serious concern to the Latvian authorities for several years. In 2017, the Cabinet of Ministers enacted several regulations on training and examination of insolvency administrators, tightening the disciplinary process for insolvency administrators, and improving the record-keeping by insolvency administrators. Parliament also amended the Civil Procedure Law and the Insolvency Law to provide for an electronic insolvency monitoring system that will disseminate public information about insolvency proceedings.

A newly-empowered Insolvency Administration oversees the professionalism of insolvency administrators. In 2017, the Insolvency Administration took over the authority of certifying and terminating insolvency administrators. Nearly 900 cases were filed in court last year to remove insolvency administrators. The Administration terminated 51 administrators' certificates for reasons including failing to take the professional examination, acting in bad faith, or repeatedly violating regulations.

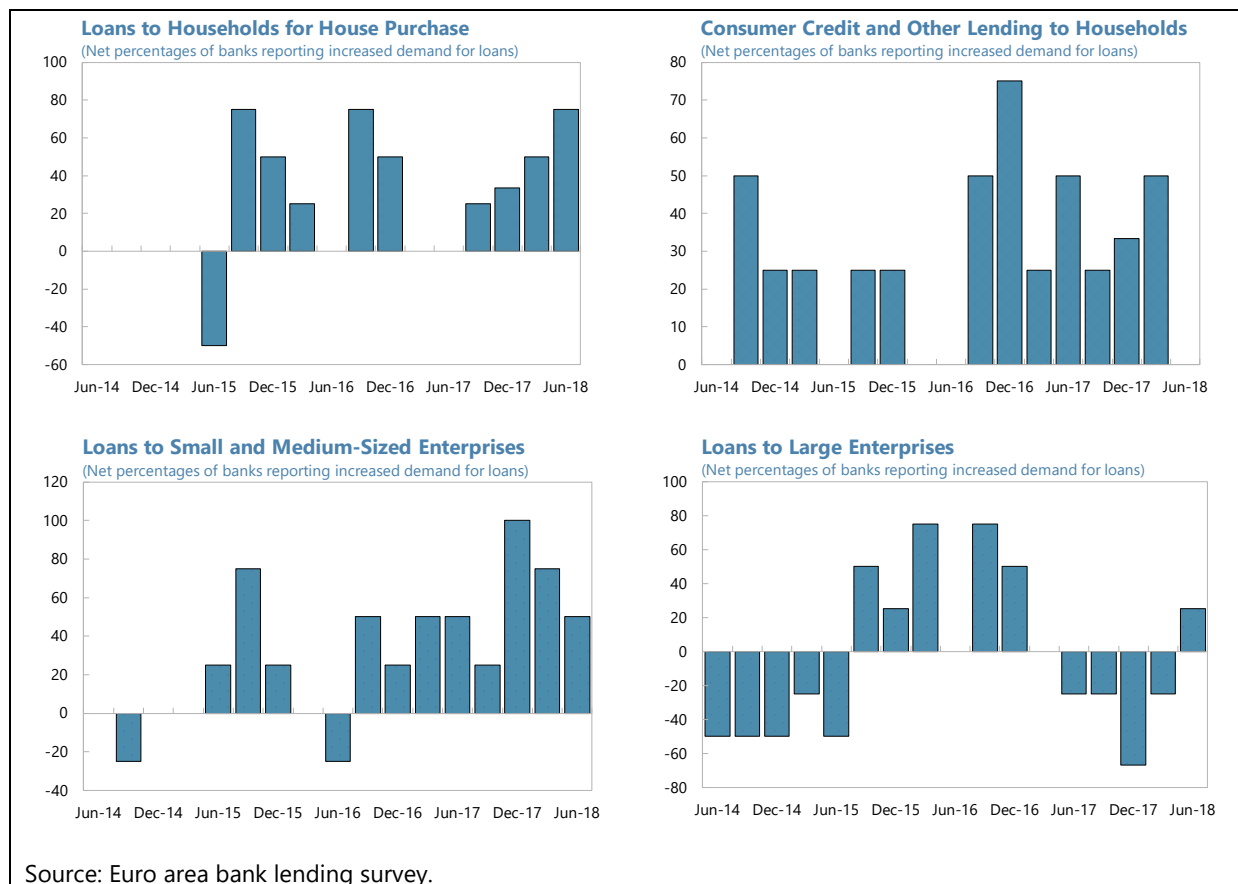
Ongoing IMF technical assistance is helping to complete a mid-term evaluation of the implementation of the Insolvency Policy Development Guidelines, including the status of the insolvency administration reforms, a review of insolvency administration, and an assessment of the performance monitoring system for measuring the effectiveness of insolvency proceedings.

8. Many would-be borrowers cannot get credit because their official income is inadequate. The size of Latvia's shadow economy is estimated at more than 20 percent of GDP, which is large compared to other advanced economies and larger than in Estonia and Lithuania. The phenomenon of underreported or "envelope" wages—i.e., formally registered workers receiving part of their income informally—is widespread. Similarly, underreported corporate profits represent a sizeable share of actual corporate profits. Boosting credit growth will therefore require reforms to encourage workers and firms to move from the shadow economy into the formal sector. Informal activity is strongly related to low trust in government and flourishes despite a relatively favorable business environment.

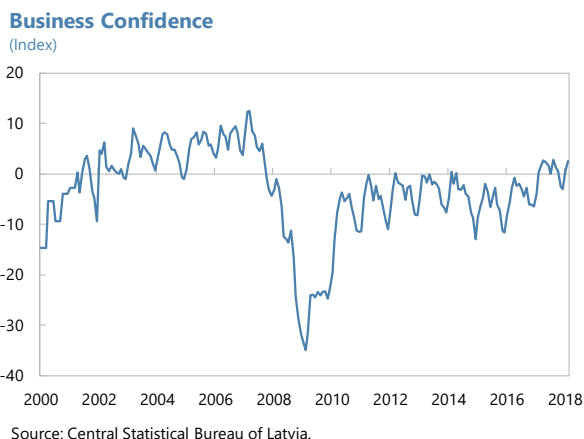


Demand-side Factors

9. Surveys paint a mixed picture of loan demand. The euro area bank lending survey, conducted by Bank of Latvia in cooperation with the ECB, shows that demand for bank credit has increased since 2015. This has been the case for households, SMEs, and large enterprises, although some decrease in demand from large enterprises was observed in 2017 owing to the use of internal financing.



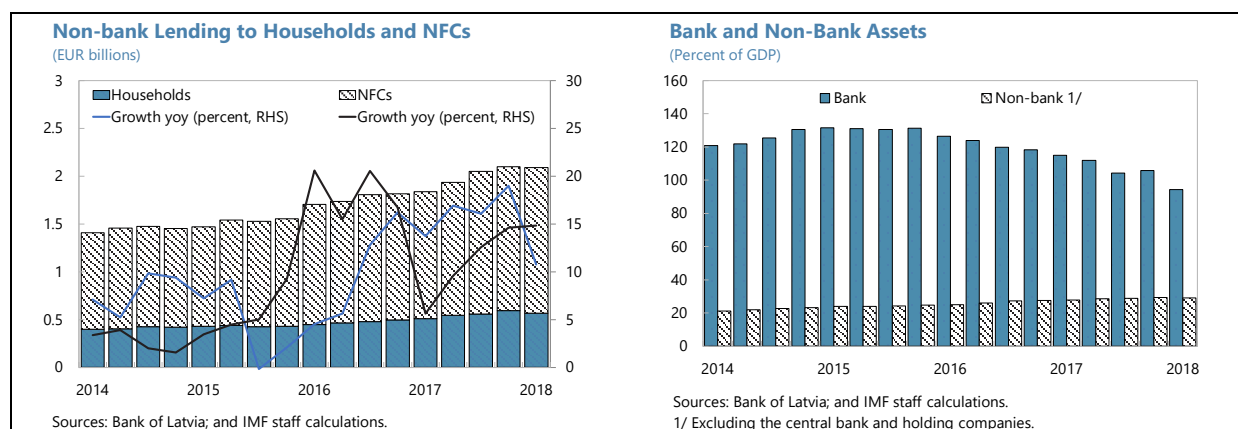
10. Other surveys, however, indicate that demand for credit has been weak. Nearly three-quarters of SMEs surveyed by the Bank of Latvia in 2016 responded that they had no need for credit, either because they did not have any immediate investment plans or because they had the resources to finance their own investments.³ Over a third said risk aversion explained their reluctance to borrow from banks in the future. Business confidence has remained subdued



³ SMEs represent more than 99 percent of all enterprises in Latvia, and their turnover accounts for more than three-quarters of total NFC turnover.

throughout the economic recovery, which could help explain why many firms do not have plans to expand.

11. Another demand-side factor behind the lack of bank credit growth is the growing tendency of borrowers to turn to non-bank financing. The non-bank financial sector (NBFS) in Latvia is small by European standards: in 2016, the assets of the NBFS and other financial intermediaries represented 42 percent of GDP compared to a euro area average of 367 percent.⁴ But the sector is growing, with non-bank lending to both households and NFCs largely outpacing bank lending in recent years. Consequently, the ratio of non-bank loans to bank loans has risen to 20 percent compared to 10 percent in 2013. The bulk of non-bank lending consists of financial leasing loans to NFCs. Non-bank lending to households is smaller, but growing rapidly. In 2017, only a quarter of new house purchases were financed by banks; the rest were financed by non-bank lenders or by the buyers' own means.⁵



⁴ Bank of Latvia, Financial Stability Report 2017.

⁵ European Commission, Country Report Latvia 2018.

Annex IV. Public Debt Sustainability Analysis

Public Sector Debt Sustainability Analysis(DSA)—Baseline Scenario

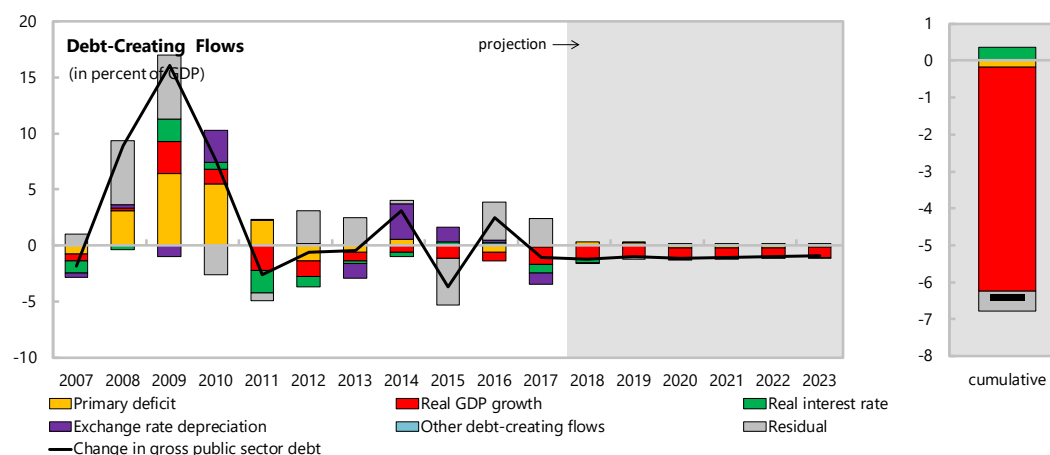
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of April 07, 2017			
	2007-2015 ^{2/}	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads			
Nominal gross public debt	30.5	37.4	36.3	35.1	34.1	32.9	31.9	30.9	29.9	EMBIG (bp) 3/			67
Public gross financing needs	3.1	0.5	5.7	5.6	5.4	3.8	2.8	1.6	1.4	5Y CDS (bp)			58
Real GDP growth (in percent)	0.6	2.2	4.5	3.7	3.3	3.1	3.0	3.0	3.0	Ratings	Foreign	Local	
Inflation (GDP deflator, in percent)	3.9	0.3	3.0	3.5	2.7	2.5	2.4	2.2	2.2	Moody's	A3	A3	
Nominal GDP growth (in percent)	4.9	2.5	7.7	7.3	6.1	5.6	5.5	5.3	5.3	S&P's	A-	A-	
Effective interest rate (in percent) ^{4/}	4.8	3.6	3.2	2.8	2.8	3.0	2.9	2.8	2.8	Fitch	A-	A-	

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023		
Change in gross public sector debt	3.0	2.5	-1.1	-1.2	-1.0	-1.2	-1.1	-1.0	-0.9	-6.4	
Identified debt-creating flows	1.8	-0.9	-3.5	-1.2	-0.8	-1.1	-1.0	-0.9	-0.9	-5.9	
Primary deficit	1.7	-0.6	-0.1	0.3	0.3	-0.2	-0.2	-0.2	-0.2	-0.2	
Primary (noninterest) revenue and grants	35.4	36.2	35.7	36.5	35.9	36.2	35.6	35.5	35.1	214.9	
Primary (noninterest) expenditure	37.1	35.5	35.6	36.9	36.2	36.0	35.4	35.3	34.9	214.7	
Automatic debt dynamics ^{5/}	0.1	-0.3	-3.3	-1.5	-1.1	-0.8	-0.8	-0.8	-0.7	-5.7	
Interest rate/growth differential ^{6/}	-0.5	-0.5	-2.4	-1.5	-1.1	-0.8	-0.8	-0.8	-0.7	-5.7	
Of which: real interest rate	-0.2	0.2	-0.8	-0.3	0.0	0.2	0.1	0.2	0.2	0.4	
Of which: real GDP growth	-0.3	-0.8	-1.6	-1.2	-1.1	-1.0	-0.9	-0.9	-0.9	-6.1	
Exchange rate depreciation ^{7/}	0.6	0.3	-1.0	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	1.2	3.4	2.4	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5	



Sources: Bloomberg Finance L.P. and IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate;

a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

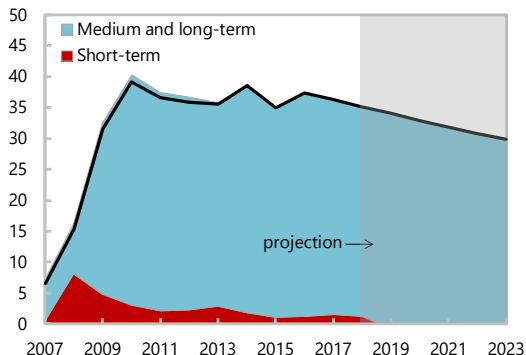
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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

Composition of Public Debt

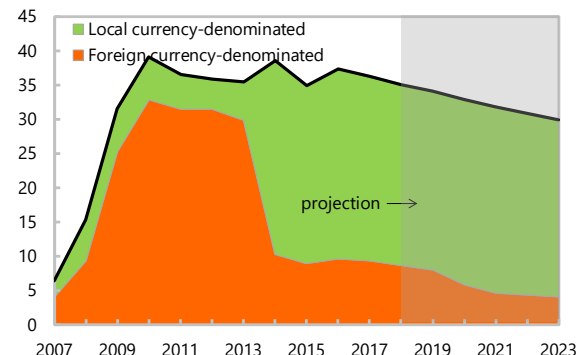
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios

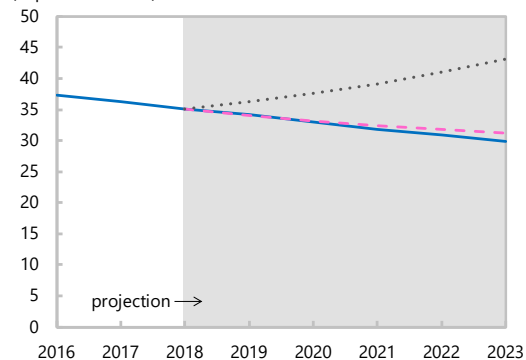
— Baseline

..... Historical

- - - Constant Primary Balance

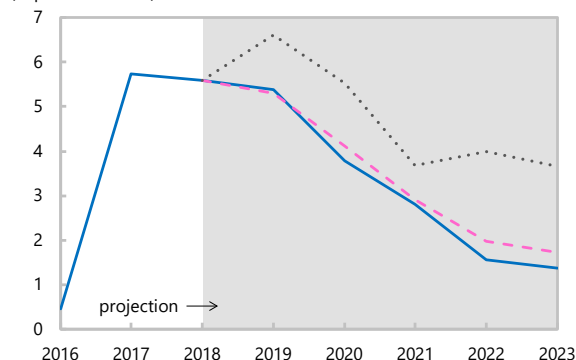
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.7	3.3	3.1	3.0	3.0	3.0
Inflation	3.5	2.7	2.5	2.4	2.2	2.2
Primary Balance	-0.3	-0.3	0.2	0.2	0.2	0.2
Effective interest rate	2.8	2.8	3.0	2.9	2.8	2.8
Constant Primary Balance Scenario						
Real GDP growth	3.7	3.3	3.1	3.0	3.0	3.0
Inflation	3.5	2.7	2.5	2.4	2.2	2.2
Primary Balance	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	2.8	2.3	2.2	2.3	2.4	2.4

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.7	0.3	0.3	0.3	0.3	0.3
Inflation	3.5	2.7	2.5	2.4	2.2	2.2
Primary Balance	-0.3	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	2.8	2.3	2.6	3.2	3.8	3.9

Source: IMF staff.

Annex V. External Debt Sustainability

Latvia: External Debt Sustainability Framework, 2013–23
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					Debt-stabilizing non-interest current account 6/ -6.1	
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022		2023
Baseline: External debt	133.9	144.1	143.6	148.8	140.9	137.0	135.2	132.2	126.3	126.9	126.9	126.9
Change in external debt	-4.3	10.2	-0.5	5.2	-7.9	-3.9	-1.7	-3.1	-5.9	0.6	0.0	0.0
Identified external debt-creating flows (4+8+9)	-5.8	-4.4	1.7	-4.7	-12.8	-2.5	-2.0	-2.2	-1.3	-1.1	-1.3	-1.3
Current account deficit, excluding interest payments	-0.6	-1.5	-2.2	-3.7	-1.3	0.8	1.1	0.9	1.3	1.8	1.9	1.9
Deficit in balance of goods and services	3.7	1.4	0.5	-0.9	1.3	3.1	3.5	3.8	4.2	4.4	4.7	4.7
Exports	60.2	60.7	60.4	60.0	60.5	61.6	60.8	60.0	59.5	58.6	57.7	57.7
Imports	63.9	62.2	60.9	59.1	61.8	64.7	64.3	63.8	63.6	63.1	62.4	62.4
Net non-debt creating capital inflows (negative)	-1.8	-1.4	-3.0	0.1	-2.1	-0.8	-0.7	-1.2	-0.8	-0.7	-0.8	-0.8
Automatic debt dynamics 1/	-3.4	-1.5	7.0	-1.0	-9.4	-2.5	-2.4	-1.9	-1.8	-2.2	-2.4	-2.4
Contribution from nominal interest rate	3.3	3.2	2.7	2.4	2.1	1.9	1.9	2.0	1.9	1.4	1.2	1.2
Contribution from real GDP growth	-3.1	-2.4	-5.0	-3.1	-6.2	-4.4	-4.2	-3.9	-3.7	-3.6	-3.6	-3.6
Contribution from price and exchange rate changes 2/	-3.6	-2.3	9.2	-0.3	-5.3	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	1.4	14.7	-2.3	9.8	4.9	-1.4	0.2	-0.8	-4.6	1.8	1.3	1.3
External debt-to-exports ratio (in percent)	222.5	237.2	237.7	247.8	232.9	222.5	222.3	220.2	212.4	216.4	219.8	219.8
Gross external financing need (in billions of US dollars) 4/	22.3	22.3	22.6	20.0	22.3	26.0	29.3	32.2	34.7	35.2	37.3	37.3
in percent of GDP	73.6	71.1	83.7	72.5	73.5	72.7	76.6	78.6	79.8	76.3	76.5	76.5
Scenario with key variables at their historical averages 5/						137.0	141.1	144.1	142.1	147.4	152.2	152.2
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.4	1.9	3.0	2.2	4.5	3.7	3.3	3.1	3.0	3.0	3.0	3.0
GDP deflator in US dollars (change in percent)	5.0	1.8	-16.5	0.0	5.1	13.6	3.8	3.6	3.1	2.9	2.6	2.6
Nominal external interest rate (in percent)	2.6	2.5	1.6	1.7	1.5	1.6	1.5	1.5	1.5	1.1	1.0	1.0
Growth of exports (US dollar terms, in percent)	5.6	4.7	-14.5	1.6	10.7	5.2	20.0	6.0	5.4	5.2	4.6	4.1
Growth of imports (US dollar terms, in percent)	4.2	1.0	-15.8	-0.7	14.9	2.5	23.3	6.7	6.1	5.8	5.1	4.6
Current account balance, excluding interest payments	0.6	1.5	2.2	3.7	1.3	3.5	5.4	-1.1	-0.9	-1.3	-1.9	-1.9
Net non-debt creating capital inflows	1.8	1.4	3.0	-0.1	2.1	1.5	0.8	0.7	1.2	0.8	0.7	0.8

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).

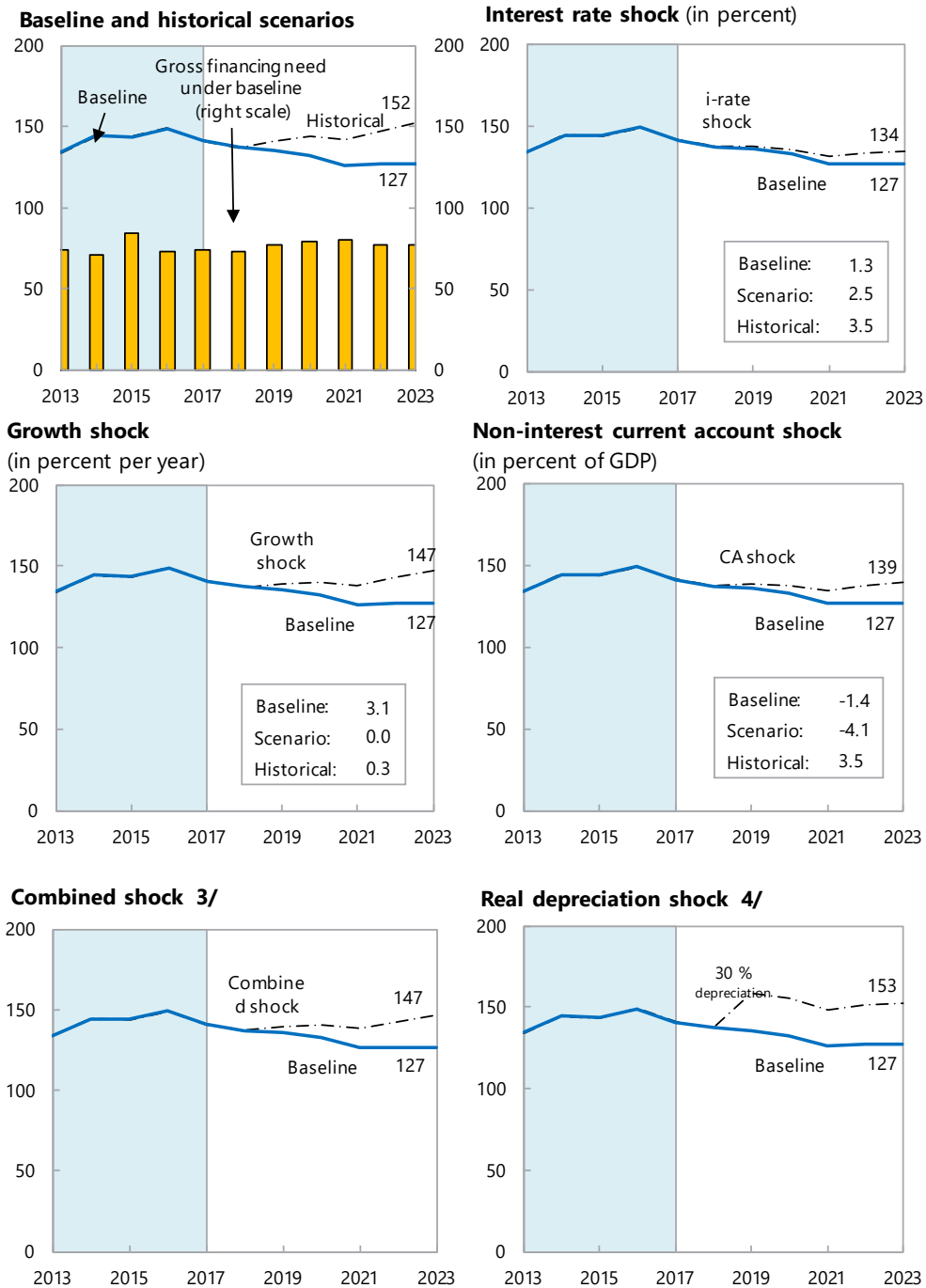
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Latvia: External Debt Sustainability—Bound Test^{1,2} (External debt n percent of GDP)

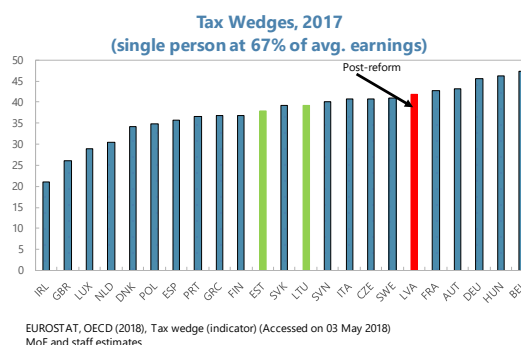


Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being 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 real depreciation of 30 percent occurs in 2017.

Annex VI. Assessing the Impact of the Tax Reform

1. A comprehensive tax reform came into effect in 2018. It encompasses changes to the tax structure and rates, and measures to improve the tax administration, reduce the shadow economy, and address inequality. These changes include: i) moving from a flat to a progressive PIT schedule, gradually increasing—and making more progressive—the non-taxable income threshold, increasing child allowances, and increasing social security contribution (SSC) rates by 1 percent;¹ and ii) changing the CIT system from gross to distributed profit taxation, and increasing the tax rate from 15 to 20 percent. To partially compensate for the revenue loss of the reform, a gradual increase of excise rates will take effect during the next three years, and VAT administrative measures will seek to reduce informality and improve revenue collection. The revenue impact of administrative measures is highly uncertain; therefore, staff's analysis only focuses on the impact of the PIT and CIT reforms.

2. The PIT reform seeks to reduce labor costs and income inequality. The new PIT system reduces the PIT rate for low incomes (up to €20,004 per year) from 23 to 20 percent, taxes middle incomes (up to €55,000 per year) at 23 percent, and higher incomes at 31.5 percent. The estimated post-reform tax wedge declines to below 40 percent—closer to the level in Estonia and Lithuania—which could help improve Latvia's competitiveness in the region. The largest impact is expected for low-wage earners, especially those with families. However, workers who already have very low wages and do not pay income taxes will be worse off due to the SSC rate increase, which undermines the income progressivity objective of the reform.

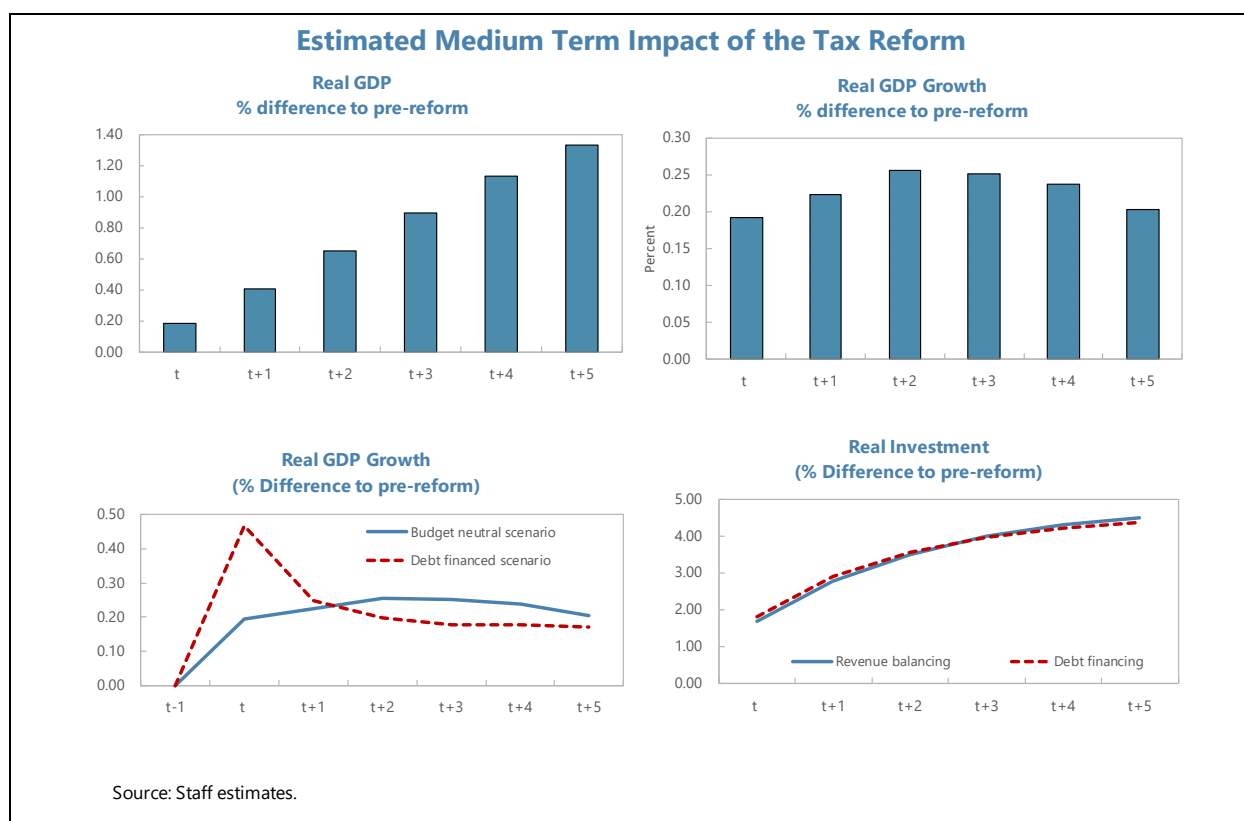


3. The CIT reform aims to stimulate investment growth. Distributed profit taxation could improve companies' balance sheets, particularly of small ones that do not benefit much from tax exemptions, and provide relief of their effective tax burden. However, the extent to which this translates into productive investment depends on businesses' behavior, which is difficult to estimate ex-ante. The reform also aims to improve balance sheet transparency, thereby improving companies' access to bank financing. Experience with this system in Estonia, where it has been in place for over a decade, shows improvement in firms' capital and liquidity. However, its impact on investment and productivity—albeit positive—remains difficult to quantify as many other factors influence firms' behavior, including economic conditions, the business environment, access to finance, the structure of the corporate sector, and the strength of corporate management.²

¹ To be used to increase financing for the healthcare reform.

² See "[Gross profit taxation versus distributed profit taxation and firm performance: effects of Estonia's corporate income tax reform.](#)" Eesti Pank Working Paper No 2/2011.

4. The reform is likely to have a positive impact on growth. As standard multipliers suggest only a minor direct impact, we simulate the dynamics of the PIT and CIT reforms using the IMF's Globally Integrated Monetary and Fiscal Model (GIMF).³ This allows a more comprehensive estimate of their medium and long-term growth impact. A Latvia-specific reform scenario is calibrated using the authorities' estimates of the improvement in the effective tax rates post reform, while the CIT reform is calibrated to simulate similar behavioral dynamics as observed in Estonia. Under a scenario, where corporates' tax relief gradually translates into productive investment, the combined PIT and CIT reforms could result in higher real GDP over the medium term by almost 1.5 percent. Financing of the reform is also a key factor in estimating its impact. Deficit financing of the reform, will have a large positive upfront impact on growth, which will dissipate quickly. Over the long term, a budget-neutral option delivers the largest benefits, especially one that focuses on revenue rebalancing.



5. The tax reform will be costly. With the new introduction of a progressive system, PIT could be permanently lower by up to 1 percent of GDP on average.⁴ CIT revenues will have an even larger impact—by about half for the first two years of implementation (similar to the pattern observed in Estonia) and gradually converge to below pre-reform levels. While the positive effect on net income of individuals and corporates will likely support consumption and investment, absent any further reforms to find stable revenue sources, the government tax revenue ratio will be permanently lower.

³ Multipliers range between 0.4–0.6, based on multipliers found in the literature for advanced economies, using the methodology explained in "[Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections](#)," IMF, 2014.

⁴ The shortfall compares staff's current baseline assumptions against PIT revenues pre-reform taking the most recent observable year as a reference point, adjusted for macroeconomic and wage dynamics.



REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION— INFORMATIONAL ANNEX

July 20, 2018

Prepared By

European Department

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STATISTICAL ISSUES	6

FUND RELATIONS

(As of June 30, 2018)

Membership Status: Joined May 19, 1992; Article VIII

General Resources Account:

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

SDR Department:

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

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

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

Projected Payments to Fund:

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

	Forthcoming		
	2018	2019	2020
Principal	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00
Total	0.00	0.00	0.00

Exchange Rate Arrangement:

As of January 1, 2014, the currency of Latvia is the euro, which floats freely and independently against other currencies. Prior to 2014, the currency of Latvia was the lat, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ± 1 percent band. On January 1, 2005, the lat was re-pegged to the euro at the rate 1 euro = 0.702804 lats, and on April 29, 2005, Latvia entered ERM II, maintaining the previous band width. Latvia maintains an exchange system free of restrictions on the payments or transfers for current international transactions. Exchange restrictions maintained for security reasons have been notified to the Fund for approval most recently in January 2018 (see EBD/18/5, January 25, 2018).

Previous Article IV Consultation:

Latvia is on the 12-month consultation cycle. The last Article IV consultation was concluded on July 7 2017 (IMF Country Report No. 17/194). The Executive Board assessment is available <http://www.imf.org/en/News/Articles/2017/07/07/pr17266-imf-executive-board-concludes-2017-article-iv-consultation-with-the-republic-of-latvia>

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.

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 (2007–17)				
Dept.	Project	Action	Timing	Counterpart
FAD	Expenditure Policy	Mission	June 2007	Ministry of Finance
FAD	Tax Policy	Mission	March 2008	Ministry of Finance
FAD	Revenue Administration	Mission	January 2009	Ministry of Finance
MCM	Bank Resolution	Mission	January 2009	FCMC, Bank of Latvia
FAD	Public Financial Management	Mission	March 2009	Ministry of Finance
MCM/ LEG	Debt Restructuring	Mission	March 2009	Ministry of Finance, FCMC
LEG	Legal Aspects of P&A Transactions	Mission	Feb–March 2009	FCMC
MCM	Bank Intervention Procedures and P&A	Mission	March 2009	FCMC
FAD	Public Financial Management	Mission	April–May 2009	Ministry of Finance
FAD	Revenue Administration	Mission	July 2009	Ministry of Finance
FAD	Public Financial Management	Resident Advisor	July 2009– June 2010	Ministry of Finance
FAD	Cash Management	Mission	July–August 2009	Ministry of Finance
MCM	Mortgage and Land Bank	Mission	Sept. 2009	Ministry of Finance
MCM	Deposit Insurance	Mission	Sept. 2009	FCMC
MCM	Liquidity Management	Mission	November 2009	Bank of Latvia
LEG	Bank Resolution Legal Framework	Mission	January 2010	FCMC
FAD	Tax Policy	Mission	February 2010	Ministry of Finance
LEG	Bank Resolution Legal Framework	Mission	February 2010	FCMC
LEG	Corporate and Personal Insolvency Law	Mission	March 2010	Ministry of Justice
FAD	Public Financial Management	Mission	April 2010	Ministry of Finance
LEG	Corporate and Personal Insolvency Law	Mission	April 2010	Ministry of Justice
MCM	Stress Testing	Mission	June 2010	Bank of Latvia
FAD	Expenditure Policy	Mission	August 2010	Ministry of Finance
FAD	Revenue Administration	Mission	Sept. 2010	Ministry of Finance
LEG	Legal Framework for Foreclosure Procedures	Missions	November 2010	Ministry of Justice
FAD	Public Financial Management	Mission	Feb–March 2011	Ministry of Finance
FAD	Tax Administration	Mission	June 2011	Ministry of Finance
MCM	Bank Resolution	Mission	July 2012	FCMC
FAD	Expenditure Rationalization	Mission	October 2012	Ministry of Finance
LEG	Insolvency Reform	Mission	May 2018	Ministry of Justice

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 adequate (A). Latvia is a subscriber of the Special Data Dissemination Standard (SDDS) and a link to Latvia's metadata is available at the IMF's website for the Dissemination Standards Bulletin Board (DSBB) ([link](#)).

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: The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB. The arrangement provides an efficient transmission of monetary statistics to the IMF and for publication in the IFS. Monetary statistics for Latvia published in the IFS cover data on central bank and other depository corporations (ODCs) using Euro Area wide and national residency criteria.

Financial sector surveillance: Latvia reports all 12 core and 13 encouraged financial soundness indicators (FSIs) for deposit takers on a quarterly basis. Also, 1 FSIs for non-financial corporations and 2 FSIs for real estate markets are reported on a quarterly basis.

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 SDDS 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 July 10, 2018

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Memo Items:	
						Data Quality—Methodological Soundness ⁸	Data Quality—Accuracy and Reliability ⁹
Exchange Rates	April 2018	May 2018	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	May 2018	06/21/2018	M	M	M		
Reserve/Base Money	Feb 2018	March 2018	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	Feb 2018	March 2018	M	M	M		
Central Bank Balance Sheet	May 2018	6/14/2018	M	M	M		
Consolidated Balance Sheet of the Banking System	May 2018	6/28/2018	M	M	M		
Interest Rates ²	Feb 2018	March 2018	M	M	M		
Consumer Price Index	Jun 2018	07/10/2018	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ —General Government ⁴	May 2018	6/18/2018	M	Q	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ —Central Government	May 2018	6/18/2018	M	Q	M		

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

As of June 1, 2017

Stocks of Central Government and Central Government-Guaranteed Debt ⁵	May 2018	6/18/2018	M	Q	M		
External Current Account Balance	Q1 2018	6/10/2018	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	April 2018	6/15/2018	M	M	M		
GDP/GNP	Q1/2018	05/31/2018	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q1 2018	6/4/2018	Q	Q	Q		
International Investment Position ⁶	Q1 2018	6/10/2018	Q	Q	Q		

¹ 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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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

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

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

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

**Statement by Thomas Ostros, Executive Director for the Republic of Latvia
and Ieva Skrivere, Advisor
August 31, 2018**

On behalf of the Latvian authorities, I would like to thank staff for fruitful and productive discussions during the Article IV mission in Riga. The authorities, overall, share staff's views regarding economic developments and outlook, including the assessment of ageing related headwinds to long-term growth. The authorities also highly appreciate the analysis provided in the selected issues papers and thank staff for timely and valuable inputs.

An expansion of domestic demand, a recovery in investment, and a very favorable external environment have contributed to a strong and broad-based growth.

The recent labor market tightening is a sign of maturing economic cycle and represents a regular economic expansion (with economic growth rates slightly above potential). An absence of a positive financial accelerator effect pushing economy towards an unsustainable growth trajectory is an important difference with the past boom when the Latvian economy experienced severe overheating pressures. Within the current creditless growth cycle the odds are against a sustained build-up of overheating and inflation pressures eventually leading to a progressive loss of cost competitiveness and sharp adjustment of economic activity.

While the inflation rate in Latvia (2.6 percent in July 2018) is slightly above the one observed in the Euro Area, it largely reflects an income convergence process with unit labor cost developments in the tradable and non-tradable sector following a path suggested by the Balassa-Samuelson effect. Moreover, a relatively larger share of food and energy in the consumer basket and the economy's high openness to trade make domestic prices more susceptible to global commodity price pressures, including relatively stronger direct cost push pressures on core inflation.

The authorities share staff's view that Latvia's cost competitiveness has held up relatively well. While there are some signs of weakening export market shares in selected neighboring countries, this largely reflects a changing pattern of re-export flows in the region, and market shares of domestically produced exports are less volatile. A positive development of profitability in the manufacturing sector is another sign pointing to a strong competitive position of Latvia's tradable sector.

The current economic expansion is an opportune moment to strengthen reform efforts, which could mitigate downside risks and raise medium-term growth potential.

The quality of the labor force has room for improvement, and skill-mismatches must be addressed to reduce persistently high structural unemployment. A focused immigration policy could be a part of the solution, and the authorities would appreciate a more granular view on further policy options to complement the measures already taken in 2017 to soften the rules that employers have to follow in attracting high-skilled workers from outside the EU. However, with broad measure of unemployment pointing at well above 10 percent, the authorities attach higher priority to policies aimed at better utilizing Latvia's existing labor pool. From a longer-term perspective it is also crucial to improve the outcomes of the healthcare sector, as Latvia's relatively low healthy life

expectancy reduces the scope to stemming ageing pressures by increasing the statutory retirement age.

In the medium term, reaching a higher investment to GDP ratio is crucial to raise potential growth and foster productivity. A number of policy areas to address business environment bottlenecks that hinder lending and investment growth (including efficiency of the insolvency regime and judiciary) are already well identified in the authorities' agenda. The authorities also agree that the availability of the EU funds supports investment and facilitates economic convergence, and the eventual slowdown of these inflows within the next planning period is a source of concern. However, having hovered around 11 percent of gross fixed capital formation since 2010 on average, the EU funds inflows constitute a small part of investment funding. The authorities would appreciate continued work on the drivers of the post-recession investment slowdown in future Article IV consultations as it is likely that there are additional layers of the problem that need to be identified and addressed.

Latvia's fiscal position remains sustainable.

The general government deficit was 0.5 percent of GDP in 2017, and it is forecasted to be 0.9 percent of GDP this year. Meanwhile, the general government gross debt is expected to gradually decline to around 35 percent of GDP in 2018. Latvia has introduced an ambitious tax reform in 2018. It aims to provide a stable and predictable tax policy, support economic growth, improve the welfare of the population, reduce the tax wedge (especially for low-wage earners), while providing sufficient and predictable tax revenues for the state and local government budget. A progressive income tax system has been introduced for the first time, the differential non-taxable minimum, the allowance for dependents, and the non-taxable minimum for pensioners has been increased, and the minimum monthly wage has been raised. Changes to the corporate income tax system will allow companies to improve their capitalization, which will facilitate lending and investment, as well as promote better acquisition of EU funds. Additionally, the Latvian authorities remain committed to further improve tax administration and reduce shadow economy.

Crisis legacies in the banking sector have been resolved, and the focus remains on removing impediments to credit growth.

The cleanup process of bank balance sheets has been finalized, and the sector has worked-out a significant stock of bad assets from the previous crisis. The special vehicles are being liquidated, loan loss provisions almost fully cover the NPL amount, and the stock of NPLs and write-offs have decreased significantly.

The authorities broadly share staff's views on the impediments to credit growth, and the comprehensive analysis of supply and demand factors provided in Annex III is appreciated. The authorities recognize the importance of a sound and operational insolvency regime for both investment climate and credit recovery. The legal framework of insolvency procedures seems to be adequate, modern and comprehensive, while its practical application could be further improved.

The authorities note that the importance of the non-bank sector in lending activities is slightly overstated in the report. A large part of the sector is not involved in lending,

while leasing operations are mostly run by companies owned by banking groups. Nevertheless, the authorities recognize the importance of continued monitoring of non-bank credit developments and provide for adequate and modern regulation to facilitate socially and economically responsible lending practices and tackle potential externalities.

The authorities emphasize their commitment to continue efforts to restore the reputation of the banking sector and to proceed with de-risking and overall change in risk tolerance.

The authorities acknowledge the importance of vigilant supervision and the need to mitigate risks in the banks servicing foreign clients (BSFC) sector. Important steps have been taken in this regard, including higher prudential requirements to financial institutions with significant share of foreign deposits. These additional capital and liquidity buffers currently allow banks to fulfil their obligations to customers and meet regulatory requirements while executing changes to their business models – by scaling down, merging, changing the type of business license or choosing to end the provision of this type of business in the Latvian financial sector. The FCMC carefully analyzes the new business strategies submitted by the BSFC banks, to ensure that the amended business models are viable and sustainable, and the new risk profiles are manageable.

During the last months, especially along with the new AML/CFT requirements regarding the riskiest opaque entities, the banking sector has been actively cleaning the customer base. The risky part of the banks' customers has decreased notably, as banks go beyond the requirements set by the Law and refuse to work with shell entities that are not prohibited but may involve high-risk activities. In July 2018 deposits of the banned type of shell companies constituted 0.03 percent of total deposits.

The authorities note that the legal framework on AML/CFT as well as supervisory capacity of the FCMC has been considerably strengthened over the recent years. The authorities are committed to further enhance information sharing among relevant institutions and increase the effectiveness of the ML/FT prevention activities. The FCMC will continue to strengthen data analytical tools to increase supervision effectiveness as well as focus on preventive measures.

The authorities are closely monitoring and supervising the liquidation process of ABLV bank.

The authorities are ensuring the lawful process and protection of creditors interests in line with additional rigorous control mechanisms for the prevention of money laundering, which are set up for this particular case, including assessing regular performance reports by liquidators, and closely monitoring the fulfillment of the approved liquidation plan. The authorities believe that in the specific case of ABLV, self-liquidation serves purposes of public interest (i.e. no taxpayers money is used) and prudential regulation (i.e. protect interests of creditors) better than compulsory liquidation under the current liquidation regime for credit institutions. The case of ABLV has highlighted the need to update existing national, as well as EU, legislation on bank liquidation to increase legal certainty when a bank is determined as "failing or likely to fail" and is liquidated under national insolvency proceedings.