INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/194

REPUBLIC OF LATVIA

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LATVIA

September 2021

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 2021 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its August 27, 2021 consideration of the staff report that concluded the Article IV consultation with the Republic of Latvia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on August 27, 2021, following discussions that ended on June 14, 2021, 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 7, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Latvia.

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.

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PRESS RELEASE

PR 21/253

IMF Executive Board Concludes 2021 Article IV Consultation with the Republic of Latvia

FOR IMMEDIATE RELEASE

Washington, DC – **September 2, 2021:** On August 27, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia.

Latvia experienced a relatively milder recession than most other European countries, contracting by 3.6 percent in 2020. While the pandemic has caused an unprecedented disruption to economic and social activity, the authorities responded with a sizable and broad-based policy response, thus mitigating its impact. These support measures have helped preserve jobs and provide liquidity to companies and income support to vulnerable groups, thereby averting a deeper recession. Fiscal balances deteriorated as a significant COVID-support package was deployed, pushing the overall deficit to 4.5 percent of GDP and public debt to 44 percent of GDP. The current account improved and reached 3 percent of GDP as domestic demand weakened.

A strong recovery is expected if mass vaccination gains momentum and containment measures are phased out. Output is projected to grow by 3.6 percent in 2021 and 5.2 percent in 2022, as stimulus and the EU-financed investment works through and vaccinations help control the spread of the virus. However, uncertainty around the baseline is unusually high with upside and downside surprises. Notably, a resurgence of new variants of the virus and a slow and/or uneven rollout of vaccines could pose significant downside risks to growth. At the same time, a ramping up of the vaccine rollout would allow activity to resume faster and help prevent long-term scarring.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the sizable and broad-based policy response to cushion the socio-economic impact of the COVID-19 pandemic. The economic outlook appears favorable, reflecting a rebound in export demand, consumption, and EU-financed public investment. Nevertheless, pandemic-related risks and uncertainty remain high. Against this background, it will be important to maintain supportive policies in the near term while preserving financial stability and fostering structural transformation to achieve greener, smarter, and more inclusive growth.

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

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

Directors supported maintaining the accommodative fiscal policy stance at the current juncture. They stressed the need to ensure that fiscal support remains well-targeted and adjusted to the evolving conditions. Once the recovery is firmly secured, fiscal policy should aim to rebuild buffers and facilitate Latvia's economic transformation, underpinned by fiscal rules. Directors noted that public investment plans focus appropriately on green and digital transformation, as well as social protection. Transparency and governance, especially in project selection and public procurement, are key to their efficiency.

Directors welcomed the resilience of the financial sector and the augmented macroprudential toolkit. They underscored the importance of risk-based supervision, focusing on exposures to COVID-sensitive sectors and small and medium enterprises, particularly as support measures are phased out. Addressing the corporate equity gap and further upgrading the insolvency regime remain important priorities to help reinvigorate corporate lending. Directors also highlighted the need to monitor banks' asset quality and risks in the housing and construction sectors. They welcomed the progress in strengthening the AML/CFT framework and the authorities' commitment to continue with further reforms.

Directors encouraged the authorities to press ahead with their reform agenda, making the most use of the European Union's Resilience and Recovery Facility. They recommended targeting improvements in digital infrastructure, healthcare, social safety nets, and human capital. Achieving the ambitious climate mitigation objectives requires a combination of investment in green technology and taxation of polluting industries. Directors also saw a need to mitigate scarring in the labor market, including through proactive job creation policies and strengthened active labor market policies. They called for continued efforts to improve productivity and the business environment more broadly.

Table 1. Latvia: Selected Economic Indicators, 2017–22

	2017	2018	2019	2020	2021	2022
					Proj.	
National accounts	(Percentage change, unless otherwise indicated)					
Real GDP	3.3	4.0	2.0	-3.6	3.6	5.2
Private consumption	3.0	2.6	2.2	-10.0	8.4	5.5
Public consumption	3.4	1.6	2.6	2.6	3.5	4.2
Gross capital formation	9.9	15.8	3.4	6.6	4.6	7.8
Gross fixed capital formation	11.4	11.8	2.1	0.2	6.0	8.2
Exports of goods and services	6.4	4.3	2.1	-2.7	3.8	3.7
Imports of goods and services	8.6	6.4	3.0	-3.3	9.1	5.0
Nominal GDP (billions of euros)	27.0	29.1	30.4	29.3	30.8	33.3
GDP per capita (thousands of euros)	13.8	15.1	15.8	15.4	16.2	17.5
Savings and Investment						
Gross national saving (percent of GDP)	23.4	23.5	21.7	25.8	24.3	23.7
Gross capital formation (percent of GDP)	22.1	23.8	22.4	22.8	24.5	24.7
Private (percent of GDP)	18.6	19.7	18.4	18.6	20.8	20.4
HICP Inflation						
Period average	2.9	2.6	2.7	0.1	2.1	2.7
End-period	2.2	2.5	2.1	-0.5	4.0	2.6
Labor market						
Unemployment rate (LFS; period average, percent)	8.7	7.4	6.3	8.1	7.7	7.2
Real gross wages	4.6	5.8	4.4	6.0	4.8	3.7
Consolidated general government 1/	(Percent of GDP, unless otherwise indicated)					
Total revenue	35.7	37.3	37.5	38.6	38.5	38.2
Total expenditure	36.5	38.1	37.9	42.5	47.4	42.2
Basic fiscal balance	-0.8	-0.7	-0.4	-3.9	-8.9	-4.0
ESA balance	-0.8	-0.8	-0.6	-4.5	-8.8	-2.6
General government gross debt	39.0	37.1	37.0	43.5	48.0	47.9
Money and credit						
Credit to private sector (annual percentage change)	-1.0	-5.6	-2.3	-4.4	...	...
Broad money (annual percentage change)	2.9	5.8	4.4	-3.6	...	...
Balance of payments						
Current account balance	1.3	-0.3	-0.6	3.0	-0.2	-1.0
Trade balance	-9.1	-8.7	-8.8	-5.0	-9.7	-9.7
Gross external debt	141.5	123.3	117.3	124.2	129.7	128.5
Net external debt 2/	22.1	20.6	18.9	14.3	13.0	12.7
Exchange rates						
U.S. dollar per euro (period average)	1.13	1.18	1.12	1.14	...	...
REER (period average; CPI based, 2005=100)	119.1	122.5	122.5	124.2	...	...
Terms of trade (annual percentage change)	0.4	1.8	0.7	2.8	-2.0	0.5

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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

July 7, 2021

KEY ISSUES

Context: The pandemic has caused an unprecedented disruption to economic and social activity, which has been met with swift, strong, and well-coordinated policy responses. These support measures have helped preserve jobs and provide liquidity to companies and income support to vulnerable groups, thereby averting a deeper recession. After contracting by 3.6 percent in 2020, real GDP is projected to grow by 3.6 percent in 2021 and 5.2 percent in 2022, as stimulus and the EU-financed investment works through and vaccinations help control the spread of the virus. However, uncertainty around the outlook is unusually large, given the evolution of the epidemiological situation and the slow start of the vaccination program.

Key Policy Recommendations: The first order of priority remains saving lives and livelihoods. Therefore, policies should remain supportive in the near term and be adjusted flexibly in response to evolving conditions. As the recovery becomes entrenched, policies should shift toward facilitating resource reallocation, addressing long-standing structural challenges, and supporting a greener, smarter, and more inclusive transformation.

- Fiscal policy should remain supportive until the recovery is entrenched. Thereafter, policy should focus on supporting the structural transformation of the economy while ensuring space to accommodate demographic and social spending costs. With the expected large increase in capital spending supported by EU funds, continued improvements in public investment management will be critical.

- Banks' asset quality should continue to be monitored closely, especially for banks exposed to sectors directly affected by the COVID crisis. An exit strategy from the support measures should be carefully planned and executed to minimize risks to financial stability. Efforts to further improve the effectiveness of the AML/CFT framework should continue.

- Structural policies should foster a sustainable recovery and mitigate scarring. Labor market policies in the near term should be proactive, focusing on preserving jobs and facilitating labor mobility, including through in-work benefits where cost-effective, hiring incentives and strengthened ALMPs. Policies should switch from job preservation to facilitating reallocation and strengthening the social safety net once the effect of the crisis becomes clearer. Investment in digital and green technologies will help boost productivity.

Approved by
Philip Gerson (EUR) and Johannes Wiegand (SPR)

Discussions were held via videoconference with Riga during June 1–14, 2021. The team comprised Bernardin Akitoby (head), Karina Garcia, Bogdan Lissovolik, and Sakai Ando (all EUR) and Carlos Acosta (LEG). Ms. Skrivere (OED) also joined the discussions. Shituo Sun and Rafaela Jarin supported the mission. The mission met with Bank of Latvia Governor Kazāks, senior representatives of the Ministry of Finance, other senior officials, and private sector representatives.

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CONTEXT

1. **The Latvian economy entered the COVID-19 crisis on a decelerating growth trend.** By 2019, growth slowed significantly to 2 percent compared to an average of 3 percent over 2016–19, because of a less supportive external environment and a slowdown in EU-financed investment. Anemic credit growth and a declining and ageing population have constrained long term growth, while low technological diffusion has depressed productivity growth.

2. **Prudent policies helped accumulate pre-crisis buffers.** Low fiscal deficits, averaging 0.4 percent of GDP over 2016–2019, helped stabilize public debt below 40 percent of GDP. Household and corporate debt continue declining to about 20 and 55 percent of GDP respectively by 2019. Banks accumulated capital and liquidity buffers above the euro area average and asset quality improved, although AML/CFT concerns lingered.

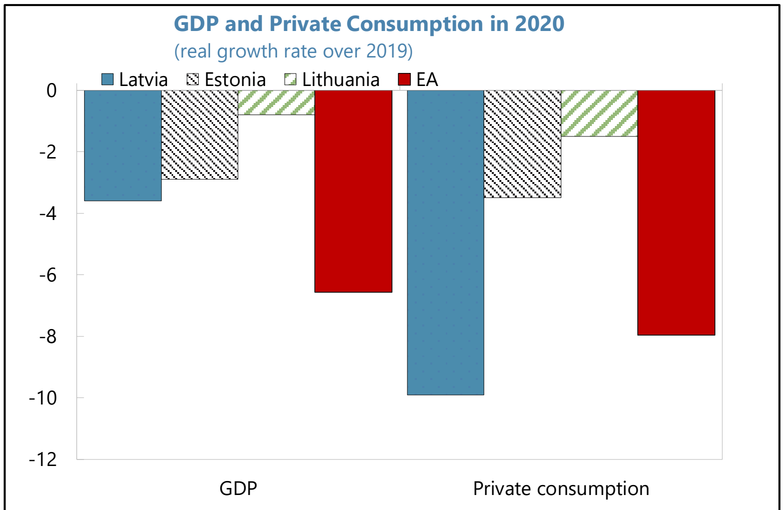
3. **Significant progress has been made towards convergence of living standards to those of western Europe, but challenges remain.** Poverty and inequality levels remain high, especially among the elderly and those with lower education levels. Social protection is limited, partly given the relatively large informality. Taxes and social benefits in Latvia have a low redistributive impact compared to other EU countries, weighing on income inequality (Figure 6).

4. **After successfully containing the first wave of COVID-19, Latvia experienced a stronger and deadlier second wave.** Following the first case in March 2020, Latvia experienced a relatively mild spread of infections during the first wave, thanks to an extensive testing program and relatively stringent containment measures. By the summer, containment measures were gradually lifted, but they were re-imposed by November as the second wave hit. The relatively high rate of deaths and hospitalizations during the second wave likely reflects prevalence of certain comorbidities and ageing. Meanwhile, after a slow start, the vaccination rollout is catching up, with about 20 percent of the population being fully vaccinated as of June 2021, compared to a European average of 25 percent. However, vaccine hesitancy is high, and the share of elderly population vaccinated is relatively low (Figure 1, Annex II).

5. **The political landscape has become more fragmented.** After months of tensions within the government, the five-party ruling coalition shrunk to four parties and lost an absolute parliamentary majority, triggering a reshuffling of several Ministerial portfolios. The upcoming 2022 parliamentary elections may put pressure on the government budget.

THE ECONOMIC IMPACT OF THE COVID-19 CRISIS AND POLICY RESPONSES

6. Latvia experienced a relatively milder recession than most other European countries. In 2020, the economy contracted by 3.6 percent, compared to an average of 6.6 percent in the euro area. Comparatively low contagion numbers and a fast reopening of the economy in the summer supported economic activity, while relatively resilient exports and a relatively low dependence on sectors most affected by COVID-19—high touch sectors—attenuated the decline in demand. (Figure 2). At the same time, private consumption collapsed, in part reflecting declining consumer confidence and stringent lockdowns amid Latvia's relatively low e-commerce infrastructure and activities. Inflation turned negative, reflecting weak domestic demand and lower energy prices. A significant negative output gap is estimated to have opened up.

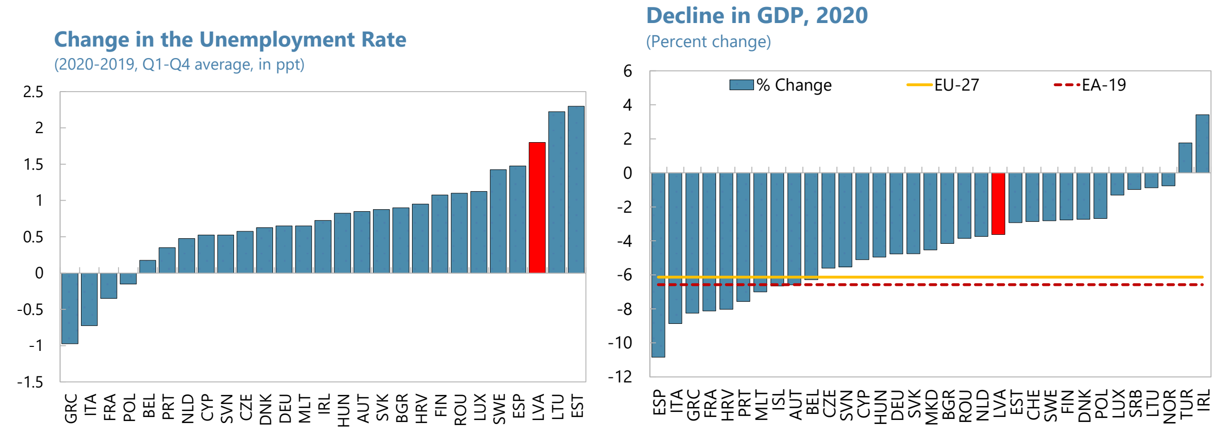


Sources: National Statistics Offices IMF staff estimates.

7. The current account improved as domestic demand weakened. Weak consumption and investment contributed to the decline in imports. The depressed imports, together with resilient goods exports, caused the current account surplus to rise to 3 percent of GDP in 2020. Given the large improvement in the current account, Latvia's external position in 2020 is assessed as stronger than the level implied by medium-term fundamentals and desirable policies (Annex IV).

8. Despite the milder recession, the economy lost more jobs than in most other European countries. Unemployment increased to 8.1 percent in 2020, slightly higher than the euro area average of 7.8 percent. Trade, accommodation and food service sectors accounted for the largest share of employment loss. Meanwhile, wage growth decelerated but wages still grew by 6 percent.

COVID-19 Impact on Unemployment and Growth

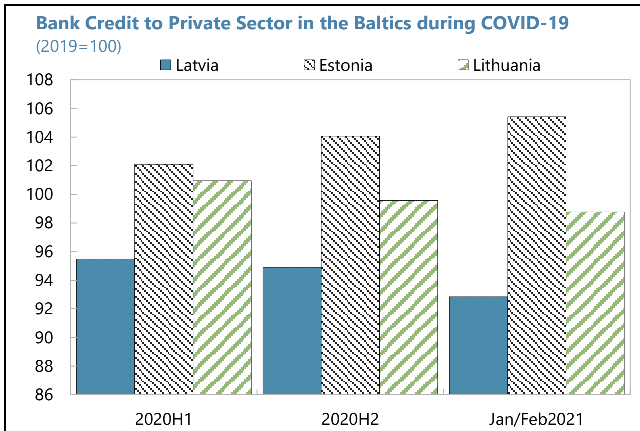


Sources: Eurostat, IMF staff calculations

Sources: Eurostat and IMF staff calculations

9. **Fiscal balances deteriorated.** The overall deficit rose to 4.5 percent of GDP, causing the public debt to increase to 44 percent of GDP.[1] Taking advantage of favorable market conditions, the deficit was financed primarily on international bond markets. Exposure to contingent liabilities through guarantees was limited to about 2 percent of GDP in 2020.

10. **The financial sector appears to have so far absorbed the COVID-19 shock well.** Banks entered the crisis in a well-capitalized and liquid position. The regulatory decision to suspend dividend payouts helped further increase banks' capital, while higher precautionary savings bolstered their liquidity. The total NPL ratio continued to fall in 2020, although NPLs rose in some contact-intensive sectors. Bank credit growth to the private sector has been subdued for years and remained negative in 2020 as lending to the corporate sector weakened. Bank profitability decreased during 2020 largely reflecting lower trading and commission income. Loan interest rates have remained comparatively high despite the ECB's accommodative monetary policy. Real estate prices eased somewhat at the onset of the crisis but reverted to the previous increasing trend and continued to increase through the first half of 2021 with an incipient recovery in mortgage lending.



Sources: Haver Analytics and IMF staff estimates.

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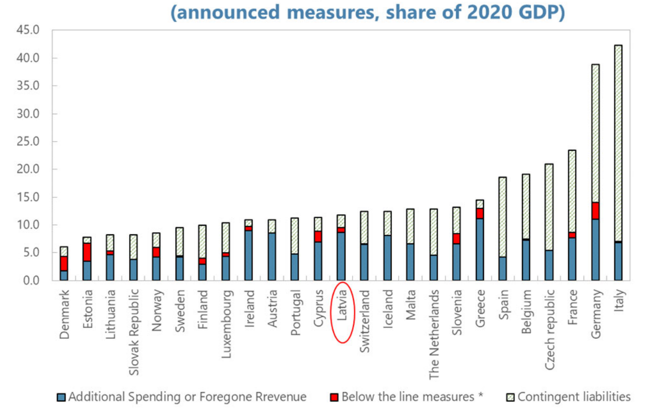
[1] While tax revenues seem to have held up in 2020, this largely reflects a base effect on CIT revenues, which were particularly low in 2019 reflecting the transition period granted in the 2018 Tax Policy Guidelines. In addition, 2020 corporate taxes were paid on the distributed 2019 profits, before the pandemic hit.

11. The relatively mild impact of the pandemic on output reflects in part the sizable support implemented by the authorities. Using available fiscal space and relaxation of EU fiscal rules, the government announced several support packages amounting to about 12 percent of GDP. Most of the measures focused on supporting business with guarantees and loans, expanding social assistance through transfers and unemployment benefits, and preserving jobs through wage subsidies. However, less than half of the announced measures was disbursed in 2020, with business support and some employment support programs showing the lowest take up.[2] This may reflect in part the uncertainty about the impact of the crisis on business in 2020 as well as relatively narrow eligibility criteria of employment support programs (Annex II).

Fiscal Measures in Response to the COVID-19 Pandemic (announced measures, share of 2020 GDP)



12. Substantial support was also provided through the financial sector. Latvia's banks actively participated in the payments moratoria that the European Banking Authority (EBA) initiated in March 2020, which helped relieve pressure on borrowers. The measures, concentrated in the real estate and hospitality sectors, were implemented flexibly taking account of clients' conditions. A significant share of the moratoria expired by mid-2021. In addition to the banks moratoria, the ECB and local financial sector regulator (the FCMC) extended forbearance measures that allowed banks to use capital and liquidity buffers to absorb COVID-19-related shocks on businesses and households.[3]

13. The authorities' anti-crisis measures helped cushion the economic impact of the crisis, but less so its impact on unemployment. The lack of STW programs in place before the crisis meant that the authorities needed to design and implement programs as the crisis was unfolding. This could partly explain the narrow eligibility criteria for downtime benefits, which initially included only those that were 100 percent off-work. Later in the crisis, the authorities expanded the eligibility requirements as the design of STW programs was refined.

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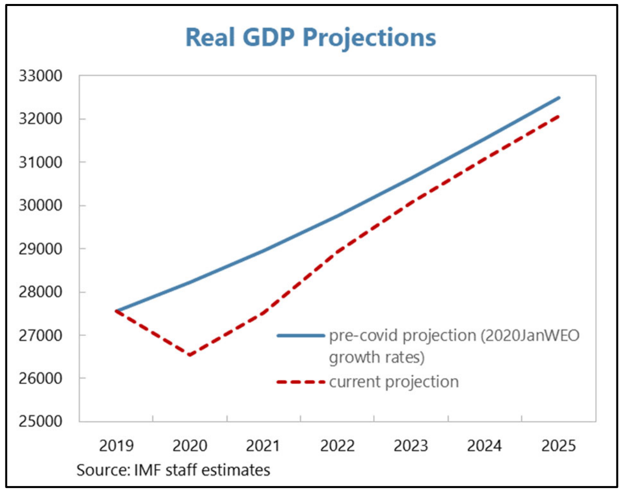
[2] A portion of previously announced measures in 2020 was phased out to 2021, including loans and guarantees to specific sectors and the amount of EU funds restructured to support COVID-relief measures.

[3] In particular, banks were allowed to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR). (See ECB announcements).

OUTLOOK AND RISKS

14. A strong recovery is expected as mass vaccination gains momentum and containment measures are phased out. Output is projected to grow by 3.6 percent in 2021 and 5.2 percent in 2022, supported by a strong recovery in consumption driven by pent up demand and an accumulation of precautionary savings. The recovery is expected to pick up speed during the second half of 2021 provided that the vaccine rollout ramps up and economic activity recovers with the gradual reopening of the economy. With the increase in domestic demand and commodity prices, inflation is assumed to pick up before stabilizing at around 2 percent over the medium term. An acceleration of capital spending[4] supported by EU funds, including grants under the Resilience and Recovery Facility (RRF) is expected to support medium-term growth. The negative output gap is projected to gradually close over the medium term. Staff's macroeconomic projections imply limited scarring over the medium term, with the real GDP level projected to be lower than its pre-crisis trend by 1.3 percent by 2025.



15. Uncertainty around the baseline is unusually high with upside and downside surprises possible. A resurgence of new cases and new variants of the virus, a delay of treatment and vaccines or failure to tackle vaccine hesitancy could pose significant downside risks to growth, as containment measures will have to remain for a longer period, thus dampening economic activity and further deteriorating the fiscal outlook. A slow and/or uneven rollout of vaccines could impact economic activity directly and through persistent behavioral changes. With limited spare capacity, the large inflow of EU-investment funds could renew overheating concerns in the construction sector. On the upside, a ramping up of the vaccine rollout would allow activity to resume faster and help prevent long-term scarring but could add inflationary pressures amid already fast wage growth (Annex I).

Authorities' Views

16. The authorities agreed with the staff's outlook and risk assessment. They noted that the economic contraction in 2020 was mostly driven by a large decline in private consumption because of COVID-19 restrictions on service and retail sectors. They concurred that the pandemic remains the main source of uncertainty for the outlook and were determined to ramp up mass vaccination to 60 to 70 percent of the population by fall. Under these circumstances, they saw a robust recovery in 2021, driven by strong external demand for manufacturing products, pent-up demand, precautionary savings accumulated during the pandemic, and EU-financed public investment.

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[4] Capital spending includes "net acquisition of non-financial assets" and "capital transfers."

However, they were concerned about capacity constraints in the construction sector and the shortages of skilled labor.

POLICY DISCUSSIONS: SUPPORTING THE GRADUAL REOPENING AND THE POST-COVID-19 RECOVERY

Discussions focused on policy options to support the recovery while laying the foundation for long-term growth. Policies should remain supportive in the near term and should be adjusted flexibly to the evolving conditions. In the absence of own monetary policy, available policy tools -fiscal and macroprudential policy- should be proactive to prevent the accumulation of imbalances, especially if the ECB's monetary policy stance becomes too loose for Latvia. As the recovery becomes entrenched, policies should shift toward facilitating reallocation and securing smarter, greener, and more inclusive growth.

A. Fiscal Policy: Sustainably Supporting the Recovery

17. The budget for 2021 envisages additional support measures. An extension of temporary support measures of more than 9 percent of GDP is planned[5] in response to the surge of the second COVID-19 wave and still large unemployment. Spending priorities focus on continuing support to the health sector, expanding work and unemployment benefits, and providing business support. The large increase in the wage bill to GDP ratio reflects in part the decline in nominal GDP in 2020 and the minimum wage increase introduced in 2021. Tax policy changes were introduced in 2021 but are not expected to have a significant impact on the fiscal position this year.[6] Over the medium term, the authorities envision a substantial increase in investment supported by EU funds, including grants under the RRF. The investment strategy's priorities will be green investment, digitalization, health, and social protection (Annex III). Overall, the headline fiscal deficit is projected to widen to more than 8 percent of GDP in 2021 before declining over the medium term, as economic activity resumes and exceptional measures are phased out. The public debt ratio is expected to peak at 48 percent of GDP in 2021 and steadily decline over the medium term (Annex VII). The SGP fiscal rule escape clause applies in 2021, and will remain in place through 2022.

18. Fiscal policy should remain supportive until a sustained recovery emerges. With some fiscal space available, the authorities' response to the crisis has been sizeable and helped address the immediate health concerns and avert a deeper economic contraction. Staff supports the 2021 fiscal stance, which will underpin the rebound in consumption and mitigate scarring. As the epidemiological situation evolves, the adequacy of measures deployed should be assessed and

[5] As planned under the 2021 Stability Program. More recently, the authorities are considering additional measures that could amount to close to 11 percent of GDP.

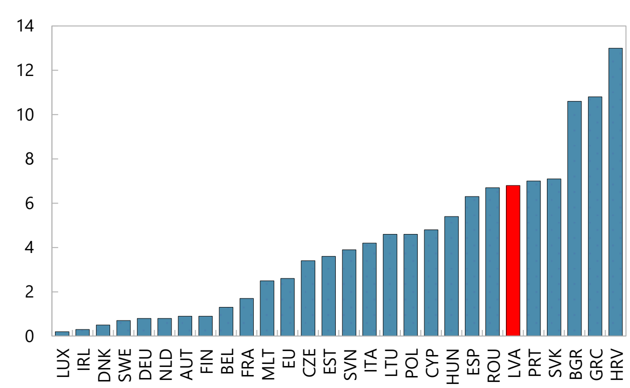
[6] The main objective was to improve labor tax competitiveness, promote competitiveness of enterprises, reduce income inequality for the working population through tax policy, and address several shortcomings of the tax system identified during the COVID-19 crisis. See 2021 Stability Program.

adjustments made where necessary, as targeting and efficiency will remain key to use fiscal space efficiently. With a very uncertain outlook for the recovery, fiscal support needs to remain available until the recovery is well-established. Should the recovery falter, fiscal stimulus should be further extended to soften the social and economic impact on vulnerable households and liquidity constrained viable corporates. Spending should be focused on anti-crisis measures and shielded from the political business cycle. Furthermore, while Latvia's minimum wage is still below that of its Baltic neighbors, the authorities should be mindful of potential pressures on overall wages in the economy. Further increases, if not aligned with productivity growth, could undermine competitiveness.

19. Medium-term fiscal policy should support a structural transformation of the economy. The authorities' investment plan rightly puts emphasis on digitalization and greening of the economy, but efficient and targeted investment strategies will be key to maximize the impact on long term growth, prevent capacity utilization bottle necks and deliver a faster and more sustainable recovery. The large fiscal support that was provided will likely reduce fiscal space in the medium term. Therefore, the credibility of the medium-term fiscal framework (MTFF) should continue to be supported by fiscal rules that support a gradual restoration of fiscal space once the recovery is firmly entrenched while still providing targeted support to the post-pandemic transformation of the economy.

20. High governance standards and careful monitoring are essential given the significant stimulus provided and ambitious investment plans. All COVID-19-related transactions should continue to be reported transparently, audited independently and audited reports published. Furthermore, as one of the largest recipients of RRF funds, bottle necks in spending could emerge. To mitigate absorptive capacity risks, the authorities should aim to reduce efficiency gaps in the public expenditure process, particularly on project appraisal and management of PPPs.[7] To reduce risks from resource misallocation, the authorities should continue to improve public procurement transparency and efficiency, including by public access to procurement contracts for crisis-related spending. The authorities should also seek to enhance their anticorruption framework in line with the 2020 GRECO recommendations.[8] Local authorities' and SOEs' governance and reporting should also be strengthened.

RRF Grants (percent of 2020 GDP)



Source: EC Debt Sustainability Monitor

[7] See Country Report No. 18/267.

[8] GRECO Latvia Compliance Report. October 2020.

Authorities' Views

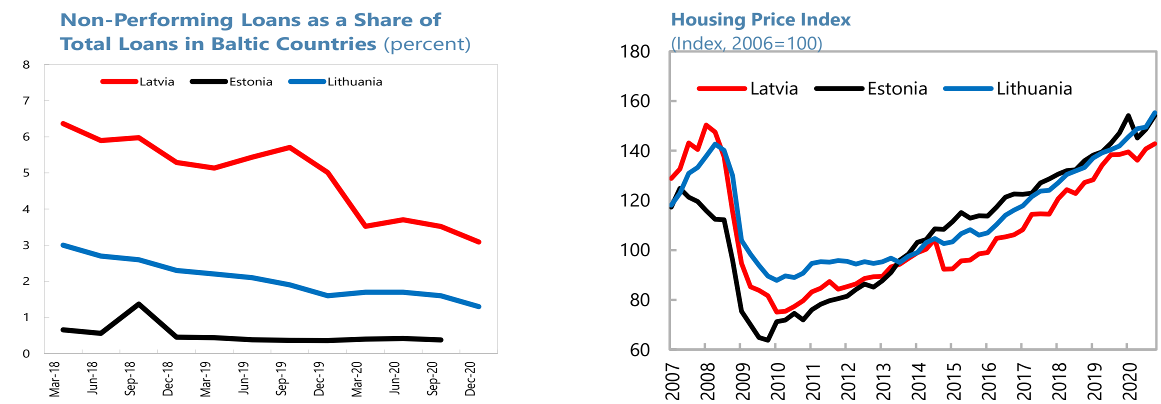
21. The authorities agreed with the near-term and medium-term fiscal policy advice. Regarding the fiscal measures to fight the COVID-19 crisis, they emphasized that the budget for 2021 provides adequate, more targeted support to address the crisis and that their Fiscal Law is flexible enough to extend further support in 2022, if needed. However, this support will be phased out gradually to avoid any "cliff-effects". They also stressed the need to ring-fence COVID-19-related spending to avoid using it to respond to spending pressures from the political business cycle. Over the medium term, a gradual rebuilding of fiscal buffers will be supported by the Stability and Growth Pact (SGP). Given the large volume of planned EU-financed investment, the authorities agreed that the investment strategy should be supported by efficient public investment management to maximize the investment returns in terms of a more inclusive and greener transformation of the economy. A coordinated strategy with the private sector will help mitigate absorptive capacity bottlenecks in the construction sector.

22. The authorities agreed that maintaining high governance standards is key in managing emergency spending. They noted that all COVID-19 expenditures are reported transparently, audited independently by the State Audit Office, and published on their website. They noted progress is being made in improving the anticorruption framework and pointed to ongoing work in addressing recommendations of the GRECO report.

B. Financial Sector Policies: Safeguarding Financial Stability and Reviving Credit Growth

23. Risks to financial stability have been contained so far, as the financial sector entered the crisis in a solid position. The capital adequacy ratio (CAR) of the overall banking system and profitability remain well above the EU average. While asset quality has historically been a concern, it has improved substantially due to proactive NPL resolution, although legacy NPLs remain in manufacturing and in the asset portfolios of banks previously serving foreign clients (BSFCs). The COVID-19 shock has increased NPLs in contact-intensive sectors, but their share in banks' loan portfolios is very limited. However, credit remains weak following protracted deleveraging, reflecting, among other, cautious bank lending policies in the face of high riskiness of the corporate sector and remaining bottlenecks to asset recovery.[9] While real estate prices have been on a prolonged uptrend, robust wage growth and similar price dynamics in regional peers suggest that house prices remain broadly aligned with fundamentals. However, the expected surge in construction, backed by a large inflow of EU-investment funds, could renew overvaluation concerns in property prices.

[9] See IMF Country Report No. 19/264.



Sources: Respective countries' SDDS pages and national authorities

24. Risk-based supervision should continue. Government measures and prudential regulations have temporarily eased the impact of the crisis on the banking sector while supporting borrowers. However, risks could re-emerge as the support measures are phased out, which is evidenced by moderate increases in banks' Stage-2 loans. Supervisors should ensure that banks are prepared to tackle a significant increase in NPL levels and conduct risk-based supervision. Supervision should continue to ensure that non-SSM banks are subject to the same extraordinary monitoring applied to the SSM banks and require banks to continually assess borrowers' creditworthiness. Bank exposures to sectors heavily affected by the pandemic should be in the supervisory focus. The integration of the financial sector supervisor, FCMC, within the Bank of Latvia, is to be completed in 2023.

25. The exit strategy from the support measures will require careful balancing and proactive NPL management. Although the number of bankruptcies has been on a declining trend, financial stability risks could increase as the government support programs and temporary curbs on bankruptcy procedures expire. Support to borrowers and forbearance measures for banks should continue to be withdrawn gradually as the recovery takes hold, and eligibility should be increasingly tailored to the viable (or potentially viable) firms in the most hard-hit contact-intensive services sectors and viable SMEs. As the recovery strengthens, prudential standards should be normalized so that problem assets can be recognized and dealt with in a timely manner. In the event of significant build-up of NPLs, Latvia's post-GFC NPL resolution experience based on banks' active write-offs and their own internal asset management companies should be leveraged as part of the menu of workout options under the integrated supervisory review and evaluation process.

26. The authorities should spearhead deeper structural reforms to bolster sound credit provision to the economy. Policy priorities include:

- **Corporate strategies and recapitalization.** Latvia's corporate sector is characterized by the predominance of SMEs and micro firms.[10] Staff encouraged the authorities to assess the

[10] See https://www.eib.org/en/publications/econ-eibis-2020-latvia.

size of the corporate equity gap and policy options to address it, including through equity injections. Recent and ongoing work on policy options to resolve corporate stress suggests that grant-based support is the best option for micro enterprises, which could complement the existing recapitalization fund of 0.3 percent of GDP that has been created for larger enterprises.[11] Recapitalization programs should be based on a "triage" approach (sorting companies into viable, viable with restructuring, and non-viable).

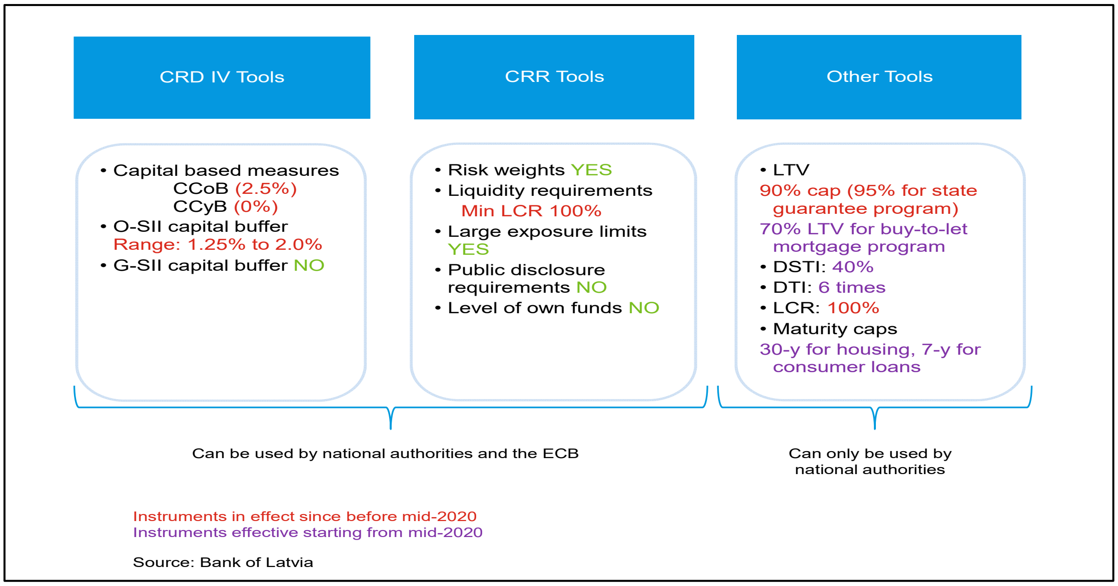
- **Banking sector resilience and consolidation.** Initial stress tests suggest that Latvian banks' capital cushions are comparatively robust to the risks of corporate stress (Annex V). Against this background, the ongoing re-orientation of former BSFCs away from unsustainable business models should ease lending constraints for profitable banks.

- **Insolvency processes.** Latvia has already significantly progressed in upgrading the insolvency regime by strengthening the regulation of insolvency administrators and data collection mechanisms.[12] The ongoing implementation of the EU restructuring directive presents an opportunity to address remaining gaps, including upgrading the rehabilitation process and simplifying corporate debt restructuring through out-of-court and hybrid procedures (Annex VIII).

27. Recent additions to the macroprudential toolkit expand tailored options to solidify stability. While Latvia's macroprudential policy framework is built on strong foundations, new borrower-based measures came into force in mid-2020, including debt-to-income (DTI) and debt-service-to-income (DSTI) ratios, caps on real estate loan maturity, and limits on buy-to-let borrowing. These parameters were prepared before COVID-19 and were not yet binding in 2020, thereby playing a pre-emptive role. They have supplemented existing tools, helping incentivize prudent lending practices and build loss absorption capacity to future shocks should market imbalances emerge in the housing and related sectors. The augmented macroprudential toolkit will need to be periodically re-calibrated in line with economic conditions and updated assessments of vulnerability, particularly if cyclical divergences between Latvia and the euro-area emerge, including by drawing on the ongoing BoL's work on new indicators of cyclical risk assessments.

[11] See IMF WP 21/56 and "Solvency Support form Enterprises" (EUR Corporate Living Group Note No 1).

[12] A recent EBA benchmarking analysis suggests a better view on Latvia's comparative position in debt enforcement by larger banks.



28. Latvia has made significant progress in strengthening its AML/CFT framework. As a result of reforms to the AML/CFT system, Latvia avoided gray listing by the FATF in February 2020, including by increasing the effectiveness of the system (e.g., AML/CFT risk based supervision and availability of beneficial ownership information of legal persons registered in Latvia). Moreover, in December 2019, Moneyval issued a follow-up report, with all FATF Recommendations rated as being sufficient for technical compliance (Annex IX). Building on this progress, the authorities conducted a National ML/FT Risk Assessment (NRA) in 2020 and risk mitigation measures are currently being implemented based on the outcomes of the NRA. Latvia should follow through on its plans to further strengthen the effectiveness of its regime. Regional Fund TA on AML/CFT will help deepen the reform agenda. In parallel, in line with the needs of the real economy the FCMC should continue to intensively monitor the refocusing of the business models of the banks formerly servicing foreign clients.

29. Climate change risk should continue to be monitored. The BoL's 2020 financial stability report assesses that climate change risks to the financial sector do not appear to be significant as its exposure to carbon-intensive economic sectors is relatively small. An assessment of the environmental risks is included in the supervisory priorities for 2021.

Authorities' Views

30. The authorities believe that the financial sector risks from COVID-19 are largely contained. While acknowledging that asset quality in pandemic-hit sectors could deteriorate further once COVID-19 support is phased out, they noted that NPLs continued to decline during the crisis and that banks 'exposure to hardest-hit sectors is very limited. Supervisors have been continually monitoring banks' health and requiring banks to assess clients' creditworthiness. The authorities noted that the deterioration of bank profitability in 2020 was temporary, and it already started to recover in recent months. The Bank of Latvia's stress tests point to banks' capital and liquidity being resilient even in very adverse scenarios.

31. The authorities shared staff's concern over a protracted decline in corporate lending. They noted that the lingering decline in credit after the financial crisis has dampened economic activity. The trend has been exacerbated by the COVID-19 crisis, given the high uncertainty that has depressed private investment. The still-elevated loan interest rates and fragmentation in the credit market may have also dampened demand for credit. They planned to study further the determinants of corporate lending in the Baltic countries and explore policy options to reverse the declining trend.

32. The authorities agreed that successful exit strategy hinges on corporate recapitalization and a robust insolvency regime. They were in the process of assessing the corporate equity gap and the need to address it beyond the current recapitalization program for larger enterprises. The Ministry of Justice is moving to further strengthen the insolvency procedures, including through legislation on regulation of insolvency administrators and the forthcoming adoption of the EU restructuring and insolvency directive.

33. The authorities stressed their resolve to build on the 2019 Moneyval follow-up assessment and further upgrade AML/CFT procedures. They pointed to the favorable conclusions from the 2020 National Risk Assessment and unveiled plans to promptly implement the 6th EU AML directive and new amendments to the AML/CTPF law regarding customer due diligence. In the context of the ongoing move to risk-based AML/CFT activities, they noted reduced risk exposures and enhanced capacity to manage risk as evidence of striking the right balance between robust implementation of AML rules and risks. The authorities emphasized progress in cross-border and interagency cooperation on AML issues. These include, inter-alia, the establishment of unprecedented cooperation between FIUs of 25 states in cross-border financial analysis related to a Latvian bank accused of money laundering; these efforts were led by FIU Latvia (under the aegis of an "International Financial Intelligence Taskforce"). On the domestic front, high-level cooperation is ensured through Financial Sector Development Board, whereas day-to-day cooperation in AML/CFT is ensured through, among other things, a coordination platform for supervisory authorities. In that regard, Latvia has established a fully functional public-private partnership platform for AML/CFT purposes, led by the FIU. These and other efforts undertaken by Latvia in recent years have resulted in a significant increase in cases disseminated by the FIU and investigated by law enforcement authorities, including stand-alone money laundering investigations as well as investigations of professional money laundering. The authorities continued to monitor the refocusing of the business models of banks formerly serving foreign customers, noting that their overall capital and liquidity remained solid during the crisis.

C. Structural Policies: Building the Foundation for Sustainable, Inclusive, and Greener Growth

Preventing Long-Term Scarring in the Labor Marker

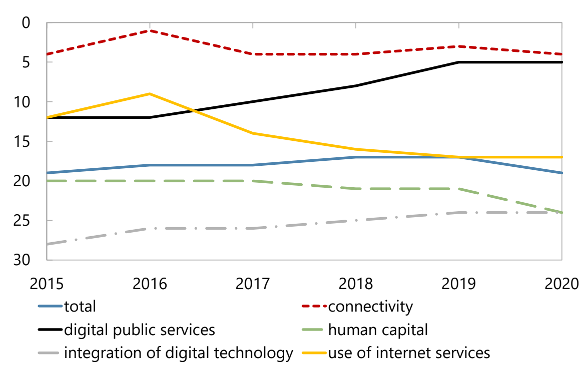
34. The pandemic's impact on the labor market was relatively large and uneven across groups. Low-skilled and lower paid workers were affected disproportionately more than their higher-skilled and higher paid peers. Similarly, young workers showed a larger increase in unemployment than other age cohorts. These outcomes reflect the need for targeted policies to prevent long-term unemployment for vulnerable groups and mitigate inequality that was already high relative to other EU countries (Figure 6).

35. Policies to facilitate job creation and ensure a smooth reallocation of labor would minimize the economic and social costs of the COVID-19 crisis. Labor market policy should remain nimble and flexible to be responsive to the shifting demand. In the near term, employment support programs should continue to ensure adequate coverage of vulnerable workers to tackle unemployment. However, policies should be proactive, focusing on preserving jobs and facilitating labor mobility, including through in-work benefits where cost-effective, hiring incentives, and strengthening of ALMPs. As the longer-term consequences of the crisis become clearer, the focus should shift from protecting jobs to facilitating reallocation of labor to the newly created jobs within and across sectors, while continuing to provide support to the unemployed. Active labor market policy should be used to assist the transition of workers between jobs, including through reskilling and upskilling, facilitating job search services, and reducing the hiring costs for firms. These can be supplemented with measures aimed at improving the business environment and strengthening the social safety net to support those unable to return to work.

Supporting Sustainable Growth

36. The authorities have rightly identified digitalization as one of the key areas to support future growth. Despite recent progress made along the digitalization of public services, there is still scope to accelerate digitalization in some areas. The country's overall score on the Digital Economy and Society Index (DESI) is 18th out of the 28 EU countries in 2020. Connectivity and digital public services ranked high and helped with distance learning during the COVID-19 crisis. Latvia, however, lags behind the leaders in human capital and integration of technology by business (24th and 23rd respectively), warranting the step-up of its efforts in these areas as envisaged in the Recovery and Resilience Plan.

Ranking of Latvia DESI within 28 EU countries



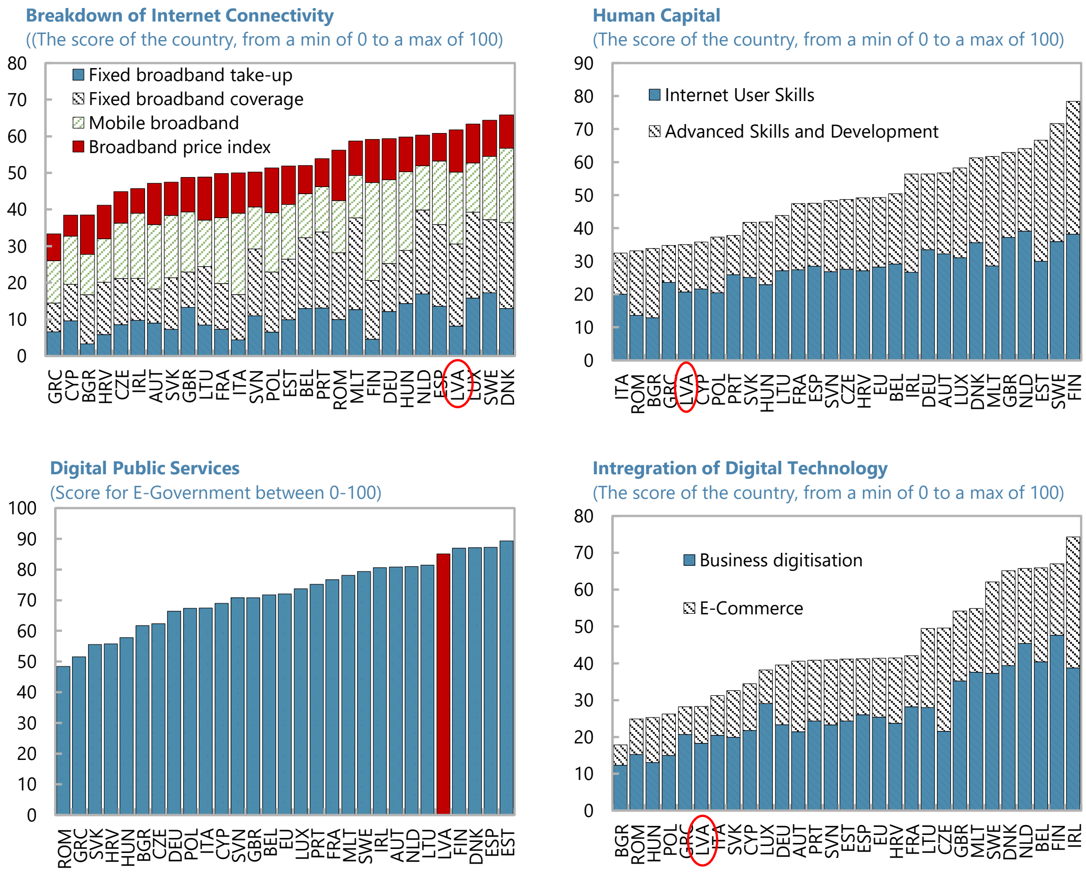
Source: Digital Economy and Society Index

37. The authorities are taking advantage of the RRF funds to press ahead with their digitalization agenda. Efforts should be targeted at (1) building human capital through domestically investing in education and externally attracting ICT talents, and (2) creating an enabling environment through regulations and incentives. The OECD[13] has also provided recommendations to enhance trust in a digital environment and unleash digital innovation, in particular, to continue efforts to strengthen the governance framework for digital security and

[13] OECD (2021), Going Digital in Latvia, OECD Reviews of Digital Transformation, OECD Publishing, Paris.

educate the general public. The government's draft Recovery and Resilience Plan envisages an allocation of close to EUR 365 million to digital transformation (20 percent of the allocation of RRF funds) which, if spent well, would help Latvia close important gaps and have a catalytic effect on private sector investments. E-commerce is one of the promising areas to develop, given the current low E-commerce sales of Latvia's businesses.

Latvia: Internet Access and Digitalization, 2020

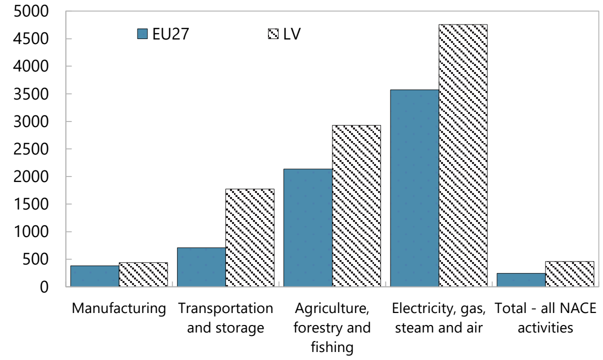


Source: Digital Economy and Society Index

38. Latvia has set ambitious goals to deliver on its commitments under the Paris Agreement. Latvia aims to reduce greenhouse gases (GHG) emissions by 65 percent compared to 1990 by 2030 and achieve climate neutrality by 2050. Progress has been made in some areas, including the achievement of the 2020 emission reduction target. However, the emission intensity in some sectors is higher than the EU average, suggesting there is room to catch up with the technology frontier, particularly in electricity, agriculture, and transportation sectors. In particular, a carbon pricing mechanism that covers the transportation sector - the largest GHG-emitting sector -

could be considered.[14] Across the economic sectors, the improvement of energy efficiency in buildings and housing as well as strengthening the capacity to mitigate natural disaster risks are key objectives.[15] Leveraging their RRF allocation, the authorities have established three main areas for reform and investment: (1) reducing GHG emissions in the transportation sector; (2) increasing energy efficiency; and (3) adapting to climate change. Continued investment in research and innovation with specific policy measures would support Latvia's green transition by closing the gap with the technology frontier.

GHG emission intensity in 2019
(Grams per value-added in euro, current prices)



Sources: Eurostat

Authorities' Views

39. The authorities agreed that proactive and flexible labor market policies are needed to mitigate scarring risks in the labor market. They noted that employment support measures have been upgraded since the beginning of the crisis, including the refinement of the eligibility criteria for the downtime benefit and the introduction of wage subsidies for part-time workers. They also noted that the recent reform of the minimum income is expected to reduce poverty and inequality, thus mitigating scarring risks. They agreed that employment support measures should be time-bound but phased out gradually to avoid a sudden surge of layoffs. They also agreed that economic transformation will require policies to support the efficient labor reallocation and upskilling and noted the recent update of their existing training programs is well placed to assist in this goal.

40. The authorities emphasized that digitalization is paramount to their smart growth and economic transformation strategies. While pointing out progress in digital public services and connectivity, they acknowledged that further steps are needed, including the expansion of connectivity in rural areas, building digital human capital, and reform of innovation management. They noted that the use of e-commerce increased during the COVID-19 crisis and is expected to grow further. They see that the governance framework of digital security has been established at the government level, and the awareness and trust in digital security need to be enhanced at the level of individual person and business.

41. The authorities agreed that implementing their strategy for a low-carbon economy is critical for green growth. They noted that R&D is an important element not only for the reduction of GHG emissions but also for productivity growth. They acknowledged that challenges remain in several sectors, including the transportation sector. Furthermore, it needs to be taken into account that the European Commission will revise individual member state targets and come up with several

[14] The EU Emissions Trading System covers the power sector, manufacturing industry, and airlines operating between countries but does not cover transport and heating emissions in buildings.

[15] See Latvia's National Adaptation Plan.

proposals in the summer of 2021. The enhanced non-ETS GHG emission reduction target will pose additional challenges and require additional funds. Furthermore, awareness of transition process among the public needs to be enhanced.

STAFF APPRAISAL

42. **The authorities' sizable and broad-based policy response has been key to mitigating the economic and social impact of COVID-19.** The support boosted expectations and economic confidence. Overall, Latvia saw a milder recession in 2020 than most euro area countries.

43. **A strong recovery is expected assuming mass vaccinations gain momentum.** The rebound would be driven by pent-up consumption demand and continued strong foreign demand for manufacturing goods. Capital spending supported by EU funds is expected to bolster medium-term growth. While risks are balanced overall, key downside risks include virus mutations and slow pace of vaccinations. Latvia's external position is assessed as stronger than the level implied by fundamentals and desirable policies.

44. **Fiscal policy should remain supportive until a sustained recovery takes hold.** The budget for 2021 appropriately maintains temporary support to fight the COVID-19 crisis. The adequacy of measures should be assessed and targeted in a timely manner in line with the evolution of the pandemic. If the recovery falters, the authorities should further extend fiscal support to soften the impact on vulnerable sectors of the economy.

45. **Medium-term fiscal policy should aim to rebuild fiscal buffers and support the transformation to a more sustainable and more digital economy.** The credibility of the medium-term fiscal framework should continue to be underpinned by rules that support a gradual rebuilding of fiscal space once the recovery is firmly entrenched. Latvia's investment plan, supported by new resources under the Next Generation and Cohesion Policy EU instruments, will help transform the economy. However, execution risks related to this plan need to be mitigated. Therefore, investment decisions should be based on robust project selection and management, with a transparent procurement system and effective oversight. Close coordination with the private sector will help mitigate capacity utilization bottlenecks, particularly in the construction sector.

46. **While the financial sector has so far appeared resilient, risk-based supervision should continue.** The banking sector entered the crisis with comfortable capital and liquidity positions. Supervisors' attention should continue to focus on banks with lower financial soundness profiles and those exposed to COVID-sensitive sectors and SMEs. The augmented macroprudential toolkit will usefully complement policymakers' tools to mitigate medium-term financial vulnerabilities should imbalances emerge in the housing and construction sectors.

47. **Exiting from the support measures will require corporate recapitalization and an enhanced insolvency regime.** It is important to assess the size of the corporate equity gap and policy options to address it, including grant-based support for micro enterprises. A rigorous "triage"

approach should underpin corporate recapitalization programs. In parallel, progress in reforming the insolvency regime should continue with a view to facilitating the rapid repair of corporate balance sheets.

48. The authorities should build on their commendable progress in strengthening their AML/CFT framework. Latvia should implement its plans to further strengthen the effectiveness of its AML/CFT regime, including by implementing risk-mitigation measures that were elaborated in the 2020 National ML/FT Risk Assessment. Regional IMF technical assistance on AML/CFT will contribute to the reform agenda.

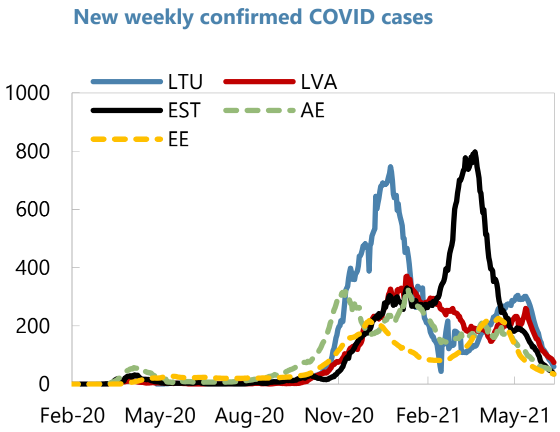
49. Labor market policies should aim to minimize the economic and social costs of COVID-19. Employment support programs should continue to ensure adequate coverage of vulnerable workers to tackle unemployment. Job-friendly policies should be proactive and nimble, including in-work benefits where cost-effective, hiring incentives, and strengthened active labor market policies. Over time, the focus should gradually shift to facilitating the reallocation of workers to new jobs. Steps to improve the business environment and the social safety net could complement these reforms.

50. Investment in digital and green projects would increase productivity and resilience. The RRF and supporting reforms are an opportunity to accelerate the digital transformation and green the economy. In digitalization, efforts should be targeted at improving the digital infrastructure, building human capital, and creating an enabling environment through regulations and incentives. Investment in green projects should be combined with strengthened taxation of polluting sectors.

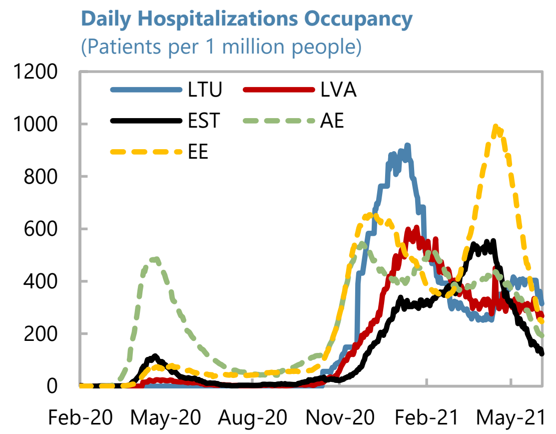
51. It is recommended that the next Article IV consultation take place on the regular 12-month cycle.

Figure 1. Latvia: COVID-19 Developments

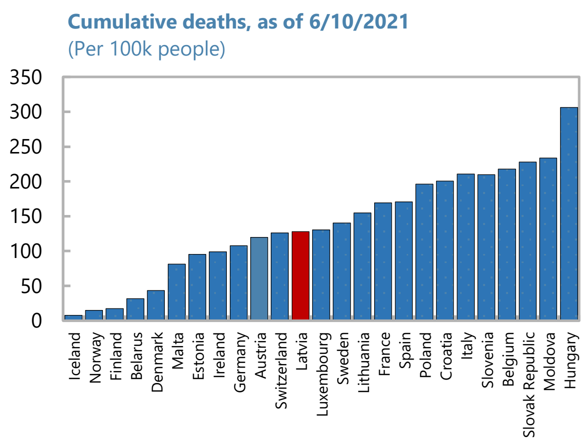
Latvia was hit hard by a second wave of the virus



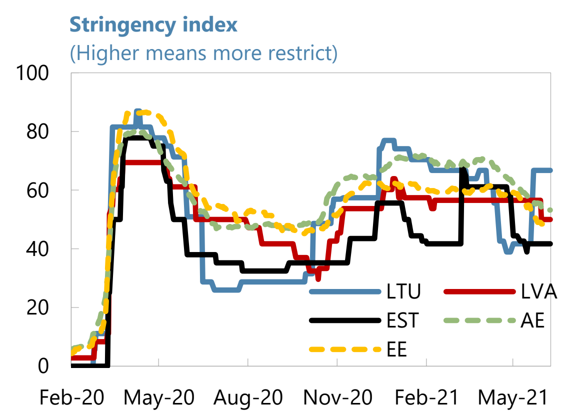
Hospitalization rates increased fast…



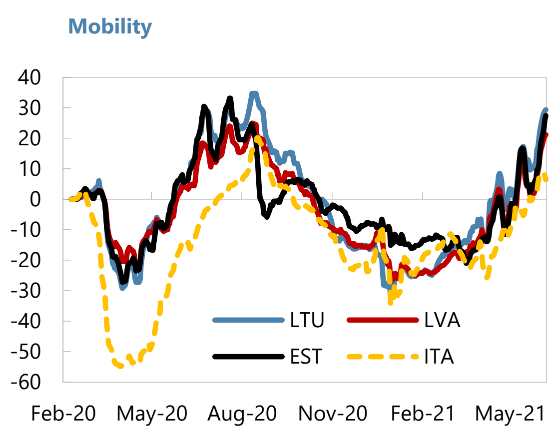
…but human costs have been relatively low



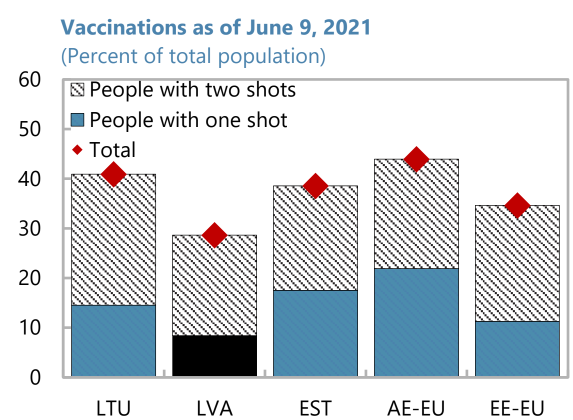
Containment measures were relatively less stringent than during the first wave…



…facilitating mobility.



The vaccination rollout is lagging peers.

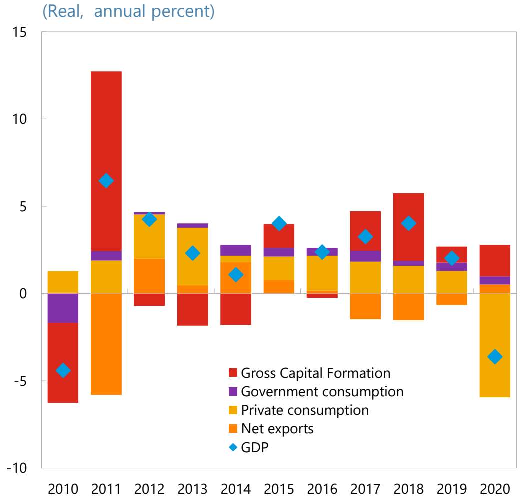


Sources: Bloomberg Finance L.P.; ECDC; Our World in Data, Worldometers; Google; IMF, WEO; and IMF staff calculations.
Note: AE refers to advanced European countries and EE refers to emerging European countries.

Figure 2. Latvia: Macroeconomic Developments

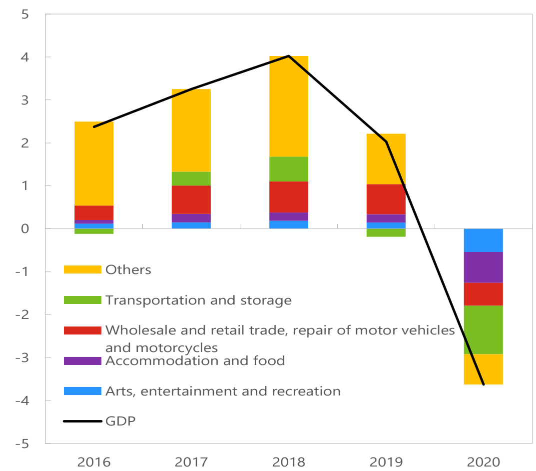
The COVID crisis caused a significant contraction, led by a collapse in consumption…

GDP Growth and Contributions
(Real, annual percent)



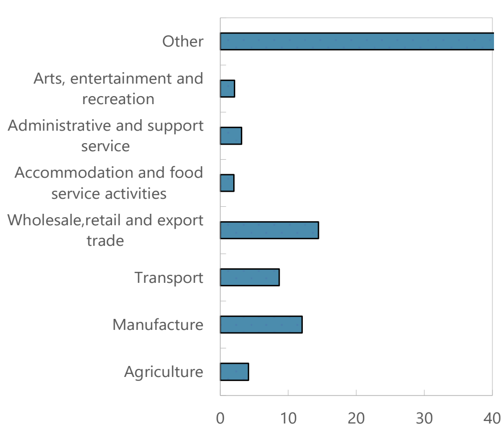
High-touch sectors absorbed the brunt of the shock…

Contribution to GDP growth
(In percent)



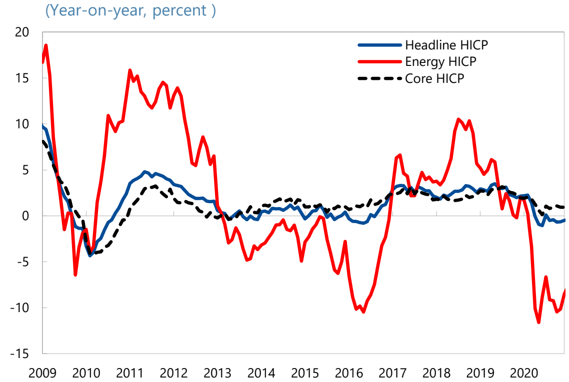
…though their contribution to gross value added in the economy is not large.

Average share in 2017-2019 Gross VA



Low energy prices and subdued consumption kept inflation low.

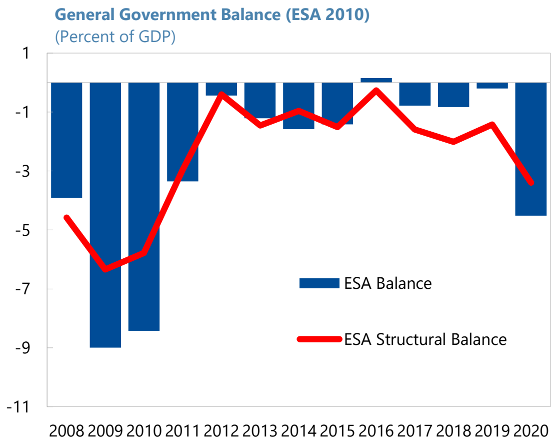
HICP Inflation
(Year-on-year, percent)



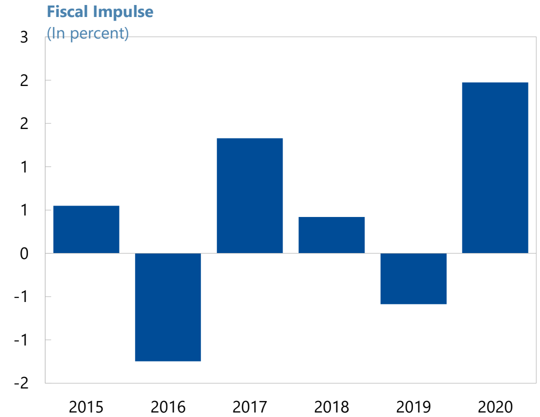
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 3. Latvia: Fiscal Developments

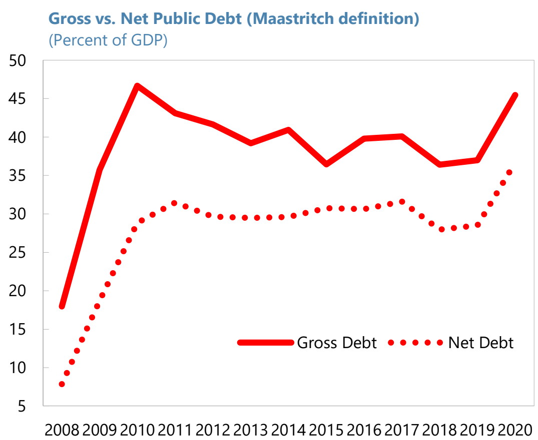
Fiscal balances have deteriorated…



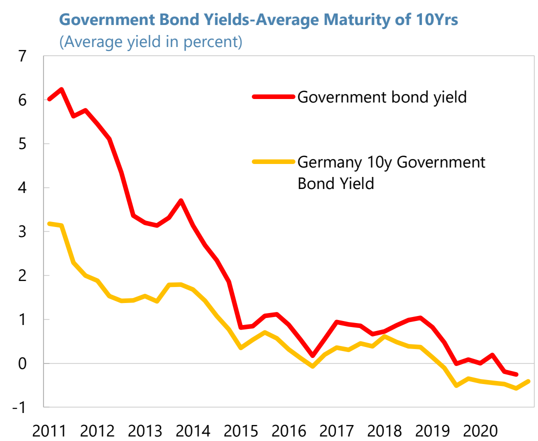
…as significant crisis relief measures were deployed.



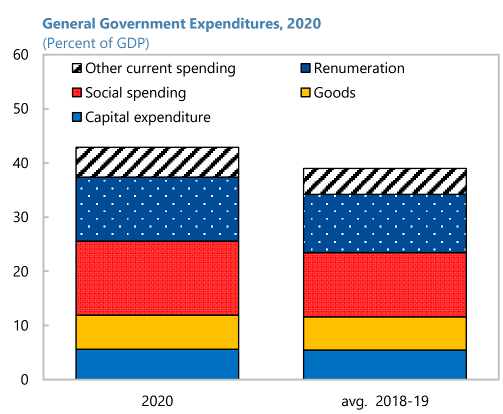
Public debt has increased…



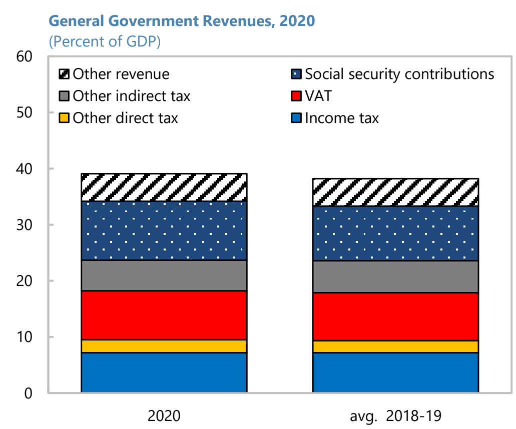
…amid strong market access at favorable conditions.



Social spending has increased…



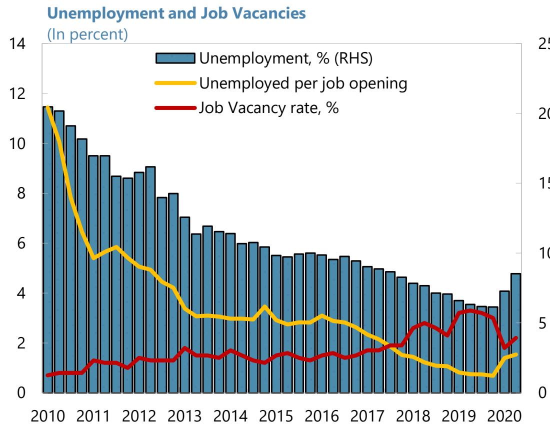
…while revenue sources held up.



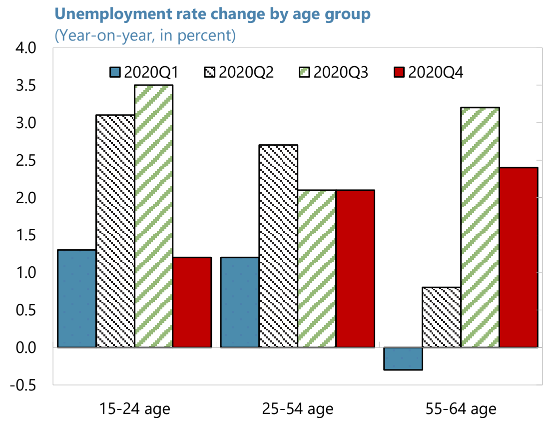
Sources: Latvian authorities, Eurostat, Haver Analytics; and IMF staff calculations.

Figure 4. Latvia: Labor Market

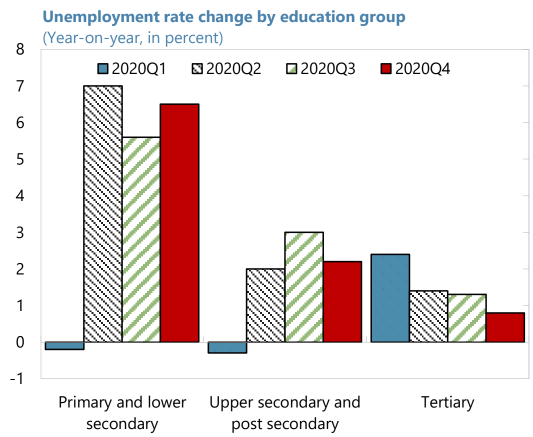
Unemployment increased significantly....



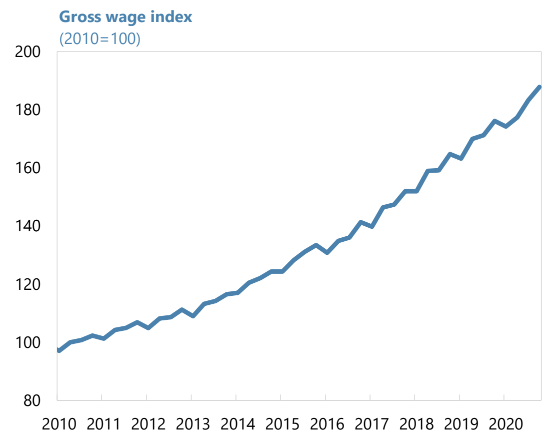
...disproportionately affecting the young...



...and those with lower education.



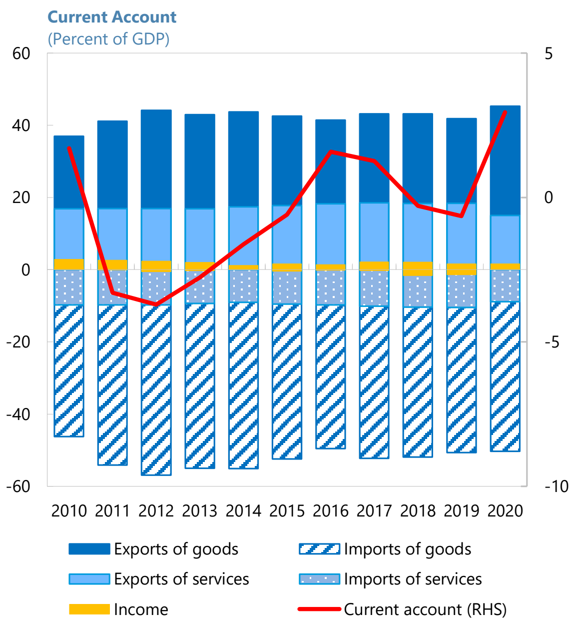
Meanwhile, wages continued growing.



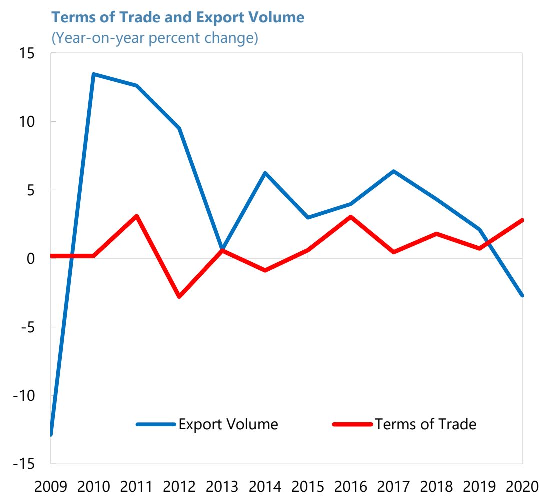
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 5. Latvia: Balance of Payments

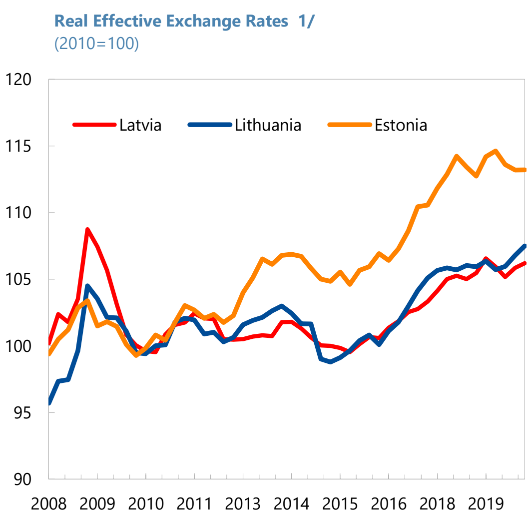
The current account swung into a surplus in 2020…



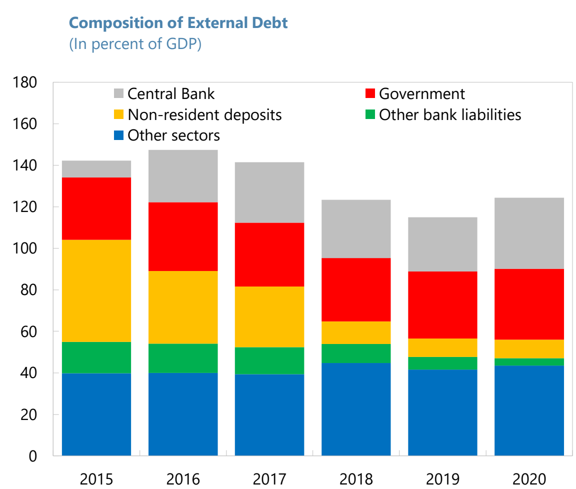
… despite a decline in export volumes.



External competitiveness held up in 2020.



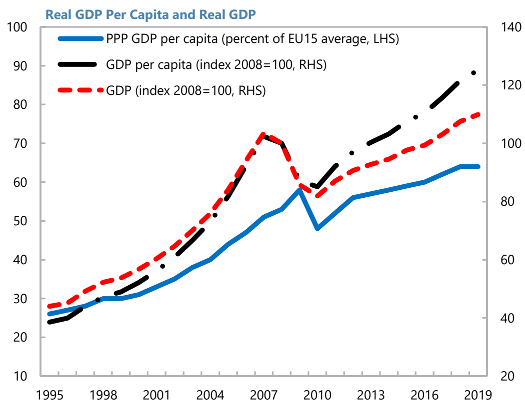
Public external debt burden increased.



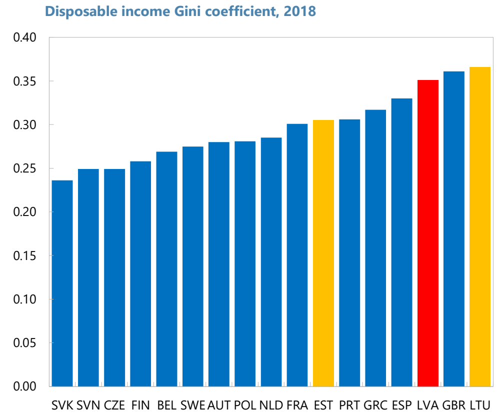
Sources: Bank of Latvia; Statistics Latvia; European Commission; and IMF staff calculations.
1/ Real effective exchange rates are based on IC–37 countries for ULC.

Figure 6. Latvia: Inequality and Poverty Indicators

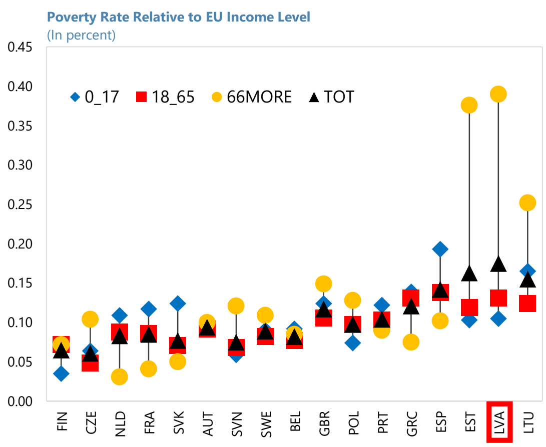
GDP per capita remains below Western Europe.



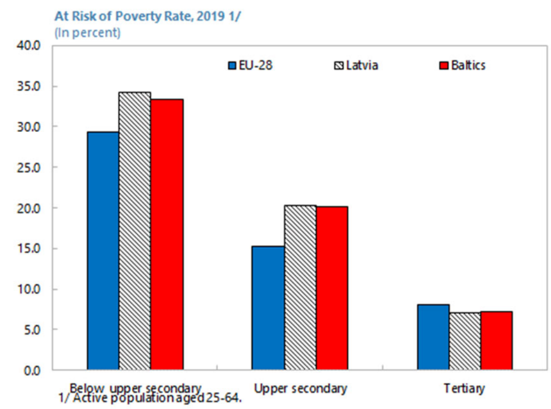
Income inequality is one of the highest in the EU.



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



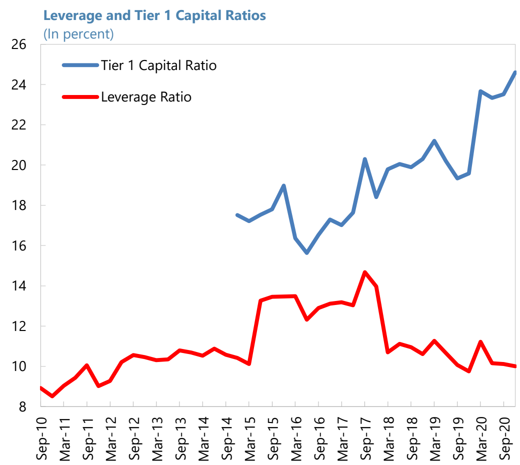
.... and those with lower education.



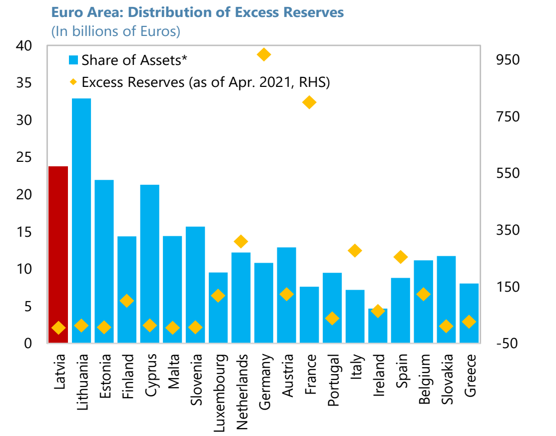
Sources: OECD (2021), Poverty rate (indicator). doi: 10.1787/0fe1315d-en (Accessed on April 2021); Eurostat and IMF staff calculations.

Figure 7. Latvia: Banking Sector Developments

Banks hold high capital buffers...

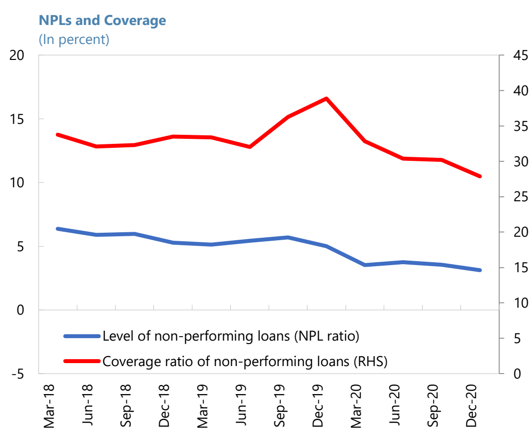


...and excess reserves relative to assets, the second highest in the euro-area.

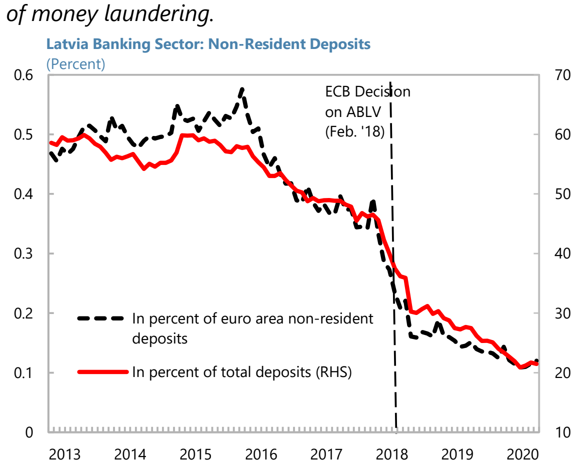


Note: */ consolidated assets as of Dec. 2020.

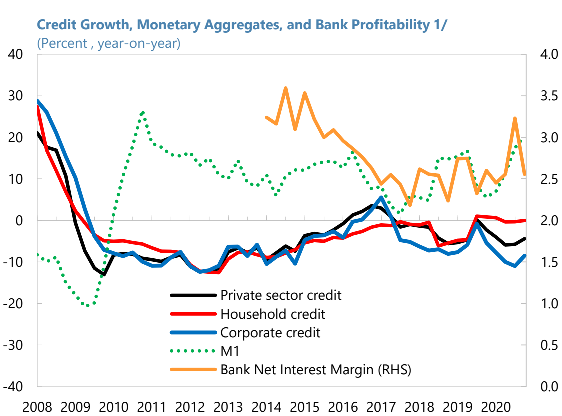
The asset quality in bank lending books continues to improve.



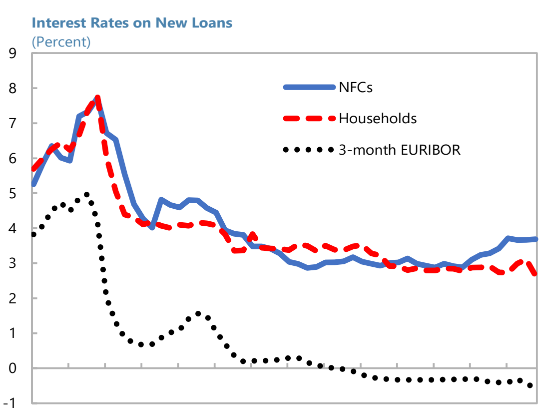
The retrenchment of non-resident deposits reduces the risk of money laundering.



Banks' willingness to lend remains low ...



... as lending rates have started to creep up for corporates.

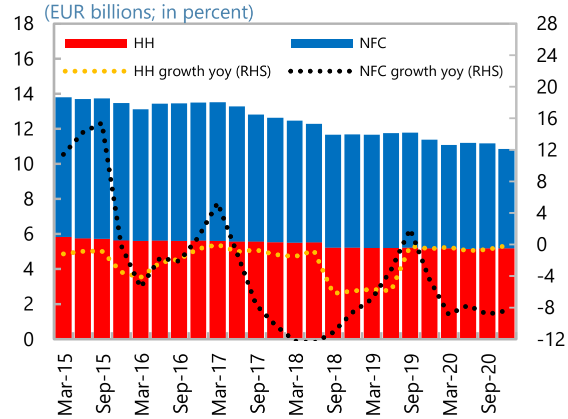


Sources: Bank of Latvia; ECB; FCMC; and IMF staff calculations.
1/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

Figure 8. Latvia: Indicators of Financial System's Credit

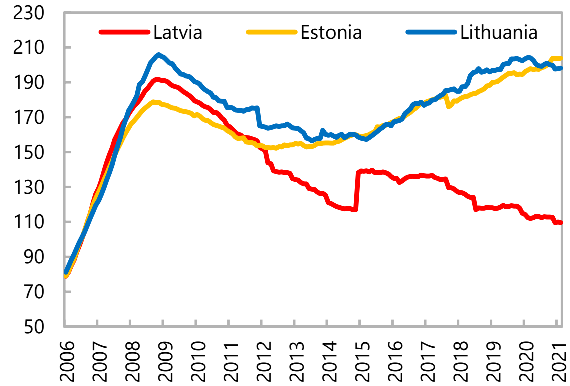
Bank lending has continued shrinking in nominal terms…

Bank Lending to Households and NFCs
(EUR billions; in percent)



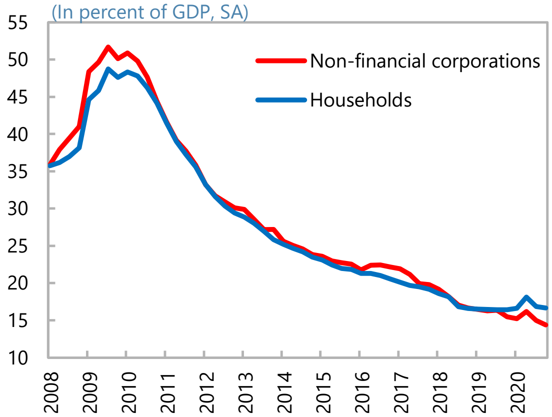
…with Latvia clearly lagging its Baltic peers.

Loans to Households and Non-Financial Corporations
(Index, 2006=100)



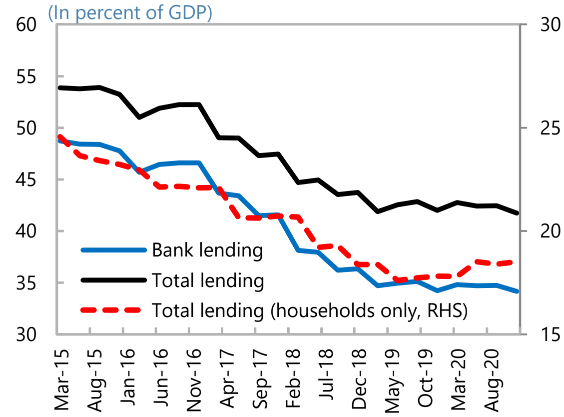
With household credit being a little more resilient than that to non-financial corporates…

Households and Corporate Debt
(In percent of GDP, SA)



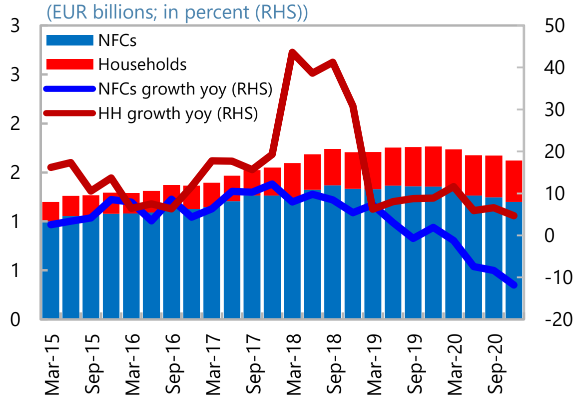
…and total lending to residents stabilizing more recently.

Latvia Credit to Residents
(In percent of GDP)



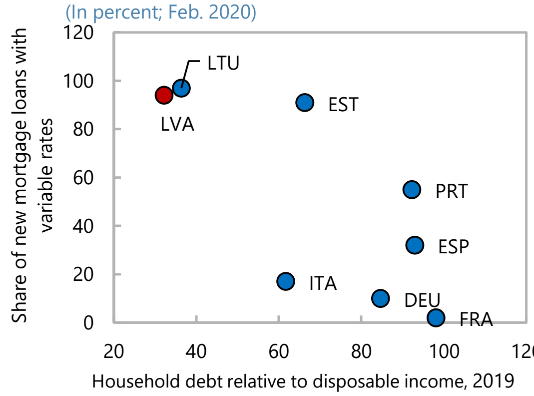
Reflecting in particular non-bank lending to households…

Non-Bank Lending to Households and NFCs
(EUR billions; in percent (RHS))



…but mortgage credit has a vulnerability due to high share of variable interest rates.

Household Debt and Share of Variable Rate Mortgages
(In percent; Feb. 2020)

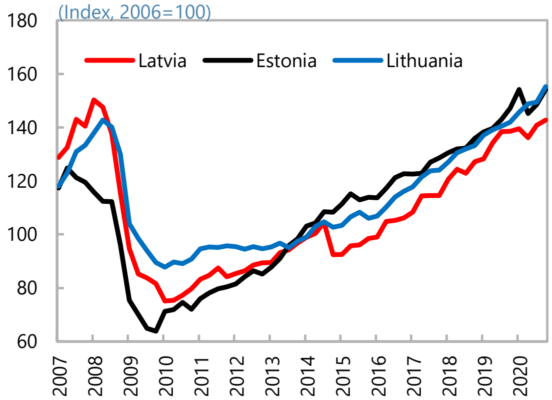


Sources: Bank of Latvia; ECB; FCMC; and IMF staff calculations.

Figure 9. Latvia: Housing Market Indicators

Increases in Latvia's house prices have been broadly similar to those of its Baltic neighbors...

Housing Price Index
(Index, 2006=100)

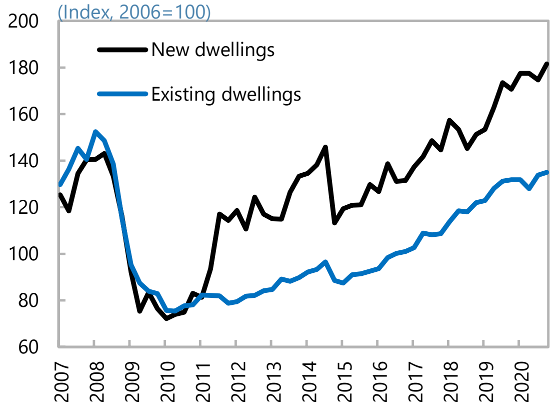


...and on average close to wage growth more recently.

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

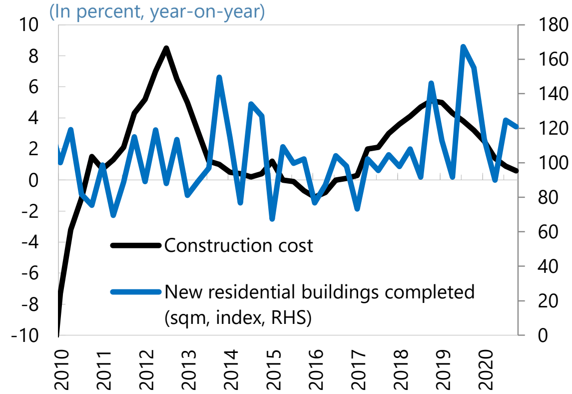
With prices for new dwellings rising particularly rapidly...

Residential Property Prices
(Index, 2006=100)



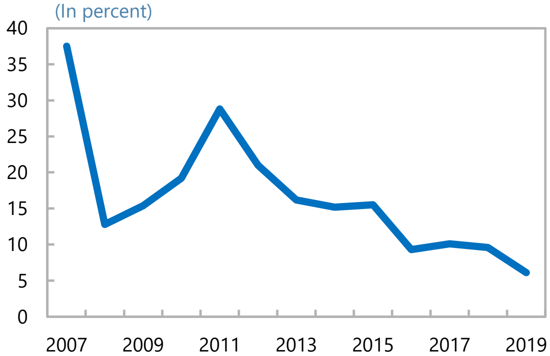
...and construction activity being volatile

Construction Activity
(In percent, year-on-year)



Housing is becoming gradually more affordable...

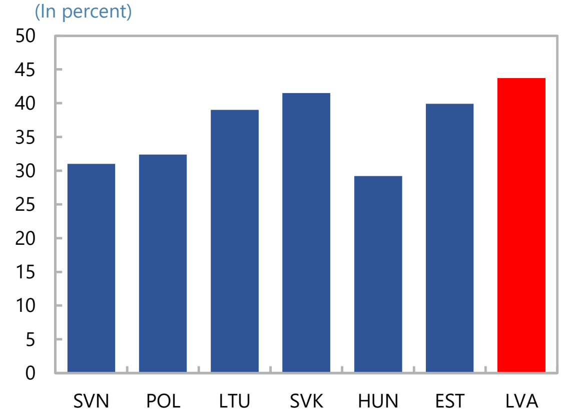
Housing Cost Burden Rate
(In percent)



Note: The share of population living in HH that spent 40% or more of their disposable income on housing.

...but the loan to value ratio is a little higher than in peers.

Household Loan-to-Value ratio
(In percent)



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

Table 1. Latvia: Selected Economic Indicators, 2017–22

	2017	2018	2019	2020	2021	2022
					Proj.	
National accounts	(Percentage change, unless otherwise indicated)					
Real GDP	3.3	4.0	2.0	-3.6	3.6	5.2
Private consumption	3.0	2.6	2.2	-10.0	8.4	5.5
Public consumption	3.4	1.6	2.6	2.6	3.5	4.2
Gross capital formation	9.9	15.8	3.4	6.6	4.6	7.8
Gross fixed capital formation	11.4	11.8	2.1	0.2	6.0	8.2
Exports of goods and services	6.4	4.3	2.1	-2.7	3.8	3.7
Imports of goods and services	8.6	6.4	3.0	-3.3	9.1	5.0
Nominal GDP (billions of euros)	27.0	29.1	30.4	29.3	30.8	33.3
GDP per capita (thousands of euros)	13.8	15.1	15.8	15.4	16.2	17.5
Savings and Investment						
Gross national saving (percent of GDP)	23.4	23.5	21.7	25.8	24.3	23.7
Gross capital formation (percent of GDP)	22.1	23.8	22.4	22.8	24.5	24.7
Private (percent of GDP)	18.6	19.7	18.4	18.6	20.8	20.4
HICP Inflation						
Period average	2.9	2.6	2.7	0.1	2.1	2.7
End-period	2.2	2.5	2.1	-0.5	4.0	2.6
Labor market						
Unemployment rate (LFS; period average, percent)	8.7	7.4	6.3	8.1	7.7	7.2
Real gross wages	4.6	5.8	4.4	6.0	4.8	3.7
Consolidated general government 1/	(Percent of GDP, unless otherwise indicated)					
Total revenue	35.7	37.3	37.5	38.6	38.5	38.2
Total expenditure	36.5	38.1	37.9	42.5	47.4	42.2
Basic fiscal balance	-0.8	-0.7	-0.4	-3.9	-8.9	-4.0
ESA balance	-0.8	-0.8	-0.6	-4.5	-8.8	-2.6
General government gross debt	39.0	37.1	37.0	43.5	48.0	47.9
Money and credit						
Credit to private sector (annual percentage change)	-1.0	-5.6	-2.3	-4.4	…	…
Broad money (annual percentage change)	2.9	5.8	4.4	-3.6	…	…
Balance of payments						
Current account balance	1.3	-0.3	-0.6	3.0	-0.2	-1.0
Trade balance	-9.1	-8.7	-8.8	-5.0	-9.7	-9.7
Gross external debt	141.5	123.3	117.3	124.2	129.7	128.5
Net external debt 2/	22.1	20.6	18.9	14.3	13.0	12.7
Exchange rates						
U.S. dollar per euro (period average)	1.13	1.18	1.12	1.14	…	…
REER (period average; CPI based, 2005=100)	119.1	122.5	122.5	124.2	…	…
Terms of trade (annual percentage change)	0.4	1.8	0.7	2.8	-2.0	0.5

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, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
			Est			Proj			
	(Percentage change, unless otherwise indicated)								
National accounts									
Real GDP	4.0	2.0	-3.6	3.6	5.2	4.0	3.3	3.2	3.0
Consumption	2.4	2.3	-7.1	7.1	5.2	4.0	3.1	2.9	3.0
Private consumption	2.6	2.2	-10.0	8.4	5.5	4.0	3.0	3.0	3.0
Public consumption	1.6	2.6	2.6	3.5	4.2	4.2	3.2	2.7	3.0
Gross capital formation	15.8	3.4	6.6	4.6	7.8	7.6	5.3	4.1	3.7
Gross fixed capital formation	11.8	2.1	0.2	6.0	8.2	8.3	5.4	3.9	3.9
Exports of goods and services	4.3	2.1	-2.7	3.8	3.7	2.7	2.4	2.3	2.2
Imports of goods and services	6.4	3.0	-3.3	9.1	5.0	4.5	3.2	2.5	2.6
Contributions to growth									
Domestic demand	5.7	2.7	-3.7	6.7	6.4	5.5	4.1	3.6	3.6
Net exports	-1.5	-0.7	0.5	-3.8	-1.2	-1.6	-0.8	-0.4	-0.5
HICP inflation									
Period average	2.6	2.7	0.1	2.1	2.7	2.2	2.0	2.2	2.2
End-period	2.5	2.1	-0.5	4.0	2.6	1.9	2.2	2.2	2.0
Labor market									
Unemployment rate (LFS, percent)	7.4	6.3	8.1	7.7	7.2	7.1	7.0	7.0	7.0
Employment (period average, percent)	1.6	0.1	-1.9	0.7	0.8	0.4	0.1	0.0	0.0
Real gross wages	5.8	4.4	6.0	4.8	3.7	3.8	3.8	3.5	3.4
	(Percent of GDP)								
Consolidated general government 1/									
Total revenue	37.3	37.5	38.6	38.5	38.2	39.1	38.9	38.0	37.6
Total expenditure	38.1	37.9	42.5	47.4	42.2	40.1	39.4	38.5	37.9
ESA balance	-0.8	-0.6	-4.5	-8.8	-2.6	-1.4	-0.8	-0.7	-0.5
ESA structural balance	-2.0	-1.4	-3.3	-7.9	-2.2	-1.2	-0.8	-0.7	-0.5
General government gross debt	37.1	37.0	43.5	48.0	47.9	45.6	43.4	41.1	38.8
Saving and investment									
Gross national saving	23.5	21.7	25.8	24.3	23.7	23.6	23.7	23.4	23.3
Foreign saving	0.3	0.6	-3.0	0.2	1.0	1.9	2.1	2.6	2.8
Gross capital formation	23.8	22.4	22.8	24.5	24.7	25.5	25.9	26.0	26.0
External sector									
Current account balance	-0.3	-0.6	3.0	-0.2	-1.0	-1.9	-2.1	-2.6	-2.8
Net IIP	-46.5	-41.7	-36.6	-35.3	-32.6	-31.3	-30.4	-30.5	-30.7
Gross external debt	123.3	117.3	124.2	129.7	128.5	125.9	121.9	119.2	115.9
Net external debt	20.6	18.9	14.3	13.0	12.7	13.3	14.2	16.0	18.1
Memorandum items:									
Nominal GDP (billions of euros)	29.1	30.4	29.3	30.8	33.3	35.2	37.1	39.1	41.2
Output gap (percent)	3.1	2.7	-3.1	-2.5	-1.0	-0.5	-0.2	0.0	0.0
Potential output growth (percent)	3.0	2.4	2.1	3.0	3.6	3.4	3.0	3.0	3.0
Terms of trade (annual percentage change)	1.8	0.7	2.8	-2.0	0.5	0.0	0.2	0.2	0.2

Sources: Latvian authorities; and IMF staff calculations.

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

Table 3. Latvia: General Government Operations, 2018–26 1/

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
				(percent of GDP)					
Revenue	37.3	37.5	38.6	38.5	38.2	39.1	38.9	38.0	37.6
Taxes	20.6	20.3	20.8	21.4	21.6	21.7	21.6	21.8	21.7
Personal Income Tax	5.9	6.3	6.2	6.4	6.3	6.4	6.4	6.4	6.5
Corporate Income Tax	1.0	0.1	0.7	0.8	0.9	0.9	0.9	0.9	0.9
Property Tax	0.8	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Value-added tax	8.4	8.7	8.7	8.9	9.1	9.3	9.3	9.3	9.3
Excise tax	3.5	3.5	3.6	3.6	3.6	3.5	3.4	3.5	3.5
Other taxes	0.9	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Social Contributions	9.1	9.5	9.9	9.3	9.6	9.7	9.7	9.7	9.7
Grants	3.9	4.3	4.4	4.6	4.2	5.1	5.1	3.7	3.5
o/w EU Funds	3.8	...	...	...	...	...	...	...	...
Other revenue	3.8	3.4	3.5	3.2	2.8	2.6	2.4	2.4	2.3
Expenditure 2/	38.1	37.9	42.5	47.4	42.2	40.1	39.4	38.5	37.9
Expense	34.0	33.9	38.2	43.7	37.9	35.6	35.4	35.0	34.6
Compensation of Employees	8.4	8.6	9.2	9.5	9.4	9.5	9.6	9.6	9.6
Use of goods and services	5.3	5.0	5.0	5.1	4.5	4.3	4.3	4.3	4.3
Interest	0.9	0.9	0.9	0.9	0.7	0.7	0.6	0.6	0.6
Subsidies	7.8	7.7	9.5	12.1	10.2	8.4	8.3	8.0	7.8
Grants	1.1	1.1	1.3	1.4	1.2	1.1	1.1	1.1	1.1
Payments to EU budget	0.9	1.0	1.1	1.2	1.1	1.0	1.0	1.0	1.0
International organizations	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Social Support	10.5	10.7	12.3	14.8	11.8	11.6	11.5	11.3	11.1
Pensions	7.2	7.3	8.1	8.1	7.9	7.7	7.6	7.5	7.3
Other	3.3	3.4	4.3	6.7	4.0	3.9	3.9	3.9	3.8
Other expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net acquisition of nonfinancial assets	4.1	4.0	4.3	3.7	4.3	4.5	4.0	3.5	3.3
Gross Operating Balance	3.3	3.6	0.4	-5.2	0.3	3.6	3.5	3.0	3.0
Net lending/borrowing	-0.7	-0.4	-3.9	-8.9	-4.0	-0.9	-0.5	-0.4	-0.3
Net acquisition of financial assets	-0.7	...	...	...	...	...	...	...	...
Domestic financing	-0.8	-3.0	1.9	0.7	0.6	0.9	1.6	-0.4	1.1
External financing	1.5	3.4	2.0	8.2	3.4	0.1	-1.1	0.8	-0.9
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items									
ESA balance	-0.8	-0.6	-4.5	-8.8	-2.6	-1.4	-0.8	-0.7	-0.5
ESA structural balance 3/	-2.0	-1.4	-3.3	-7.9	-2.2	-1.2	-0.8	-0.7	-0.5
General government debt	37.1	37.0	43.5	48.0	47.9	45.6	43.4	41.1	38.8
Nominal GDP (billions of euros)	29.1	30.4	29.3	30.8	33.3	35.2	37.1	39.1	41.2

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, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
	(Percent of GDP, unless otherwise indicated)								
Current account	-0.3	-0.6	3.0	-0.2	-1.0	-1.9	-2.1	-2.6	-2.8
Goods and services (fob)	-0.8	-0.8	1.2	-3.5	-3.8	-4.9	-5.2	-5.1	-5.2
Goods (fob)	-8.7	-8.8	-5.0	-9.7	-9.7	-10.4	-10.6	-10.4	-10.3
Exports	43.1	41.8	45.3	50.8	48.6	47.0	46.2	45.4	44.5
Imports	-51.8	-50.6	-50.3	-60.6	-58.3	-57.5	-56.8	-55.8	-54.9
Services	7.9	8.0	6.2	6.2	5.9	5.5	5.4	5.3	5.1
Credit	18.3	18.4	15.0	16.8	16.1	15.6	15.3	15.0	14.8
Debit	-10.4	-10.4	-8.8	-10.6	-10.2	-10.1	-10.0	-9.8	-9.6
Primary Income	-1.6	-1.4	0.1	0.9	0.6	0.5	0.5	0.4	0.3
Compensation of employees	1.7	1.7	1.4	1.7	1.6	1.7	1.7	1.8	1.8
Investment income	-4.6	-4.2	-2.5	-1.9	-2.1	-2.2	-2.2	-2.3	-2.3
Secondary Income	2.1	1.6	1.6	2.4	2.3	2.6	2.6	2.1	2.1
Capital and financial account	-1.1	0.4	-4.3	0.2	1.0	1.9	2.1	2.6	2.8
Capital account	1.8	1.5	1.7	1.1	1.1	1.3	1.2	0.9	0.9
Financial account	-2.9	-1.1	-6.0	-0.9	0.0	0.6	0.9	1.7	1.9
Direct investment	2.2	2.9	1.8	1.7	1.7	1.6	1.4	1.4	1.3
Portfolio investment and financial derivatives	4.1	1.7	-13.5	-0.2	-1.1	-4.4	-5.0	-2.6	-5.2
of which: general government net issuance	2.3	3.3	-1.2	4.8	3.9	0.3	-0.5	1.9	-0.9
Other investment	-9.6	-6.0	7.2	-2.4	-0.6	3.4	4.4	2.9	5.8
Reserve assets	0.4	0.3	-1.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.4	0.2	1.3	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent change, unless otherwise indicated)								
Goods and Services									
Export value (fob)	7.7	2.3	-3.5	18.0	3.1	2.5	3.6	3.5	3.3
Import value (fob)	8.0	2.5	-6.6	26.5	3.9	4.4	4.1	3.5	3.5
Export volume	4.3	2.1	-2.7	3.8	3.7	2.7	2.4	2.3	2.2
Import volume	6.4	3.0	-3.3	9.1	5.0	4.5	3.2	2.5	2.6
Gross reserves (billions of euros)	3.8	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Gross external debt (billions of euros)	35.9	35.7	36.4	40.0	42.7	44.3	45.2	46.6	47.7
Medium- and long-term (billions of euros)	20.0	21.4	20.6	22.0	22.7	22.1	21.0	20.4	19.3
Short term (billions of euros)	15.9	14.3	15.8	18.0	20.1	22.2	24.3	26.3	28.4
Net external debt (billions of euros) 1/	6.0	5.7	4.2	4.0	4.2	4.7	5.3	6.3	7.4
Gross external debt (percent of GDP)	123.3	117.3	124.2	129.7	128.5	125.9	121.9	119.2	115.9
Medium and long term (percent of GDP)	68.7	70.3	70.2	71.4	68.2	62.9	56.5	52.1	46.9
Short term (percent of GDP)	54.6	47.0	54.0	58.2	60.3	63.1	65.4	67.1	69.0
Net external debt (percent of GDP) 1/	20.6	18.9	14.3	13.0	12.7	13.3	14.2	16.0	18.1
Memo items									
Nominal GDP (billions of euros)	29.1	30.4	29.3	30.8	33.3	35.2	37.1	39.1	41.2
U.S. dollar per euro (period average)	1.18	1.12	1.14	…	…	…	…	…	…

Sources: Latvian authorities; and IMF staff calculations. Methodologies are based on BPM6, although sign conventions follow BPM5.

1/ Gross external debt liabilities minus gross external debt assets.

Table 5. Latvia: Financial Soundness Indicators, 2015–20

(In percent, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020
Commercial banks						
Capital Adequacy						
Regulatory capital to risk-weighted assets 1/	21.8	20.4	20.8	22.3	21.7	25.7
Regulatory Tier I capital to risk-weighted assets 1/	19.3	17.3	18.5	20.3	20.2	24.6
Capital and reserves to assets	10.1	10.1	11.1	12.8	9.7	10.3
Asset Quality						
Annual growth of bank loans	-13.4	21.9	-1.9	-13.6	-1.7	1.7
Annual growth of bank loans to Nonfinancial corporations	-1.6	7.8	-2.0	-3.0	-7.0	-5.5
Annual growth of bank loans to other domestic sectors	-4.1	0.4	1.1	-4.2	-0.8	0.5
Sectoral distribution of loans (in % of total loans, stock)	100.0	100.0	100.0	100.0	100.0	100.0
Residents	66.3	75.6	81.7	84.5	86.5	86.7
Non-residents	33.7	24.4	18.3	15.5	13.5	13.3
Loans past due over 90 days	4.6	6.3	5.5	5.0	5.0	3.1
Earnings and Profitability						
ROA (after tax)	1.2	1.6	1.0	1.2	0.4	0.7
ROE (after tax)	12.3	16.6	9.4	9.7	3.1	5.4
Liquidity						
Liquid assets to total assets	35.7	30.4	34.0	30.0	31.8	31.0
Liquid assets to short term liabilities	46.5	37.5	42.1	37.2	41.2	38.6
Customers deposits to (non-interbank) loans	157.0	144.8	140.7	120.3	127.8	129.2
Sensitivity to Market Risk						
FX deposits to total deposits 2/	43.1	34.2	29.1	…	…	…
FX loans to total loans 2/	13.8	12.5	8.4	…	…	…

Source: International Monetary Fund FSI database.

1/ Regulatory Tier 1 capital to risk weighted assets as from Dec 2009 is calculated as Tier 1 capital (including
Regulatory capital to risk-weighted assets and Regulatory Tier 1 capital to risk-weighted assets in the column of

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

Annex I. Risk Assessment Matrix[1]

Source of Risks, Likelihood, and Time Horizon	Impact on Latvia	Recommended Policy Response
Medium (short to medium term) **Unexpected shifts in the COVID-19 pandemic.** **Asynchronous progress.** Limited access to, and the longer-than-expected deployment of, vaccines— combined with the dwindling policy space—prompt a reassessment of countries' growth prospects. **Prolonged pandemic.** The disease proves harder to eradicate (e.g., due to new virus strains, short effectiveness of vaccines, or widespread unwillingness to take them), requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable. For countries with policy space, prolonged support—though needed to cushion the economy—exacerbates stretched asset valuations, fueling financial vulnerabilities. For those with limited space, policy support is insufficient. **Faster containment.** Pandemic is contained faster than expected due to the rapid production and distribution of vaccines, thereby boosting confidence and economic activity.	**High** Slow start of vaccinations in Latvia (even relative to the EU), coupled with the still-significant level of the virus in the first half of 2021, coupled with proliferation of new virus strains, implies a high impact. Risks are mitigated by a strong public balance sheet. Latvia's significant financial system buffers mitigate financial vulnerabilities.	Participate in global and European policy responses. Ramp up implementation of the vaccination strategy. Continue providing support until firm signs of a sustained recovery emerge. Mitigate "social scarring" through targeted policies to reduce poverty and inequality gaps.
Medium (medium term) **Accelerating de-globalization.** Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	**Medium** As an open economy, Latvia would be affected through trade (including supply chains), confidence, and FDI channels. Economic growth and employment would suffer.	Participate in global and European policy responses. Provide fiscal support (through automatic stabilizers and discretionary). Manage risks through export diversification.
Medium (short term) **Sharp rise in risk premia exposes financial and fiscal vulnerabilities:** A reassessment of market fundamentals (e.g., in response to adverse COVID-19 developments) triggers a widespread risk-off event. Risk asset prices fall sharply and volatility spikes, leading to significant losses in major non-bank financial institutions. Higher risk premia generate financing difficulties for leveraged firms (including those operating in unviable activities) and households, and a wave of bankruptcies erode banks' capital buffers. Financing difficulties extend to sovereigns with excessive public debt, leading to cascading debt defaults.	Medium Higher sovereign risk premia resulting from a loss of policy credibility could weaken confidence and make bank funding more costly.	Right-size the fiscal policy response to the crisis, supported by well-tailored fiscal responsibility frameworks in line with the EU guidelines. Continue to enhance the macroprudential toolkit and rely on the available financial sector buffers, including banks' high capitalization and liquidity.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. 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. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Source of Risks, Likelihood, and Time Horizon	Impact on Latvia	Recommended Policy Response
Medium (short to medium term) **Cyber-attacks** on critical infrastructure, institutions, and financial systems trigger systemic financial instability or widespread disruptions in socio-economic activities and remote work arrangements.	**Low** Latvia is susceptible to cyber-attacks and this risk could rise given the planned increases in reliance on ICT processes and innovation (though appropriate per se).	Participate in global and European defenses against cyber-attacks. Continue strong efforts to improve national cyber-security by allocating sufficient fiscal resources and through vigilant regulation.
Medium (short to medium term) **Risks from AML/CFT issues.** If progress is not maintained, banks could come under pressure from financial markets' perceptions of AML/CFT concerns, including in the broader Nordic region, or tighter global financial conditions with lower risk appetite.	**Medium** Curtailed credit supply, confidence loss, pressures on correspondent banking relationships, and AML/CFT setbacks in local affiliates could weigh on the Latvian financial sector.	Further strengthen the AML/CFT framework. Preserve high capitalization and liquidity. Step up cross-border supervision, including cooperation with home-country authorities. Persevere with business model transformations of banks formerly servicing foreign clients.

Annex II. Impact of the COVID-19 Crisis

Evolution of the Epidemiological Situation

1. **After containing the first wave of COVID-19, Latvia experienced a severe second wave in the fall of 2020.** Since the first confirmed COVID-19 infection on March 4, 2020, there have been over 100 thousand cases and more than 2,000 deaths as of June 2021. After the authorities had successfully handled the first wave, Latvia witnessed an exponential increase of cases and hospitalizations during the second wave, after a quick relaxation of measures during the summer. By the fall of 2020, the positivity rate in Latvia climbed to almost 9 percent, above the peak of 3.8 percent during the first wave. In response, the government accelerated testing and contact tracing, by leveraging cooperation between public and private laboratories. This strategy helped achieve one of the highest rates of testing per capita (Figure 1).

2. **The containment strategy has evolved.** After being one of the first European countries to declare a state of emergency, Latvia enforced containment measures and quickly adopted alternative work arrangements and distance-learning. Since February 2021, Latvia adopted a new containment strategy based upon a four-stage risk system based on the number of new cases over a 14-day period. The degree of risk has a direct bearing on which precautionary measures will be in place and whether they are heading for further tightening or relaxation.

3. **The roll out of mass vaccination is slowly catching up.** A special unit was created to coordinate mass vaccination and supported the development and implementation of IT solutions in partnership with the private sector to help manage the vaccination process. However, vaccine supply shortage created bottlenecks in the early stages of the program. In addition, vaccine hesitancy, one of the largest in the euro area, and hard to reach rural communities also contributed to the initial slow roll-out.[1]

Policy Response

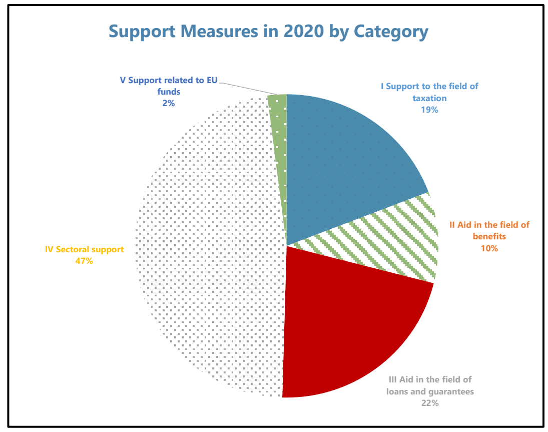
4. **To mitigate the impact of the containment measures, Latvia announced a series of packages amounting to about 12 percent of GDP. However, the execution of these measures amounted to 4.5 percent of GDP in 2020.** The wide range of measures can broadly be divided into four fields:

- *Taxation:* Extension or division of the term for payment of taxes into terms of up to three years, cancellation of personal income tax advance payments, and refund of VAT overpayment within 30 days.

[1] See Rollout of COVID-19 vaccines in the EU/EEA: challenges and good practice.

- *Benefits:* Downtime support for company employees, patent payers, self-employed and young workers, support for wage subsidies for part-time workers sickness and disability benefits, and parental benefits.

- *Corporate support:* Support through loans and guarantees includes credit guarantees, portfolio guarantees, and working capital loans through the National Financial Institution (ALTUM).



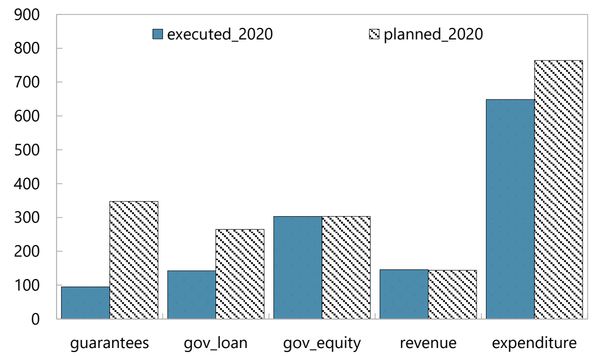
- *Sectoral support:* Grants and financial support to several sectors of the economy, including health, transportation, and other impacted sectors.

5. Support measures were also provided through financial channels. Banks reacted proactively to the COVID-19 crisis by agreeing to extend moratoria in line with EBA guidance. At clients' request, the payment of principal was fully or partially deferred for a period of up to six months for corporates and up to 1 year for individuals. Most of the moratoria ended by early-2021. Since the beginning of the outbreak, the FCMC adopted an individual and flexible approach to supervision, in line with the approach taken by the ECB and EBA. These forbearance measures allowed banks to use capital and liquidity buffers to absorb COVID-19-related shocks on businesses and households. Combined with the low-interest-rate environment supported by the ECB's accommodative monetary policy and sectoral support through the national finance institution ALTUM, the government created favorable financial conditions for borrowers during the COVID-19 crisis in 2020.

6. Legislative changes were introduced to temporarily shield the corporate sector and individuals from bankruptcy procedures. Creditors were restricted from initiating bankruptcy procedures from March 22, 2020 to September 1, 2020 and from December 23, 2020 to September 1, 2021. Furthermore, it was mandated that submissions to open restructuring or insolvency cases had to be made only in electronic form, de-facto introducing a limitation for in-person filings. In addition, several temporary rules were introduced to support debtors, including: (i) a longer period for implementation of the restructuring plans; (ii) a "safe harbor" principle (e.g., suspension of the duty to file for insolvency) for the debtors; and (iii) the right for individual debtors that are subjected to insolvency proceedings to request postponement of the terms of payments to creditors under the envisioned restructuring plan.

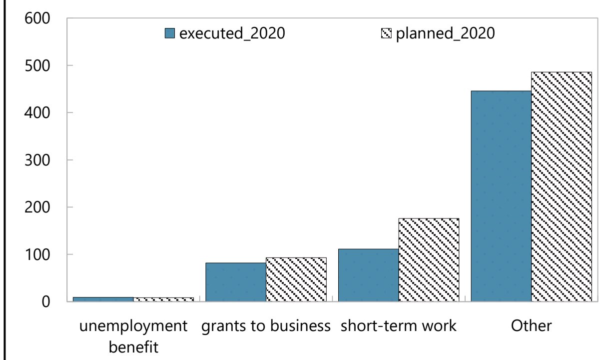
7. The take-up of the measures in 2020 was relatively low on business support and STW programs. The low take-up rate in the loans and guarantees is partly due to the overestimation of the support likely needed at the initial stage of the crisis, when the support measures had to be designed under significant uncertainty and where signaling of adequate support was critical to maintaining confidence. The low take-up of STW programs in 2020 is partly explained by the initial narrow eligibility criteria as well as the availability of other programs providing business relief with more attractive terms and larger scope of utilization. The measures with high take-up, including tax relief and equity injections, contributed to the mitigation of the COVID-19 crisis in liquidity constrained corporates. At the same time, the percent of jobs benefiting from government measures during the first wave of the crisis was lower than in other EU countries.

Take-up of COVID measures 2020
(Billion euros)



Source: Ministry of Finance.

Take-up of COVID measures for selected program 2020
(Million Euros)



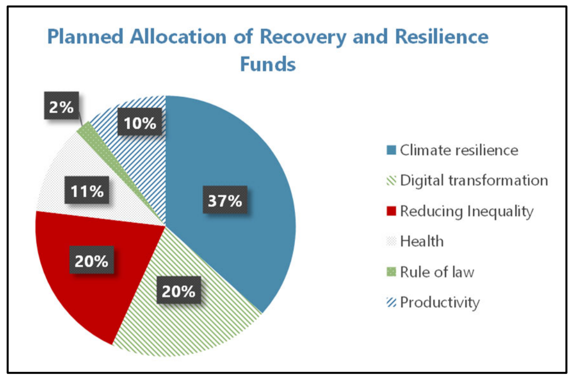
Source: Ministry of Finance

8. Further support measures are planned to be extended in 2021 in several areas. Some support measures have already had a high take-up during the second wave in 2021. As of May 23, more amount for downtime allowance has been disbursed than planned. Several new measures introduced for the second wave also attracted high take-up, including the allowance for families with children, which has already exhausted the planned amount as of May 23, and the grant for current assets of business. Most support measures are planned to end in 2021 unless the epidemiological situation worsens.

Annex III. Allocation of Funds Under the European Resilience and Recovery Facility

1. Latvia is expected to receive a significant amount of EU resources over the coming years. The lion's share of the resources is expected to come from the Cohesion Funds (almost EUR 5 billion for the programing period 2021–27). Latvia is also one of the largest recipients of grants under the RRF, eligible to EUR 2.02 billion (6.5 percent of GDP), of which EUR 1.85 billion have been approved.[1] The remainder will be allocated in 2023 based on the economic situation in the EU Member States. The timing and pace of disbursement of the approved amounts are still uncertain as the authorities have yet to finalize specific plans and investment strategies. However, strategic priorities for the use of RRF funds have already been prepared and submitted to the European Commission.

2. A significant share of RRF funds is expected to be devoted to climate change and digital transformation. The Latvian National Recovery and Sustainability Plan (NRSP) sets out a strategic framework for spending the grant allocation focusing on economic stabilization, reorientation of the economy, and new growth opportunities. The framework identifies priority areas, with almost 60 percent of the funds expected to finance Latvia's climate change initiatives and digital transformation. The rest will be devoted to addressing long-standing challenges of inequality, health, productivity growth and strengthening the rule of law (including reducing economic crimes, improving business environment, and improving state and local governance).



3. The efficient use of these funds could have a significant positive impact on growth. RRF funds are expected to contribute to a large increase in capital spending. Staff's previous analysis showed that such an increase in public investment could have a significant positive impact on productivity and medium-term growth. Simulations suggested that an increase in capital expenditure of 0.5 percent of GDP per year could increase real GDP growth by 0.7 percent above baseline projections over the medium term. [2] However, an efficient selection of growth-enhancing projects will help maximize the impact on growth.

[1] As of June 2021, The European Commission approved Latvia's revised National Recovery and Resilience Plan worth EUR 1.8 billion.

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

Annex IV. External Sector Assessment

Overall Assessment: *The external position of Latvia in 2020 was stronger than the level implied by fundamentals and desirable policies. The current account (CA) balance improved amid the sharp decline in global trade.*

Potential Policy Responses: *Policies in the near term should focus on saving lives and providing fiscal support to cushion the economic and social impact of the COVID-19 shock. Structural policies to increase the resilience of the economy to future shocks, including increasing capital investment and health spending would help mitigate risks of long-term scarring and prevent potential accumulation of future imbalances. Improving adequacy and targeting of the social safety net could reduce accumulation of large precautionary savings.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Both foreign assets and liabilities increased in 2020. Gross assets increased from 120 to 136 percent of GDP, and gross liabilities increased from 162 to 173 percent of GDP. The asset increase was mainly driven by portfolio investment, while the liability increase was on account of other investment, partly reflecting ECB operations. The NIIP improved to -37 percent of GDP in 2020, from -42 percent of GDP in 2019. Gross external debt increased from 117 percent of GDP in 2019 to 124 percent of GDP at end-2020, but the level is substantially below the 2016 level (147 percent of GDP).

Assessment. The current NIIP does not imply risks to external sustainability. The NIIP is expected to improve over the medium term.

2020 (% GDP)	NIIP: -37	Gross Assets: 136	Debt Assets: 110	Gross Liab.: 173	Debt Liab.: 124

Current Account

Background. The current account balance improved from -0.6 percent of GDP in 2019 to 3 percent of GDP in 2020. Imports of goods declined due to the collapse of domestic demand during the COVID-19 crisis, but exports of goods were resilient, leading to a shrinkage of the deficit in the goods balance from -8.8 percent in 2019 to -5 percent in 2020. Both services exports and imports declined, but the former declined more, resulting in the shrinkage of the services surplus from 8 percent of GDP in 2019 to 6.2 percent of GDP in 2020. Primary income balance improved from -1.4 percent of GDP in 2019 to 0.1 percent of GDP in 2020, driven by the decline in dividends payments. Secondary income remained stable.

Assessment. Overall, the current account position is assessed to be stronger than implied by fundamentals and desirable policies. The EBA-lite CA model results suggest a CA gap of 2.7 percent of GDP in 2020, and the gap attributed to policies amounts to 4.6 percent of GDP. This mainly reflects Latvia's lower public health expenditure and smaller fiscal policy gap compared to the world. The COVID19 adjuster offsets the temporary decline in tourism activity and change in the oil trade balance. The current account balance is projected to turn into a small deficit as the domestic demand for both consumption and investment recovers.

Latvia: Model Estimates for 2020 (in percent of GDP)

	CA model	REER model
CA-Actual	**3.0**	
Cyclical contributions (from model) (-)	1.0	
COVID-19 adjustor (+)	0.2	
Additional temporary/statistical factors (+)	0.0	
Natural disasters and conflicts (-)	0.0	
Adjusted CA	**2.2**	
CA Norm (from model) 1/	**-0.6**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**-0.6**	
CA Gap	**2.7**	**3.3**
o/w Relative policy gap	4.6	
Elasticity	-0.45	
REER Gap (in percent)	**-6.1**	**-7.3**

1/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The REER appreciated by 1.3 percent in 2020. From 2015 to 2020, the REER appreciated by 6 percent. The competitiveness has been gradually declining as wage growth has exceeded productivity growth, against the backdrop of the aging population and the resulting labor supply shortages. The gross wage growth weakened from 7.2 percent in 2019 to 6.2 percent in 2020 but still remains strong.

Assessment. The EBA-lite CA model suggests an undervaluation of 6.1 percent. The EBA-lite REER Index model finds an undervaluation of 7.3 percent, consistent with a stronger external position than implied by fundamentals and desirable policies.

Capital and Financial Accounts: Flows and Policy Measures

Background. The capital account balance was 1.7 percent of GDP, mainly reflecting the transfer of funds from the EU. The level is similar to 2018 (1.8 percent of GDP) and 2019 (1.5 percent of GDP). The financial account increased from 1.1 percent of GDP in 2019 to 6 percent of GDP in 2020. Portfolio investment assets and liabilities in currency and deposits marked a sharp increase, reflecting partly reflecting ECB operations.

Assessment. Risks related to capital flows are assessed to be small.

FX Intervention and Reserves Level

Background. The Euro has the status of a global reserve currency. Thus, reserves held by euro area economies are typically low by standard metrics (14.7 percent of GDP for Latvia as of end-2020). The currency is free-floating.

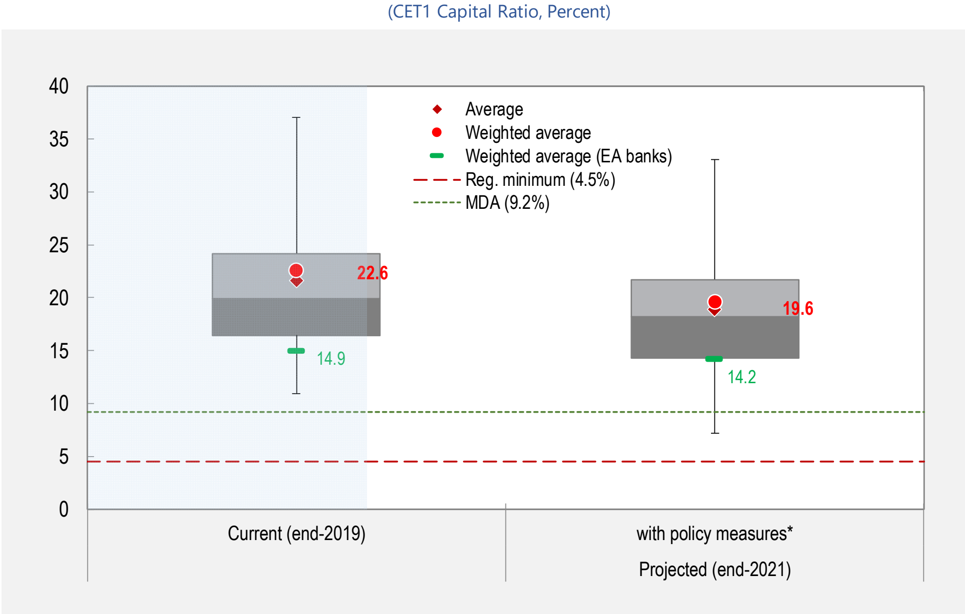
Assessment. Reserve level is assessed to be adequate.

Annex V. The Impact of COVID-19 on Latvia's Banks

1. Staff assessed impact of the COVID-19 shock on large Latvian (and European) banks' solvency in a stress-testing model that incorporates available information on the borrower support measures.[1] The model is based on staff's baseline macroeconomic scenario and incorporates granular information on corporate and sectoral bank exposures. The shock causes a decline in banks' capital through three main channels: (i) larger loan loss write-offs; (ii) lower bank profitability; and (iii) higher risk weights.

2. Results indicate that the main Latvian banks are resilient to the shock and that its impact is further cushioned by the support measures. The exercise covers eight largest Latvian banks, which account for 90 percent of the banking system's assets, and compares them to their peers in the euro-area. Latvian banks' weighted average CET-1 ratio would fall by 3 percentage points by end-2021 but would remain well above regulatory minima and the euro-area average (by 6½ percentage points). These results reflect Latvian banks' comparatively high capital cushions and low exposure to the "non-essential" sectors that were most affected by the pandemic. Overall, the results suggest that the capital positions of the Latvian banks are unlikely to create additional supply-side bottlenecks to new lending as a result of the COVID-19 shock, putting in sharper relief deeper structural factors that need to be addressed for reviving credit growth in the economy.

Latvian Banks—Solvency Stress Test (Extended Coverage), Baseline Scenario
(CET1 Capital Ratio, Percent)



Sources: EBA; ECB; ESRB; FitchConnect; S&P Market Intelligence; and IMF staff estimates.
Note: CCB=capital conservation buffer, CET1=common equity Tier 1, MDA=maximum distributable amount (weighted average). The grey shaded area of the boxplots shows the inter-quartile range (25th to 75th percentile), with whiskers at the 5th and 95th percentile of the distribution. */ Debt repayment relief (moratoria) for businesses and households, public credit guarantees, deferred bankruptcy proceedings, and dividend restrictions (only in 2020).

[1] See IMF Departmental Paper 2021/008 for details of the stress-testing methodology.

Annex VI. External Debt Sustainability Assessment

1. Latvia's gross external debt increased by 750 million euros in 2020 from 2019, mainly driven by the increase in the Bank of Latvia's currency and deposits. Monetary and financial institutions' foreign deposits, excluding the Bank of Latvia (BoL), declined by 930 million euros from 2019 to 2020, while the BoL's foreign deposits increased by 2.1 billion euros. External debt of non-financial corporations and households, and direct investment 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 from around 124 percent in 2020 to below 116 percent of GDP in 2026. The current account balance excluding interest payments is projected to be -1.2 percent of GDP in 2026, above the debt stabilizing level (-5.5 percent of GDP). Gross financing needs are projected to increase gradually.

3. External debt seems broadly resilient to various shocks. Under most shocks and the historical scenario, Latvia's external debt-to-GDP ratio would be near or below its 2020 level over the projection horizon until 2026.

Table 1. External Debt Sustainability Framework (2016–26)

(Percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	147.4	141.5	123.3	117.3	124.2			**129.7**	**128.5**	**125.9**	**121.9**	**119.2**	**115.9**	**-5.5**
2 Change in external debt	5.1	-5.9	-18.1	-6.1	6.9			5.5	-1.2	-2.6	-4.1	-2.6	-3.3	
3 Identified external debt-creating flows (4+8+9)	-6.2	-12.3	-13.0	-6.9	-0.6			-5.5	-6.7	-4.4	-3.2	-2.5	-1.9	
4 Current account deficit, excluding interest payments	-3.9	-3.3	-1.5	-1.4	-4.8			-1.5	-0.7	0.0	0.4	0.9	1.2	
5 Deficit in balance of goods and services	-0.3	0.6	0.8	0.8	-1.2			3.5	3.8	4.9	5.2	5.1	5.2	
6 Exports	59.6	61.6	61.4	60.2	60.3			67.7	64.7	62.6	61.6	60.5	59.3	
7 Imports	59.3	62.3	62.2	61.1	59.1			71.2	68.5	67.6	66.8	65.6	64.5	
8 Net non-debt creating capital inflows (negative)	-0.2	-2.0	-2.2	-3.0	-1.8			-1.7	-1.7	-1.6	-1.4	-1.4	-1.3	
9 Automatic debt dynamics 1/	-2.1	-7.0	-9.3	-2.6	6.0			-2.3	-4.3	-2.9	-2.2	-2.1	-1.8	
10 Contribution from nominal interest rate	2.3	2.0	1.8	2.0	1.8			1.7	1.8	1.8	1.7	1.6	1.6	
11 Contribution from real GDP growth	-3.3	-4.4	-5.0	-2.5	4.3			-4.0	-6.1	-4.7	-3.9	-3.7	-3.4	
12 Contribution from price and exchange rate changes 2/	-1.2	-4.6	-6.1	-2.1	-0.2			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	11.3	6.4	-5.1	0.9	7.5			11.0	5.5	1.8	-0.8	-0.2	-1.3	
External debt-to-exports ratio (in percent)	247.2	229.6	200.8	194.7	206.0			191.6	198.6	201.1	197.9	197.2	195.5	
Gross external financing need (in billions of US dollars) 4/	19.9	21.8	25.2	19.8	17.1			21.7	23.2	27.7	31.0	33.6	37.2	
in percent of GDP	71.1	71.7	73.2	58.1	51.1	10-Year	10-Year	57.9	56.1	62.4	65.5	67.1	70.1	
Scenario with key variables at their historical averages 5/								**129.7**	**135.5**	**135.4**	**131.8**	**128.8**	**124.2**	**-3.8**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	2.4	3.3	4.0	2.0	-3.6	2.6	2.7	3.6	5.2	4.0	3.3	3.2	3.0	
GDP deflator in US dollars (change in percent)	0.6	5.1	8.7	-3.0	2.0	1.1	8.1	8.1	4.9	3.3	2.9	2.8	2.6	
Nominal external interest rate (in percent)	1.7	1.5	1.4	1.6	1.5	2.1	0.8	1.5	1.5	1.5	1.5	1.4	1.4	
Growth of exports (US dollar terms, in percent)	1.8	12.1	12.7	-3.0	-1.6	5.1	11.5	25.8	5.5	3.9	4.5	4.2	3.7	
Growth of imports (US dollar terms, in percent)	-1.5	14.0	13.0	-2.9	-4.8	4.8	14.2	34.8	6.3	5.8	5.1	4.2	4.0	
Current account balance, excluding interest payments	3.9	3.3	1.5	1.4	4.8	2.2	1.4	1.5	0.7	0.0	-0.4	-0.9	-1.2	
Net non-debt creating capital inflows	0.2	2.0	2.2	3.0	1.8	2.3	1.3	1.7	1.7	1.6	1.4	1.4	1.3	

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.

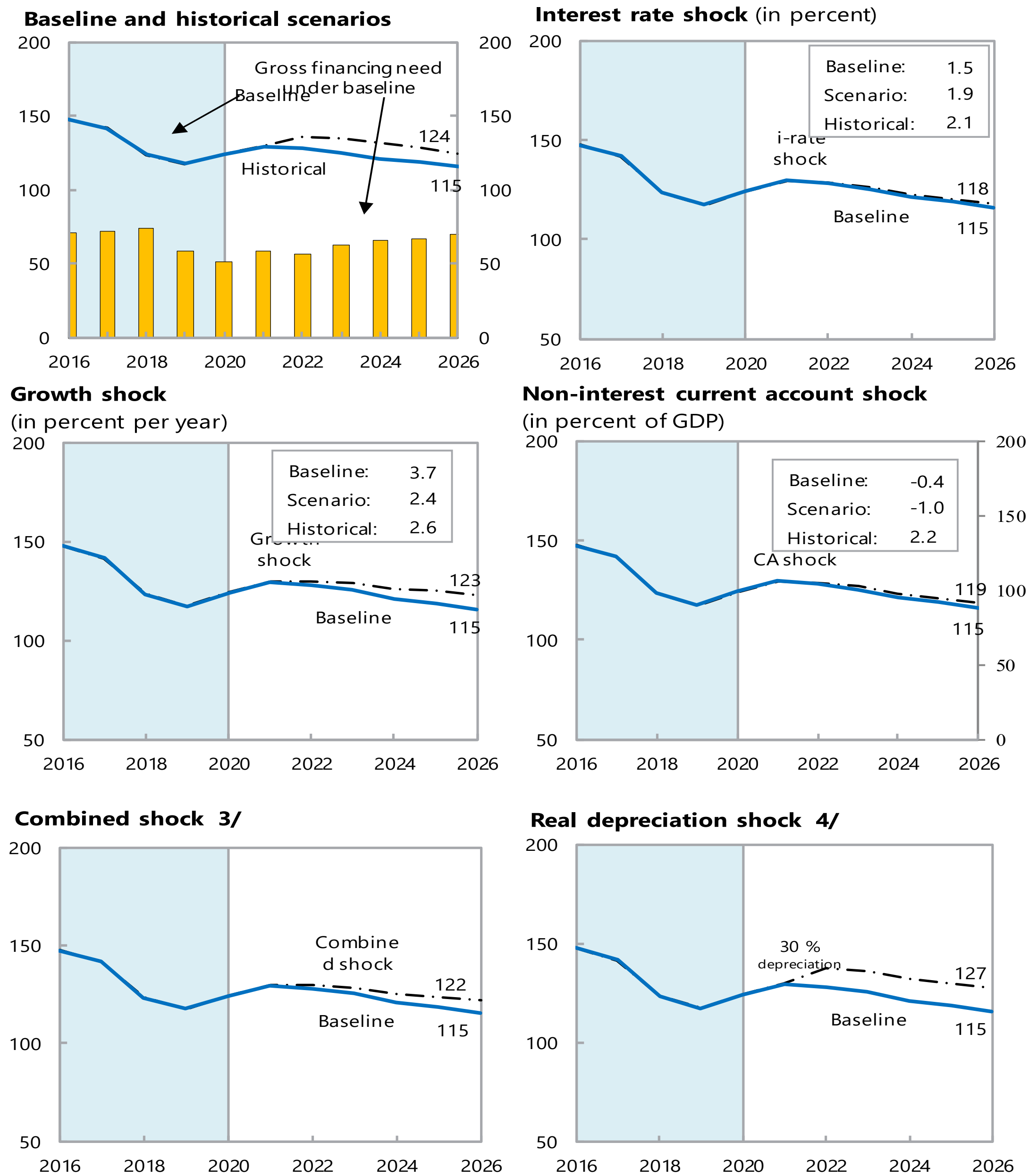
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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.

Figure 1. 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 2021.

Annex VII. Public Sector Debt Sustainability Assessment

Table 1. Public Sector DSA - Baseline Scenario

(in percent of GDP unless otherwise indicated)

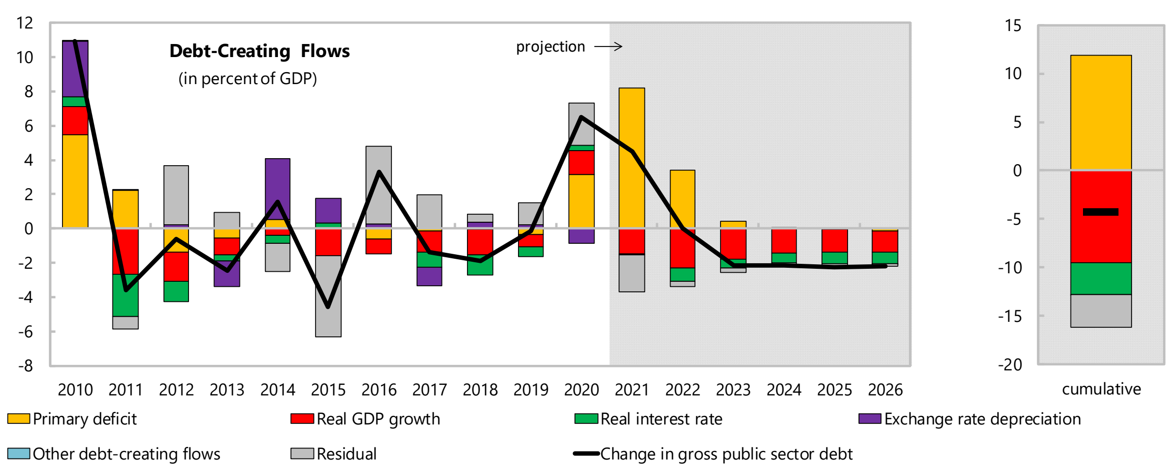
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	40.8	37.0	43.5	47.9	47.9	45.8	43.6	41.4	39.2
Public gross financing needs	7.1	4.4	9.2	15.4	5.9	5.4	3.8	3.6	2.3
Real GDP growth (in percent)	2.6	2.0	-3.6	3.6	5.2	4.0	3.3	3.2	3.0
Inflation (GDP deflator, in percent)	2.3	2.3	0.1	1.5	2.6	1.9	2.0	2.1	2.2
Nominal GDP growth (in percent)	5.0	4.4	-3.6	5.1	7.9	5.9	5.4	5.4	5.2
Effective interest rate (in percent) [4/]	3.5	2.4	2.3	1.5	0.9	0.8	0.8	0.5	0.5

As of December 30, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		51
5Y CDS (bp)		58
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A-	A-
Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.2	-0.1	6.5	4.5	0.0	-2.1	-2.2	-2.2	-2.2	-4.3	
Identified debt-creating flows	-0.3	-1.4	4.0	6.7	0.3	-1.9	-1.9	-2.1	-2.0	-1.0	
Primary deficit	0.6	-0.3	3.2	8.2	3.4	0.4	0.1	0.0	-0.2	11.9	-1.9
Primary (noninterest) revenue and grants	36.0	37.4	38.4	38.4	38.1	39.0	38.7	37.9	37.5	229.5	
Primary (noninterest) expenditure	36.6	37.0	41.6	46.5	41.5	39.4	38.8	37.9	37.3	241.4	
Automatic debt dynamics [5/]	-0.9	-1.1	0.8	-1.5	-3.1	-2.3	-2.0	-2.0	-1.9	-12.8	
Interest rate/growth differential [6/]	-1.7	-1.3	1.7	-1.5	-3.1	-2.3	-2.0	-2.0	-1.9	-12.8	
Of which: real interest rate	-0.6	-0.6	0.3	0.0	-0.8	-0.5	-0.6	-0.7	-0.7	-3.3	
Of which: real GDP growth	-1.0	-0.7	1.4	-1.5	-2.3	-1.8	-1.4	-1.3	-1.2	-9.5	
Exchange rate depreciation [7/]	0.7	0.2	-0.9	…	…	…	…	…	…	…	
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 Euroarea loans)	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/]	0.5	1.3	2.5	-2.2	-0.3	-0.2	-0.2	-0.2	-0.2	-3.3	



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.

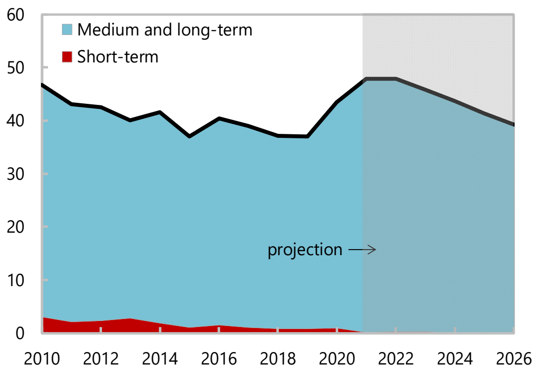
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

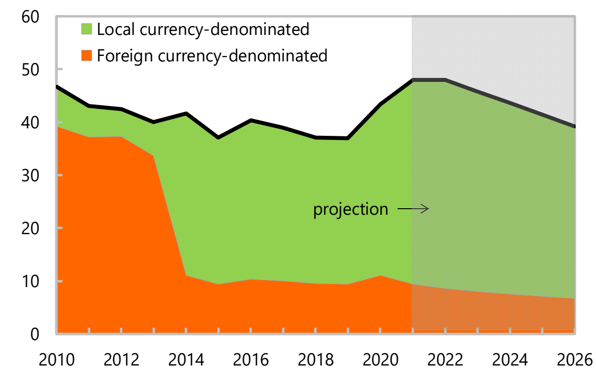
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

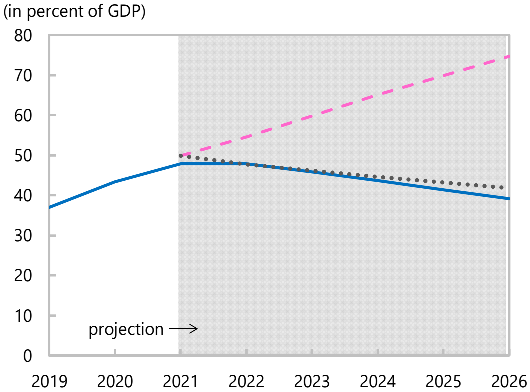


Alternative Scenarios

Baseline Historical Constant Primary Balance

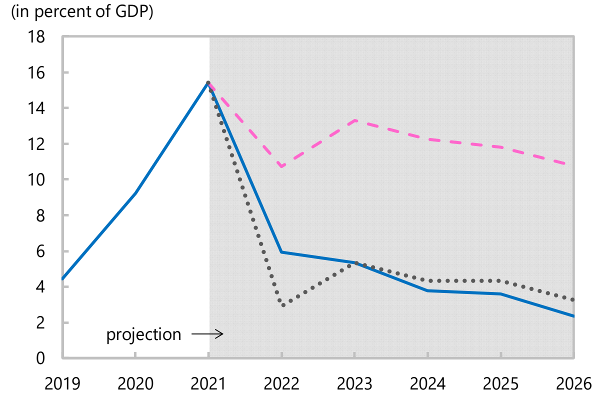
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	3.6	5.2	4.0	3.3	3.2	3.0
Inflation	1.5	2.6	1.9	2.0	2.1	2.2
Primary Balance	-8.2	-3.4	-0.4	-0.1	0.0	0.2
Effective interest rate	1.5	0.9	0.8	0.8	0.5	0.5
Constant Primary Balance Scenario						
Real GDP growth	3.6	5.2	4.0	3.3	3.2	3.0
Inflation	1.5	2.6	1.9	2.0	2.1	2.2
Primary Balance	-8.2	-8.2	-8.2	-8.2	-8.2	-8.2
Effective interest rate	1.5	0.9	0.7	0.6	0.3	0.3

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	3.6	2.6	2.6	2.6	2.6	2.6
Inflation	1.5	2.6	1.9	2.0	2.1	2.2
Primary Balance	-8.2	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	1.5	0.9	0.9	1.1	1.1	1.3

Source: IMF staff.

Annex VIII. The Insolvency System in Latvia

In the past years, Latvia embarked on ambitious reforms of its insolvency framework. Some of these reforms have already produced positive effects while others are work in progress. The global COVID-19 crisis, and the unprecedented economic challenges it poses, has emphasized the importance and heightened the urgency of having effective debt resolution frameworks in place. Thanks to its continued efforts towards improving its insolvency framework in recent years, Latvia is well placed to address the additional challenges brought by the pandemic and should continue pressing further with the steadfast completion of reforms necessary to strengthen its insolvency system.

1. **Latvia has undertaken reforms of its insolvency framework, which concerned multiple parts of the insolvency system.** Three key aspects of these reforms relate to the *regime for insolvency administrators*, *the rehabilitation processes*, and *data collection and statistical systems*. As explained below, some of the reforms in these areas have already produced positive effects while others are work in progress.[1]

2. **The strengthening of the regime for insolvency administrators has had positive noticeable effects, but some areas for improvement remain.** The regime has been recently strengthened following a number of cases that involved serious abuses and malpractices by insolvency administrators. The reforms already rendered positive results in some areas; namely, the qualification and licensing requirements, the system for appointment, as well as the enhanced supervision by the Insolvency Control Service. The Insolvency Control Service has increased its resources for the supervision of insolvency administrators, on-site and off-site; and has dealt effectively with the complaints against insolvency administrators. Work is also underway to extend the licensing period for insolvency administrators beyond the current two-year limit. At the same time, more progress is needed in some areas: the assessment of the reputation of candidates to obtain or renew an insolvency administrator license would benefit from clear and objective rules[2] and insolvency administrators should be allowed to conclude the cases for which they were validly appointed. The random appointment system currently in place could be enhanced by establishing different categories of insolvency administrators based on area and level of expertise as well as the type and size of debtor. This would ensure that complex cases are directed to a suitable pool of administrators with sufficient expertise and allow a degree of specialization among administrators. Expenses should also be contained so as to allow remuneration of insolvency administrators in cases and adequate insurance coverage should be ensured.

3. **The rehabilitation process (Legal Protection Proceeding) presents several challenges, but reforms are underway as part of the implementation of the EU Directive on Restructuring and Second Chance.** Legal Protection Proceedings, as the main instrument for the reorganization of

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[1] This annex draws on key findings from the IMF Technical Assistance Report "*Evaluation of the Insolvency Framework,*" March 11, 2019, and has been updated to include more recent developments.

[2] The Insolvency Control Service is currently preparing and will publish a summary of cases on the compliance of an insolvency administrator with the good repute requirement that may serve as guidance in this area.

viable enterprises in Latvia, does not seem to have been fulfilling that function. The number of cases where a plan is concluded is limited, and this suggests that the procedure is used, in many cases, just as a delaying tactic against creditor action. A series of changes would be required to introduce a proper balance between reorganization and liquidation in the Latvian insolvency system, facilitating the rehabilitation of viable businesses and long-term growth. The ongoing work on the implementation of the EU Directive on restructuring and second chance presents an opportunity to address the shortcomings impacting the use of the Legal Protection Proceeding and simplify corporate debt restructuring through out-of-court and hybrid restructuring procedures.

4. Latvia has a sophisticated data collection system. The Latvian authorities have devoted resources to the establishment of insolvency data collection systems: the Insolvency Register captures important information on all insolvency proceedings; the Insolvency Control Service gathers abundant data from the insolvency administrators' reports and compiles comprehensive statistical reports on the Latvian insolvency system. The recent introduction of the Electronic Insolvency Accounting System in 2019 has further bolstered the amount, granularity, and periodicity of data available to the Insolvency Control Service.

5. There are some issues in data collection and the methodology for the elaboration of statistical reports while the integration of the different data systems would increase the effectiveness of supervision. The methodology for statistics needs some adjustments, particularly in the measurement of the recovery of secured credit. The contents of reported data could include economic information; this would increase the use of statistical reports, raising awareness about the importance of the insolvency system among other authorities. Controls over the supervisors of Legal Protection Proceedings could also be introduced in the electronic system. Reports can then be analyzed for statistical purposes.

Annex IX. Recent AML/CFT Progress in Latvia

1. MONEYVAL concluded a detailed assessment of the effectiveness of Latvia's AML/CFT system in 2018. The assessment report measured the effectiveness of Latvia's AML/CFT framework against 11 immediate outcomes (IOs) (i.e., assessing whether the AML/CFT system achieves results in line with its ML/TF risks) and Latvia's technical compliance (i.e., assessing the country's legal and regulatory framework against the FATF 40 Recommendations).

2. For technical compliance, Latvia is currently compliant or largely compliant with all 40 FATF Recommendations after the adoption of the 1st Enhanced Follow-up Report adopted by MONEYVAL in December 2019, which upgraded Latvia's ratings on several recommendations.

3. Regarding effectiveness, Latvia substantially met 1 of the 11 IOs, with the remaining being either of moderate (8 IOs) or low effectiveness (2 IOs). In February 2020, the Financial Action Task Force (FATF) Plenary decided that tangible and positive progress was also made by Latvia on all key recommended actions for the IOs rated Low or Moderate by MONEYVAL in 2018, and as a result, Latvia was removed from and avoided being subjected to the FATF's International Co-operation Review Group (ICRG) monitoring (the FATF's 'gray list').

4. The following are some of the key improvements reported by Latvia since the last Article IV consultation in strengthening the effectiveness of its regime that are particularly relevant for the financial sector and risk mitigation[1]:

- Latvia has established a coordination platform to develop a common understanding of ML/FT risks and has used the platform to share knowledge and supervisory practices.
- The FCMC has indicated that it has increased the frequency of onsite inspections of banks that hold foreign deposits, and also notes that all high-risk banks in the sector are being subject to onsite inspections.
- Latvia has carried out an impact assessment of the resources allocated to AML/CFT supervisors, where as a result, additional resources have been allocated.
- Supervisors have provided guidance and training on enterprise-wide risk assessments and are inspecting the risk assessments of their obliged entities.
- Supervisors have conducted outreach to improve obliged entities' ML/FT risk understanding. Obliged entities have been made aware of the national risk assessments and were involved in producing the sectoral ML/FT risk assessments.

[1] The key improvements listed are not exhaustive since progress has also been reported on other areas of the effectiveness regime.

- Supervisors have provided updated guidelines and training to obliged entities to improve their understanding of the need to carry out risk-based supervision.

- Existing legal persons are required to collect and send information on the beneficial ownership to the Enterprise Register. In addition, priority was given to the LLC sector, considered a high-risk sector according to the NRA where the implementation of sanctions for non-compliance with these requirements is ongoing.

- The Beneficial Ownership (BO) register is fully operational, and law enforcement authorities have access to BO records free of charge. Latvia has also taken measures to prevent the misuse of Latvian companies where at least one shareholder is a non-resident.

- A mechanism to compel obliged entities to determine their BO through the development of a common understanding, training activities, and cooperation with supervisors has been established.

Ratings Key[2]					
Technical compliance	Recommendations	Compliant	Largely compliant	Partially compliant	Non-compliant
Effectiveness	Immediate outcomes	High	Substantial	Moderate	Low

[2] There are four possible levels of technical compliance: compliant (C), largely compliant (LC), partially compliant (PC), and non-compliant (NC). C and LC ratings are considered sufficient by FATF, PC and NC would require follow-up measures. The latter two are not included since Latvia has only C or LC left. For effectiveness, there are four possible levels: High (HE), Substantial (SE), Moderate (ME) and Low (LE) effectiveness. HE and SE are considered sufficient. While there have been no re-ratings on effectiveness, as previously noted, Latvia reported progress in the IOs rated ME and LE.

Technical Compliance—40 Recommendations—To assess the legal and institutional framework

Recommendations that are underlined in this table were originally rated one notch lower but were upgraded by MONEYVAL in December 2019 as part of the country's 1st Enhanced Follow-up Report.

R.1	Assessing risk and applying risk-based approach	**R.2**	*National cooperation and coordination (originally rated LC)*
R.3	Money laundering offence	**R.4**	Confiscation and provisional measures
R.5	Terrorist financing offence	**R.6**	*Targeted financial sanctions for terrorism (originally rated PC)*
R.7	*Targeted financial sanctions for proliferation (originally rated PC)*	**R.8**	NPOs
R.9	Financial institution secrecy laws	**R.10**	*Customer due diligence (originally rated PC)*
R.11	Record keeping	**R.12**	Politically exposed persons
R.13	Correspondent banking	**R.14**	Money or value transfer services
R.15	New technologies	**R.16**	Wire transfers
R.17	Reliance on third parties	**R.18**	Internal controls and foreign branches and subsidiaries
R.19	Higher risk countries	**R.20**	Reporting of suspicious transactions
R.21	Tipping off and confidentiality	**R.22**	*DNFBPs: Customer due diligence (originally rated PC)*
R.23	DNFBPs: Other measures	**R.24**	Transparency and BO of legal persons
R.25	Transparency and BO of legal arrangements	**R.26**	*Regulation and supervision of financial institutions (originally rated PC)*
R.27	Powers of supervision	**R.28**	*Regulation and supervision of DNFBPs (originally rated PC)*
R.29	Financial Intelligence Unit	**R.30**	Responsibilities of law enforcement and investigative authorities
R.31	Powers of law enforcement and investigative authorities	**R.32**	*Cash couriers (originally rated PC)*
R.33	Statistics	**R.34**	Guidance and feedback
R.35	Sanctions	**R.36**	International instruments
R.37	Mutual legal assistance	**R.38**	Mutual legal assistance: freezing and confiscation
R.39	*Extradition (originally rated PC)*	**R.40**	*Other forms of international cooperation (originally rated PC)*

Effectiveness —11 Immediate outcomes[3] **—**To assess if the legal and institutional framework generates results in line with the country's risks

IO.1	Risk, policy, and coordination	**IO.2**	International cooperation
IO.3	Supervision	**IO.4**	Preventive measures
IO.5	Legal persons and arrangements Terrorist financing offence	**IO.6**	Financial intelligence
IO.7	Money laundering investigations and prosecution	**IO.8**	Confiscation
IO.9	Terrorist financing investigations and prosecution	**IO.10**	Terrorist financing preventive measures and financial sanctions
IO.11	Proliferation financing financial sanctions		

[3] As noted in the footnote above, the ratings on effectiveness are from MONEYVAL's 2018 assessment report. While there have been no re-ratings on effectiveness, as previously noted, Latvia reported progress in relation to effectiveness as part of the successful efforts to avoid FATF gray listing.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 7, 2021

Prepared by The European Department

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FUND RELATIONS

(As of March 31, 2021)

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)	332.25	99.98
Reserve Tranche Position	0.06	0.02

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	120.82	100.00
Holdings	120.83	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		
	2021	**2022**	**2023**
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 againstother currencies. Prior to 2014, the currency of Latvia was the lat, which was introduced in March 1993to 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 August 7, 2019 (IMF Country Report No. 19/264). The Executive Board assessment is available https://www.imf.org/en/Publications/CR/Issues/2019/08/06/Republic-of-Latvia-2019-Article-IV-Consultation-Press-Release-and-Staff-Report-48565

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'sfinancial 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 theBoard 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 duringNovember 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
MCM	Deposit Insurance	Mission	Sept. 2009	FinanceFCMC
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 is 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, one FSIs for non-financial corporations and two 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 monthly data on balance of payments and IIP, and quarterly data on 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 May 6, 2021)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	May 6, 2021	May 6, 2021	D	D	D
International Reserve Assets and Reserve Liabilities of the MonetaryAuthorities[1]	March 2021	March 2021	M	M	M
Reserve/Base Money	March 2021	March 2021	M	M	M
Broad Money	March 2021	March 2021	M	M	M
Central Bank Balance Sheet	March 2021	March 2021	M	M	M
Consolidated Balance Sheet of the Banking System	March 2021	March 2021	M	M	M
Interest Rates[2]	March 2021	March 2021	M	M	M
Consumer Price Index	April 2021	April 2021	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—GeneralGovernment[4]	Q4/2020	April 2021	Q	Q	M
Revenue, Expenditure, Balance and Composition of Financing[3]——CentralGovernment	March 2021	March 2021	M	Q	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	March 2021	March 2021	M	Q	M
External Current Account Balance	February 2021	February 2021	M	M	M
Exports and Imports of Goods andServices	February 2021	February 2021	M	M	M
GDP/GNP	Q4 2020	Q4 2020	Q	Q	Q
Gross External Debt	Q4 2020	Q4 2020	Q	Q	Q
International Investment Position[6]	Q4 2020	Q4 2020	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).

Statement by Mr. Pösö, Executive Director, and
Ms. Skrivere, Advisor to the Executive Director
August 27, 2021

On behalf of the Latvian authorities, we would like to thank staff for the candid and professional discussions during the Article IV mission held via videoconferences in June. The authorities highly appreciate staff's analytical work and contributions to relevant policy discussions. Overall, the authorities share staff's views reflected in the report regarding the outlook and challenges the Latvian economy is facing, as well as broadly agree with the policy recommendations.

Outlook and risks

Following the sharp contraction in 2020, a robust recovery is underway. Driven by strong external demand and pent-up internal demand, as well as supported by a considerable policy response to the COVID-19 crisis, growth is expected to rebound strongly in 2022 – 2023. Substantial EU-financed capital spending is expected to make a significant contribution to growth in the years beyond 2023.

Inflation was close to zero in 2020 but has picked up lately. The average inflation rate is projected to surpass 2 percent in 2021, and the recovery is expected to exercise some upward pressure on prices also in 2022. However, the current inflation momentum is mostly driven by volatile energy prices and is projected to gradually recede in the following years.

The scenario of recurring waves of the pandemic in combination with insufficient vaccine take-up remains the main risk to the otherwise benign outlook. Complacency, induced by the low incidence numbers, and vaccine hesitancy somewhat slowed the speed of vaccination over the summer. By mid-August, approximately 43 percent of the population have received at least one vaccine dose. This number remains well below the authorities' goal of a 60 to 70 percent vaccination rate by fall. The authorities are continuously exploring and introducing new incentives to increase the rate of vaccination.

Fiscal policy

Fiscal policy remains highly accommodative in 2021. The budget deficit is expected to widen to close to 9 percent of GDP in 2021 and then decrease to 2.6 and 1.4 percent in 2022 and 2023, respectively. While the initial COVID-19 crisis support was limited predominantly to the sectors particularly hard-hit by the crisis, the second wave of measures introduced in the fall of 2020 was more inclusive and covered a wider range of groups affected by the crisis. These measures are designed to be temporary and will be gradually withdrawn once the conditions improve. Relatively low public debt, which according to current projections is expected to peak below 50 percent of GDP in 2021, provides ample space to bolster the economy in case additional support is needed.

The Latvian authorities are committed to maintaining high standards of governance and transparency, in particular, with regards to crisis-related expenditures. All information on COVID-19 crisis support is publicly available, the use of the resources is audited by the State Audit Office, and the results of the audits are published on their website. The authorities also continue to upgrade the anticorruption framework. Addressing the recommendations of the GRECO report is an important step in this direction.

Structural reforms

Years 2022-2026 will mark a significant increase in the EU-financed capital spending. This funding provides an excellent opportunity to modernize the Latvian economy and implement the authorities' climate and digitalization goals. According to the current plans, 37 percent of the EUR 1.85 billion Recovery and Resilience Facility (RRF) will be allocated to climate-related projects, and further 20 percent to digitalization.

The authorities are also continuing the health sector and regional reforms. A significant share of the RRF funding is earmarked to support these ongoing reforms aimed at improving access to health services and reducing regional and social disparities. A major consolidation of municipalities was undertaken in 2021.

This surge in investment raises concerns about possible labor market tightening. In particular, the construction sector may face labor shortages in 2023 and 2024 when EU-financed inflows are expected to peak. While employment in the construction sector currently remains subdued, the sentiment data indicate a moderate increase in the labor shortage. The authorities are well aware of the necessity to carefully manage the timing of projects and cooperate with the private sector to avoid bunching of labor-intensive projects.

The output contraction in 2020 had a considerable and uneven effect on the labor market. Low-skilled and low-wage employees, as well as the young suffered disproportionally compared to other groups. In order to limit the risk of scarring, the authorities upgraded the support package in the fall of 2020. Eligibility to receive downtime benefits was broadened to apply to all taxpayers, and new wage subsidies for part-time workers were introduced. In the future, it is likely that additional measures to support the efficient labor reallocation and upskilling will be necessary.

Financial sector

Financial stability risks from the COVID-19 crisis remain largely contained. The financial system entered the crisis well-capitalized and profitable, and with limited exposure to the most hard-hit sectors like hospitality. Banks are sufficiently resilient to tackle the expected deterioration in asset quality once COVID-19 related support is phased out. The authorities' stress tests indicate that banks' capital and liquidity are sufficient to withstand a very adverse scenario.

A number of new borrower-based measures strengthening the macroprudential framework came into effect in 2020. The key elements of the new framework are limits to debt-to-net-income and limits to debt-service-to-net-income, as well as limits to maximum term and loan-to-value (LTV) for buy-to-let properties (in addition to earlier LTV limits). These measures were timed to apprehend any acceleration of the credit cycle, and since no signs of market imbalance were present at the introduction of the package, the measures were calibrated very close to the prevailing best market practice. Household lending growth, although picking up lately, has remained moderate, and at the current juncture, the authorities find that the measures already in place are sufficient to ensure adequate lending standards.

Anemic credit growth to non-financial corporations has been a long-standing feature of the Latvian economy, and the COVD-19 crisis has not increased banks' appetite to issue new loans. High lending rates have likely been one of the factors behind weak demand for new credit and remain an important factor hindering economic growth. Interest rates on loans to non-financial corporations are among the highest in the euro area, at levels difficult to explain even if accounted for by conventional determinants like credit risk spreads, NPLs, degree of risk aversion, operating costs etc.[1]

A major institutional reform is underway to integrate the financial supervisory authority, the Financial and Capital Market Commission (FCMC), into the Bank of Latvia. Both institutions have already started preparatory work to incorporate functions assigned to the FCMC into the central bank's structure. The process of integration is currently on track to be successfully completed by 2023.

AML/CFT framework

Over the last few years, Latvia's AML/CFT framework has been significantly strengthened. This progress is duly recognized in the report, and Annex IX lists a number of key activities the authorities have pursued to upgrade the framework.

The authorities would also like to highlight the following improvements:

- Institutions' ability to enforce AML/CFT procedures has been considerably strengthened. A clear commitment of law enforcement authorities, prosecutors, and courts has yielded substantive and tangible results: a wider use of circumstantial evidence, parallel financial investigations, focus on professional money laundering at financial institutions, and on high-level officials have resulted in a detection of a number of stand-alone money laundering cases.
- Significant outreach and communication efforts have brought about substantial improvements in credit institutions. Banks' vulnerabilities have decreased significantly due to enhanced ability to identify and report suspicious

[1] Bank of Latvia Working paper 2/2021 *Interest Rate Spreads in the Baltics and the Rest of the Euro Area: Understanding the Factors behind the Differences.*
https://datnes.latvijasbanka.lv/papers/discussion/dp_2_2021.pdf

transactions and terminate cooperation with high-risk customers and shell arrangements.

- The Beneficial Ownership register is fully operational. The register provides information free of charge both to law enforcement authorities and the general public. In this respect, Latvia is among the leading countries in the EU (according to *Transparency International)*.[2]
- The authorities have also taken a number of decisive steps to strengthen its CFT framework and regulatory provisions on sanctions compliance. Substantial work has been done to clarify the division of competences between various institutions involved and to ensure that all necessary legal instruments are introduced in the regulatory framework. In addition, extensive outreach activities have improved institutions' ability to identify risks associated with the financing of terrorism.

The efforts undertaken over the recent years have resulted in a significant increase in the cases disseminated by the Financial Intelligence Unit and investigated by law enforcement authorities.

The Latvian authorities are committed to further enhancing the AML/CFT framework. The authorities plan to further upgrade AML/CFT procedures, in line with the 2019 *Moneyval* follow-up assessment. The ongoing regional Fund technical assistance project on AML/CFT, encompassing all countries of the Nordic-Baltic constituency, is also expected to provide valuable analysis and additional guidance.

[2] https://transparency.eu/eu-must-act-beneficial-ownership-registers/