INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/264

REPUBLIC OF LATVIA

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

August 2019

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 2019 Article IV consultation with Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on lapse-of-time basis following discussions that ended on June 28, 2019, 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 22, 2019.
- An **Informational Annex** prepared by the IMF staff.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 19/312
FOR IMMEDIATE RELEASE
August 7, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with the Republic of Latvia

On August 6, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia and considered and endorsed the staff appraisal without a meeting.

Real GDP growth reached 4.8 percent in 2018, led by a pick-up of private investment along with a boom in EU-funded construction and strong growth in IT and communications. Wage growth accelerated to 5.7 percent as the labor market continued to tighten. Unemployment declined to an all-time low rate of 7.4 percent, while core inflation slowed to 2 percent in 2018. The current account swung into a deficit of 1 percent of GDP as export volumes decelerated, while total external debt declined significantly by 20 percentage points due to a sharp decline in non-resident deposits. Growth is expected to decelerate in 2019 to just above 3 percent, as a slower pace of EU funds absorption and wage growth moderates domestic demand.

Despite revenue overperformance, fiscal policy was expansionary in 2018, driven by fast absorption of EU investment funds and a substantial increase in public sector wages. The 2018 general government deficit reached 1 percent of GDP, implying a fiscal stimulus of about 0.4 percent of GDP. Still, public debt remains firmly on a downward path amid favorable financing conditions.

The financial system remains stable despite a significant balance sheet restructuring of banks servicing foreign clients. Banks remains well capitalized and liquid, with capital levels about 40 percent higher than the euro area average and average liquidity coverage four times the regulatory minimum. Still, credit growth remains elusive; while the government-sponsored mortgage program contributed to a slight recovery of household credit by end-2018, total household credit declined by 5.4 percent and credit to non-financial corporations declined by 5.8 percent.

[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 Assessment[2]

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

The Latvian economy has become considerably more resilient since the global financial crisis, and economic prospects remain favorable. There are no significant economic imbalances; external and government debt are on declining paths; and private sector balance sheets continue to improve. Inflation has been moderate, and competitiveness has held up. The external position is assessed to be moderately stronger than implied by medium-term fundamentals and desirable policies. Growth has been strong, and while it is projected to decelerate in the medium term, it is expected to converge to a still robust rate of 3 percent.

However, important challenges and risks may test the economy's resilience. First, Latvia's population continues to decline, which strains the labor market and poses a long-term growth challenge. Second, weaker than expected external growth, especially in the euro area, and rising protectionism could significantly weigh on exports. Third, the financial system still confronts financial integrity risks. Failure to strengthen the effectiveness of the AML/CFT regime and refocus BSFCs could undermine the stability of the financial system and its ability to support the economy.

Growth-enhancing reforms are aptly considered a priority by the government. Ongoing efforts to ease labor market constraints should be redoubled, including by promoting better skill matching and reducing long-term unemployment, increasing labor participation of targeted groups, encouraging the return of Latvian emigrants and allowing entry of skilled immigrants. Raising productivity growth will allow more rapid wage growth to take place sustainably and help slow emigration. Reforms that improve firms' access to finance, encourage investment in research and development, and attract foreign direct investment could yield important productivity gains.

The authorities' planned fiscal stance reverses past procyclicality and is appropriate given the expected deceleration of the economy. Given Latvia's relatively low and declining government debt and favorable financing terms, some fiscal space is available to react to shocks. Nonetheless, in the short run, the authorities should avoid public sector wage increases that are not aligned with productivity and should carefully assess the potential fiscal costs of new spending initiatives, in order to preserve fiscal space. If negative shocks affect the economy, the authorities should allow automatic stabilizers to operate fully and could consider temporary high-quality measures to support the economy in the event of a severe downturn.

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

Long-term fiscal policies should aim to accommodate the impact of demographic and social spending costs and support productivity-boosting reforms. New stable revenue sources would be needed to adequately cover growing age-related demands on the budget. Given Latvia's vast investment needs, the authorities should focus capital spending on projects that have the potential to catalyze private investment and have high social impact. Poverty and inequality concerns could be addressed by improving the adequacy and targeting of existing social programs. Reforms to strengthen the transparency and governance of local authorities and state-owned enterprises can help improve the use of public resources and prevent misuse.

The authorities have signaled strong political commitment at the highest level to restore the reputation of the financial system. Efforts to reduce exposure to risky banking operations, address MONEYVAL's recommendations, and oversee BSFCs' new business plans are welcome. Long-term reforms need to focus on the effectiveness of the AML/CFT regime by enhancing risk-based supervision, the quality and use of financial intelligence, the application of preventive measures, investigation and prosecution, and coordination among relevant national and regional authorities. Upgrading the supervisory powers for bank liquidation to include mandatory out-of-court administrative liquidation would reduce legal uncertainty and limit potential contingent liabilities, consistent with EU harmonization efforts.

The financial system needs to become more supportive of the domestic economy. Efforts to revive credit growth should focus on completing the ongoing insolvency reforms to lower lending costs. Steps are also needed to strengthen the revenue administration to more effectively combat the shadow economy. Careful oversight of banks' de-risking and business model re-orientation towards the real economy should encourage consolidation and ease lending constraints. Improving access to the system of state loan guarantee programs could spur SME lending. New preemptive macroprudential measures should support sound lending standards and mitigate medium-term financial sector vulnerabilities amid persistently rising property prices.

Republic of Latvia: Selected Economic Indicators, 2015–20

	2015	2016	2017	2018	2019	2020
					Projections	
National accounts	(Percentage change, unless otherwise indicated)					
Real GDP	3.0	2.1	4.6	4.8	3.2	3.1
Private consumption	2.5	1.4	4.1	4.5	3.5	3.2
Public consumption	1.9	3.9	4.1	4.0	3.0	3.0
Gross capital formation	2.4	2.5	14.0	15.1	6.0	5.0
Gross fixed capital formation	-0.5	-8.4	13.1	16.4	6.0	5.0
Exports of goods and services	3.1	4.4	6.2	1.8	2.2	2.3
Imports of goods and services	2.1	4.4	8.9	5.1	3.2	3.2
Nominal GDP (billions of euros)	24.3	25.0	27.0	29.5	31.4	33.1
GDP per capita (thousands of euros)	12.2	12.7	13.9	15.3	16.3	17.2
Savings and Investment						
Gross national saving (percent of GDP)	21.8	22.3	22.9	23.2	23.0	23.0
Gross capital formation (percent of GDP)	22.2	20.7	22.2	24.2	24.4	24.7
Private (percent of GDP)	18.4	18.1	18.7	20.1	20.6	21.4
HICP Inflation						
Period average	0.2	0.1	2.9	2.6	2.7	2.4
End-period	0.4	2.1	2.2	2.5	2.6	2.4
Labor market						
Unemployment rate (LFS; period average, percent) 1/	9.9	9.6	8.7	7.4	6.7	6.9
Real gross wages	6.6	4.9	4.8	5.7	4.5	4.5
	(Percent of GDP, unless otherwise indicated)					
Consolidated general government 1/						
Total revenue	36.2	36.2	35.6	36.9	35.7	35.7
Total expenditure	37.8	36.6	36.4	37.6	36.4	36.1
Basic fiscal balance	-1.5	-0.4	-0.8	-0.7	-0.7	-0.4
ESA balance	-1.4	0.1	-0.6	-1.0	-0.5	-0.4
General government gross debt	36.8	40.3	40.0	35.9	36.1	34.4
Money and credit						
Credit to private sector (annual percentage change)	-2.3	3.5	-1.0	-5.6	...	...
Broad money (annual percentage change)	7.5	6.6	2.9	5.8	...	...
Balance of payments						
Current account balance	-0.5	1.6	0.7	-1.0	-1.5	-1.6
Trade balance	-9.0	-7.5	-8.5	-8.7	-8.6	-8.7
Gross external debt	143.7	148.9	140.5	121.0	117.4	114.4
Net external debt 2/	30.7	29.2	25.5	21.2	23.7	22.7
Exchange rates						
U.S. dollar per euro (period average)	1.11	1.11	1.13	1.18	...	...
REER (period average; CPI based, 2005=100)	120.8	122.0	123.0	126.5	...	...
Terms of trade (annual percentage change)	0.6	2.8	0.7	2.0	0.4	0.2

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

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.
2/ Gross external debt minus gross external debt assets.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

July 22, 2019

KEY ISSUES

Context. The economy continued to expand rapidly in 2018, as growth surprised with a strong construction-driven upswing. Fiscal and current account deficits are at manageable levels, as is the public debt. The financial system remains stable, despite a significant balance sheet restructuring of banks servicing foreign clients. The growth outlook is favorable, but risks weigh on the downside due to a less supportive external environment.

Challenges. In the short term, the authorities need to address challenges posed by labor market tightness, the expected deceleration of EU investment funds, anemic credit growth, and lingering integrity and reputational risks in the financial sector. Higher productivity and investment growth are needed to offset the impact of Latvia's exceptionally unfavorable demographic trends and achieve robust long-term growth and rapid income convergence.

Staff views.

- Structural reforms should aim to ease labor market constraints through measures reducing structural unemployment, increasing labor force participation, and stemming incentives for emigration. Increasing investment in new technologies, improving access to finance, and increasing FDI inflows could help raise productivity growth.
- The planned fiscal stance is appropriate and provides space to face downside risks in the medium term. If such risks materialize, automatic stabilizers should be allowed to operate fully and fiscal space deployed, if necessary, through high-quality measures. The long-term fiscal policy mix should support productivity improvements and ensure space to accommodate demographic and social spending costs.
- Strengthening the effectiveness of the AML/CFT framework, upgrading supervisory powers for bank resolution, as well as de-risking and consolidating the banking sector will be critical to mitigating reputational risks to the financial system and aligning bank activities with the financing needs of the real economy. Further reforms to the insolvency regime, combating the shadow economy, improving SMEs' access to finance, and preemptively introducing tailored macroprudential measures would help revive credit growth and mitigate medium-term financial sector vulnerabilities.

Approved By
Philip Gerson (EUR) and Zuzana Murgasova (SPR)

Discussions were held in Frankfurt on June 14 and in Riga during June 17–28. The team comprised Iva Petrova (Head), Kodjovi Eklou, Karina Garcia, Andreas Jobst, and Yi Wu (all EUR), and Kathleen Kao (LEG). Ms. Skrivere (OED) also joined the discussions. Nhu Nguyen and Hannah Jung supported the mission from headquarters.

CONTENTS

CONTEXT 4

RECENT ECONOMIC DEVELOPMENTS 5

OUTLOOK AND RISKS 7

POLICY DISCUSSIONS: PREPARING FOR THE SLOWDOWN 9

A. Macro-structural Policies: Raising Productivity 9

B. Fiscal Policy: Supporting Growth 12

C. Macro-Financial Policies: Restoring Confidence in the Financial System and Reviving Credit Growth 17

STAFF APPRAISAL 22

BOX

1. Risk Assessment Matrix 24

FIGURES

1. Real Sector 25
2. Fiscal Developments 26
3. Inflation 27
4. Labor Market 28
5. Balance of Payments 29
6. Inequality and Poverty 30
7. Banking Sector Developments 31
8. Credit Growth Developments 32
9. Macro-Financial Conditions 33

TABLES

1. Selected Economic Indicators, 2015–20 ____ 34
2. Macroeconomic Framework, 2015–24 ____ 35
3. General Government Operations, 2015–24 ____ 36
4. Medium-Term Balance of Payments, 2015–24 ____ 37
5. Financial Soundness Indicators, 2014–18 ____ 38

ANNEXES

I. External Sector Assessment ____ 39
II. External Debt Sustainability Assessment ____ 40
III. Public Sector Debt Sustainability Analysis (DSA) ____ 43
IV. Modeling the Impact of Domestic Risks to the Outlook ____ 45
V. Estimating Potential Growth ____ 51
VI. Further Investigation of Credit Constraints ____ 53

CONTEXT

1. **Ten years after the crisis, the Latvian economy continues to strengthen.** Growth has averaged 3½ percent and accelerated above 4 percent in 2017–18; the current account has been balanced on average, and external debt has declined by more than a quarter since its post-crisis peak. Credit to GDP has almost halved, and balance sheets have improved significantly. Latvia is in a much stronger position to face adverse shocks and weather an economic downturn than it was before 2008.

2. **However, structural constraints create obstacles to a more robust and equitable long-term growth.** A tight labor market and a rapidly declining population create binding capacity constraints and limit potential growth. Investment and capital accumulation—once EU funds taper off—will peter if credit growth remains anemic. Low technological diffusion constrains the acceleration of productivity growth. As poverty and inequality remain high, especially among the elderly, Latvia's aging population is bound to put pressure on fiscal resources and create difficult policy choices about the most efficient use of limited public money.

3. **Reputational risks still mar the financial system.** Latvia's third largest bank, ABLV, is undergoing self-administered liquidation after its closure in 2018 due to alleged money laundering (ML). An assessment by MONEYVAL[1] raised concerns about Latvia's anti-money laundering and combating the financing of terrorism (AML/CFT) regime. The number of low ratings that this entailed put the country at risk of being designated (grey-listed) as a jurisdiction with strategic AML/CFT deficiencies. The business model refocusing of Latvia's banks servicing foreign clients (BSFC) remains untested and could result in greater risk-taking in an over-banked sector.

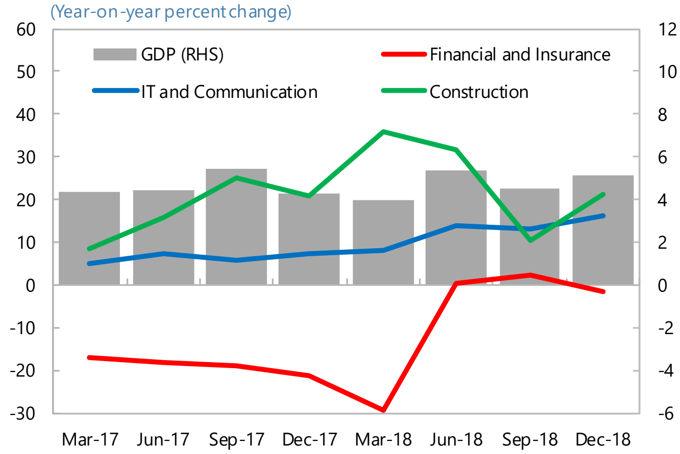
4. **The 2018 Article IV recommendations have been broadly reflected in Latvia's policies.** The new five-party government coalition, which took office in January 2019, has demonstrated strong cohesion and commitment to addressing the challenges the economy faces. The 2019 budget and medium-term stability plan reverse last year's procyclicality and commit to fiscal prudence, in line with staff recommendations. The authorities have taken actions to reduce exposure to risky banking operations, including through efforts to address MONEYVAL's recommendations and by overseeing new business plans of BSFCs. The reforms of the insolvency regime and labor markets—vocational education and training, active labor market policies, and access to housing—have progressed.

[1] Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (the body of the Council of Europe tasked with assessing compliance with the international standard on anti-money laundering and combating the financing of terrorism as promulgated by the Financial Action Task Force).

RECENT ECONOMIC DEVELOPMENTS

5. **Real GDP growth continued to surprise on the upside.** It reached 4.8 percent in 2018, significantly exceeding staff's expectations, with growth in the last quarter generating a strong momentum for 2019. Construction, driven by private investment and rapid utilization of EU structural funds, was the main sector behind this performance. The IT and communication sectors also showed very strong growth, fully offsetting the weak performance of financial services due to the downsizing of BSFCs (Figure 1).

Gross Value Added of Selected Sectors
(Year-on-year percent change)

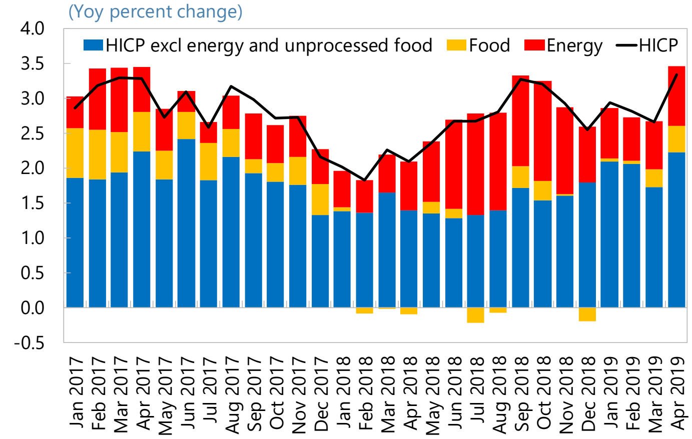


Sources: Central Statistical Bureau of Latvia; Haver Analytics; and IMF staff calculations.

6. **Fiscal policy was expansionary despite revenue overperformance.** Total cash revenues exceeded staff projections by about 0.3 percent of GDP, thanks to a substantial increase in non-tax revenues[2] and buoyant corporate income tax and social security contribution collections supported by better than expected profits and strong wage growth and employment. Expenditure was driven by EU-funded investments and an increase in health and defense spending. The 2018 deficit of 1 percent of GDP was broadly in line with staff projections and implied a fiscal stimulus of about 0.4 percent of GDP (Figure 2).

7. **Inflationary pressures eased somewhat in 2018.** Average headline inflation decelerated to 2.6 percent in 2018, driven by a decline in global food prices and a VAT reduction for fruits and vegetables, but picked up at the beginning of 2019 reflecting a delayed adjustment in administered gas and electricity prices in response to the energy price increase in 2018 (Figure 3). Average core inflation, at about 2 percent, was 0.6 percentage points lower than in 2017, but accelerated at the end of 2018 following an increase in excise taxes. Energy prices contributed near 1 percentage point to headline HICP and the delayed passthrough to transport and housing accounted for about 0.3 percentage point of core inflation.

HICP Inflation
(Yoy percent change)



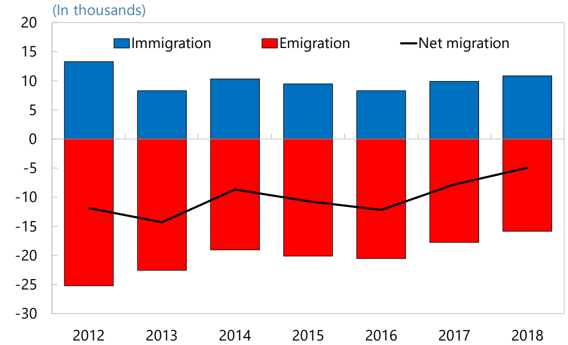
Sources: Central Statistical Bureau of Latvia; and IMF staff calculations.

---

[2] Due to an extraordinary dividend payment of Latvenergo and premium payments for government-issued bonds. These revenues are excluded from the 2018 ESA balance.

8. Wages increased significantly, as the labor market continued to tighten. A labor shortage and the increase in minimum wages at the beginning of 2018 pushed real wage growth to 5.7 percent, with private and public sector wages seeing equivalent increases (Figure 4). The highest wage growth was in the health sector (16 percent), following the health care reform that provided higher salaries for medical workers. Unemployment declined significantly to 7.4 percent at end-2018, while labor force participation reached an all-time high of 78 percent. At its lowest level in 10 years, net migration continues to put pressure on the labor market, but at a slower pace.

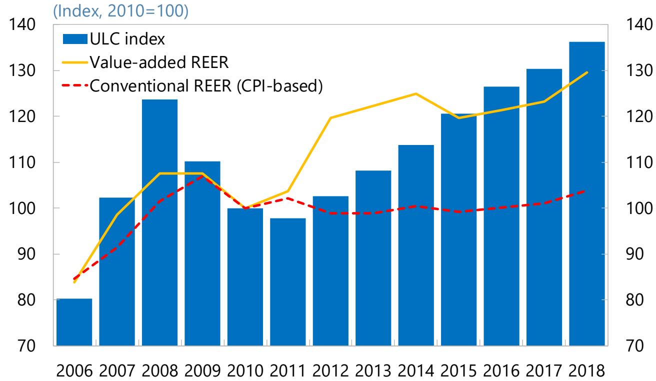
Migration Trends
(In thousands)



Sources: Central Statistical Bureau of Latvia; and IMF staff calculations.

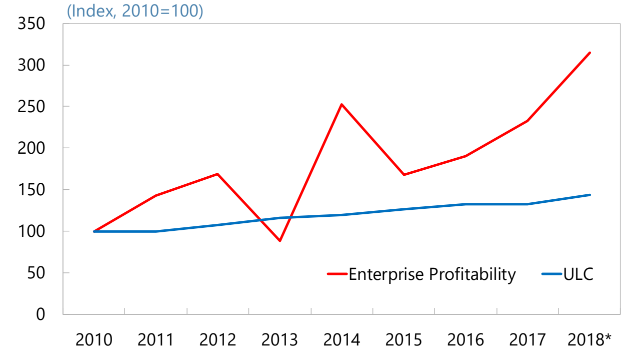
9. The current account swung to a deficit. Despite a moderate terms-of-trade improvement, the current account turned into a deficit of 1 percent of GDP in 2018 (Figure 5). Export volume growth decelerated to 1.8 percent amid a moderation in external demand, poor food and agricultural production, partly due to adverse weather conditions, and a decline in exports of financial services on the back of shrinking non-resident deposits. Import volumes grew by 5.1 percent amid strong investment and robust household consumption. Rising real wages pushed unit labor costs to above their pre-crisis peak, and the CPI-based REER continued to appreciate. REER measures accounting for Latvia's share in global supply chains show a larger appreciation, signaling a faster erosion of competitiveness compared to standard REER measures.[3] Yet, profitability in key export-oriented sectors is still very strong. The external sector position is assessed to be moderately stronger than implied by fundamentals and desirable policies. The current account gap is largely attributed to policy gaps, mainly low public health spending and a meager credit growth, only partially offset by a higher-than-desirable fiscal deficit (Annex I).

Conventional, Value-added REER and ULC
(Index, 2010=100)



Sources: Bems and Johnson (2017); Timmer et al (2015); and IMF staff calculations.

Enterprise Profitability vs. ULC in Manufacturing
(Index, 2010=100)

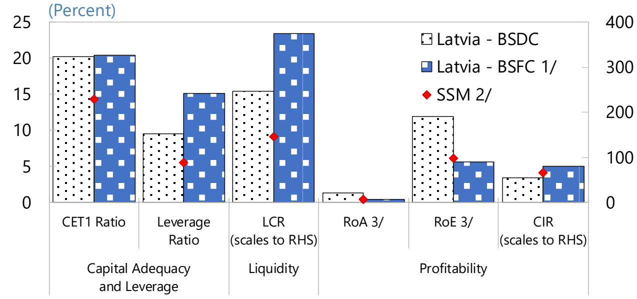


*2018 is an estimated average of 2018Q1-Q4.
Sources: Central Statistical Bureau of Latvia; Haver Analytics; and IMF staff calculations.

[3] Staff estimates suggest that a 10 percent increase in value added based REER is associated with about 0.2 percentage point decline in growth. (See Republic of Latvia: Selected Issues, International Monetary Fund, 2019, forthcoming)

10. The banking system is solvent, profitable, and liquid, but credit growth remains elusive. Capital levels about 40 percent higher than the euro area average suggest ample capital buffers. With average liquidity coverage four times the regulatory minimum, the banking system has the highest share of excess reserves (about 20 percent of total assets) in the euro area. While profitability has slightly decreased since 2016, it remains solid, as slow credit growth has helped stabilize net interest margins amid lower lending rates. Asset quality continues to improve, with NPLs of retail and NFC lending further declining to almost 3 percent—far below the euro area average. The de-risking[4] and deleveraging of the BSFC sector further dampened already weak credit growth. While the government-sponsored mortgage program contributed to a slight recovery of household (HH) credit in 2018Q4, SME lending programs have been less successful. Total HH credit declined by 5.4 percent and credit to non-financial corporations declined by 5.8 percent (Figure 7).

Banking Sector Indicators (Q4 2018)
(Percent)



Note: BSDC = banks servicing domestic clients, BSFC = banks servicing foreign clients, CET1 = Common Equity Tier 1, CIR = cost-to-income ratio, LCR = liquidity coverage ratio, RHS = right hand side; 1/ Data based on consolidated (solo) reporting from 8 (3) banks; 2/ All significant banks (110) directly supervised by the ECB at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP); 3/ For SSM: RoE and RoA are computed by dividing "net profit/loss" by, respectively, "equity" and "total assets" at the end of the corresponding reference period.
Sources: ECB; FCMC; and staff calculations.

11. Public and external debt remain firmly on a downward path. Latvia's investment-grade rating was reaffirmed, helping maintain stable market access at very low spreads. These favorable conditions have allowed the authorities to lengthen public debt maturities, recently launching a successful 30-year Eurobond. Prudent fiscal deficits and favorable macroeconomic conditions have helped reduce the public debt burden to 37 percent of GDP in 2018. The sharp decline in non-resident deposits led to a reduction of external debt by a whopping 20 percentage points in 2018 (Annex II and III).

OUTLOOK AND RISKS

12. Growth is expected to decelerate in 2019. A slower pace of EU fund absorption and wage growth will moderate domestic demand, bringing GDP growth to just above 3 percent. Export growth is expected to recover slightly as one-off adverse weather effects wear off, but will remain sluggish in line with a slowdown in trading partners' growth and weak service export growth. While the domestic demand

Medium-Term Outlook
(percent change)

	2018	2019	2020	2024
Real GDP	4.8	3.2	3.1	3.0
Consumption	4.4	3.4	3.2	3.1
Gross investment	15.1	6.0	5.0	5.0
Exports	1.8	2.2	2.3	2.2
Imports	5.1	3.2	3.2	3.1

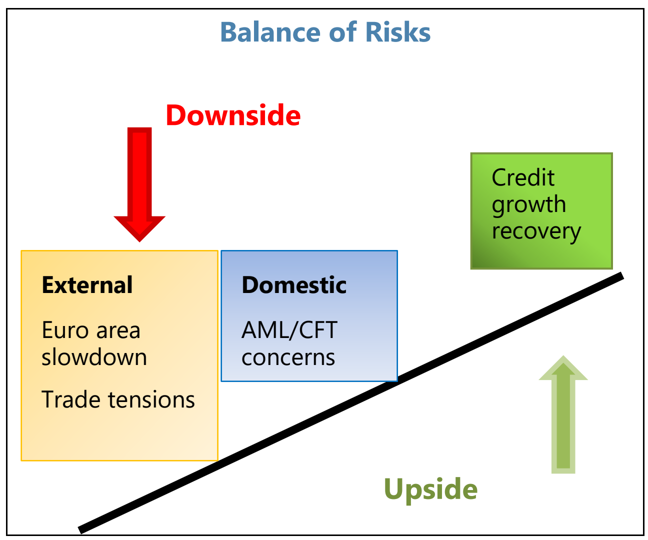
Sources: Central Statistical Bureau of Latvia and IMF Staff calculations.

[4] "De-risking" refers to the process by which Latvian financial institutions are terminating customers and accounts perceived as being high-risk. The term is not used in reference to any actions on the part of foreign correspondent banks towards their Latvian counterparts.

slowdown is projected to impact imports, a trade balance deterioration will further widen the current account. Over the medium term, GDP growth is projected to gradually converge to its potential of 3 percent, as EU funds taper off, and capacity constraints become more binding.

13. Wage pressures will keep inflation above 2 percent. With unemployment below its natural rate—estimated near 8 percent—the labor market will continue to pose constraints and keep wage growth above 4 percent before decelerating in line with productivity.[5] Inflation is projected to gradually ease and settle at slightly above 2 percent, reflecting catch-up effects relative to the euro area.

14. Risks to the baseline are tilted to the downside, with external factors becoming more prominent. Being a small open economy and relatively well integrated in global supply chains, Latvia could suffer from weaker than expected external growth, especially in the euro area, a sharp tightening of global financial conditions, and rising protectionism. Staff estimates that weak external demand due to a slowdown in the euro area could adversely impact growth by about ½ percentage point.[6] Escalation of trade tensions could reduce growth by up to ¼ percentage point.[7] A sharp downturn combining the above shocks with a severe confidence shock could reduce growth significantly more.



15. Domestic risks stem from AML/CFT concerns. A failure to improve the AML/CFT regime in line with MONEYVAL's main recommendations could trigger a grey-listing by the FATF in February 2020 and severely damage confidence in Latvia's financial sector and its oversight. While the growth impact of ABLV's closure has so far been negligible, AML/CFT deficiencies in screening claims of non-insured creditors could raise reputational risks. Similarly, failure to refocus the BSFC sector towards a viable business model could put financial sector stability at risk. AML/CFT concerns could have a significant impact on Latvia's sovereign risk premium and credit conditions (Annex IV) if they result in additional failures in the BSFC sector and/or trigger further withdrawal of parent support of large foreign-owned banks that provide significant domestic lending. Upside risks stem from a faster than projected recovery in credit growth due to effective insolvency administration reforms.

[5] Latvia's productivity gains translate into similar real wage increases in the long run. See IMF, 2018, "Regional Economic Outlook Europe."

[6] The size of the shock is equivalent to a no-deal Brexit scenario with significant border disruptions and severe tightening of financial conditions. See "Euro Area Policies—Staff Report for the 2019 Article IV Consultation."

[7] Tariff shocks based on April 2018 WEO scenario and a structural model accounting for supply chain linkages (Republic of Latvia: Selected Issues, International Monetary Fund, 2019, forthcoming).

Authorities' Views

16. Despite slight differences in near-term growth projections, the authorities broadly agreed with staff's views on the outlook and risks. They expressed a concern that if wages continue to grow near their current pace as the economy moves into a slower gear, profit margins might decrease with gradually worsening cost competitiveness. However, they agreed that signs are inconclusive yet, as wage and producer price growth is decelerating, and consumer price inflation remains at a healthy level. While they emphasized that external risks are greater than domestic, they concurred that risks in the financial sector need to be promptly addressed.

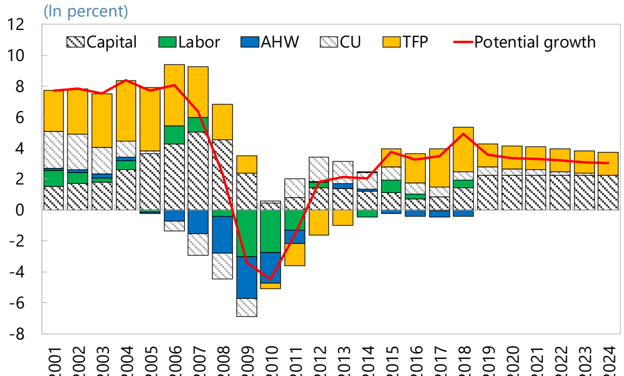
POLICY DISCUSSIONS: PREPARING FOR THE SLOWDOWN

Policy discussions focused on the medium and long-term growth outlook and policy options to boost productivity. Higher productivity growth is needed to offset the large projected growth impact of demographic headwinds and ensure robust long-term potential growth and rapid convergence with the average euro area per capita income. The fiscal stance is appropriate, and fiscal space is available to face adverse shocks. The focus of fiscal policy should turn to the long-term policy mix needed to support productivity improvements and address poverty and inequality. Concerted efforts are needed to address AML/CFT concerns, repair the reputation of the financial system, and ensure that it supports the credit needs of the real economy.

A. Macro-structural Policies: Raising Productivity

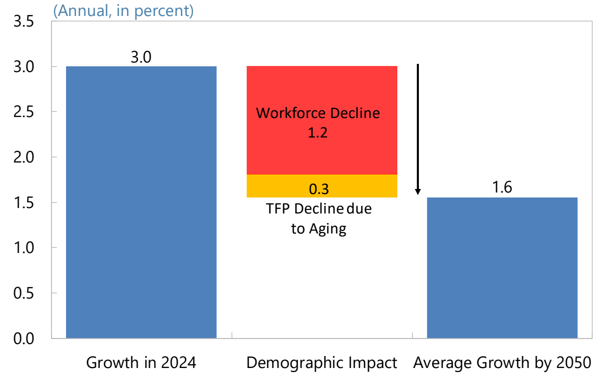
17. Medium-term growth is projected to remain strong. GDP growth is expected to decelerate in 2019 and converge to its potential of 3 percent by 2022 (Annex V). Demographic projections suggest that the working age population will reverse its upward trend observed in the recent past and become a significant drag on GDP growth. Supported by ongoing tax and structural reforms, which are expected to underpin a gradual recovery of credit growth and encourage private investment, capital accumulation will remain a steady contributor to potential growth even in the face of tapering EU investment funds. The contribution of TFP growth is assumed to remain in line with its long-term historical average of 1.5 percent.

Potential Growth Projection in the Baseline Scenario
(In percent)



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

Long-Term Potential Growth
(Annual, in percent)



Sources: UN WPP, ILO; and IMF staff calculations.

18. However, the long-term outlook for potential growth is very challenging.[8] The working age population is projected to decline by about 31 percent in the next thirty years, implying an average reduction in annual average potential growth of 1¼ percentage points. Furthermore, labor force aging—with the share of workers above the age of 55 increasing by about 3.6 percentage points—is projected to dampen productivity. The adverse effect of the aging workforce on TFP implies an additional dent on potential growth of about ¼ percentage points by 2050. In the very long run, potential growth is thus likely to average around 1½ percent. With 2050 output level lower by a third than if growth were to remain at 3 percent, income convergence will continue, but at a much lower pace.[9]

19. Reforms that ease labor market constraints could partially offset the negative impact of adverse demographics trends. Measures that improve access to housing, reform vocational education and training, encourage lifelong learning and increase participation in active labor market policies (ALMPs) would promote better skill matching and help reduce structural unemployment. This would also strengthen competitiveness and prevent wages from eroding profitability in the medium term. Policies that help increase participation rates of targeted groups—youth, women, and older workers could increase labor supply in the long run. However, except for policies that stem emigration and encourage permanent immigrant labor, labor reforms would fall significantly short of offsetting the longer-term impact of demographic trends.[10] Appropriate costs of tertiary education and incentives for those completing it—residents and nonresidents—to work in Latvia could stem net emigration of skilled workers. Most importantly, increasing productivity growth would allow more rapid wage growth and thus help narrow the income gap between Latvia and the euro area, reducing outward migration and supporting potential growth.

20. Productivity is being held back by impediments to investment and lack of diffusion of new technologies. TFP growth has increased steadily since the crisis, but on average remains well below its high pre-crisis levels due to the very slow transformation of human and physical capital. Latvia's capital stock is largely composed of buildings and structures. The share of technological equipment and intellectual property in total fixed assets—about 2 percent—has increased only marginally since its pre-crisis level and remains the lowest among European peers. Gross R&D spending—at 0.5 percent of GDP—is only a quarter of the EU average. The share of innovative companies—only 6.3 percent of total—is also very low compared to an EU average of 14 percent.

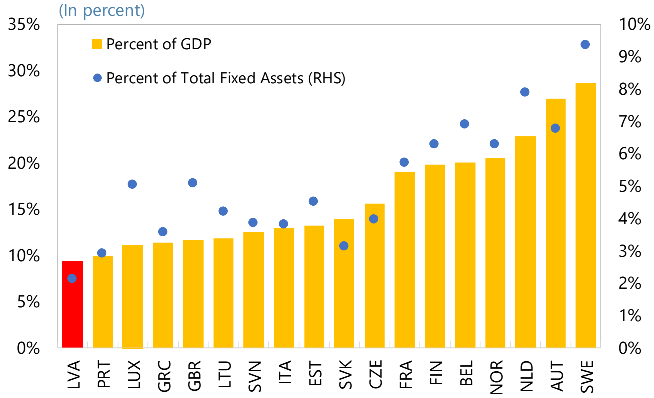
---

[8] See IMF Country Report No. 18/267.

[9] Staff estimates that Latvia's GDP per capita will be at Western European level in 2050 if Latvia's GDP growth remains at 3 percent (compared to about 66 percent currently) and about 86 percent of the average GDP per capita of Western European countries if Latvia's GDP growth averages 1½ percent by 2050. See IMF, "Demographic Headwinds in Central and Eastern Europe", Departmental Paper No. 19/12.

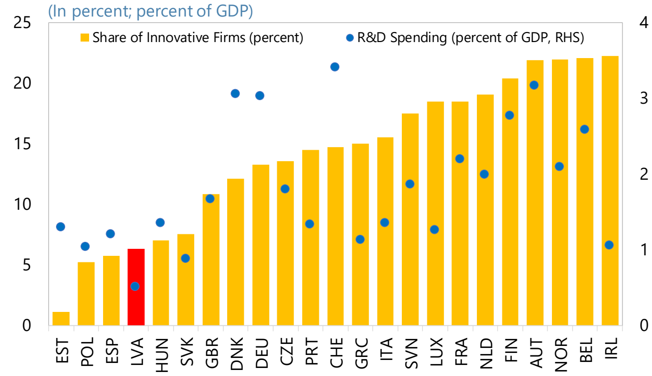
[10] Stemming emigration would still lead to a decline in the working age population of 28.5 percent by 2050. See IMF, "Demographic Headwinds in Central and Eastern Europe", Departmental Paper No. 19/12.

Fixed Assets: Technology and Intellectual Property, 2016
(In percent)



Sources: Eurostat; and IMF staff calculations.

R&D Spending and Innovation, 2017
(In percent; percent of GDP)



Source: Eurostat; OECD Science, Technology and Industry Scoreboard 2017; and IMF staff calculations.

21. Structural reforms supporting TFP growth will thus be critical to mitigate the demographic impact on potential growth. Maintaining potential growth at 3 percent in the long run would require an improvement in TFP growth of near ½ percentage point. There are several avenues to achieve this improvement:

- *Investment in new technologies*. Evidence points to a positive impact of intangible assets on productivity growth.[11] The ability of firms to invest in new technologies hinges on reforms addressing obstacles to the provision of credit and other measures boosting investment. The 2017 income tax reform may encourage reinvestment of profits, once it is fully effective. Specific tax incentives—replacing tax incentives that expired in 2018—could encourage R&D investment, but need to be carefully designed to improve uptake and prevent misuse.

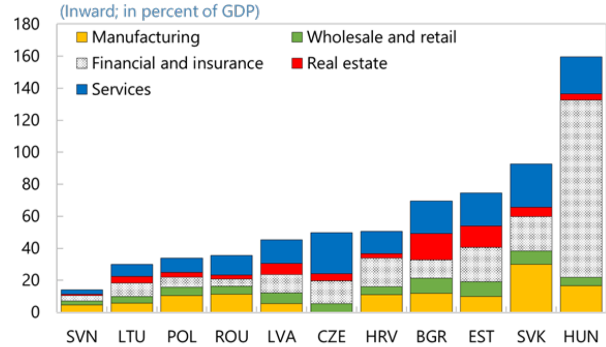
- *Access to finance*. Staff's analysis shows that Latvia's companies with access to finance tend to have higher productivity growth. An increase in debt financing (as measured by debt-to-asset ratio) by 10 percentage points tends to be associated with higher productivity growth by about 0.5 percentage point. Increasing access to finance, especially for small productive firms, could thus have large efficiency gains.

- *Better resource allocation.* Staff also finds that an excess debt burden hurts productivity growth, and financially distressed firms negatively impact the productivity growth of other firms in the same sector, possibly by holding up productive resources and reducing their ability to borrow. To achieve higher TFP growth, resources need to be allocated among healthy firms, while insolvent companies need to be liquidated or restructured under more efficient procedures (see financial sector section).

[11] See Republic of Latvia: Selected Issues, International Monetary Fund, 2019, forthcoming.

- *FDI inflows*. Despite having some of the least restrictive FDI rules in the EU,[12] Latvia's FDI inflows have been relatively weak, especially in the non-service sector. This is in part because of deterrents, such as red tape, perceived corruption, informality, and public sector inefficiencies.[13] Addressing these deterrents and encouraging FDI inflows, especially majority-stake acquisitions, could also help raise productivity growth.[14] In this regard, the OECD estimates significant long-term growth benefit of SOE stake sales and strengthening competition in Latvia.[15]

FDI Stock by Industry
(Inward; in percent of GDP)



Note: Value of foreign investors' equity in and net loans received by enterprises of a specific industry resident in the reporting economy.
Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Authorities' Views

22. The authorities agreed that easing labor market constraints would support competitiveness in the short and medium term. They reiterated their skepticism about differentiating minimum wages across regions due to administrative complexities but emphasized their efforts to reduce structural unemployment by improving skill matching, upskilling, and ALMP uptake. Regarding migration policies, they agreed that the focus should be on encouraging inward and discouraging outward migration and were open to policies that would attract high-skilled immigrant labor. The authorities consider productivity-enhancing reforms as critical to mitigating the negative impact of adverse demographic trends on long-term growth. Improving the business environment is necessary to attract foreign and domestic investment, while capital market development could help unlock financing for large firms and redirect bank financing to medium and small enterprises. They also noted that cost pressures from labor shortages are creating incentives for companies to invest in new technologies, but policies are nonetheless needed to improve R&D spending.

B. Fiscal Policy: Supporting Growth

23. Fiscal policy in 2019 is projected to be slightly contractionary. With a lower revenue intake, as the full impact of the tax reform kicks in, and limited new spending initiatives, the 2019 overall balance is expected to improve by 0.4 percent of GDP. Higher spending (0.6 percent of GDP)

[12] The OECD FDI restrictiveness index gauges the restrictiveness of a country's FDI rules by looking at four main types of restrictions: foreign equity restrictions; discriminatory screening or approval mechanisms; restrictions on key foreign personnel and operational restrictions. The index takes values between 0 for open and 1 for closed.

[13] See FICIL Sentiment Index, 2018.

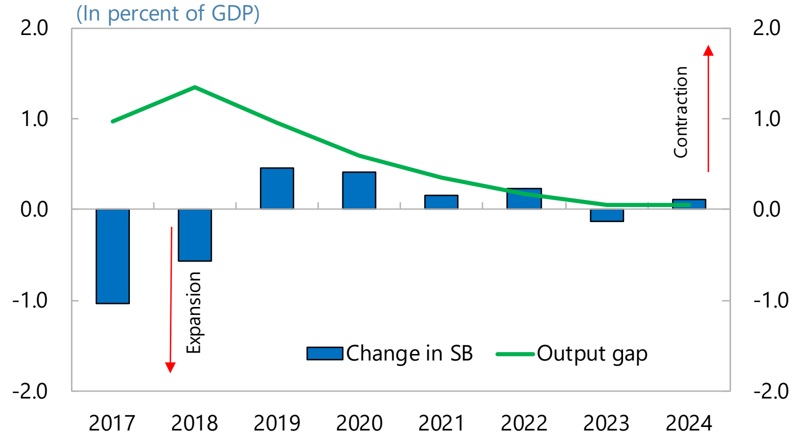
[14] Fons-Rosen, C., S. Kalemli-Ozcan, B. Sørensen, C. Villegas-Sanchez, and V. Volosovych (2019), "Quantifying Productivity Gains from Foreign Investment" find that productivity gains emerge 4 years after an increase in foreign investment, mainly in the case of majority stake acquisitions.

[15] OECD, 2019, Economic Survey of Latvia.

on wage increases for health and judiciary workers (0.2 percent of GDP), one-off special benefits of ministry of interior employees,[16] and public investment are compensated with an increase in social security contributions, new measures to boost tax compliance, and exceptional revenues from SOE dividend payments and sale of CO_2 allowances (about 0.6 percent of GDP).[17] With a closing output gap, the structural effort amounts to about 0.4 percent of GDP.

24. Under current policies, the fiscal stance is expected to be broadly neutral over the medium term. The authorities' medium-term objectives outlined in the 2019 Stability Program, suggest there are no immediate risks of fiscal imbalances. These objectives would help achieve a small consolidation of about 0.3 percent of GDP over the medium term, enough to keep public debt relatively low, declining, and manageable (Annex III). However, new measures currently under discussion, including further wage increases, tax adjustments, and a territorial reform could entail fiscal costs that need to be carefully assessed and for which financing sources need to be identified in future budgets. While recent increases to the minimum wage and wages in specific sectors have not undermined fiscal stability, it has put pressure on the overall wages in the economy, particularly in the service sector. Further increases, if not aligned with productivity growth, could undermine competitiveness and should thus be avoided.

Structural Balance and the Business Cycle
(In percent of GDP)



Sources: Ministry of Finance; and IMF staff calculations.

25. The targeted fiscal path suggests Latvia has some fiscal space to react to shocks. Fiscal space is underpinned by solid access to financing under favorable terms and relatively low debt burden and gross financing needs, both of which are projected to be on a declining path under the baseline and stress scenarios. Furthermore, public debt and the fiscal stance seem resilient even under a temporary expansionary fiscal policy scenario.[18] Given the closing of the output gap and existing uncertainties related to ongoing and planned reforms, the authorities' fiscal path is appropriate. Should negative shocks materialize, the authorities should let automatic stabilizers operate fully. In the event of a severe economic downturn, expansionary fiscal policy through temporary, high-quality measures could be considered.

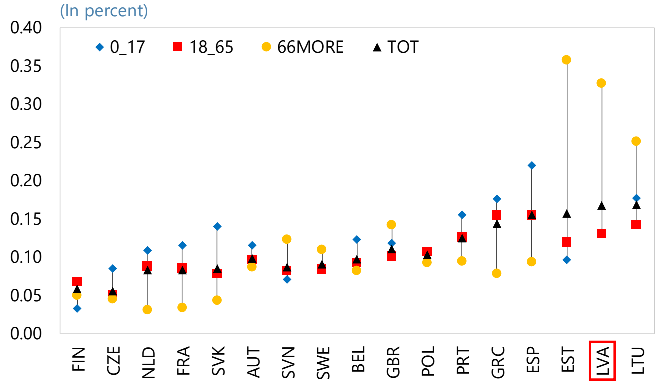
[16] A one-off entitlement every five years.

[17] The emission sales took place in 2018, but revenues are recorded on accrual basis in 2019. The exceptional SOE dividend is excluded from the 2019 ESA balance.

[18] This scenario assumes an expansionary fiscal policy of 2 percent of GDP over 2 years.

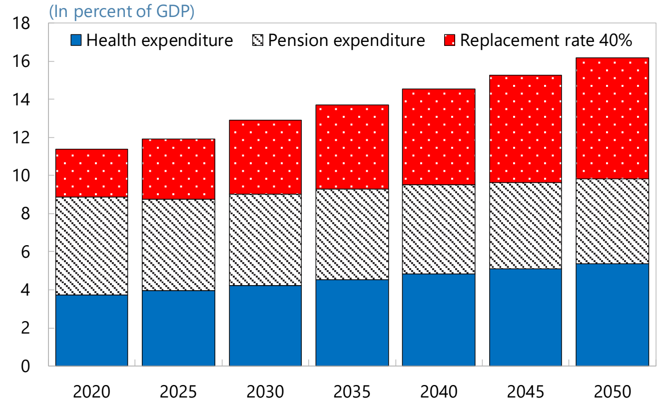
26. Room for policy maneuvering could be limited over the long term. Spending needs could increase if social and fiscal pressures to address relatively high poverty and inequality levels and a rapidly aging population increase.[19] Due to a significant decline in replacement rates to about 16 percent by 2050 under the existing retirement benefit rules, long-term pension spending costs are projected to fall, offsetting the rise in health and other long-term care spending. The existing pension system thus ensures fiscal sustainability, but raises questions of its social sustainability, especially considering already high poverty rates among the elderly. Balancing social and fiscal sustainability may require policies to expand fiscal space over the long term. Raising replacement rates to the recommended ILO minimum of 40 percent could increase costs by almost 4 percentage points of GDP over the next ten years.[20]

Poverty Rate Relative to EU Income Level, 2016
(In percent)



Source: OECD (2019), Poverty rate (indicator). doi: 10.1787/0fe1315d-en (Accessed on 07 May 2019)

Age-related Spending Projections
(In percent of GDP)



Source: IMF staff calculations.

27. The long-term fiscal policy mix thus needs to remain focused on securing resources to accommodate demographic and other social spending costs and boosting productivity and potential growth:

- **Identifying new growth-friendly revenue sources.** VAT revenue could increase without unduly increasing the tax burden, for example by simplifying the rate structure and reducing noncompliance. Latvia's large persistent VAT gap relative to EU peers suggests that improvements in tax administration and combating the shadow economy could yield significant revenue benefits. Efforts to increase Latvia's intake from property taxes—significantly below the euro area average—could also provide a sustainable source of revenue. The government' proposal to revise the methodology for estimating cadastral values is a welcome step.

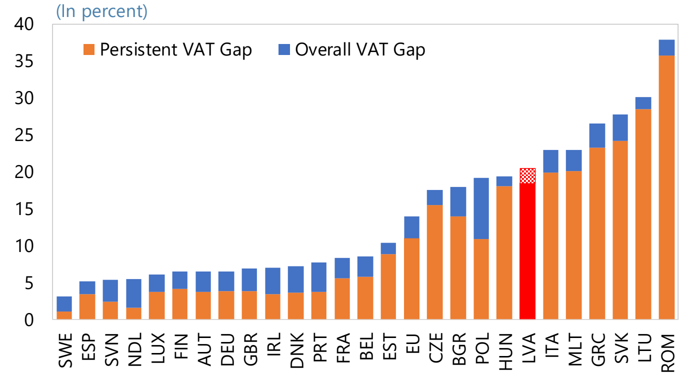
[19] See IMF Country Report No. 18/266.

[20] See IMF, "Demographic Headwinds in Central and Easter Europe," Departmental Paper No. 19/12. ILO's minimum standard requires that the replacement rate be at least 40 percent of previous earnings after 30 years of contributions for at least those beneficiaries with earnings lower than prevailing or average levels.

Furthermore, a relatively low effective tax rate on CO_2 emissions provides scope for raising energy tax revenue by aligning the effective taxation of CO_2 emissions and other pollutants across different fuels and uses, while also meeting Latvia's commitments under the Paris Agreement.[21] Finally, while recent amendments to the microenterprise regime aim to reduce tax expenditures, their impact should be monitored closely to ensure the regime is not used solely for tax optimization purposes and does not hinder the growth of innovative firms.

VAT Gap

(In percent)

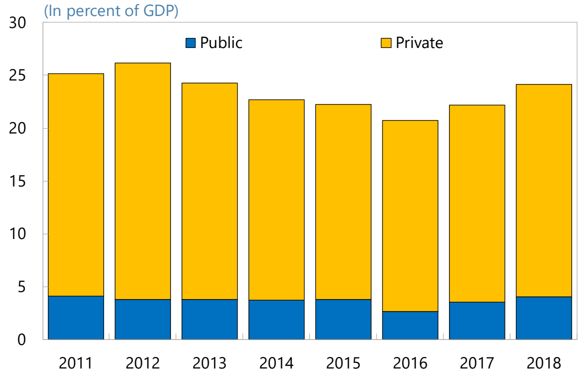


Note: The VAT gap is the difference between the expected VAT revenue and the amount collected and measures the effectiveness of tax compliance measures.
Source: Nerudova and Dobranschi, 2019.

- **Maximizing investment returns.** Despite a recent surge, total public and private investment in the economy would decline as EU funds taper off. While the level of public investment is in line with the EU average, Latvia's investment needs are large and the quality of infrastructure—particularly roads, railway and energy connectivity—lags neighboring countries. This is an obstacle to labor mobility, regional economic development, and FDI inflows. Structural policies that increase public capital spending could help induce private investment, thus giving a push to productivity and GDP growth.[22] As EU funds taper off, the authorities should maximize their benefit by supporting investment projects that have a high return, catalyze private investment, and could be frontloaded should the economy need support in a downturn.

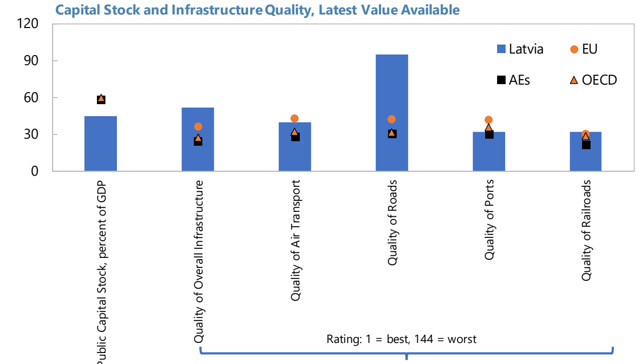
Investment by Sector

(In percent of GDP)



Sources: Central Statistical Bureau of Latvia; and IMF staff calculations.

Capital Stock and Infrastructure Quality, Latest Value Available



Sources: IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook; World Development Indicators; IMF Investment and Capital Stock Dataset; and World Economic Forum.

[21] See OECD (2019), OECD Economic Surveys: Latvia 2019, OECD Publishing, Paris; and OECD (2018), Taxing Energy Use 2018: Companion to the Taxing Energy Use Database, OECD Publishing, Paris.

[22] Staff simulations suggest that a permanent increase in capital expenditure of 0.5 percent of GDP per year, could increase real GDP growth by about 0.2 percent per annum over the medium term. See IMF, Country Report No. 18/266.

- **Reforming the public administration.** Adjusting the level and composition of public sector employment could facilitate more effective service delivery and ease the existing labor market tightness.[23] The ongoing public administration reform seeks to address these issues, but needs to include the broader public sector to achieve meaningful efficiency gains. The current territorial reform proposal¸ seeking to further reduce the large number of municipalities (119)[24] by about 2⁄3 within the next two years, is an opportunity to right size the public administration and the provision of services to a declining and aging population. Local authorities account for about 60 percent of general government employments and 30 percent of expenditures (above the 23 percent EU average); salaries constitute 45 percent of their expense (significantly above the 32 percent EU average). International experience on the success of municipal consolidation is mixed; however, consolidating municipalities could yield benefits through economies of scales and synergies in public service provision. Strengthening public procurement transparency and efficiency and local authorities' and SOEs' governance and reporting would help improve the allocation of resources and prevent misuse of public funds.
- **Improving the adequacy and targeting of social programs.** Better results in addressing poverty can be achieved by redesigning existing programs, linking eligibility requirements to socio-economic indicators, introducing uniform standards across municipalities, and completing the guaranteed minimum income reform.[25] Funding a larger social housing stock would also have an impact on poverty outcomes due to its potential to improve regional labor mobility and lower structural unemployment (Figure 6).

Authorities' Views

28. The authorities agreed with staff's views that, as new policy initiatives are being considered, their fiscal impact and ultimate benefit need to be carefully assessed to prevent unduly eroding fiscal space. They also concurred that the long-term fiscal policy mix needs to focus on securing growth-friendly revenue sources to make room for age-related and social spending and to support policies that can boost potential growth. However, the authorities were skeptical about the prospects of raising sufficient revenues to support a significant increase in pension replacement rates in the long run, and therefore considered that raising productivity would be key in balancing fiscal and social sustainability outcomes.

[23] See IMF Country Report No. 18/267.

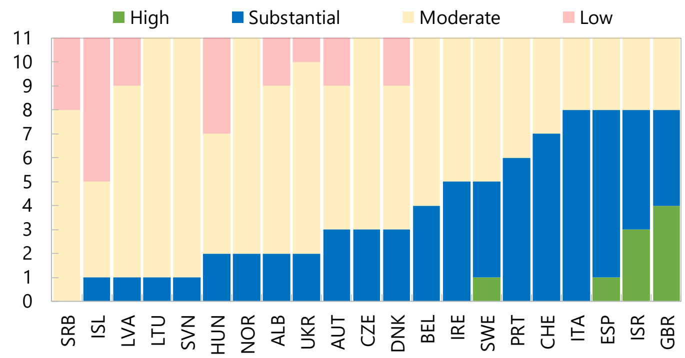
[24] Strictly speaking it is 110 municipalities and 9 cities.

[25] The stalled reform proposal aims to address shortcomings of the narrow eligibility requirement and the poor adequacy of the program.

C. Macro-Financial Policies: Restoring Confidence in the Financial System and Reviving Credit Growth

Completing AML/CFT Risk Management and Compliance Reforms

Assessment Ratings of Effectiveness



Note: Includes only European countries for which assessments under the 2013 FATF Methodology are available. Based on MONEYVAL assessments for ALB, CZE, HUN, LVA, LTU, SRB, SVN, and UKR; FATF assessments for AUT, BEL, CHE, DNK, ESP, GBR, IRE, ISL, NOR, PRT, and SWE; and IMF/FATF assessment for ITA. Ratings reflect the extent to which a country's measures are effective. The assessments are conducted on the basis of 11 immediate outcomes, which represent key goals that an effective AML/CFT system should achieve.
Source: Financial Action Task Force (FATF), *Consolidated Assessment Ratings,* April 17, 2019.

29. **Money laundering concerns related to BSFCs continue to weigh on Latvia's financial sector.** Significant gaps in implementation of the AML/CFT framework hampered its effectiveness, exacerbating money laundering and terrorist financing (ML/TF) risks in the banking system, contributing to a withdrawal of global correspondent banks from Latvia and a decline of external funding. The country's third largest bank, ABLV, has been in self-liquidation since June 2018 after allegations of institutionalized money laundering accelerated deposit outflows, triggering the ECB to determine that the institution was "likely to fail." Given ABLV's limited role in the domestic economy, the implications for the economy and the financial system have been primarily reputational.[26]

30. **MONEYVAL's assessment of Latvia's AML/CFT regime found significant deficiencies which, if unaddressed, could lead to Latvia being grey-listed by FATF.** Failing to address Latvia's AML/CFT deficiencies could expose the financial system and the economy to significant further financial integrity and reputational risks and undermine its competitiveness. Notwithstanding the authorities' significant efforts in this area[27], the task ahead is challenging due to the need to demonstrate effectiveness of the AML/CFT regime—including long-term institutional reforms—through progress in several key areas:

- **Strengthening AML/CFT supervision.** Supervisory authorities need to improve their understanding and analysis of ML/TF threats and vulnerabilities and strengthen risk-based

[26] IMF Country Report No. 18/266 estimated the direct impact of ABLV on growth at 0.5 percentage points, which was weathered amidst strong 2018 growth performance. BSFCs have relatively little activity in Latvia, with less than 6 percent of their total lending involving domestic clients.

[27] The authorities have passed: (i) amendments to the AML/CFT Law limiting the engagement of Latvian financial institutions with certain types of shell entities; (ii) amendments to the Law on Sanctions, supplemented by Regulations of Enhanced Due Diligence providing detailed guidance on obligations under the law; (iii) measures to transpose the Fifth EU Anti-Money Laundering Directive, including provisions on beneficial ownership; and (iv) amendments of the FCMC Act and the Credit Institutions Law to widen the FCMC mandate to include AML/CFT supervision of banks in both going and gone concern cases. Amendments to the FCMC Act also prompted the replacement of the Chair and Deputy Chair of FCMC.

supervision. They should also aid financial institutions in developing their own risk assessments, mitigation measures, and internal controls.

- **Ensuring accurate beneficial ownership information.** Shell entities have been misused in Latvia for ML/TF purposes, especially in BSFC activities. The effectiveness of recent amendments to Law on the Prevention of Money Laundering and Terrorism Financing intended to improve the availability of companies' beneficial owner information should be carefully monitored. The proper identification of beneficial ownership through the application of preventive measures (e.g., customer due diligence) should be a specific area of focus of AML/CFT supervision.

- **Improving AML/CFT preventive measures and reporting.** The quality and level of reporting of suspicious transactions by financial entities needs to improve and the reporting requirements should be clarified. Special focus should be on ensuring effective implementation of preventive measures by higher risk entities, such as BSFCs, including with respect to targeted financial sanctions.

- **Enhancing AML/CFT enforcement.** Cooperation across supervisory, financial intelligence, tax administration, and law enforcement authorities, the recruitment and training of additional staff, and the application of adequate IT solutions would help enforcement efforts and improve analytical capabilities. Strengthening investigative and prosecutorial bodies would improve their ability to more effectively lay charges and prove cases of ML/TF, which could contribute to making criminal sanctions more effective, proportionate, and dissuasive. The development of sentencing guidelines would also be helpful in this regard.

31. These reforms would benefit from intensive regional cooperation. The absence of a common EU-wide AML/CFT supervisory framework creates a need for greater cross-border coordination, especially given AML/CFT concerns in several Baltic and Nordic countries. At a regional level, coordination is needed to identify the sources of ML risks and possible spillover effects due to close financial interlinkages across the Nordic-Baltic countries. At an EU level, consideration should be given to establishing a European-level institution responsible for AML/CFT supervision, which will facilitate a consistent approach to cross-border risks and contribute toward supervisory convergence on AML/CFT issues.[28]

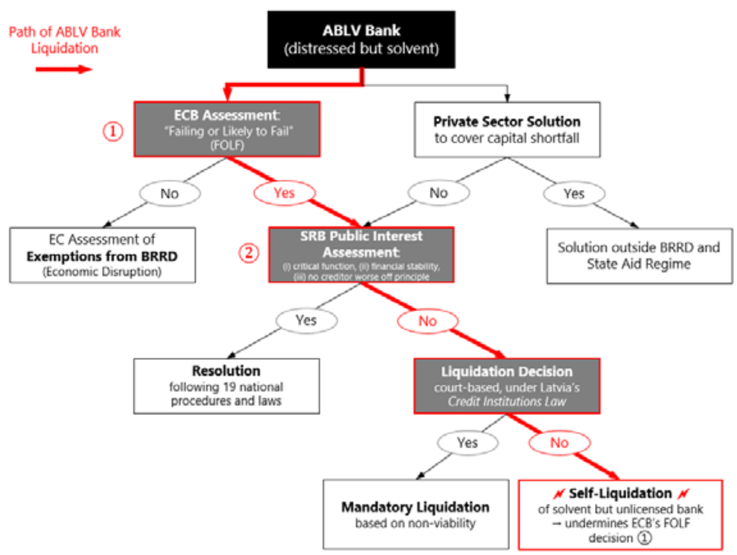
Upgrading the Resolution Regime and De-risking the Banking Sector

32. ABLV's protracted liquidation reveals deficiencies in the regulatory framework and prudential oversight. Legal gaps and evolving supervisory capacity continue to amplify challenges from the fragmented resolution regime for euro area banks that are deemed less significant or whose failure is not expected to have a destabilizing effect on the financial system and the wider

[28] The Euro Area Financial System Stability Assessment recommended that euro area authorities consider establishing a European-level institution responsible for AML/CFT supervision. See IMF Country Report No. 18/226.

economy. Persistent supervisory weaknesses in ABLV's liquidation proceedings call for further strengthening the FCMC's role in bank resolution:

- **Addressing lingering AML/CFT concerns.** In July 2018, ABLV's self-liquidation commenced under a complex coordination structure among liquidators, financial, and law enforcement authorities. The FCMC's role in this process includes monitoring payouts to mitigate the risk of payments to entities associated with money laundering and ensuring the filing of suspicious transaction reports on creditors' funds or sales. The long period required to develop a methodology for screening ABLV's creditors points to the challenges of balancing creditor interests and supervisory and financial stability objectives in an environment of heightened AML/CFT scrutiny. The extensive reliance by the FCMC and FIU on third-party experts in ABLV's liquidation underscores the need for stronger supervisory and enforcement capacity, better operational coordination, and adequate resources to effectively address AML/CFT compliance breaches in complex cases.
- **Upgrading supervisory powers for bank liquidation.** The FCMC recommends court-appointed administrators and supervises the asset management during liquidations. Amendments to the Credit Institutions Law now allow mandatory liquidation of banks whose license is withdrawn due to AML/CFT breaches. However, the FCMC cannot impose timely liquidation of solvent banks that are deemed "failing or likely to fail" (FOLF) by the ECB, but are not resolved by the SRB.[29] An amendment of the regulatory framework enabling mandatory out-of-court administrative liquidation (with an administrator appointed by the FCMC) in such cases[30] would reduce legal uncertainty about the wind-down of failing banks and about potential contingent liabilities to the government.



33. Refocusing BSFCs' business models and aligning them with the financing needs of the real economy would help restore confidence in the banking sector. ABLV's closure and the subsequent pressure to de-risk BSFCs (including terminating activities with some shell companies) has led to a reduction of non-resident deposits by more than 60 percent since end-2017, with their

[29] Since AML/CFT supervision is outside the ECB's mandate, any supervisory assessment of non-viability underpinning a FOLF decision will always be motivated by another reason (as was the case with ABLV bank).

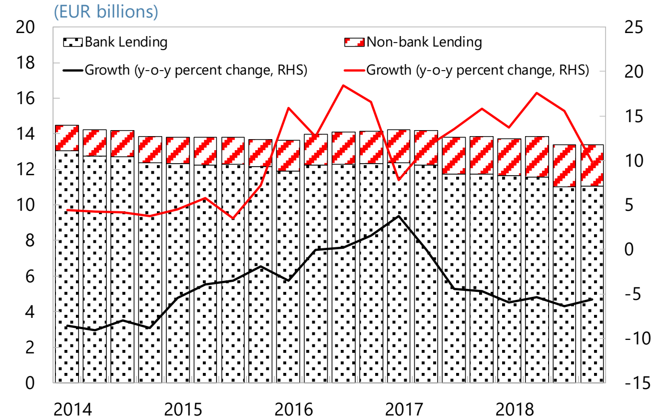
[30] Voluntary liquidation should be limited to cases when the license has not been revoked and only after an assessment by independent audit that available assets are sufficient to reimburse investors.

share declining to about 20 percent of total deposits. Higher prudential requirements on banks with a significant share of foreign deposits have also forced BSFCs to seek new business models with a greater focus on domestic activities where much larger, foreign banks already play a dominant role. The FCMC has assessed these business models under the *Supervisory Review and Evaluation Process* (SREP)— considering future business strategies and risk impact—but their sustainability is yet to be proven. Monitoring closely BSFCs with a focus on continued de-risking, prudent lending practices, and enhanced operational efficiency would ensure that their new activities are carried out in line with appropriate risk mitigation strategies and do not increase financial stability risks or create contingent liabilities for the government. A risk-based business model review involving opaque entities could use a harmonized SREP methodology for less significant institutions (LSIs) to limit supervisory capture.

Supporting Credit Growth

34. Structural gaps and heightened uncertainty in the financial system have exacerbated credit bottlenecks. Despite borrowing costs at record lows and rising demand, lending to both households and non-financial corporations (NFCs) remains timid. Some lending headroom of larger banks is being displaced by the absorption of legacy portfolios of banks exiting the Latvian market. Tightening lending standards and declining loan-to-deposit ratios also signal that banks' lending policies remain cautious due to concerns about the effectiveness of the insolvency regime and widespread informality.[31] The riskiness of corporate lending remains one of the highest in the euro area (with credit risk-weights of many banks exceeding 80 percent). Despite reforms strengthening insolvency administration, asset recovery rates remain low by international comparison. While evidence on loan demand is mixed, a high share of self-financing and low business confidence still weigh on the willingness to borrow. While non-bank lending is picking up, outpacing bank lending, it still represents only about 20 percent of total lending (Annex VI).

Bank vs. Non-bank Lending
(EUR billions)



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

35. Efforts to revive credit growth could focus on several key areas. Ensuring high standards for insolvency administration would help raise creditors' expected recovery rates and lower the cost of lending. Ongoing efforts in strengthening the revenue administration would help reduce the informal sector and improve borrowers' transparency. Consolidation of the banking sector aiming to improve operational efficiency and prevent unsustainable business models would ease lending

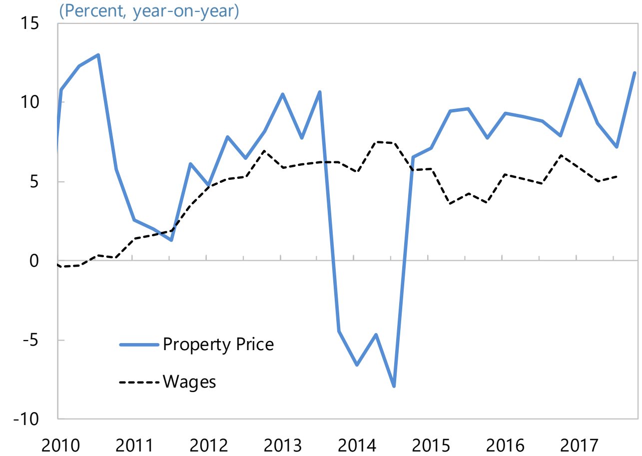
[31] The deposit base funding domestic lending has been unaffected by the liquidation of ABLV Bank. As of end-March 2019, only 0.5 percent of total domestic bank loans were funded by foreign deposits, of which about 7 percent are foreign currency-denominated.

constraints for profitable banks. Making the system of state loan guarantee programs more accessible and transparent could spur SME lending.

Preempting Buildup of Macro-Financial Vulnerabilities

36. The rapid rise in property prices merits attention. Despite a shrinking population, real house prices have increased by more than 7 percent per year over the last three years due to a surge in construction costs and prices of new dwellings. Current valuation indicators (price-to-income and price-to-rent ratios and deviations from long-term fundamentals) signal potential vulnerability to overvaluation of housing prices over the medium term. Yet, there are no acute financial imbalances, as the house price index is still about 20 percent below its pre-crisis peak in 2008, and aggregate house price developments have not been spurred by credit growth. Outstanding mortgage loans have dropped below 20 percent of GDP at end-2018, far below the euro area average of about 38 percent of GDP.

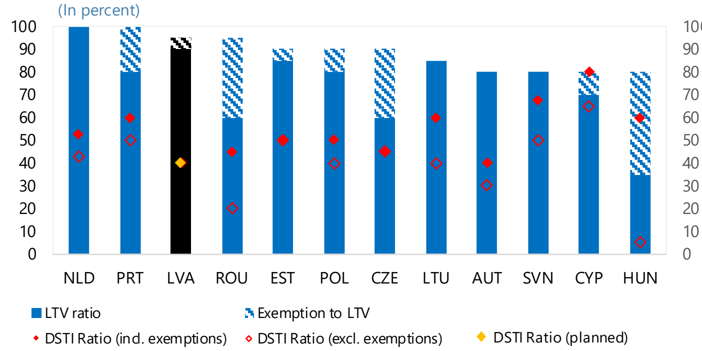
Real Average Gross Monthly Wages and Real Property Prices
(Percent, year-on-year)



Sources: Bank of Latvia; Haver Analytics; and IMF staff calculations.

37. Timely adoption of precautionary macroprudential measures can help contain medium-term balance sheet risks. The high share of variable rate mortgages raises the risk to debt service capacity if household leverage increases, while a slowing wage growth could reduce debt affordability. BSFCs' re-orientation may also result in a deterioration of borrower quality if they loosen credit standards and increase household lending to maintain profitability amid falling margins. Latvia's macroprudential measures are relatively lenient compared to those in other EU countries and could be preemptively adjusted. Lowering the current LTV ratio limit of 90 percent to 80 percent (closer to other European peers) for residential mortgage lending, imposing restrictions on home refinancing, introducing a debt service-to-income (DSTI) limit, and limiting the maximum maturity of mortgages and consumer loans would mitigate vulnerabilities related to real-estate exposures. Higher provisions for loans with LTV ratios above the limit and regular assessments of collateral valuation standards would prevent excessively risky lending. Finally, macroprudential measures should apply to leasing companies to prevent potential regulatory arbitrage between them and banks.

Macroprudential Policy: Selected EU Countries with LTV and DTSI Limits
(In percent)



Sources: European Systemic Risk Board; and IMF staff calculations.

Authorities' Views

38. The authorities broadly agreed with staff's views. National authorities emphasized that important legislative changes have been introduced to reduce AML/CFT concerns and international sanctions risks and address MONEYVAL's recommendations. They agreed that demonstrating effectiveness will take time and requires considerable efforts, including the timely liquidation of ABLV under a transparent review process to mitigate reputational risks. They also agreed that expanding supervisory powers for mandatory liquidation would be welcome but should be considered once the ongoing review of the EU banking resolution regime is completed. The authorities agreed that preemptive macroprudential measures would be appropriate to safeguard prudent bank lending amid persistently rising housing prices. They noted that, notwithstanding the low household debt and the sluggish lending, considering the record-low interest rates, they already plan to introduce pre-emptively DSTI, DTI, and credit maturity caps, in addition to the existing LTV cap to ensure sound lending standards through the cycle.

STAFF APPRAISAL

39. The Latvian economy has become considerably more resilient since the global financial crisis, and economic prospects remain favorable. There are no significant economic imbalances; external and government debt are on declining paths; and private sector balance sheets continue to improve. Inflation has been moderate, and competitiveness has held up. The external position is assessed to be moderately stronger than implied by medium-term fundamentals and desirable policies. Growth has been strong, and while it is projected to decelerate in the medium term, it is expected to converge to a still robust rate of 3 percent.

40. However, important challenges and risks may test the economy's resilience. First, Latvia's population continues to decline, which strains the labor market and poses a long-term growth challenge. Second, weaker than expected external growth, especially in the euro area, and rising protectionism could significantly weigh on exports. Third, the financial system still confronts financial integrity risks. Failure to strengthen the effectiveness of the AML/CFT regime and refocus BSFCs could undermine the stability of the financial system and its ability to support the economy.

41. Growth-enhancing reforms are aptly considered a priority by the government. Ongoing efforts to ease labor market constraints should be redoubled, including by promoting better skill matching and reducing long-term unemployment, increasing labor participation of targeted groups, encouraging the return of Latvian emigrants and allowing entry of skilled immigrants. Raising productivity growth will allow more rapid wage growth to take place sustainably and help slow emigration. Reforms that improve firms' access to finance, encourage investment in research and development, and attract foreign direct investment could yield important productivity gains.

42. The authorities' planned fiscal stance reverses past procyclicality and is appropriate given the expected deceleration of the economy. Given Latvia's relatively low and declining government debt and favorable financing terms, some fiscal space is available to react to shocks. Nonetheless, in the short run, the authorities should avoid public sector wage increases that are not aligned with productivity and should carefully assess the potential fiscal costs of new spending initiatives, in order to preserve fiscal space. If negative shocks affect the economy, the authorities should allow automatic stabilizers to operate fully and could consider temporary high-quality measures to support the economy in the event of a severe downturn.

43. Long-term fiscal policies should aim to accommodate the impact of demographic and social spending costs and support productivity-boosting reforms. New stable revenue sources would be needed to adequately cover growing age-related demands on the budget. Given Latvia's vast investment needs, the authorities should focus capital spending on projects that have the potential to catalyze private investment and have high social impact. Poverty and inequality concerns could be addressed by improving the adequacy and targeting of existing social programs. Reforms to strengthen the transparency and governance of local authorities and state-owned enterprises can help improve the use of public resources and prevent misuse.

44. The authorities have signaled strong political commitment at the highest level to restore the reputation of the financial system. Efforts to reduce exposure to risky banking operations, address MONEYVAL's recommendations, and oversee BSFCs' new business plans are welcome. Long-term reforms need to focus on the effectiveness of the AML/CFT regime by enhancing risk-based supervision, the quality and use of financial intelligence, the application of preventive measures, investigation and prosecution, and coordination among relevant national and regional authorities. Upgrading the supervisory powers for bank liquidation to include mandatory out-of-court administrative liquidation would reduce legal uncertainty and limit potential contingent liabilities, consistent with EU harmonization efforts.

45. The financial system needs to become more supportive of the domestic economy. Efforts to revive credit growth should focus on completing the ongoing insolvency reforms to lower lending costs. Steps are also needed to strengthen the revenue administration to more effectively combat the shadow economy. Careful oversight of banks' de-risking and business model re-orientation towards the real economy should encourage consolidation and ease lending constraints. Improving access to the system of state loan guarantee programs could spur SME lending. New preemptive macroprudential measures should support sound lending standards and mitigate medium-term financial sector vulnerabilities amid persistently rising property prices.

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

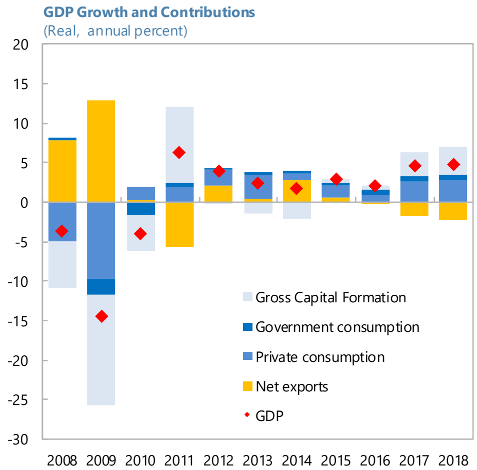
Box 1. Risk Assessment Matrix[1]

Source of Risk and Likelihood	Impact if Realized	Policy Recommendations Mitigation/Response
High **Rising protectionism and retreat from multilateralism.** Escalating and sustained trade actions threaten the global trade system, regional integration, as well as global and regional collaboration. Additional barriers and the threat of new actions reduce growth directly and through adverse confidence effects. Geopolitical competition and fraying consensus about the benefits of globalization lead to economic fragmentation with adverse effects on growth and stability.	**High** As a small open economy and relatively well integrated in global supply chains, Latvia could be impacted through trade channels. Staff estimate that escalation of trade tensions could reduce growth by up to ¼ percentage point.	Continue to diversify product and export markets. Pursue structural policies that enhance productivity and strengthen competitiveness. Participate in coordinated policy response at the European level.
High **Weaker-than-expected global growth.** Synchronized growth slowdown as weakening outlooks in the U.S., Europe and China feed off each other. Weak foreign demand makes euro area businesses delay investment, faltering confidence reduces private consumption, debt sustainability concerns further dampens growth. A disorderly Brexit could cause market disruption with negative spillovers. Disregard for common fiscal rules and rising sovereign yields for high-debt countries undermines medium term growth.	**High** 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. Staff estimates that a weak external demand due to a slow-down in the euro area could adversely impact growth by about ½ percentage point.	Participate in coordinated policy response at the European level. Allow automatic stabilizers to operate. In the event of a severe economic downturn, fiscal policy through temporary, high-quality measures, should be considered.
High/Medium **Sharp tightening of global financial conditions as a result of:** market expectation of tighter U.S. monetary policy or sustained rise in risk premium in reaction to concerns about debt levels in some euro area countries; a disorderly Brexit; or idiosyncratic policy missteps in large emerging markets. Causing higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn.	**Low/Medium** Could raise the public cost of debt financing. Domestically, sharp increases of the interest rate could further hinder credit growth. The impact could be high if the shock is combined with one or more of the above shocks, impacting growth significantly.	Perception of Latvia as a safe asset and the issuance of long-term sovereign debt are mitigating factors. Continue implementing prudent debt management policies and build buffers.
High **Delays in the implementation of AML/CFT reforms** **Failure to refocus the BSFC sector towards a viable business model**	**High** Could trigger a grey-listing by the FATF and severely damage confidence in the financial sector and its oversight and have an impact on the sovereign risk premium and credit conditions. Could undermine confidence in the financial sector, put its stability at risk, and hinder credit growth.	Promptly address recommendations in the MONEYVAL report, ensure the proper liquidation of ABLV, including by implementing a careful screening of claims of non-insured creditors and AML/CFT controls. Closely monitor the re-orientation of banks to ensure their new activities do not increase financial stability risks or create contingent liabilities for the government.

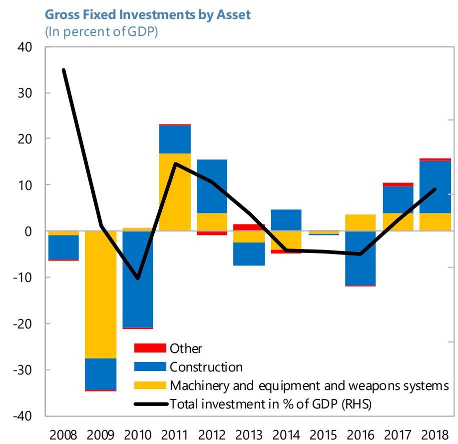
1\ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability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

Figure 1. Latvia: Real Sector

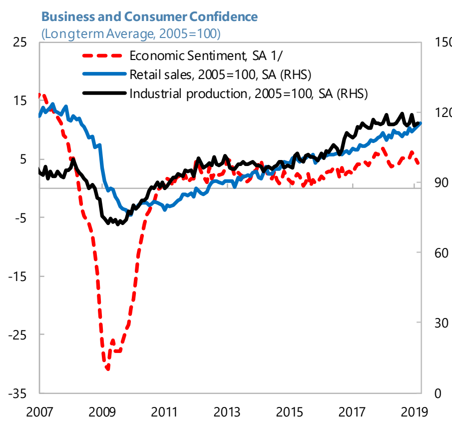
Growth remained strong in 2018…



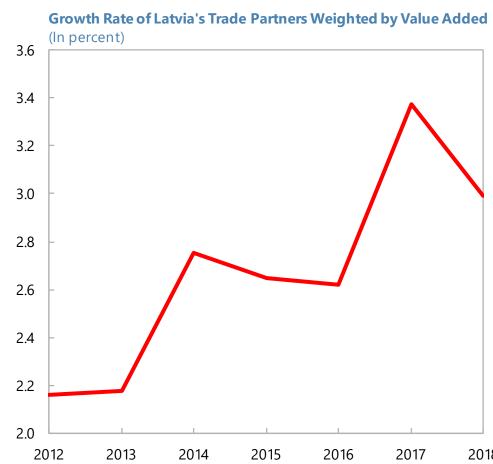
…driven by an acceleration in construction…



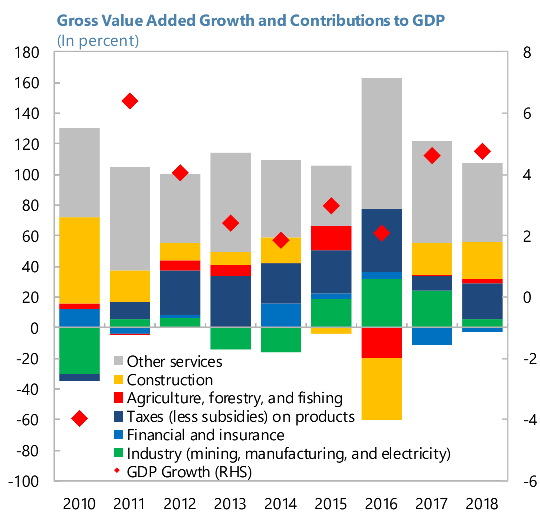
… robust sentiment environment…



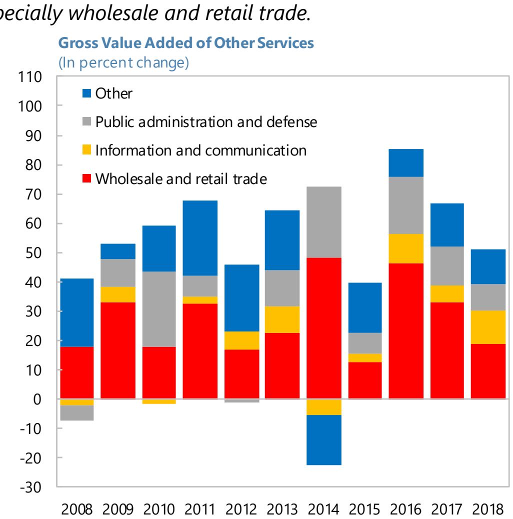
…and supportive external demand.



Services had the largest contribution to growth…



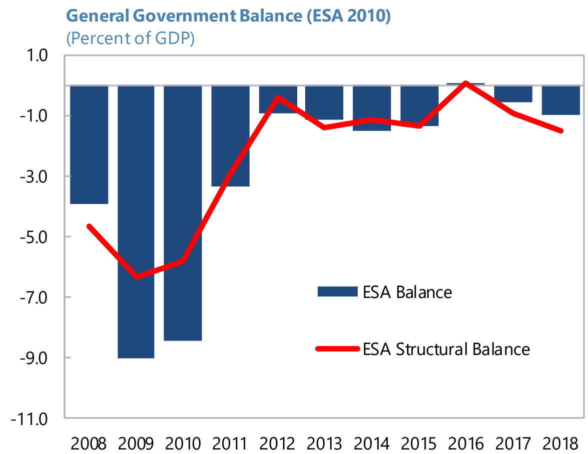
…especially wholesale and retail trade.



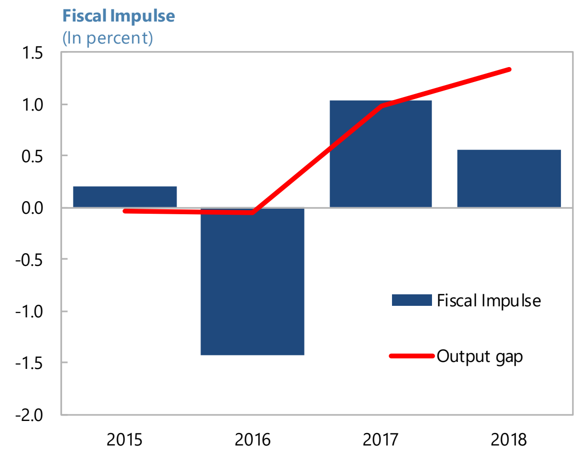
Sources: Eurostat; Haver Analytics; Central Statistical Bureau of Latvia; and IMF staff calculations.

Figure 2. Latvia: Fiscal Developments

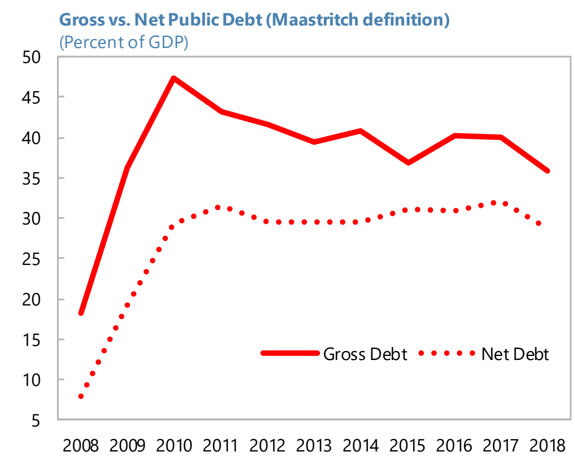
Fiscal balances have remained at prudent levels…



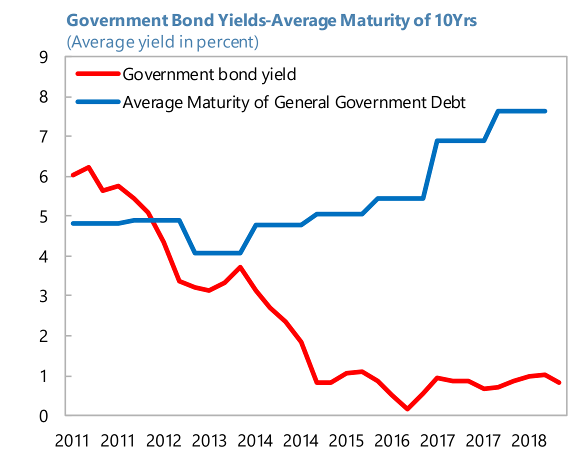
…but fiscal policy has been procyclical and expansionary.



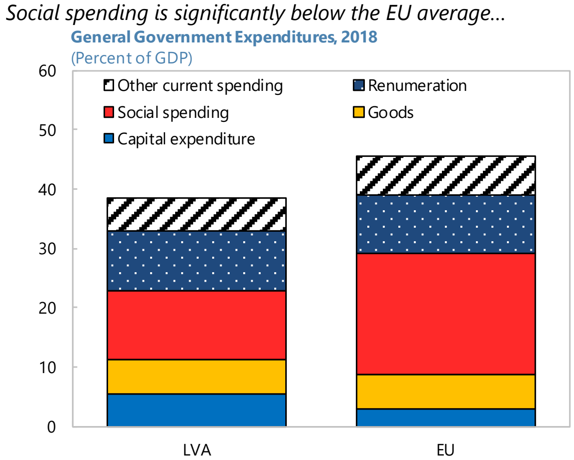
Public debt is relatively low…



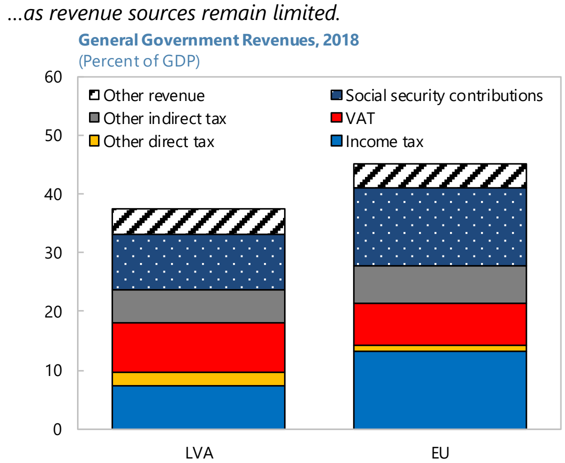
…as maturities have lengthened amid strong market access at favorable terms.



Social spending is significantly below the EU average…



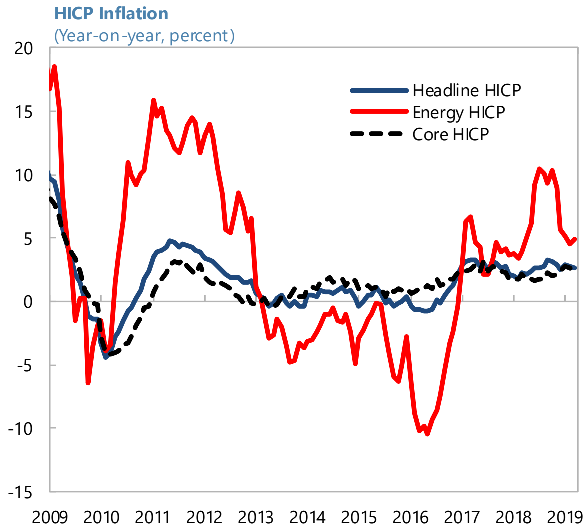
…as revenue sources remain limited.



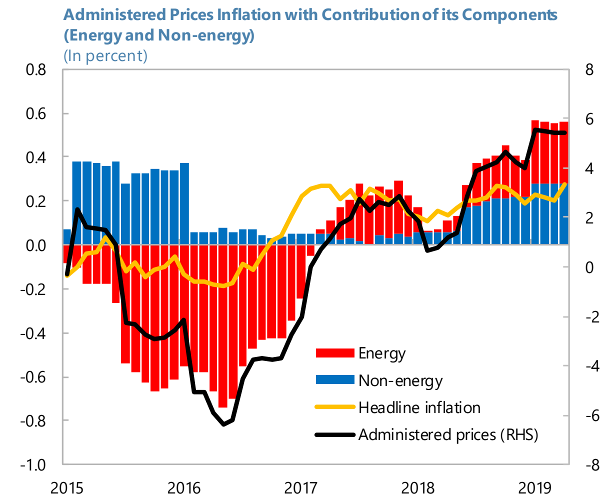
Sources: Eurostat; Haver Analytics; Central Statistical Bureau of Latvia; and IMF staff calculations.

Figure 3. Latvia: Inflation

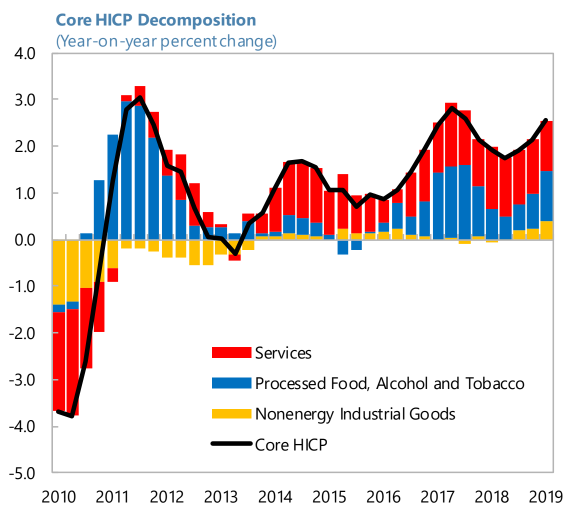
Headline inflation eased from its 2017 peak, but remained above 2 percent amid high energy prices...



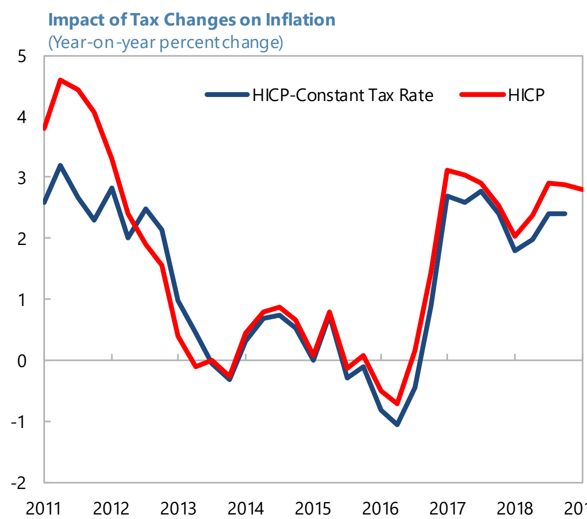
...and an adjustment to electricity and administered prices in early 2019.



Core inflation accelerated at the end-2018...



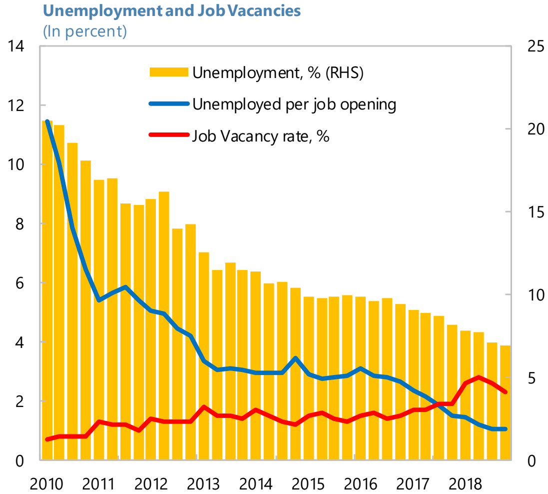
...following further hikes in excise taxes.



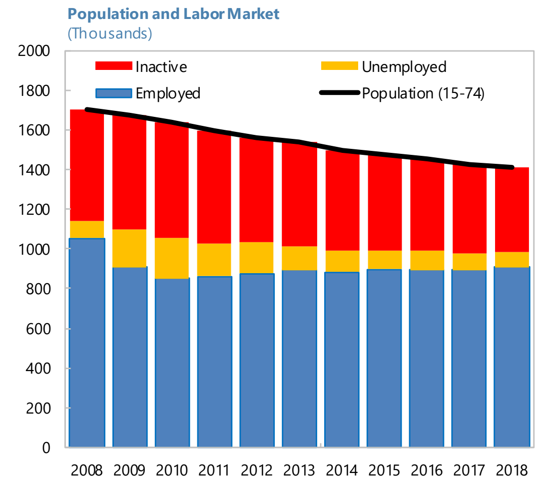
Sources: Eurostat; Haver Analytics; Central Statistical Bureau of Latvia; and IMF staff calculations.

Figure 4. Latvia: Labor Market

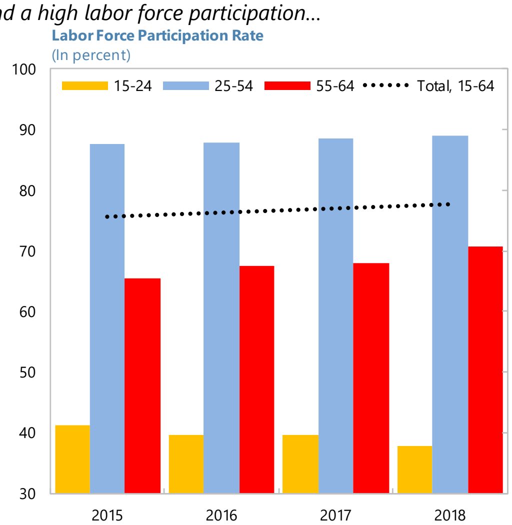
A tightening labor market…



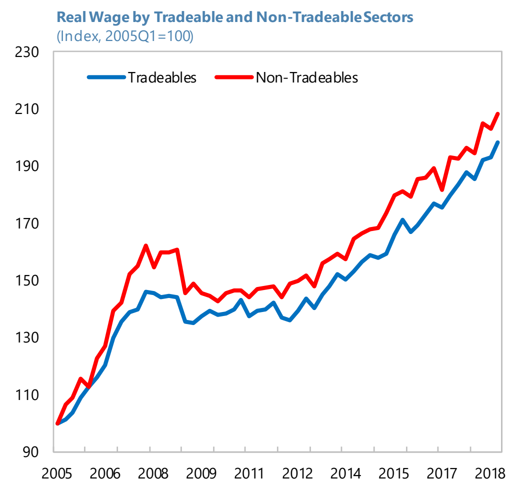
…with a declining working age population…



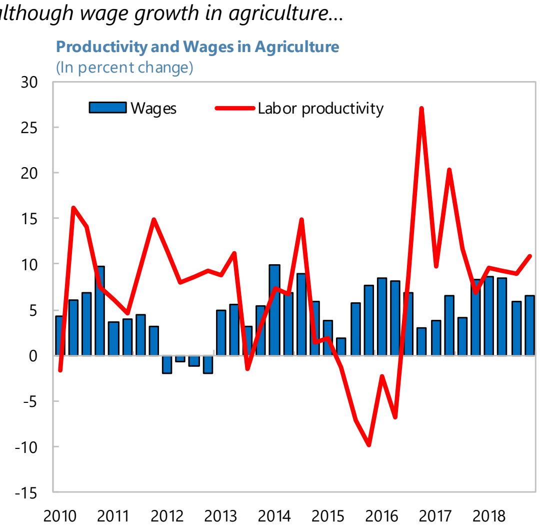
…and a high labor force participation…



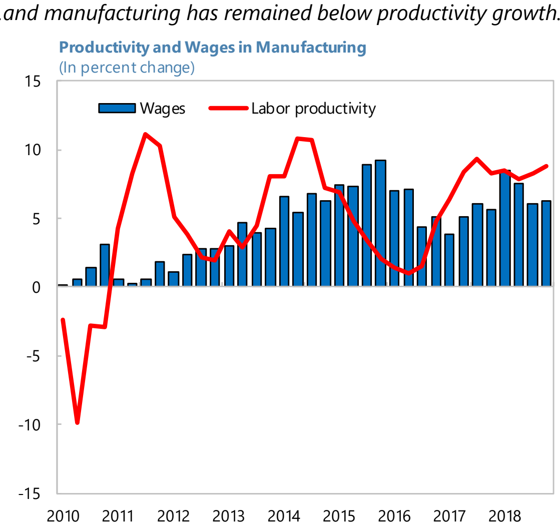
…have resulted in rapidly rising wages,…



…although wage growth in agriculture…



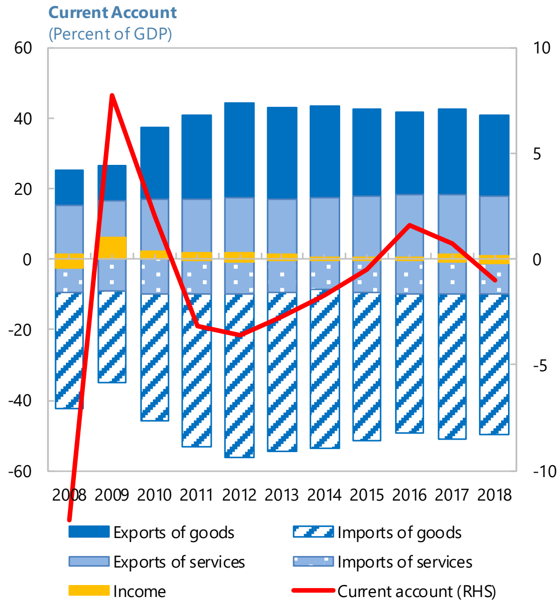
…and manufacturing has remained below productivity growth.



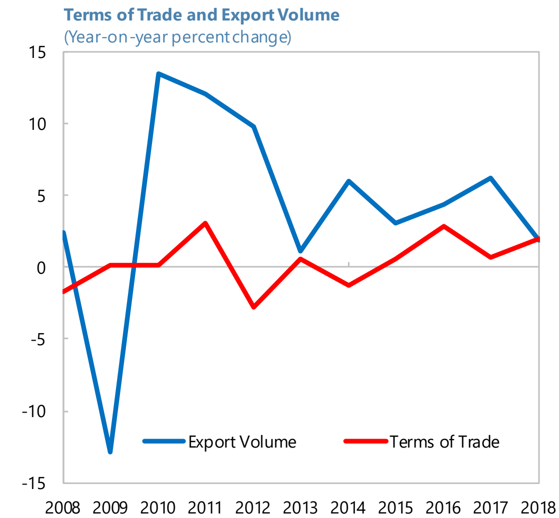
Sources: Eurostat; Haver Analytics; Central Statistical Bureau of Latvia; and IMF staff calculations.

Figure 5. Latvia: Balance of Payments

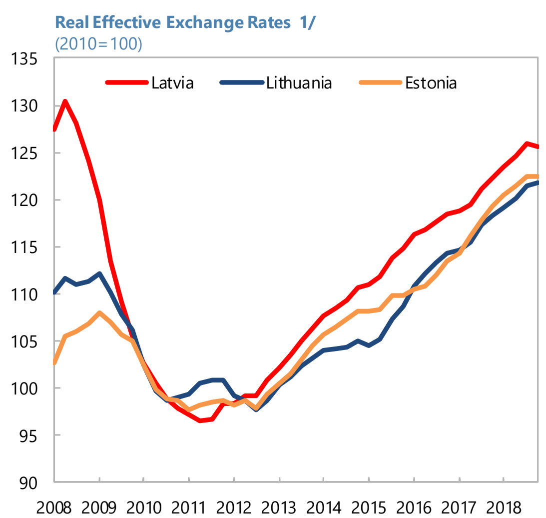
The current account swung into a small deficit in 2018…



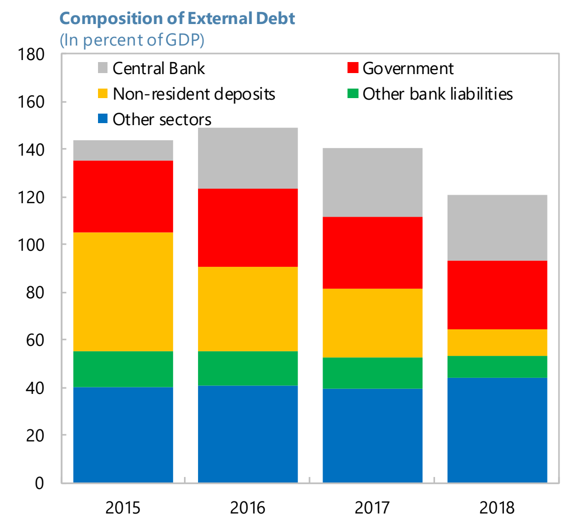
…despite some small improvements in the terms of trade, as export growth slowed.



Latvia's REER has appreciated relative to peers in recent years.



External debt has declined with the shrinking of non-resident deposits.

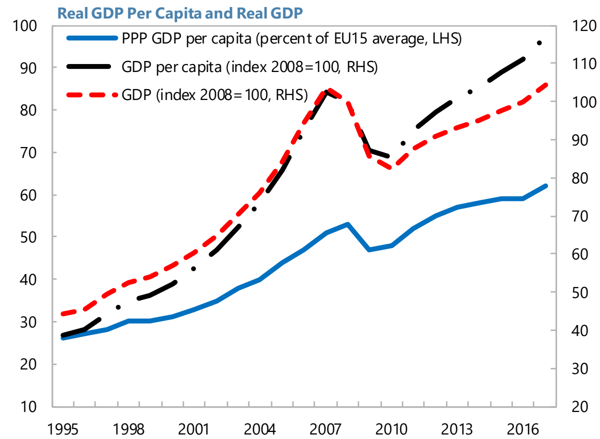


Sources: Bank of Latvia; Central Statistical Bureau of Latvia; European Commission; and IMF staff calculations.

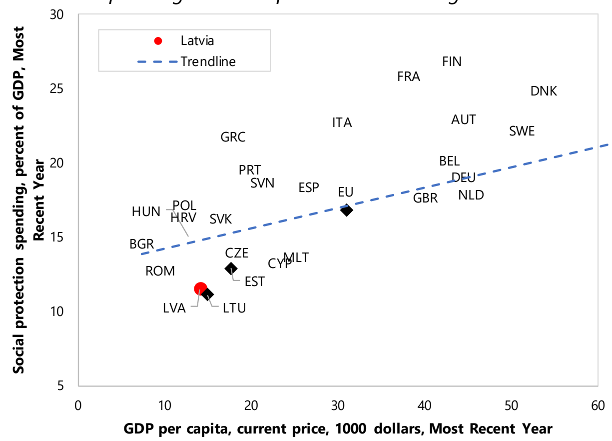
1/ Real effective exchange rates are based on IC-37 countries for ULC.

Figure 6. Latvia: Inequality and Poverty

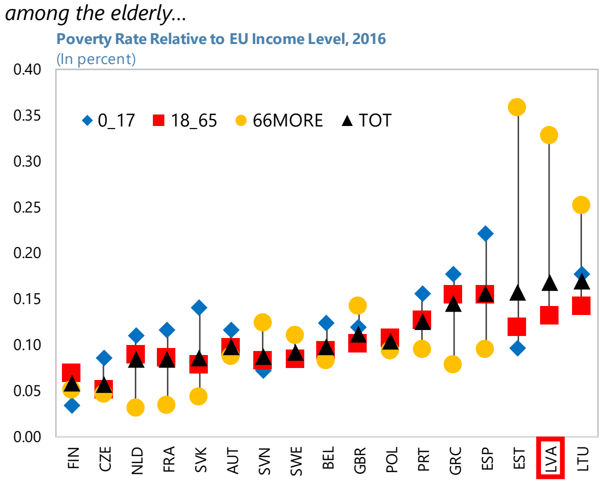
Latvia's GDP per capita remains well below the Euro Area...



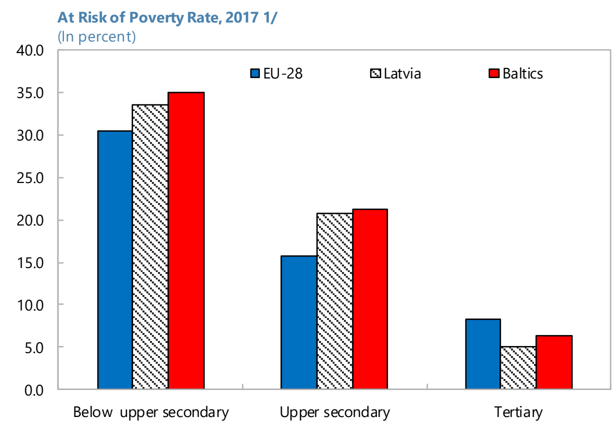
...and spending on social protection is among the lowest.



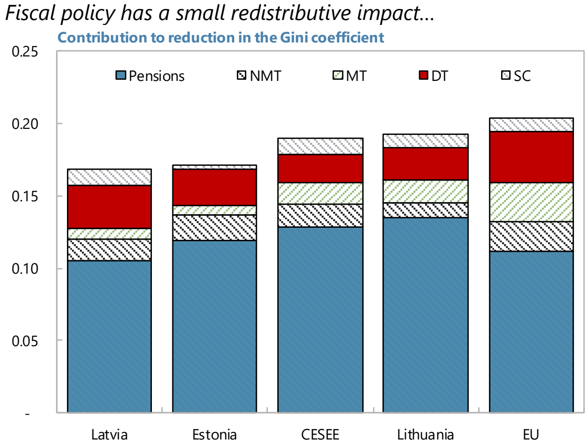
Poverty rates are some of the highest in the EU, especially among the elderly...



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

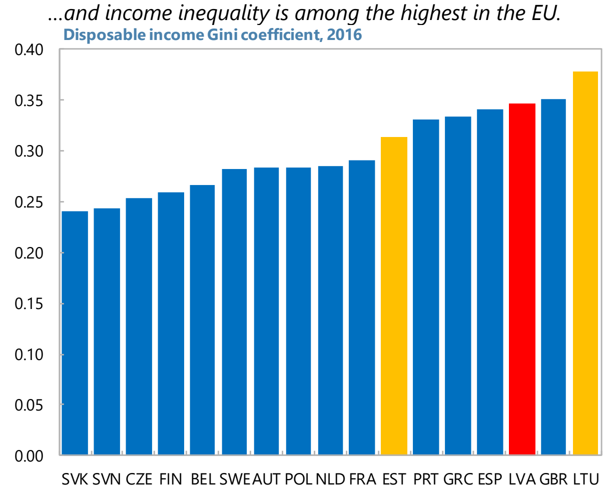


Fiscal policy has a small redistributive impact...



Note: SC= Social Contributions; DT= Direct Taxes; MT= Means -tested social spending; NMT= Non-means-tested social spending.

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

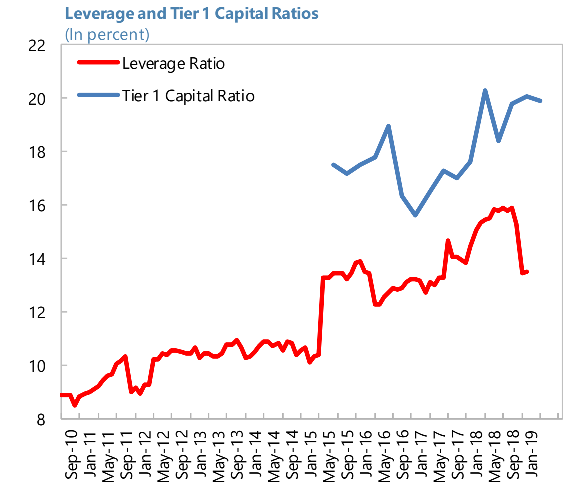


Sources: Eurostat; Euromod; IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook; ASPIRE; Haver Analytics; OECD (2019), Poverty rate (indicator). doi: 10.1787/0fe1315d-en (Accessed on 07 May 2019); and IMF staff calculations.

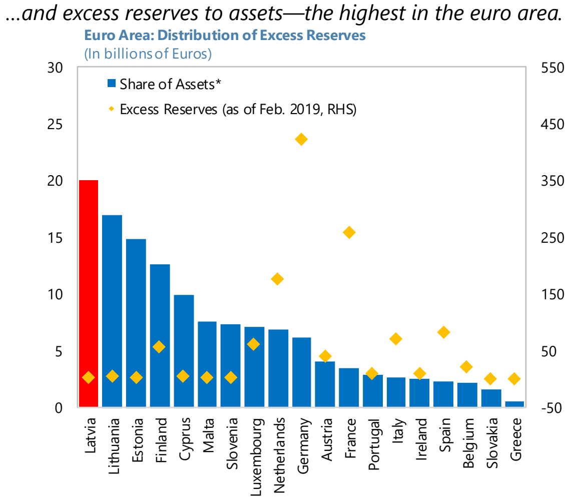
1/Active population aged 25–64.

Figure 7. Latvia: Banking Sector Developments

Banks hold high capital buffers…

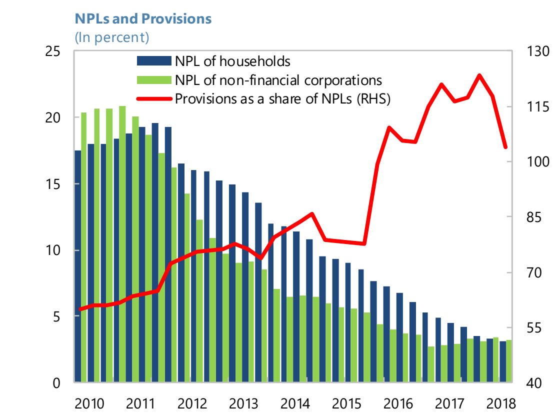


…and excess reserves to assets—the highest in the euro area.

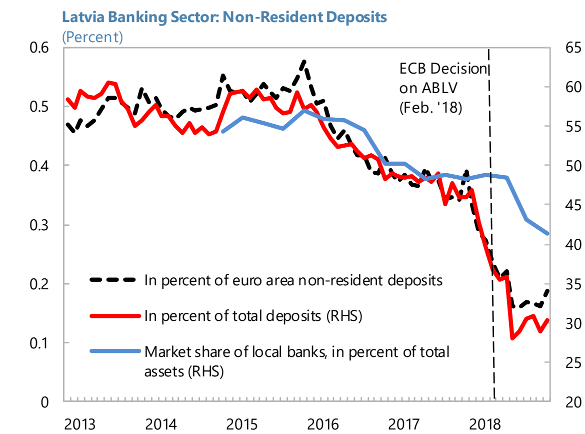


Note: */ consolidated assets as of Dec. 2018.

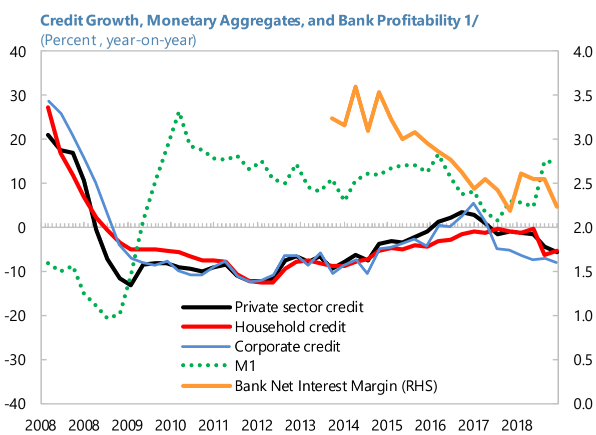
The asset quality in bank lending books continues to improve.



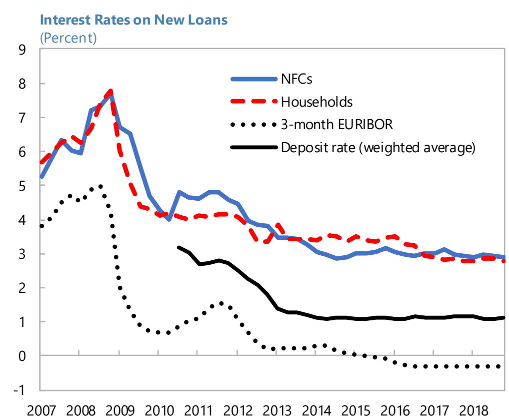
The retrenchment of non-resident deposits increased consolidation pressures on BSFCs.



Banks' willingness to lend is constrained by declining interest rate margins …



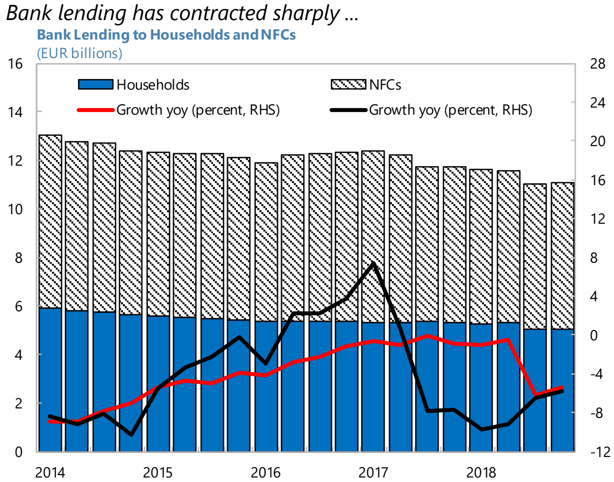
… as lending rates have declined more than deposits rates.



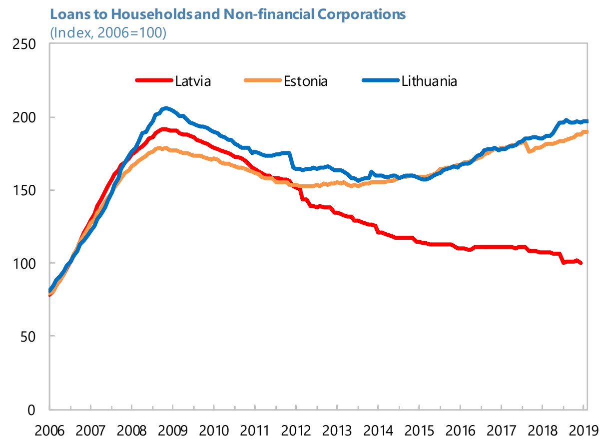
Sources: Bank of Latvia; FCMC; Haver Analytics; and IMF staff calculations.
1/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

Figure 8. Latvia: Credit Growth Developments

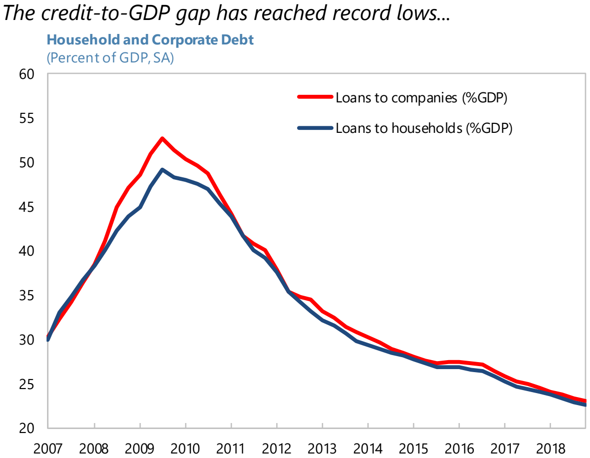
Bank lending has contracted sharply …



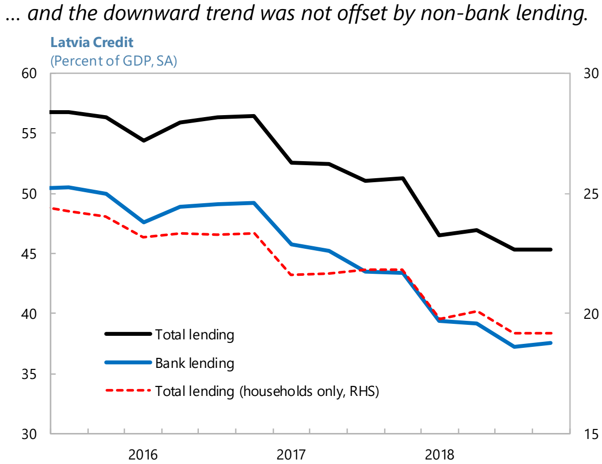
… which defies the trend in other Baltic countries.



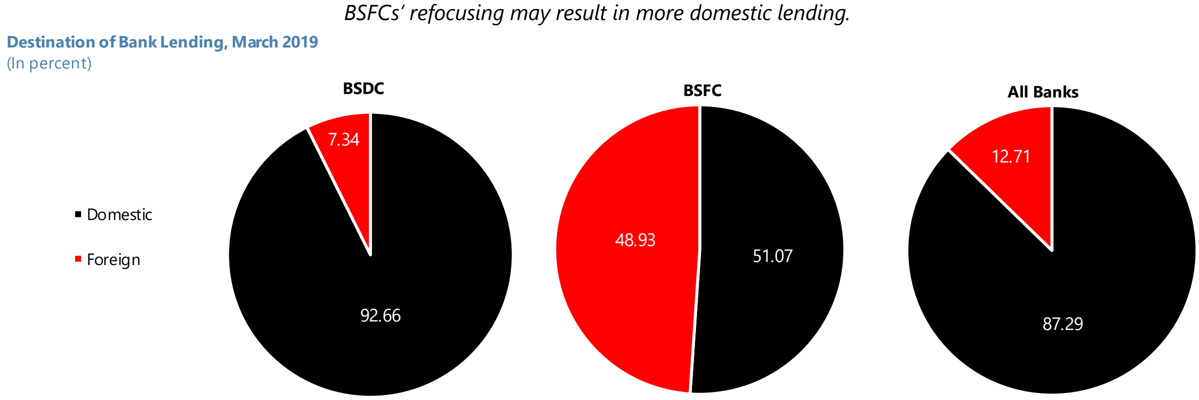
The credit-to-GDP gap has reached record lows…



… and the downward trend was not offset by non-bank lending.



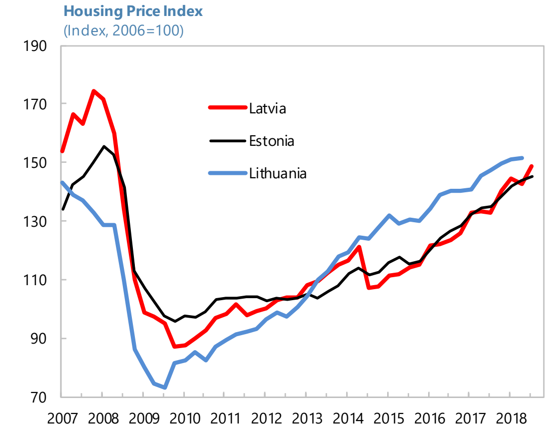
BSFCs' refocusing may result in more domestic lending.



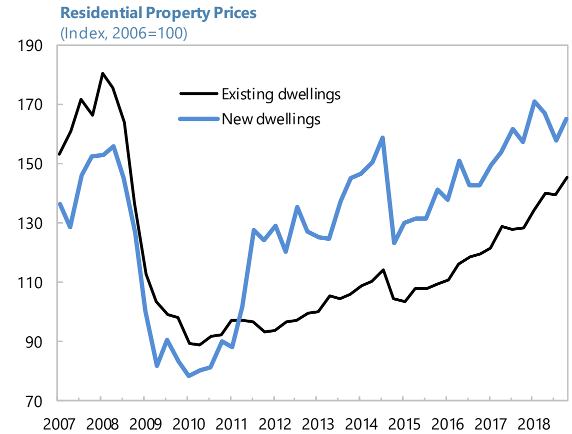
Sources: European Central Bank; Bank of Latvia; and IMF staff calculations.

Figure 9. Latvia: Macro-Financial Conditions

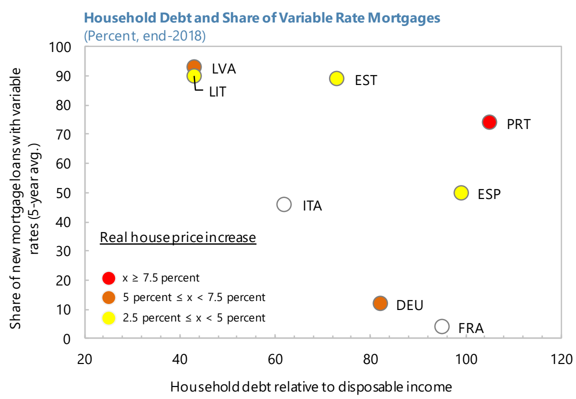
House prices—still below their pre-crisis peak—have increased…



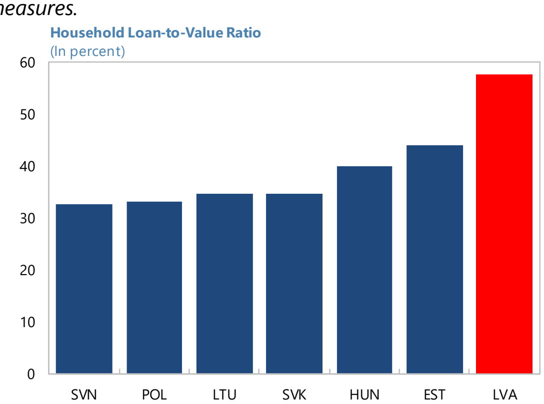
…driven by the supply of new housing.



While household debt levels are still low, the share of variable-rate mortgages is unusually high …



… and would require preemptive adjustment of macroprudential measures.



Macroprudential Indicators for Latvia and Selected Euro Area countries
(In percent, as of end-2018)

	Credit Development				Private Sector Debt	Overvaluation of Property Prices		Risk Mispricing
	Bank credit-to-GDP ratio 1/	Real total credit 1/	Bank credit-to-GDP gap 3/	Total credit-to-GDP gap 3/	Debt service ratio 1/	Real house prices (RRE), change 2/	RRE price-to-income ratio, change 2/	NFPS lending spreads 1/
Latvia	**-5.5**	**-0.1**	**-18.9**	**-22.8**	**-0.6**	**7.1**	**2.3**	**-0.3**
Lithuania	-1.0	7.6	-4.3	0.1	0.1	4.3	1.3	0.2
Estonia	-3.4	1.3	3.3	-11.1	-0.3	3.6	-1.0	-0.3
Portugal	-7.1	-2.1	-40.1	-51.6	-1.3	8.0	5.3	-0.1
Italy	-2.1	0.0	-12.2	-17.4	-0.4	-1.6	-2.3	0.2
Spain	-6.2	-2.4	-40.3	-51.8	-0.9	4.7	4.0	-0.2
Germany	0.1	2.8	-1.9	-1.2	0.1	5.6	2.7	-0.1
France	2.8	2.1	2.3	3.9	0.3	1.1	0.7	0.0
Netherlands	-5.3	-0.3	-25.3	-22.9	-0.8	6.8	5.7	0.8

Note: RRE=residential real estate price index; NFPS=non-financial private sector. The color coding corresponds to the "final risk rating" established by the ECB in its macroprudential surveillance framework, where red/orange/yellow reflect "pronounced"/"medium/"low" vulnerabilities, respectively. 1/ two-year average change; 2/ three-year average change; 3/ in percentage points.

Sources: Bank of Latvia; European Central Bank; European Systemic Risk Board; Haver Analytics; and IMF staff calculations.

Table 1. Latvia: Selected Economic Indicators, 2015–20

	2015	2016	2017	2018	2019	2020
					Proj.	
National accounts	(Percentage change, unless otherwise indicated)					
Real GDP	3.0	2.1	4.6	4.8	3.2	3.1
Private consumption	2.5	1.4	4.1	4.5	3.5	3.2
Public consumption	1.9	3.9	4.1	4.0	3.0	3.0
Gross capital formation	2.4	2.5	14.0	15.1	6.0	5.0
Gross fixed capital formation	-0.5	-8.4	13.1	16.4	6.0	5.0
Exports of goods and services	3.1	4.4	6.2	1.8	2.2	2.3
Imports of goods and services	2.1	4.4	8.9	5.1	3.2	3.2
Nominal GDP (billions of euros)	24.3	25.0	27.0	29.5	31.4	33.1
GDP per capita (thousands of euros)	12.2	12.7	13.9	15.3	16.3	17.2
Savings and Investment						
Gross national saving (percent of GDP)	21.8	22.3	22.9	23.2	23.0	23.0
Gross capital formation (percent of GDP)	22.2	20.7	22.2	24.2	24.4	24.7
Private (percent of GDP)	18.4	18.1	18.7	20.1	20.6	21.4
HICP Inflation						
Period average	0.2	0.1	2.9	2.6	2.7	2.4
End-period	0.4	2.1	2.2	2.5	2.6	2.4
Labor market						
Unemployment rate (LFS; period average, percent)	9.9	9.6	8.7	7.4	6.7	6.9
Real gross wages	6.6	4.9	4.8	5.7	4.5	4.5
	(Percent of GDP, unless otherwise indicated)					
Consolidated general government 1/						
Total revenue	36.2	36.2	35.6	36.9	35.7	35.7
Total expenditure	37.8	36.6	36.4	37.6	36.4	36.1
Basic fiscal balance	-1.5	-0.4	-0.8	-0.7	-0.7	-0.4
ESA balance	-1.4	0.1	-0.6	-1.0	-0.5	-0.4
General government gross debt	36.8	40.3	40.0	35.9	36.1	34.4
Money and credit						
Credit to private sector (annual percentage change)	-2.3	3.5	-1.0	-5.6	…	…
Broad money (annual percentage change)	7.5	6.6	2.9	5.8	…	…
Balance of payments						
Current account balance	-0.5	1.6	0.7	-1.0	-1.5	-1.6
Trade balance	-9.0	-7.5	-8.5	-8.7	-8.6	-8.7
Gross external debt	143.7	148.9	140.5	121.0	117.4	114.4
Net external debt 2/	30.7	29.2	25.5	21.2	23.7	22.7
Exchange rates						
U.S. dollar per euro (period average)	1.11	1.11	1.13	1.18	…	…
REER (period average; CPI based, 2005=100)	120.8	122.0	123.0	126.5	…	…
Terms of trade (annual percentage change)	0.6	2.8	0.7	2.0	0.4	0.2

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

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

2/ Gross external debt minus gross external assets.

Table 2. Latvia: Macroeconomic Framework, 2015–24

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Est			Proj			
	(Percentage change, unless otherwise indicated)									
National accounts										
Real GDP	3.0	2.1	4.6	4.8	3.2	3.1	3.1	3.0	3.0	3.0
Consumption	2.4	1.9	4.1	4.4	3.4	3.2	3.1	3.1	3.1	3.1
Private consumption	2.5	1.4	4.1	4.5	3.5	3.2	3.2	3.1	3.1	3.1
Public consumption	1.9	3.9	4.1	4.0	3.0	3.0	3.0	3.0	3.0	3.0
Gross capital formation	2.4	2.5	14.0	15.1	6.0	5.0	5.0	5.0	5.0	5.0
Gross fixed capital formation	-0.5	-8.4	13.1	16.4	6.0	5.0	5.0	5.0	5.0	5.0
Exports of goods and services	3.1	4.4	6.2	1.8	2.2	2.3	2.3	2.2	2.2	2.2
Imports of goods and services	2.1	4.4	8.9	5.1	3.2	3.2	3.1	3.1	3.1	3.1
Contributions to growth										
Domestic demand	2.4	2.1	6.3	7.0	4.2	3.8	3.8	3.8	3.8	3.8
Net exports	0.6	0.0	-1.7	-2.2	-0.7	-0.7	-0.7	-0.7	-0.8	-0.8
HICP inflation										
Period average	0.2	0.1	2.9	2.6	2.7	2.4	2.3	2.2	2.1	2.1
End-period	0.4	2.1	2.2	2.5	2.6	2.4	2.3	2.2	2.1	2.1
Labor market										
Unemployment rate (LFS, percent)	9.9	9.6	8.7	7.4	6.7	6.9	7.0	7.2	7.3	7.3
Employment (period average, percent)	1.3	-0.3	0.2	1.6	1.0	0.5	0.2	0.0	0.0	0.0
Real gross wages	6.6	4.9	4.8	5.7	4.5	4.5	3.9	3.3	3.0	3.0
	(Percent of GDP)									
Consolidated general government 1/										
Total revenue	36.2	36.2	35.6	36.9	35.7	35.7	34.2	33.4	33.6	33.7
Total expenditure	37.8	36.6	36.4	37.6	36.4	36.1	35.5	34.8	34.0	34.0
ESA balance	-1.4	0.1	-0.6	-1.0	-0.5	-0.4	-0.4	-0.2	-0.4	-0.3
ESA structural balance	-1.4	0.1	-0.9	-1.5	-1.1	-0.6	-0.5	-0.3	-0.4	-0.3
General government gross debt	36.8	40.3	40.0	35.9	36.1	34.4	34.6	33.8	32.3	31.3
Saving and investment										
Gross national saving	21.8	22.3	22.9	23.2	23.0	23.0	22.9	22.9	22.9	22.8
Private	18.3	18.6	19.0	19.3	18.8	19.2	19.1	19.1	19.3	19.1
Public 2/	3.4	3.8	4.0	3.9	4.2	3.8	3.8	3.7	3.6	3.7
Foreign saving 3/	0.5	-1.6	-0.7	1.0	1.5	1.6	2.1	2.5	2.8	3.3
Gross capital formation	22.2	20.7	22.2	24.2	24.4	24.7	25.0	25.3	25.7	26.1
Private	18.4	18.1	18.7	20.1	20.6	21.4	21.8	22.3	22.7	23.1
Public	3.8	2.6	3.5	4.0	3.8	3.3	3.2	3.0	3.0	3.0
External sector										
Current account balance	-0.5	1.6	0.7	-1.0	-1.5	-1.6	-2.1	-2.5	-2.8	-3.3
Net IIP	-63.5	-58.4	-56.3	-49.1	-48.4	-46.2	-44.8	-44.0	-43.7	-43.9
Gross external debt	143.7	148.9	140.5	121.0	117.4	114.4	112.1	109.7	107.9	106.2
Net external debt 4/	30.7	29.2	25.5	21.2	23.7	22.7	22.2	22.5	23.3	24.4
Memorandum items:										
Nominal GDP (billions of euros)	24.3	25.0	27.0	29.5	31.4	33.1	34.9	36.7	38.6	40.5
Output gap (percent)	0.0	0.0	1.0	1.3	1.0	0.6	0.4	0.2	0.0	0.0
Potential output growth (percent)	3.1	2.1	3.6	4.4	3.6	3.5	3.4	3.2	3.2	3.0
Terms of trade (annual percentage change)	0.6	2.8	0.7	2.0	0.4	0.2	0.1	0.0	-0.1	-0.1

Sources: Latvian authorities; and IMF staff calculations.

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 assets.

Table 3. Latvia: General Government Operations, 2015–24[1]

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Projections					
	(percent of GDP)									
Revenue	36.2	36.2	35.6	36.9	35.7	35.7	34.2	33.4	33.6	33.7
Taxes	20.4	21.1	21.1	20.3	19.9	20.1	20.1	20.0	20.0	20.1
Personal Income Tax	5.9	6.1	6.3	5.9	5.6	5.2	5.1	5.1	5.1	5.1
Corporate Income Tax	1.6	1.7	1.6	1.0	0.6	1.1	1.1	1.1	1.1	1.1
Property Tax	0.8	0.9	0.8	0.8	0.7	0.7	0.7	0.6	0.7	0.6
Value-added tax	7.8	8.1	8.1	8.3	8.5	8.6	8.7	8.8	8.8	8.8
Excise tax	3.3	3.4	3.4	3.5	3.6	3.7	3.6	3.6	3.6	3.6
Other taxes	1.0	1.0	0.9	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Social Contributions	8.4	8.4	8.3	8.6	8.7	8.8	8.8	8.8	8.8	8.8
Grants	4.1	3.0	2.7	3.8	3.7	3.6	2.7	2.2	2.3	2.3
o/w EU Funds	4.1	3.0	2.7	3.8	...	...	...	...	...	...
Other revenue	3.3	3.6	3.3	3.7	3.1	2.9	2.3	2.2	2.2	2.2
Expenditure 2/	37.8	36.6	36.4	37.6	36.4	36.1	35.5	34.8	34.0	34.0
Expense	34.0	34.0	32.9	33.6	32.6	32.8	32.3	31.8	31.0	31.0
Compensation of Employees	8.2	8.4	8.5	8.3	8.5	8.3	8.1	7.8	7.6	7.6
Use of goods and services	4.8	4.8	4.9	5.2	4.8	4.7	4.5	4.4	4.3	4.3
Interest	1.8	1.2	1.1	0.9	0.8	0.9	0.9	0.8	0.8	0.8
Subsidies	7.4	7.6	7.0	7.7	7.0	7.2	7.0	7.0	6.7	6.7
Grants	1.2	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Payments to EU budget	1.0	1.0	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9
International organizations	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social Support	10.6	10.8	10.5	10.4	10.5	10.7	10.7	10.7	10.6	10.6
Pensions	7.5	7.4	7.2	7.1	7.1	7.3	7.4	7.3	7.3	7.2
Other	3.1	3.3	3.3	3.3	3.3	3.3	3.4	3.4	3.4	3.4
Other expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net acquisition of nonfinancial assets	3.8	2.6	3.5	4.0	3.8	3.3	3.2	3.0	3.0	3.0
Gross Operating Balance	2.2	2.2	2.7	3.3	3.1	2.9	1.9	1.6	2.6	2.7
Net lending/borrowing	-1.5	-0.4	-0.8	-0.7	-0.7	-0.4	-1.3	-1.4	-0.4	-0.3
Net financial transactions	-1.5	-0.4	-0.8	-0.7	-0.7	-0.4	-1.3	-1.4	-0.4	-0.3
Net acquisition of financial assets	5.1	-4.4	0.6	-0.7	...	...	...	...	...	...
Net incurrence of liabilities	-3.6	4.8	0.2	1.4	0.7	0.4	1.3	1.4	0.4	0.3
Domestic financing	6.5	-2.9	1.4	0.8	-2.2	-1.5	-0.3	0.2	-0.9	-1.4
External financing	-4.9	3.3	-0.6	0.0	2.9	1.8	1.6	1.1	1.3	1.7
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items										
ESA balance	-1.4	0.1	-0.6	-1.0	-0.5	-0.4	-0.4	-0.2	-0.4	-0.3
ESA structural balance 3/	-1.4	0.1	-0.9	-1.5	-1.1	-0.6	-0.5	-0.3	-0.4	-0.3
General government debt	36.8	40.3	40.0	35.9	36.1	34.4	34.6	33.8	32.3	31.3
Nominal GDP (billions of euros)	24.3	25.0	27.0	29.5	31.4	33.1	34.9	36.7	38.6	40.5

Sources: Latvia authorities and IMF staff estimates.

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

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

3/ Exclude one-off and unsustainable measures.

Table 4. Latvia: Medium-Term Balance of Payments, 2015–24

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Projections					
				(Percent of GDP, unless otherwise indicated)						
Current account	-0.5	1.6	0.7	-1.0	-1.5	-1.6	-2.1	-2.5	-2.8	-3.3
Goods and services (fob)	-0.5	1.2	0.1	-0.6	-0.9	-1.3	-1.7	-2.1	-2.6	-3.1
Goods (fob)	-9.0	-7.5	-8.5	-8.7	-8.6	-8.7	-8.9	-9.1	-9.3	-9.6
Exports	42.5	41.6	42.7	41.0	39.3	38.2	37.3	36.5	35.8	35.1
Imports	-51.6	-49.1	-51.2	-49.7	-47.9	-46.9	-46.2	-45.6	-45.1	-44.7
Services	8.5	8.7	8.6	8.1	7.7	7.4	7.2	7.0	6.7	6.5
Credit	17.9	18.4	18.4	17.9	17.2	16.7	16.3	16.0	15.7	15.4
Debit	-9.4	-9.7	-9.8	-9.8	-9.5	-9.3	-9.1	-9.0	-8.9	-8.8
Primary Income	-0.6	-0.3	-0.7	-1.3	-1.4	-1.1	-1.1	-1.0	-0.8	-0.7
Compensation of employees	2.5	2.2	1.9	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Investment income	-3.9	-3.7	-3.6	-4.2	-4.1	-4.1	-4.0	-3.9	-3.8	-3.8
Secondary Income	0.6	0.7	1.3	1.0	0.8	0.8	0.6	0.6	0.6	0.5
Capital and financial account	0.7	-1.7	-0.5	-0.2	1.5	1.7	2.1	2.5	2.9	3.3
Capital account	2.8	1.0	0.8	1.8	1.4	1.4	1.3	1.2	1.2	1.1
Financial account	-2.1	-2.7	-1.3	-2.0	0.1	0.3	0.8	1.3	1.7	2.2
Direct investment	2.4	0.1	1.9	2.1	1.4	1.3	1.2	1.2	1.2	1.1
Portfolio investment and financial derivatives	-11.6	-5.1	-6.4	3.9	2.8	0.9	0.7	0.2	0.2	0.7
of which: general government net issuance	-0.6	3.9	0.1	2.2	4.8	1.9	1.6	1.4	1.3	1.7
Other investment	8.5	2.8	6.5	-8.4	-4.1	-1.9	-1.1	-0.2	0.3	0.4
Reserve assets	-1.3	-0.5	-3.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.3	0.1	-0.2	1.1	0.0	0.0	0.0	0.0	0.0	0.0
				(Percent change, unless otherwise indicated)						
Goods and Services										
Export value (fob)	2.4	2.2	10.0	5.2	1.8	2.7	3.0	3.0	2.9	3.2
Import value (fob)	0.9	-0.6	12.0	6.5	2.3	3.4	3.8	3.9	3.9	4.2
Export volume	3.1	4.4	6.2	1.8	2.2	2.3	2.3	2.2	2.2	2.2
Import volume	2.1	4.4	8.9	5.1	3.2	3.2	3.1	3.1	3.1	3.1
Gross reserves (billions of euros)	3.2	3.3	3.9	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Gross external debt (billions of euros)	34.9	37.3	38.0	35.7	36.8	37.9	39.1	40.3	41.6	43.1
Medium- and long-term (billions of euros)	17.3	18.4	18.1	19.9	21.0	21.9	22.7	23.5	24.4	25.3
Short term (billions of euros) 1/	17.7	18.9	19.9	15.8	15.8	16.0	16.3	16.8	17.2	17.8
Net external debt (billions of euros) 2/	7.5	7.3	6.9	6.3	7.4	7.5	7.8	8.3	9.0	9.9
Gross external debt (percent of GDP)	143.7	148.9	140.5	121.0	117.4	114.4	112.1	109.7	107.9	106.2
Medium and long term (percent of GDP)	71.0	73.4	67.0	67.4	66.9	66.1	65.2	64.0	63.2	62.4
Short term (percent of GDP) 1/	72.7	75.5	73.5	53.6	50.4	48.4	46.9	45.7	44.7	43.8
Net external debt (percent of GDP) 2/	30.7	29.2	25.5	21.2	23.7	22.7	22.2	22.5	23.3	24.4
Memo items										
Nominal GDP (billions of euros)	24.3	25.0	27.0	29.5	31.4	33.1	34.9	36.7	38.6	40.5
U.S. dollar per euro (period average)	1.11	1.11	1.13	1.18	…	…	…	…	…	…

Sources: Latvian authorities; and IMF staff calculations.

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 assets.

Table 5. Latvia: Financial Soundness Indicators, 2014–18

	2014	2015	2016	2017	2018
Commercial banks					
Capital Adequacy					
Regulatory capital to risk-weighted assets	21.0	21.8	20.4	20.8	21.7
Regulatory Tier 1 capital to risk-weighted assets	18.3	19.3	17.3	18.5	19.7
Capital and reserves to assets	9.9	10.1	10.1	11.1	12.9
Asset Quality					
Annual growth of bank loans	-6.1	0.1	3.1	-4.6	-5.6
Annual growth of bank loans to residents	-7.6	-1.5	3.1	-2.8	-5.4
Annual growth of bank loans to companies	-9.6	-1.6	1.6	-7.6	-5.8
Sectoral distribution of loans (in % of total loans, stock)	100.0	100.0	100.0	100.0	100.0
Agriculture, hunting and related service activities	2.8	2.8	2.8	3.8	3.9
Construction and real estate activities	17.9	17.3	17.9	15.5	18.4
Industry and trade	22.7	23.3	22.7	24.4	23.7
Financial intermediation	4.7	5.1	4.7	6.6	0.6
Households	37.8	36.2	37.8	35.9	40.8
Non-residents	14.0	15.4	14.0	13.9	12.7
Loans past due over 90 days 1/	6.9	4.6	6.3	5.5	5.3
Loans to households	9.5	7.6	5.3	3.5	3.1
Loans to corporations	5.9	4.4	2.7	3.1	3.2
Earnings and Profitability					
ROA (after tax)	1.1	1.2	1.6	1.0	1.3
ROE (after tax)	11.1	12.3	16.6	9.4	10.1
Liquidity					
Liquid assets to total assets	39.9	35.7	30.4	34.0	30.0
Liquid assets to short term liabilities	63.1	46.5	37.5	42.1	37.2
Customers deposits to (non-interbank) loans	151.3	157.0	144.8	140.7	120.3
Sensitivity to Market Risk					
FX deposits to total deposits	40.3	43.1	34.2	29.1	13.7
FX loans to total loans	13.0	13.8	12.5	8.4	…
Memorandum Items					
Share of non-resident deposits to total deposits	51.7	53.4	42.8	39.7	20.0

Sources: Bank of Latvia; Haver Analytics; and IMF staff calculations.
1/ As of end-June 2018.

Annex I. External Sector Assessment

1. Net international investment position (NIIP). Both foreign assets and liabilities declined in 2018. Short-term liabilities of monetary and financial institutions decreased by 5.2 billion euros (55 percent), reflecting the withdrawal of foreign deposits. The NIIP improved to -49 percent of GDP, from -56 percent of GDP in 2017, and is expected to improve further to -43 percent of GDP over the medium term. Gross external debt stood at 121 percent of GDP at end-2018.

2. Current account. The current account deficit increased to 1 percent of GDP in 2018, as export growth slowed amid a moderation in external demand and poorer agricultural output, and declining exports of financial services. The current account deficit is projected to widen in 2019 and over the medium term, as investment continues to be strong. The EBA-lite CA model results suggest a CA gap of 1.6 percent of GDP in 2018, and the gap attributed to policies amounts to 4.3 percent of GDP. This mainly reflects Latvia's lower public health expenditure and credit growth, partially offset by higher fiscal deficit compared with desirable levels. Overall, the current account position is assessed to be moderately stronger than implied by fundamentals and desirable policies.

3. Real exchange rate. The REER appreciated by 3.3 percent in 2018. The EBA-lite CA model suggests an undervaluation of 3.8 percent. The EBA-lite REER Index model finds an undervaluation of 7 percent, consistent with a moderately stronger external position than implied by fundamentals and desirable policies. However, the REER model, is not well suited for Latvia, as it produces a very large residual and poor fit, indicating the omission of important variables or structural changes in the case of Latvia.

4. Capital and financial accounts. The capital account is dominated by EU structural fund inflows, which improved markedly in 2018. FDI inflows declined substantially from the high levels in 2017. Large outflows in other investment reflected the withdrawal of foreign deposits, financed partially by a decline in banks' holding of foreign debt securities.

Table. ESA Summary

EBA-lite CA model	
CA-Actual	-1.0%
Cyclically adjusted CA	-1.0%
Multilaterally Consistent	
Cyclically adjusted CA Norm	-2.7%
CA-Gap	1.6%
of/which Policy gap	4.3%
Elasticity	-0.43
Implied REER gap	-3.8%
CA-Fitted	1.2%
Residual	-2.2%
EBA-lite REER model	
Ln(REER) Actual	4.64
Ln(REER) Fitted	4.71
Ln(REER) Norm	4.71
Residual	-0.07
REER Gap	-7.0%
of/which Policy gap	0.4%

Source: IMF staff calculations.

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 by standard metrics (12.5 percent of GDP for Latvia as of end-2018), but the currency is free floating.

6. Latvia's external position in 2018 is assessed to be moderately stronger than implied by medium-term fundamentals and desirable policies. A widening of the current account deficit from 2019 onwards is expected, on the back of a pick-up in investment.

Annex II. External Debt Sustainability Assessment

1. Latvia's external debt declined markedly in 2018 to 121 percent of GDP, from 141 percent of GDP in 2017, reflecting the decline in foreign deposits. Foreign deposits declined by 5.2 bn euros in 2018, more than offsetting a large increase in the foreign debt of non-bank financial institutions. The external debt of nonfinancial corporates and households also declined slightly.

2. Under the baseline, gross external debt is projected to continue to decline over the medium term. External debt is projected to decline to 106 percent of GDP in 2024. While the current account balance excluding interest payments is projected to deteriorate to a deficit of 1.5 percent of GDP in 2024, it is still well above the debt stabilizing level (-4.8 percent of GDP). Gross financing needs are also projected to decline.

3. External debt appears broadly resilient to various shocks. Under all shocks and the historical scenario, including the combined shock scenario, Latvia's external debt-to-GDP ratio would be either below or only marginally higher than its 2018 level by 2024.

Table 1. Latvia: External Debt Sustainability Framework, 2014–24

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
Baseline: External debt	144.1	143.7	148.9	140.5	121.0			**117.4**	**114.4**	**112.1**	**109.7**	**107.9**	**106.2**	**-4.7**
Change in external debt	10.2	-0.4	5.2	-8.4	-19.5			-3.7	-2.9	-2.4	-2.3	-1.9	-1.6	
Identified external debt-creating flows (4+8+9)	-4.4	-4.1	-5.7	-13.9	-13.5			-3.7	-3.0	-2.5	-2.0	-1.5	-1.0	
Current account deficit, excluding interest payments	-1.5	-2.2	-3.9	-2.7	-0.8			-0.2	-0.1	0.3	0.7	1.1	1.6	
Deficit in balance of goods and services	1.4	0.5	-1.2	-0.1	0.6			0.9	1.3	1.7	2.1	2.6	3.1	
Exports	60.7	60.4	60.0	61.1	58.9			56.4	54.9	53.7	52.5	51.4	50.5	
Imports	62.2	60.9	58.8	61.0	59.5			57.3	56.2	55.3	54.6	54.0	53.6	
Net non-debt creating capital inflows (negative)	-1.4	-2.8	0.0	-2.0	-2.1			-1.4	-1.3	-1.2	-1.2	-1.2	-1.1	
Automatic debt dynamics 1/	-1.5	0.9	-1.7	-9.2	-10.6			-2.1	-1.6	-1.6	-1.5	-1.4	-1.4	
Contribution from nominal interest rate	3.2	2.7	2.3	2.0	1.8			1.7	1.8	1.8	1.8	1.7	1.7	
Contribution from real GDP growth	-2.4	-5.0	-2.9	-6.3	-5.9			-3.8	-3.4	-3.3	-3.2	-3.2	-3.1	
Contribution from price and exchange rate changes 2/	-2.3	3.2	-1.2	-5.0	-6.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	14.7	3.7	10.9	5.5	-6.0			0.1	0.1	0.1	-0.4	-0.4	-0.7	
External debt-to-exports ratio (in percent)	237.2	237.8	248.3	230.0	205.6			208.0	208.3	208.7	208.9	209.7	210.4	
Gross external financing need (in billions of US dollars) 4/	22.3	22.6	19.9	21.9	25.3			20.0	20.7	21.5	20.8	21.7	24.0	
in percent of GDP	71.1	83.7	72.0	71.7	72.5	10-Year	10-Year	56.7	55.1	54.0	49.2	48.6	50.6	
Scenario with key variables at their historical averages 5/								**117.4**	**117.9**	**118.6**	**118.6**	**118.4**	**118.0**	**1.6**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						For debt stabilization	
Real GDP growth (in percent)	1.9	3.0	2.1	4.6	4.8	1.1	6.1	3.2	3.1	3.1	3.0	3.0	3.0	
GDP deflator in US dollars (change in percent)	1.8	-16.5	0.6	5.3	9.1	-0.7	9.6	-1.9	3.1	3.1	2.9	2.7	2.8	
Nominal external interest rate (in percent)	2.5	1.6	1.7	1.5	1.4	2.7	1.3	1.4	1.6	1.7	1.7	1.7	1.7	
Growth of exports (US dollar terms, in percent)	4.7	-14.5	1.9	12.2	10.1	4.5	14.0	-3.0	3.4	3.9	3.8	3.6	4.0	
Growth of imports (US dollar terms, in percent)	1.0	-15.8	-0.9	14.3	11.4	3.0	19.5	-2.4	4.2	4.7	4.7	4.6	5.1	
Current account balance, excluding interest payments	1.5	2.2	3.9	2.7	0.8	4.0	5.0	0.2	0.1	-0.3	-0.7	-1.1	-1.6	
Net non-debt creating capital inflows	1.4	2.8	0.0	2.0	2.1	2.1	1.4	1.4	1.3	1.2	1.2	1.2	1.1	

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.

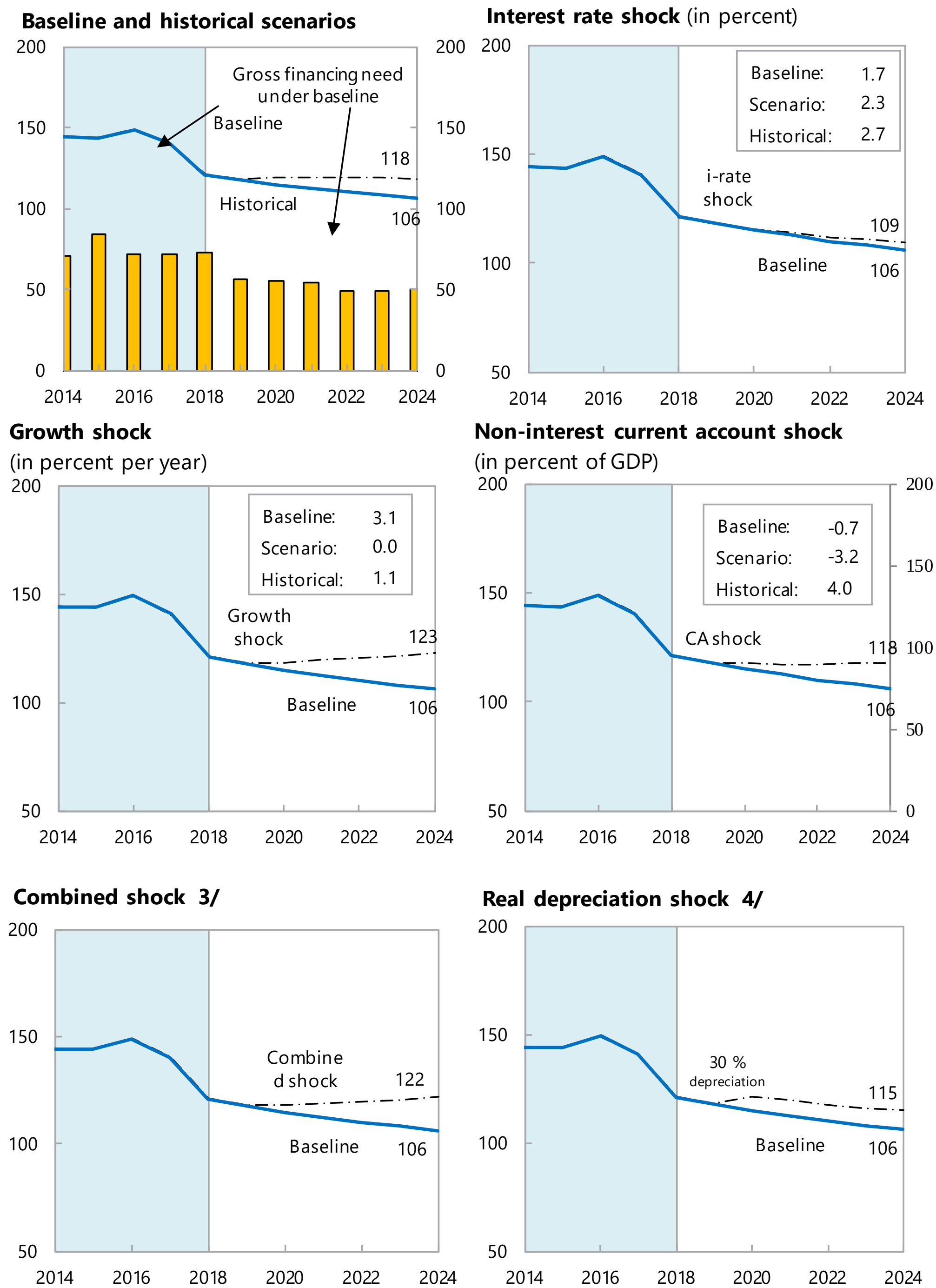
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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.

Table 2. Latvia: External Debt Sustainability: Bound Test [1, 2]

(In 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 2019.

Annex III. Public Sector Debt Sustainability Analysis (DSA)

Table 1. Public DSA—Baseline Scenario

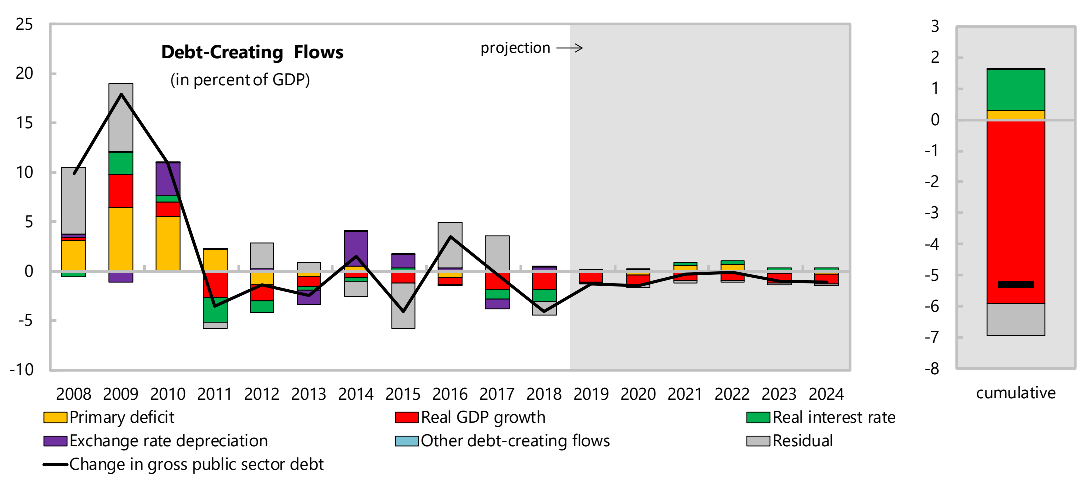
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of December 30, 2018		
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024	Sovereign Spreads		
Nominal gross public debt	38.2	40.0	35.9	34.6	33.2	32.9	32.8	31.7	30.6	EMBIG (bp) 3/		51
Public gross financing needs	9.1	4.9	3.8	5.2	5.3	6.3	3.2	2.3	4.4	5Y CDS (bp)		58
Real GDP growth (in percent)	-0.2	4.6	4.8	3.2	3.1	3.1	3.0	3.0	3.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.7	3.2	4.2	2.9	2.3	2.2	2.1	2.0	2.0	Moody's	A3	A3
Nominal GDP growth (in percent)	1.7	8.0	9.2	6.2	5.5	5.4	5.2	5.1	5.1	S&Ps	A-	A-
Effective interest rate (in percent) [4/]	4.0	2.9	2.6	2.5	2.9	3.2	3.2	3.2	3.2	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	3.6	-0.3	-4.0	-1.3	-1.4	-0.3	-0.1	-1.1	-1.1	-5.3	
Identified debt-creating flows	1.9	-3.8	-2.7	-1.2	-1.2	-0.1	0.1	-0.9	-0.9	-4.3	
Primary deficit	1.7	-0.1	-0.1	0.0	-0.4	0.6	0.7	-0.3	-0.3	0.3	-0.6
Primary (noninterest) revenue and gr	35.7	35.5	36.7	35.6	35.5	34.0	33.3	33.5	33.5	205.4	
Primary (noninterest) expenditure	37.3	35.3	36.7	35.6	35.2	34.6	33.9	33.2	33.2	205.7	
Automatic debt dynamics [5/]	0.2	-3.7	-2.7	-1.2	-0.8	-0.7	-0.6	-0.6	-0.6	-4.6	
Interest rate/growth differential [6/]	-0.5	-2.7	-3.1	-1.2	-0.8	-0.7	-0.6	-0.6	-0.6	-4.6	
Of which: real interest rate	-0.2	-1.0	-1.3	-0.2	0.2	0.3	0.3	0.3	0.4	1.3	
Of which: real GDP growth	-0.3	-1.7	-1.7	-1.1	-1.0	-1.0	-1.0	-0.9	-0.9	-5.9	
Exchange rate depreciation [7/]	0.7	-1.0	0.4	…	…	…	…	…	…	…	
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 Eur	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/]	1.7	3.5	-1.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-1.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ 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.

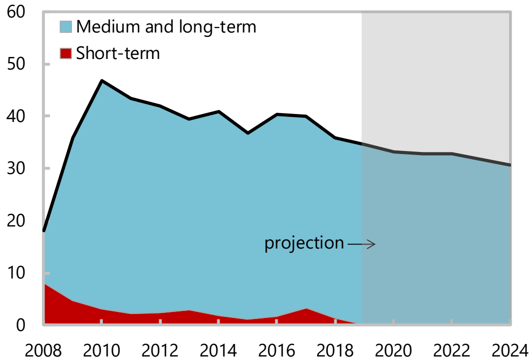
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 2. Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

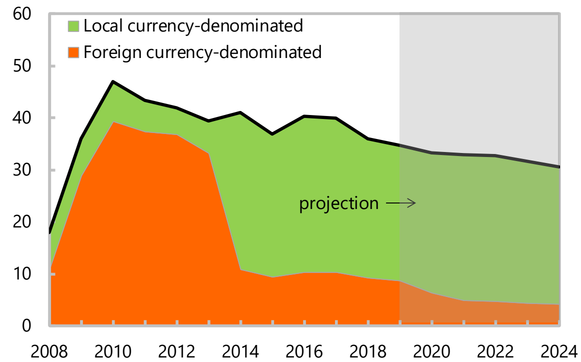
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

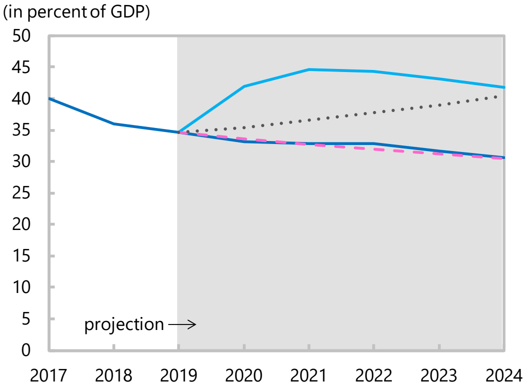


Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance

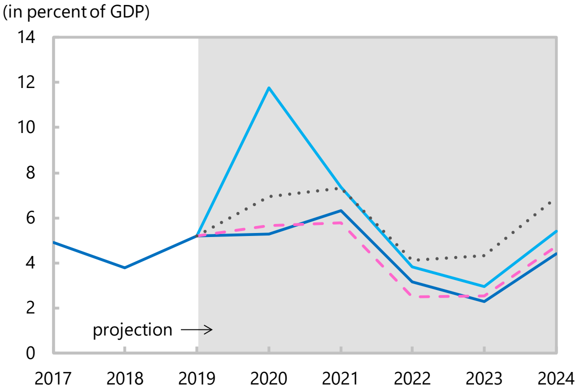
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.2	3.1	3.1	3.0	3.0	3.0
Inflation	2.9	2.3	2.2	2.1	2.0	2.0
Primary Balance	0.0	0.4	-0.6	-0.7	0.3	0.3
Effective interest rate	2.5	2.9	3.2	3.2	3.2	3.2
Constant Primary Balance Scenario						
Real GDP growth	3.2	3.1	3.1	3.0	3.0	3.0
Inflation	2.9	2.3	2.2	2.1	2.0	2.0
Primary Balance	0.0	0.0	0.0	0.0	0.0	0.0
Effective interest rate	2.5	2.9	3.2	3.2	3.2	3.3

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.2	1.1	1.1	1.1	1.1	1.1
Inflation	2.9	2.3	2.2	2.1	2.0	2.0
Primary Balance	0.0	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	2.5	2.9	3.5	3.8	3.9	4.1
Contingent Liability Shock						
Real GDP growth	3.2	-3.0	-3.0	3.0	3.0	3.0
Inflation	2.9	0.8	0.7	2.1	2.0	2.0
Primary Balance	0.0	-5.5	-0.6	-0.7	0.3	0.3
Effective interest rate	2.5	3.4	3.3	3.3	3.3	3.3

Source: IMF staff.

Annex IV. Modeling the Impact of Domestic Risks to the Outlook[1]

1. Refocusing the troubled BSFC sector and reviving credit growth hinges on completing AML/CFT and insolvency reforms. On one hand, renewed money laundering concerns could severely damage confidence in the banking sector if they result in additional bank failures or withdrawal of parent support of large subsidiaries and branches of foreign banks. On the other hand, the comprehensive legal framework covering licensing, appointment and supervision of insolvency administrators has been strengthened in the wake of serious abuses and malpractices, but continued deficiencies weigh on the recovery rate of distressed assets. This raises the cost of capital and lowers banks' willingness to lend.

2. We adapt the IMF GIMF model to simulate the macro-financial impact of these domestic risks.[2] Four different scenarios are used in the simulations:

- *AML/CFT Mild Adverse Scenario* [1a]. ABLV's protracted liquidation morphs into persistent concerns about system-wide AML/CFT compliance of BSFCs. This raises Latvia's perceived sovereign risk due to implicit contingent liabilities, and confidence effects increase the external financing cost of corporate borrowers.

- *AML/CFT Severe Adverse Scenario* [1b]. Additional BSFCs fail, and banks servicing the local economy reduce lending due to significantly constrained parent funding. This severely impairs the credit channel; the funding of the existing deposit insurance scheme is depleted, and contingent liabilities to the banking sector become explicit.

- *Insolvency Regime, Benign Scenario* [2a]. The reputational damage to the financial sector due to AML/CFT concerns is contained, and the insolvency reforms are fully effective, which improves asset recovery rates and lowers bankruptcy costs significantly over the medium term.

- *Insolvency Regime, Less Benign Scenario* [2b]. The reforms to the insolvency regime are less effective and have only a muted impact on recovery rates over the longer term.

3. The ad*verse scenarios* are calibrated to the historical sensitivity of Latvia's spreads to the precipitous outflow of non-resident deposits after ABLV's closure (Figure 1). Since end-2017, BSFC deposits have dropped from €8 billion to €3.3 billion. During this time, the corporate lending spread has increased to more than 6 percent and remains elevated by about 1.4 percentage points relative to its pre-ABLV level. Similarly, Latvia's sovereign spread (at 10-years) to German Bunds has widened to about 80 basis points (bps) and remains 34 bps higher than its pre-ABLV level.

---

[1] This annex uses GIMF simulations provided by the IMF Research Department (Michal Andrle).

[2] Kumhof, Michael, Laxton, Douglas Muir, Dirk and Susanna Mursula, 2010, "The Global Integrated Monetary and Fiscal Model (GIMF) – Theoretical Structure," IMF Working Paper 10/35, February (Washington, D.C.: International Monetary Fund), available at https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-Global-Integrated-Monetary-and-Fiscal-Model-GIMF-Theoretical-Structure-23615.

- Under Scenario [1a], we assume a temporary, but persistent nominal shock to the short-term *government bond premium* (GBPREM), with an initial increase of 56 bps in the first year (which decays by 50 percent each year over the remainder of the projection horizon). There is a perfect pass-through to bank lending rates. Nominal NFC lending rates (via the financial accelerator for business investment) increase in lock-step with higher sovereign yields and include a shock to the *external finance premium* (XFP) by 131 bps, as banks adjust lending margins to break even.

- Under Scenario [1b], the GBPREM and XFP shocks are doubled, and deteriorating confidence exacerbates negative investor confidence in the equity market.[3] In addition, the shock to NFC lending rates becomes more persistent (consistent with that of the GBPREM shock).

4. The *benign scenarios* assume a gradual convergence of Latvia's asset recovery rate to the EU average. A recent IMF technical assistance report on Latvia finds that the recovery rate was only 23 percent in 2016 (and improved to 31 percent in 2017 according to the Annual Report of the Insolvency Administrator).[4]

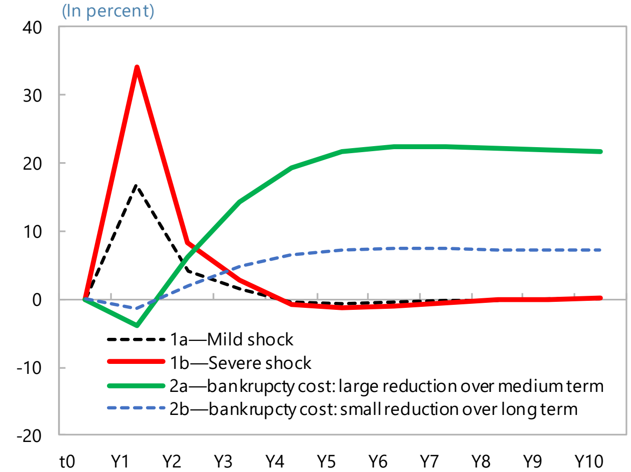
- Under Scenario [2a], bankruptcy costs decline permanently by 15 percent (phased in over three years), which implies an increase in the recovery rate of 9.6 percent.[5]

- Under Scenario [2b], reforms of the insolvency regime take longer to come into effect (5 years) and reduce bankruptcy cost by 5 percent only.

5. Prolonged and broader AML/CFT concerns could have serious implications for output growth. An increase in the sovereign and external finance risk premia under the severe adverse scenario (Scenario 1b) reduce real GDP growth by 4.5 percent on average over the medium term as real GDP and investment decline by up to 1.5 percent and 11.5 percent, respectively (Figure 2).

6. Continued efforts in reforming the insolvency regime could free up significant lending capacity and build resilience to domestic shocks. Faster recovery in credit growth due to a 15 percent reduction in bankruptcy costs would increase debt capacity of corporates (without changing their default risk) and lift real GDP growth by 3.4 percent on

Comparison of Impact on Corporate Leverage
(In percent)



Source: IMF staff calculations.

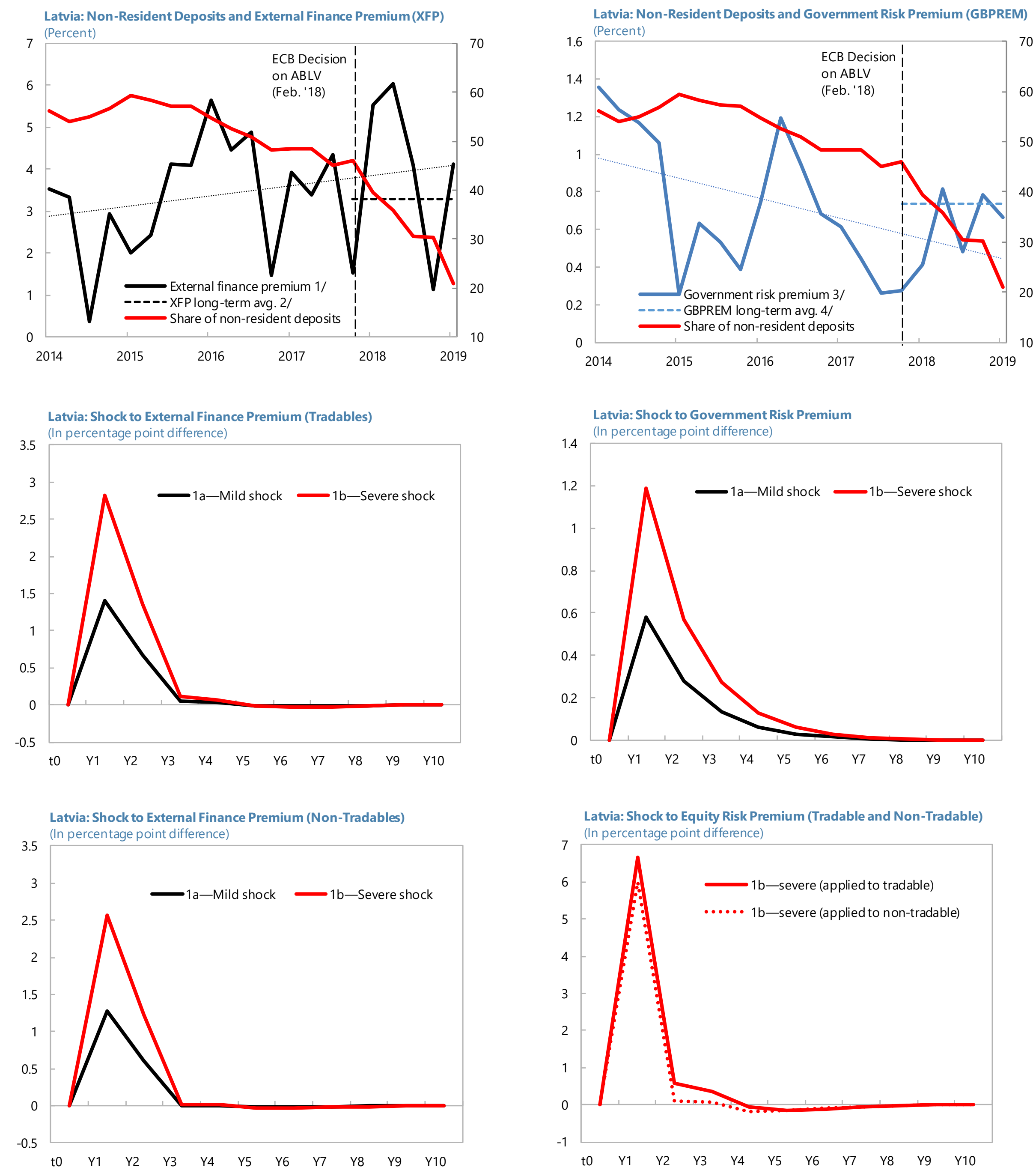
[3] This is modeled as a short-term shock to the equity risk premium of about 6.5 percent, equivalent to a drop in the equity market by about 2 percent.

[4] Based on the World Bank's *Doing Business Report*, the average recovery rate was 48.2 percent in 2016.

[5] The average debt-to-equity ratio is set to 100 percent in the current calibration of the GIMF model for Latvia, with a recovery rate of 64 percent.

average over the medium term as real GDP and investment increase by 1.1 percent and 9.0 percent, respectively, after two years (Figure 3). Higher asset recovery (by almost 10 percent) could raise the degree of sustainable leverage to offset a negative sovereign premium shock equivalent to that in the adverse scenarios over the medium term.

Figure 1. Latvia: Calibration of Macro-Financial Shocks (GIMF Model)



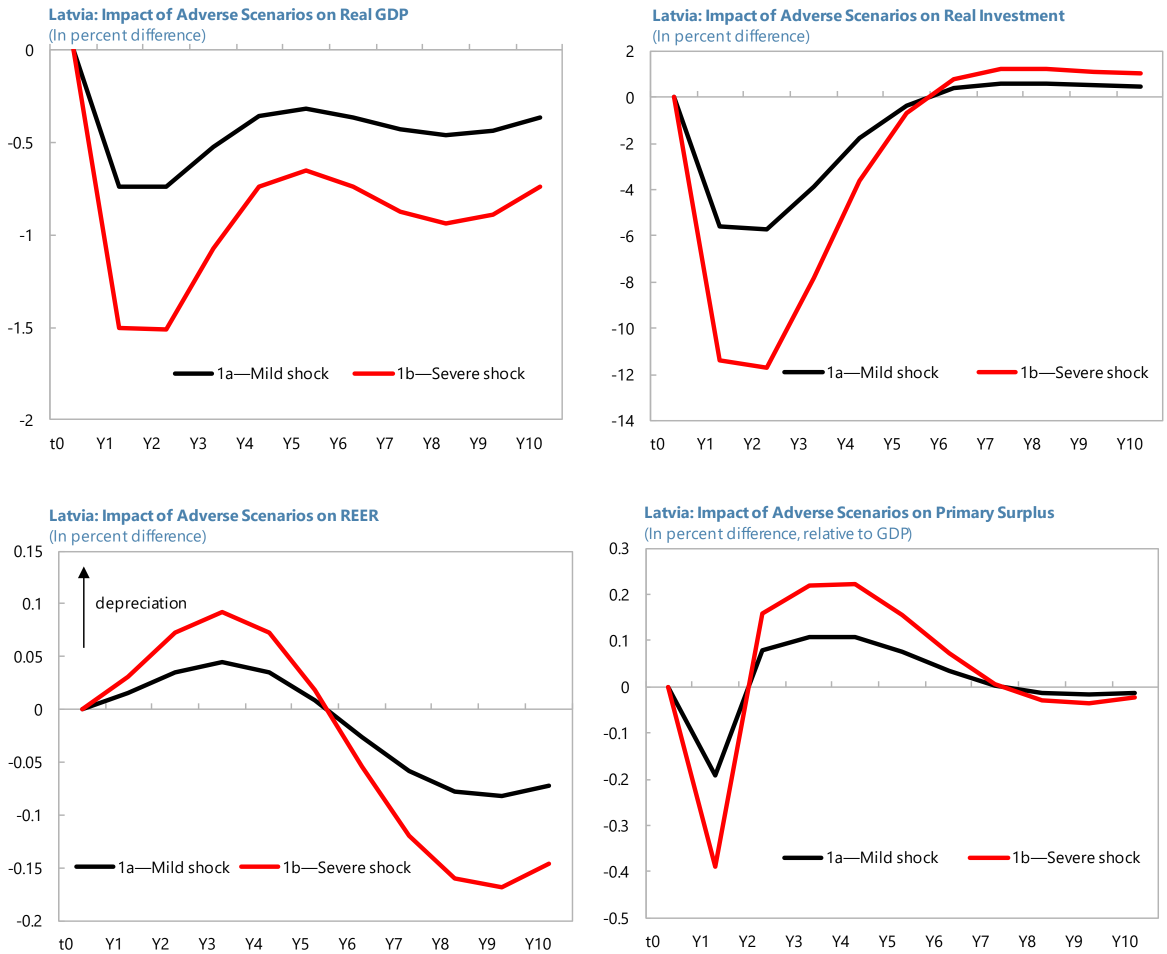
Sources: Bank of Latvia; Bloomberg L.P.; Haver Analytics; and IMF staff calculations.

1/ The external finance premium (XFP) is calculated as the difference between the corporate lending rate for loans of EUR 1 mln. or less and the 10-year sovereign yield for Latvian government bonds;

2/ the long-term average (3.28 percent) is calculated from Jan. 2014 to Feb. 2018;

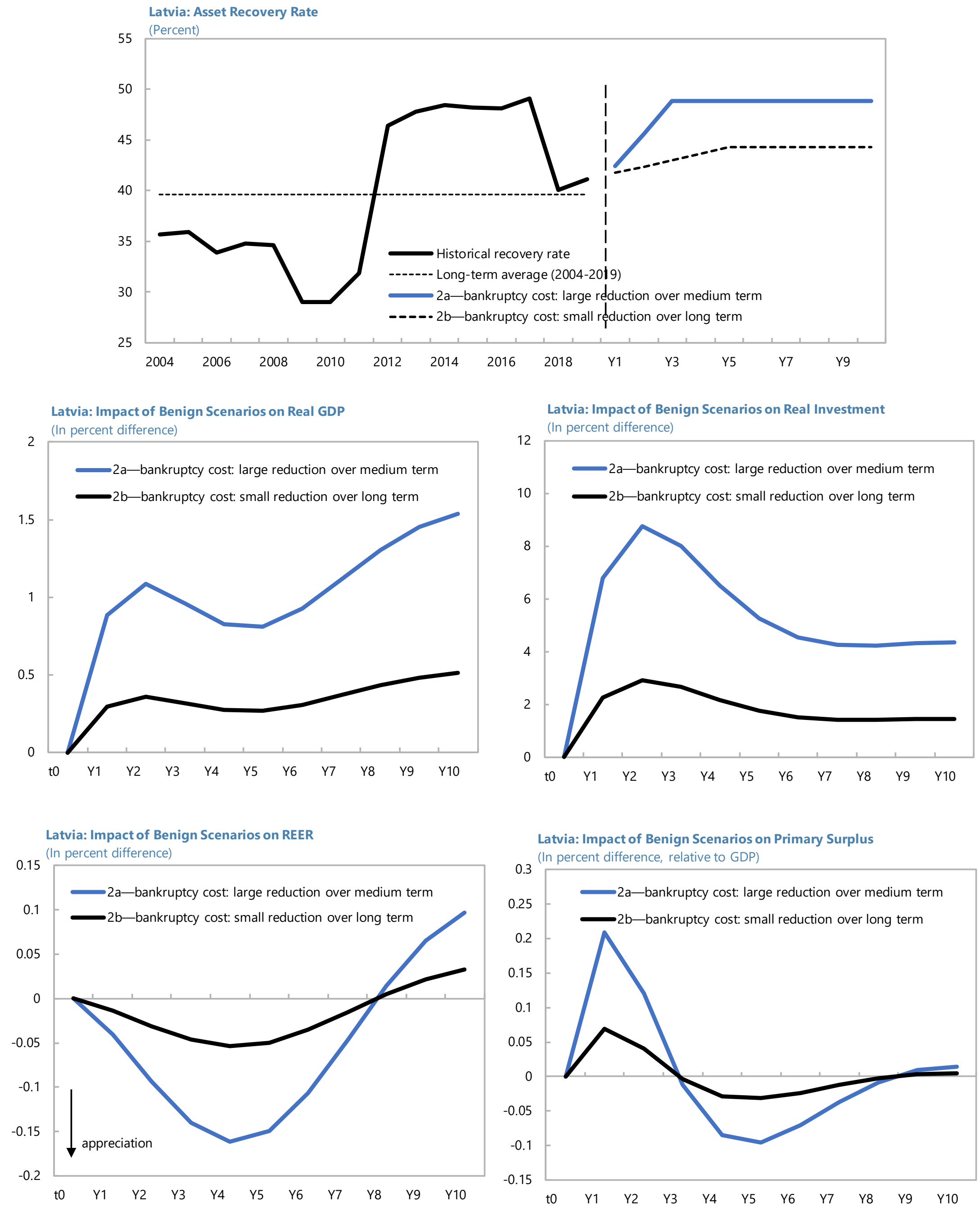
3/ The government risk premium (GBPREM) is calculated as the difference between the 10-year sovereign yields for Latvian and German government bonds; 4/ the long-term average (0.74 percent) is calculated from Jan. 2014 to Feb. 2018.

Figure 2. Latvia: Key Simulation Results of Adverse Macro-financial Shocks (GIMF Model)



Source: IMF staff calculations.

Figure 3. Latvia: Key Simulation Results of Positive Macro-financial Shocks (GIMF Model)



Sources: World Bank (Doing Business Indicators); and IMF staff calculations. Note: A 15 (5) percent permanent reducttion of the bankruptcy cost over 3 (5) years implies an increase of the recovery rate by 9.6 (3.2) percentage points.

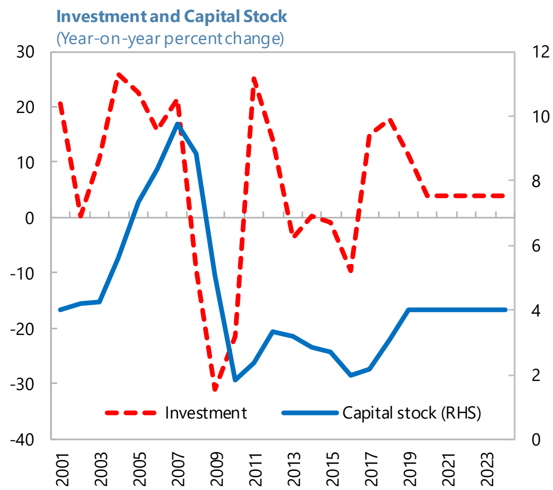
Annex V. Estimating Potential Growth[1]

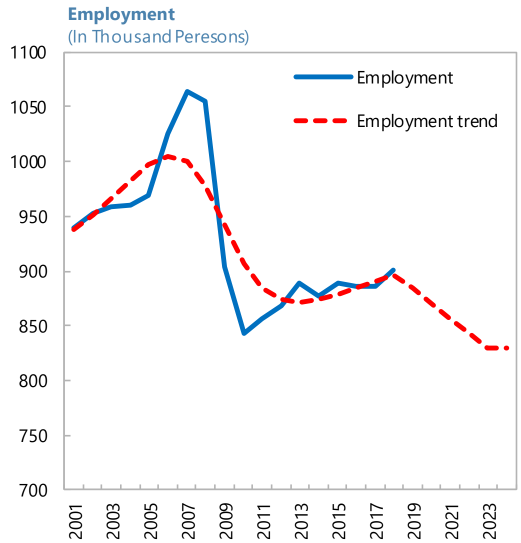
Estimates of Potential Growth

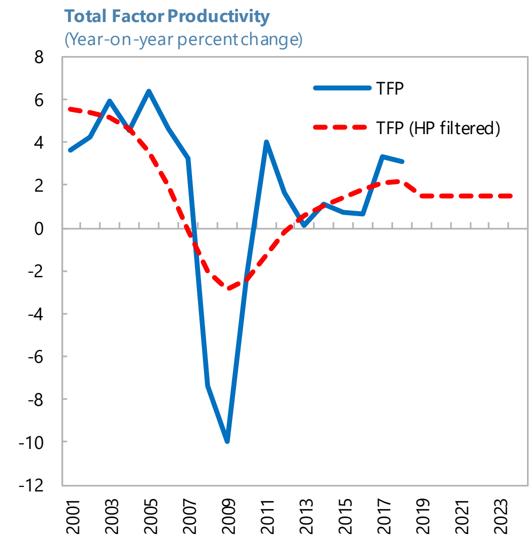
1. Staff estimates potential growth to be around 3 percent over the medium term. A production function approach underpins this projection with the following baseline assumptions:

Potential Growth Contributions

	2001-18	2012-18	2024 Proj.
GDP Growth	3.8	3.0	3.0
Capital	2.4	1.5	2.3
Capacity Utilization	0.6	1.0	0.0
Labor	-0.1	0.2	-0.7
Average Hours Worked	-0.6	-0.1	0.0
TFP Growth	1.5	0.5	1.5







Sources: Central Statistical Bureau of Latvia; and IMF staff calculations.

- **Capital:** Capital growth will be driven by an increase in investment on the back of a recovery of credit growth in the economy, which will compensate for the gradual reduction of EU investment funds. With a currently estimated capital output ratio of 3, and assumed deprecation rate of 4 percent, the projected investment rate of 5 percent and capital growth of 4 percent are just enough to preserve the capital output ratio over the medium term.

[1] This annex follows up on analysis completed in IMF Country Reports Nos. 18/267 and 17/195.

- **Labor:** Labor supply and employment have increased steadily since the crisis and have nearly reached the limits to further growth. The 2018 UN demographic projections suggest that Latvia's population and working age population will decline by about 1 percentage point annually. Therefore, staff's baseline projection assumes that the contribution of labor to potential growth will become negative in the medium term.
- **TFP growth:** Historically, Latvia enjoyed very strong productivity growth. Despite the setbacks of the crisis, TFP growth has increased steadily in recent years. Absent any targeted policy measures, TFP growth is not expected to reach its pre-crisis levels, but instead settle at a relatively conservative growth rate consistent with its long-term historical average (about 1.5 percent).

2. These estimates are subject to significant risks. In a more conservative scenario where credit growth remains subdued, the contribution of capital accumulation may remain modest (e.g., as in 2012–18) and/or TFP growth levels off at its most recent historical average of 0.5 percent, potential growth could be 1–2 percentage points lower. But there could also be upside risks, if the working age population remains relatively stable, as in recent history, and/or credit growth recovers faster than expected (potentially increasing investment by 1½–3 percentage points of GDP and the contribution of capital by ¼–¾ percentage points), medium-term potential growth could be up to 1½ percentage points higher.

3. Demographic trends are projected to reduce potential growth in half over the very long term. While the decline in labor will continue to be a drag on potential growth of similar magnitude as over the medium term, its indirect negative effect would cut potential growth by 1.4 percentage points on average in 2020–50. Under the assumption of a balanced growth path, a constant capital-labor ratio would imply a significant deceleration in capital accumulation alongside the projected labor decline.[2] Furthermore, due to a projected increase in the share of workers above the age of 55—who have significantly lower productivity than the rest of the working age population—TFP growth is likely to decline by 0.2 percentage points.[3]

Long-run Potential Growth Contributions

	2024	Average growth in 2025–50
GDP Growth	3.0	1.6
Capital	2.3	0.9
Labor	-0.7	-0.6
TFP Growth	1.5	1.3

Source: IMF staff calculations.

[2] In a simplified production function framework $gY=gA+(1-\alpha)\ gK+\alpha gL$, the balanced growth path is defined as $gY=gK=gA/\alpha+gL$, where gY is real GDP growth, gA is TFP growth, gK is capital growth, gL is labor growth, and α is labor income share.

[3] See "Demographic Headwinds in Central and Eastern Europe", Departmental Paper No. 19/12.

Annex VI. Further Investigation of Credit Constraints[1]

1. Despite record low interest rates and solid growth outturns, credit growth in Latvia has remained anemic. Bank lending to households and non-financial corporations (NFCs*)* has been sluggish, even though both solvency and liquidity conditions in the banking sector remain robust, and private sector indebtedness has reached record lows. The credit-to-GDP gap remains deeply negative.[2] Several supply and demand factors contribute to this ongoing trend.

Supply Side Effects

2. Banks have tightened credit supply to offset the negative impact of "sticky deposits rates" on net interest margins (Annex VI Figure 1). Due to the high share of variable rate lending, lower policy rates have efficiently transmitted to lower lending rates (and term premia) since the adoption of *negative interest rate policy* (NIRP) in June 2014. However, banks' profitability is increasingly challenged by their reliance on local retail deposits whose rates tend to be "downward sticky" since households and small businesses face higher cost of storing cash than banks and corporations.[3] AML/CFT breaches by BSFCs might have also introduced an "economic lower bound" of deposit rates (well above zero) to offset the diminished confidence of depositors in the banking sector and the substantial decline of non-resident deposits as a result of aggressive de-risking by BSFCs. Even after more than 3½ years of NIRP, the weighted average deposit rate in Latvia still stood at 1.13 percent at end-February 2019, with deposit rates for households and non-financial corporates at 1.17 percent and 0.79 percent, respectively. As a result, banks' net interest margins (NIMs), defined as net interest income relative to average interest-earning assets, have compressed, as lending rates for new loans have declined, and existing (variable rate) loans have re-priced, while deposit rates have not adjusted as quickly as lending rates. The structural changes in the banking sector and the adoption of new business strategies by BSFCs with a greater focus on domestic activities also creates greater potential supply in corporate and household lending. This could lower lending rates further if consolidation pressure remains subdued. Given the declining marginal rate of return from lending, most banks seem to prefer preserving high capital and liquidity buffers rather than lending.[4]

Figure 1. Squeezed Lending Margins

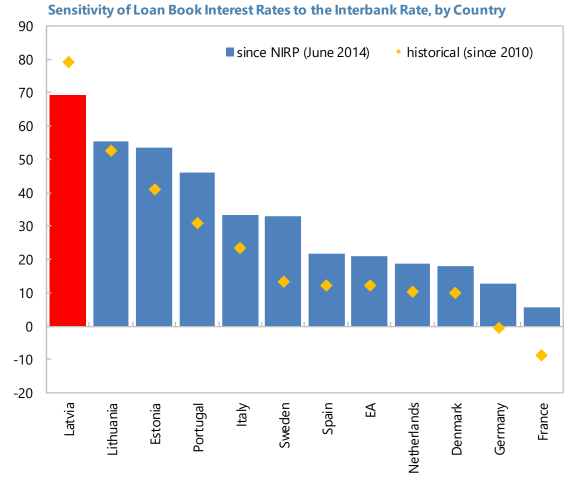
[1] This annex follows up on analysis completed in IMF Country Reports Nos. 18/266 and 16/172.

[2] In the wake of the global financial crisis, credit continued to contract even as the economy emerged from a recession, and accommodative monetary policy lowered the cost of borrowing. Both NFC and household debt-to-GDP ratios have declined steadily from their post-crisis peaks.

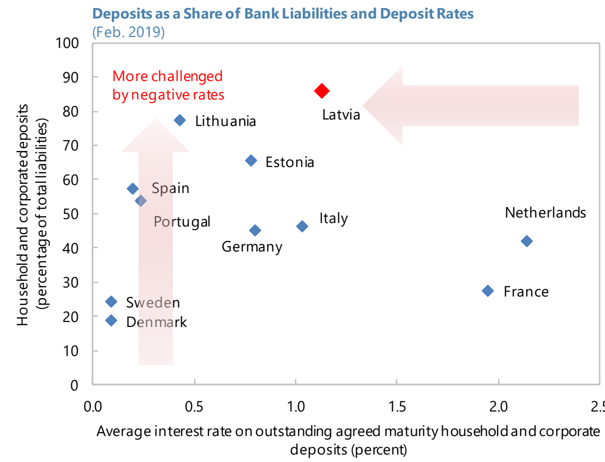
[3] The stickiness of deposit rates reflects the avoidance of being penalized to save and is determined by the actual costs of holding cash rather than deposits. For a detailed discussion, see Jobst, Andreas, and Huidan Lin, 2016, "Negative Interest Rate Policy (NIRP): Implications for Monetary Transmission and Bank Profitability in the Euro Area," IMF Working Paper No. 16/172, August (Washington, D.C.: International Monetary Fund), available at https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Negative-Interest-Rate-Policy-NIRP-Implications-for-Monetary-Transmission-and-Bank-44183.

[4] Banks could temporarily increase their lending volumes to offset higher adjustment costs in setting deposit rates at the cost of deviating temporarily from the minimum capital requirement.

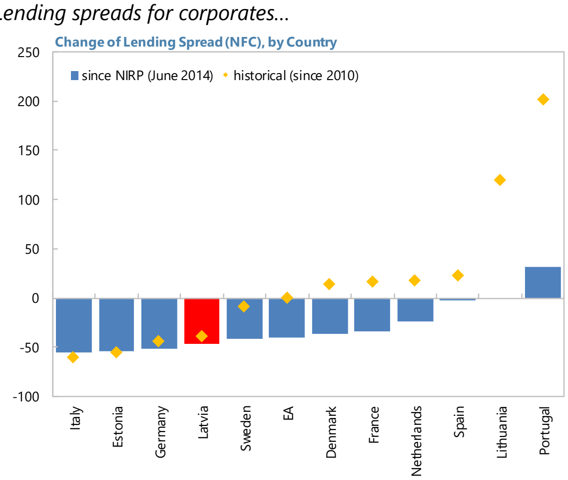
The pervasiveness of variable rate loans makes lending rates very sensitive to policy rate changes…



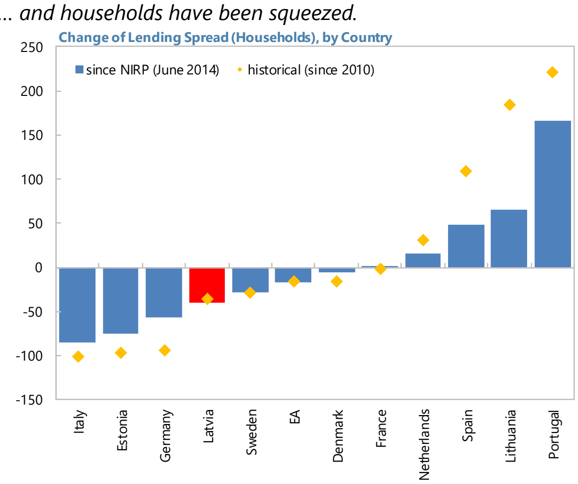
…and, in the face of "sticky" deposit rates, banks find it more costly to maintain sufficient deposit funding.



Lending spreads for corporates…



… and households have been squeezed.



Sources: Bank of Latvia; European Central Bank; Haver Analytics; OECD; World Bank Doing Business Report, 2018; and IMF staff calculations.

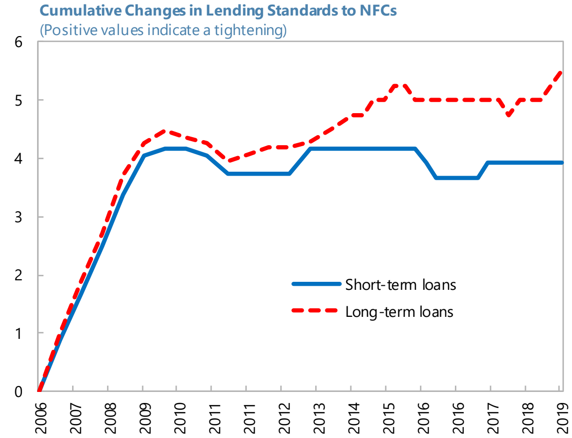
3. **Banks have also become more cautious about the future debt servicing capacity of borrowers** (Annex VI Figure 2). Although lower lending rates have eased borrowers' financial constraints, debt-to-income ratios of both households and NFCs have bottomed out. A potential deterioration in long-term debt affordability would necessitate tightening lending standards, as greater risk-taking in new lending could manifest in higher asset impairment levels.[5] Amid lingering credit risk concerns, lending standards have remained strict since the crisis, and lending conditions for long-term loans have become increasingly stringent as the stock of non-performing loans to NFCs has leveled off. Access to credit also remains more difficult in Latvia than elsewhere in the region.[6]

Figure 2. Latvia: Supply Factors of Credit Growth

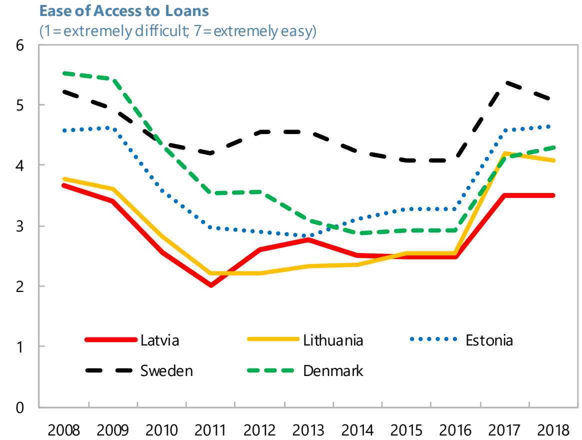
[5] The reduced debt service burden could also delay the exit of nonviable firms and distort the efficient allocation of capital and labor.

[6] The re-orientation of BSFCs' business models results in greater competition of local clients and might soften supply constraints. Since retail credit is currently directed mainly to high-income households, greater credit supply may result in lending to potentially riskier domestic borrowers, which could lead to looser credit standards.

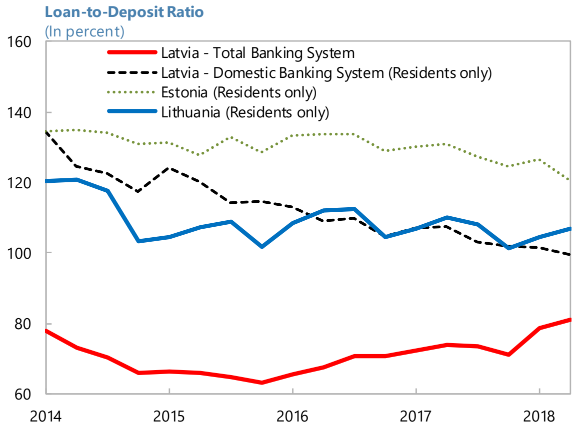
Long-term lending standards have tightened…



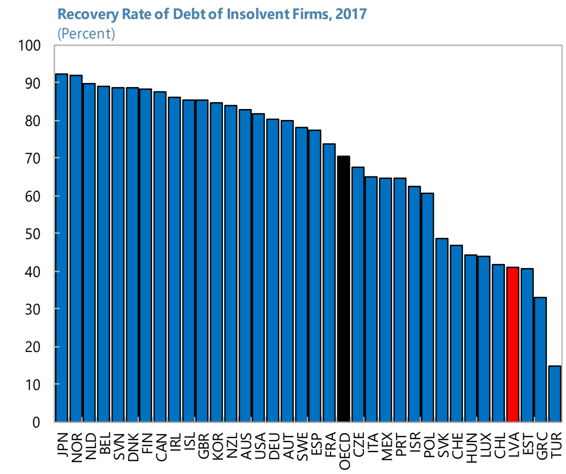
…and access to funding is more difficult than in peer countries.



Declining funding support for domestic lending signals cautiousness…



…as low asset recovery rates raise lending costs.



Sources: Bank of Latvia; European Central Bank; Haver Analytics; OECD; World Bank Doing Business Report, 2018; and IMF staff calculations.

4. Persistent gaps in the insolvency regime may weigh on investment and restrain credit growth. By effectively removing the profitability constraint of investments, the secular decline in lending rates delays corporate restructuring. This places greater emphasis on (costly) debtor screening and debt enforcement standards (which weighs on the cost-efficient origination of new loans). The recovery rate of creditors' claims remains low by international comparison, and insolvency proceedings can be excessively long and complicated, which raises the cost of bank lending.[7] While the insolvency administrator regime has been strengthened, there are still some areas for improvement in relation to the licensing, appointment, and remuneration of administrators (Box 1). Addressing these areas would improve the integrity and accountability of insolvency administrators.

Box 1. Ensuring High Standards of Insolvency Administrators[1]

[7] The riskiness of corporate lending remains one of the highest in the euro area (with credit risk-weights for some larger banks above 80 percent).

Insolvency administrators in Latvia are subject to a comprehensive legal framework covering their licensing, appointment and supervision. Following the *Guidelines for Insolvency Policy Development for 2016*-*20* ('Guidelines') adopted in 2016, the Ministry of Justice introduced new regulations governing the training and examination of insolvency administrators, tightened the disciplinary process, and improved their record-keeping requirements.[2,3]

Enhancing the insolvency administrator regime has been central to recent reforms in the wake of serious abuses and malpractices by liquidators. Legal amendments and new regulations have already produced positive effects, including in: (i) the licensing and examination procedures; (ii) the registration and selection; (iii) reporting duties and professional standards (code of conduct); and (iv) the enhanced supervision of administrators.

Nonetheless, there are still important deficiencies in the licensing, selection, and appointment of insolvency administrators:

- *Licensing*. The *Insolvency Law* determines the qualification criteria and licensing procedures. Insolvency administrators are required to meet strict legal requirements and pass a rigorous examination. However, the criteria for the evaluation of a candidate's reputation are not well defined. Clear and objective rules governing the evaluation of candidates would make the assessment of qualifications more transparent and help prevent arbitrary decision-making. Also, frequent re-validation requirements make licensing very burdensome and have an adverse impact on the effectiveness of ongoing insolvency proceedings. The current licensing period of two years should be extended, and administrators should be allowed to conclude cases for which they were validly appointed.
- *Selection process.* The rules governing the selection and appointment of administrators have been revised. As of January 2019, each insolvency administrator is now randomly selected by the court from a candidate list maintained in the *Insolvency Control Service System*, using a fully automatic and electronic mechanism of the *Court Information System*. This selection process ensures that administrators are independent and impartial. However, it does not consider administrators' area of expertise. For instance, large firms are likely to operate under very complex ownership arrangements and business operations, which warrant specialized knowledge and expertise for their orderly and effective liquidation. Grouping administrators in rosters organized by areas and levels of expertise and type of borrower would help mitigate the drawbacks of random selection and will encourage specialization.
- *Appointment in bank resolution.* In the case of credit institutions, prudential considerations are likely to require even greater specialization of administrators. Under Section 1(34f) of the *Credit Institutions Law*, administrators are appointed by the court upon recommendation by the FCMC. In liquidation cases following the withdrawal of a bank license upon AML/CFT breaches, recent amendments to the Credit Institutions Law empowers the FCMC to appoint administrators and oversee the liquidation process. However, the selection process of administrators for bank liquidation outside AML/CFT cases may require greater involvement of the FCMC, or even establishing an administrative liquidation framework, under which the FCMC can commence and carry out liquidation proceedings.

Box 1. Ensuring High Standards of Insolvency Administrators (concluded)

The rules governing the compensation and legal protection of insolvency administrators could also be improved. In cases without assets or where recovery values are low, the deposit of two salaries is reportedly used to satisfy expenses, leaving nothing to pay the administrator's remuneration. This lawful, but unfair outcome can be remedied by limiting expenses to 50 percent of the asset value and/or allocating a prorated amount of the deposit to cover the administrator's remuneration. For high-value cases, the insurance coverage for potential damages caused by the administrator to third parties is too low and would need to be aligned with the respective asset value.

____

1/ This Box benefited from contributions received from the IMF Legal Department (Amira Rasekh) and contains key findings from Technical Assistance Report "Evaluation of the Insolvency Framework," March 11, 2019.

2/ In addition, the new regulations redistributed and strengthened the competencies of the Insolvency Administration and the State Police. The Latvian Parliament also amended the Civil Procedure Law and the Insolvency Law, with the aim of allowing the publication of information about insolvency proceedings via an electronic monitoring system.

3/ The current *Guidelines* could be aligned more closely with the new European Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures, which was agreed between the European Council and the European Parliament on December 19, 2018, and has come into effect on June 6, 2019. For instance, the *Guidelines* do not define procedures to restructure debts with creditors before a company is insolvent or late on payments.

4/ Only a natural person older than 25 years who has a law degree, is fluent in Latvian, has at least three years of work experience, has passed the insolvency administrator's exam, and has an impeccable reputation may be licensed as an insolvency administrator. A rigorous examination procedure requires completion of a training course and examination on insolvency law and practice, and periodic recertification.

Demand Side Effects

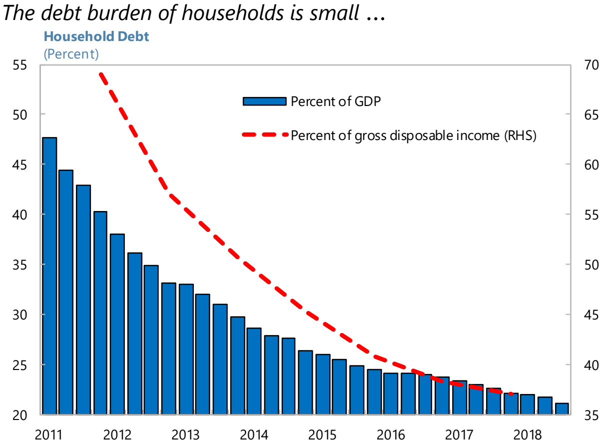
5. **Informal economic activity has hindered financial deepening and excludes potential borrowers from the financial system** (Annex VI Figure 3). Recent estimates suggest that the size of Latvia's shadow economy stands at more than 20 percent of GDP—significantly above peer countries. More than 10 percent of the working age population carries out undeclared activities. The use of "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. Thus, many potential borrowers might not be able to meet banks' lending criteria based on their reported income.

6. **Investment is often self-financed and has not kept pace with corporate profitability.** ECB's Bank Lending Survey shows that about a fifth of all reporting banks saw a net increase of loan demand from large corporates and SMEs in 2019Q1. In addition, reforms to the insolvency regime have improved the legal environment for debt restructuring, which has helped increase the debt service capacity of corporates in rapidly growing sectors, such as construction and manufacturing. Nonetheless, while the decline of loan demand by large enterprises has reversed, the recent pickup in corporate profitability continues to encourage the use of internal financing. Risk aversion among corporates remains high and explains a general reluctance to borrow as business confidence is still

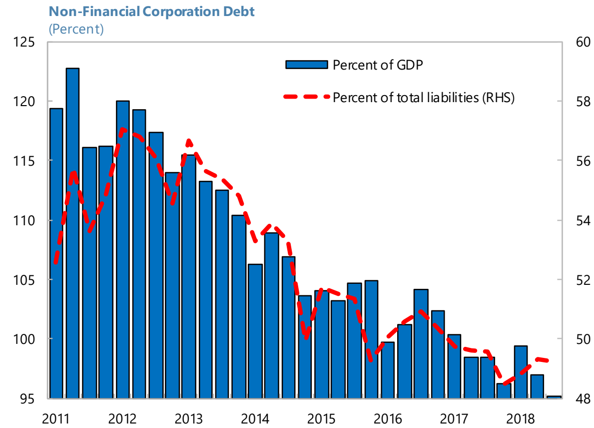
subdued. The NFC's investment rate at just above 20 percent is about half of their profit share.[8] In addition, the microenterprise regime may provide incentives for companies to remain small, which might hold back investment to grow; and the new corporate tax regime encourages the use of internal funding for investment.

Figure 3. Latvia: Demand Factors of Credit Growth

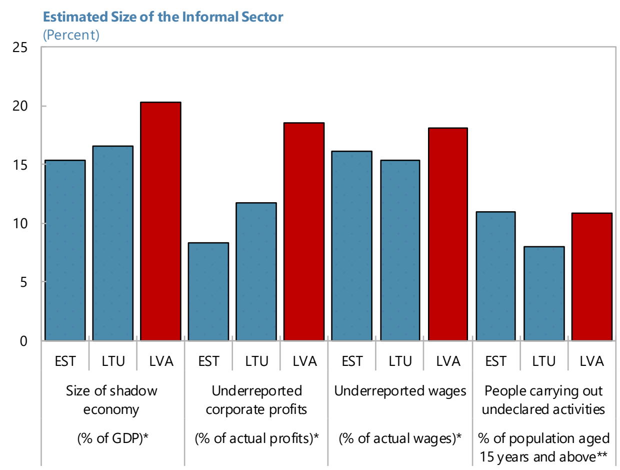
The debt burden of households is small …



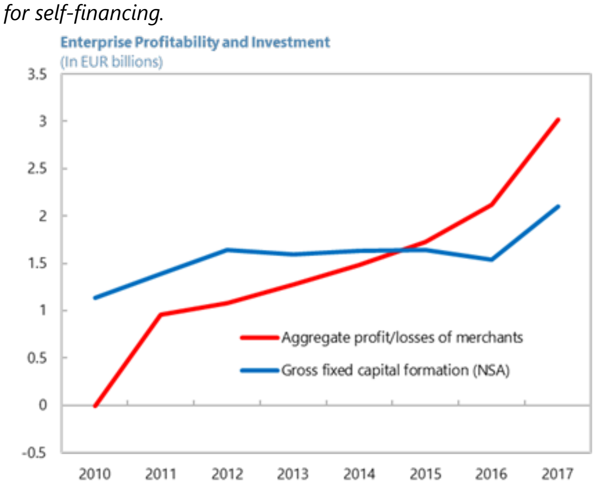
…and corporate leverage continues to decline.



But the shadow economy weakens ability to borrow …



…and rising profitability of corporates has provided headroom for self-financing.



Note: *=2016, **=2017

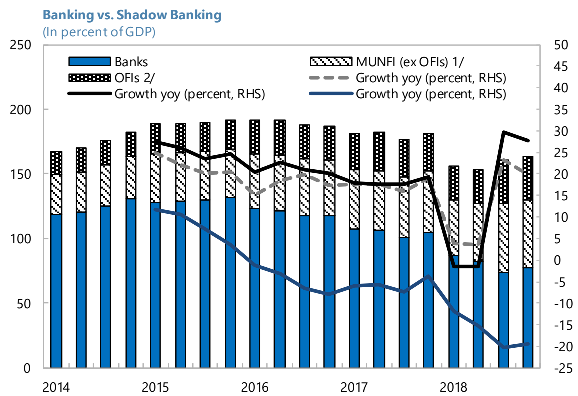
Sources: Central Statistical Bureau of Latvia; Haver Analytics; OECD; European Commission; World Economic Forum Global Competitiveness Report 2017-18; Doing Business, 2018; and IMF staff calculations.

[8] This is consistent with empirical evidence that investment tends to have a smaller contribution to growth in creditless recoveries. See Abiad, Abdul D., Dell'Ariccia, Giovanni, and Grace B. Li, 2011, "Creditless Recoveries," IMF Working Paper No. 11/58, March (Washington, D.C.: International Monetary Fund), available at https://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2011/_wp1158.ashx.

8. **The size of the shadow banking sector has doubled over the last five years and has absorbed some of the credit demand** (Annex VI Figure 4). While the universe of non-bank financial intermediation (MUNFI) remains small by European standards at 66 percent of GDP (compared to a euro area average of nearly 400 percent), non-bank lending represented almost 20 percent of total credit at end-2018 (up from 10 percent at end-2013) and has grown consistently by more than 10 percent year-on-year since 2016. Leasing companies provide the bulk of non-bank finance of about 8 percent of GDP at end-2018, mostly to NFCs (about three-quarters). Non-bank lending to households is smaller but has grown more rapidly. In 2018, a large number of new house purchases were self-financed (reflecting the low household debt-to-GDP ratio of about 20 percent in Latvia).

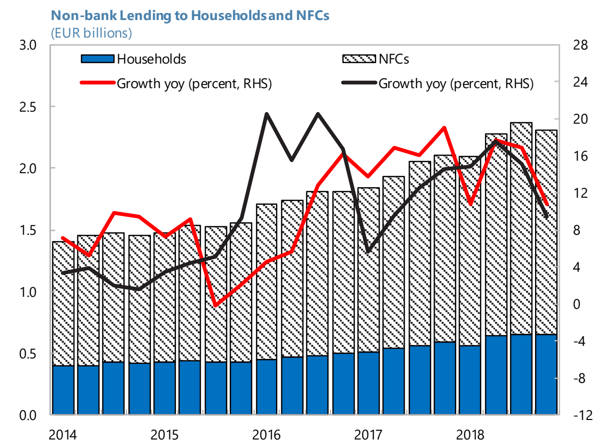
Figure 4. Latvia: Non-Bank Financial Activity (Shadow Banking)

Shadow banking represents about 40 percent of the financial sector…

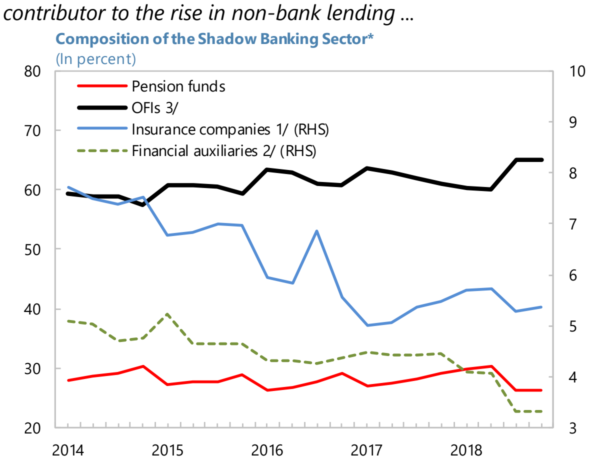


Note: 1/ MUNFI=monitoring universe of non-bank financial intermediation; 2/ OFIs=other financial institutions (which includes captive financial institutions and money lenders, leasing companies, investment funds, and other credit intermediation).

…and non-banking lending has surged, albeit from a low level.

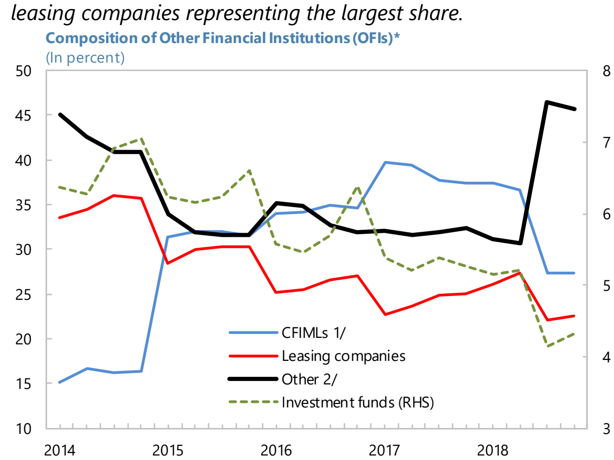


Other financial institutions (OFIs) have been the largest contributor to the rise in non-bank lending …



Note: */ MUNFI=Monitoring universe of non-bank financial intermediation; 1/ home approach 2/ includes the Financial and Capital Market Commission balance sheet (annual periodicity), state guarantee funds (not classified as general government), and other financial auxiliaries, except investment management companies; 3/ OFIs=other financial institutions (which includes captive financial institutions and money lenders, leasing companies, investment funds, and other credit intermediation).

…with captive financial institutions and money lenders as well as leasing companies representing the largest share.



Note: 1/ CFIML=captive financial institutions and money lenders; 2/ includes banks in liquidation and other financial activities (outside insurance and pensions) - Latvia does not have trust companies, CCPs/broker-dealers, and securitization vehicles (which would otherwise be included in OFIs).

Sources: Bank of Latvia; Haver Analytics; and IMF staff calculations.

9. Government supported programs have had mixed success in lifting credit demand. In contrast to the effective implementation of the state guarantee program for mortgage loans (albeit with some negative side effects of significantly raising the average LTV),[9] lending programs for SMEs and student and academic loans are underused. Making the current system more transparent and efficient could improve takeup and broaden access to educational opportunities, with significant producitivity gains in the future.

[9] The Latvian government does not provide direct subsidies for house purchase; however, it is possible to obtain a state loan guarantee for the down payment of between 10 and 20 percent for families with children and young professionals.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 22, 2019

Prepared By | European Department

CONTENTS

FUND RELATIONS ____ 2

STATISTICAL ISSUES ____ 6

FUND RELATIONS

(As of June 30, 2019)

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		
	2019	**2020**	**2021**
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 September 5 2018 (IMF Country Report No. 18/266). The Executive Board assessment is available https://www.imf.org/en/News/Articles/2018/09/05/pr18340-republic-of-latvia-imf-executive-board-concludes-2018-article-iv-consultation

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 (2007–18)				
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-Oct. 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).

National Accounts: The Central Statistical Bureau of Latvia (CSB) compiles and publishes quarterly national accounts with the production, expenditure, and income approaches on a regular and timely basis. Data is compiled in accordance with the European System of National and Regional Accounts (ESA 2010). 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 is 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 monetary and financial statistics (MFS) for Latvia are reported by ECB and published in the IFS. The monetary and financial data cover balance sheet data for the 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. Latvia reports data on several series and indicators of the Financial Access Survey (FAS), including the two indicators —the number of ATMs per 100,000 adults and the number of commercial bank branches per 100,000 adults—adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

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. The BoL is also responsible for compiling international investment position (IIP), external debt, and international reserves statistics. The BoL reports quarterly data on balance of payments and IIP, and monthly international reserves to STA on a timely basis. Balance of payments data are compiled using the format recommended in the Balance of Payments Manual, sixth edition (BPM6). Latvia reports comprehensive data to two STA's initiatives: (a) to the Coordinated Direct Investment Survey (CDIS), and (b) to the Coordinated Portfolio Investment Survey (CPIS). The BoL disseminates quarterly external debt data in the World Bank's Quarterly External Debt Statistics (QEDS) database.

Data Standards and Quality: Latvia is a subscriber of the Special Data Dissemination Standard (SDDS) Plus since August 2018 and a link to Latvia's metadata is available at the IMF's website for the Dissemination Standards Bulletin Board (DSBB).

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 2019

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	June 2019	June 2019	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2019	June 2019	M	M	M
Reserve/Base Money	Feb 2019	March 2019	M	M	M
Broad Money	Feb 2019	March 2019	M	M	M
Central Bank Balance Sheet	May 2019	June 2019	M	M	M
Consolidated Balance Sheet of the Banking System	May 2019	June 2019	M	M	M
Interest Rates[2]	May 2019	June 2019	M	M	M
Consumer Price Index	June 2019	July 2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	May 2019	June 2019	M	Q	M
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	May 2019	June 2019	M	Q	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	May 2019	June 2019	M	Q	M
External Current Account Balance	Q1 2019	June 2019	M	M	M
Exports and Imports of Goods and Services	April 2019	June 2019	M	M	M
GDP/GNP	Q1/2019	June 2019	Q	Q	Q
Gross External Debt	Q1 2019	June 2019	Q	Q	Q
International Investment Position[6]	Q1 2019	June 2019	Q	Q	Q

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

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

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

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

[5] Including currency and maturity composition.

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

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