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Republic of Latvia: First Post-Program Monitoring Discussions

The following documents have been released and are included in this package:

- The staff report prepared by a staff team of the IMF, following discussions that ended on May 15, 2012, with the officials of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 25, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Public Information Notice (PIN).
- A statement by the Executive Director for the Republic of Latvia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

First Post-Program Monitoring Discussions

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Mahmood Pradhan and Taline Koranchelian

June 25, 2012

Background: The economy has continued its recovery since the end of the Fund-EC supported program. Growth reached 5.5 percent in 2011, and is expected to reach 3.5 percent this year, though unemployment is likely to remain high. Inflation is projected to fall to 2.4 percent, which will likely be consistent with meeting the Maastricht reference value, but only just. The budget deficit declined to 3.5 percent of GDP last year and is projected to fall this year to about 2 percent of GDP, well-below the Maastricht criterion. The program's strong track record has facilitated a return to capital markets, with $1.5 billion issued since mid-2011. Though discussions considered the implications of the Euro Area crisis, the baseline assumption in this report is that these tensions do not intensify significantly.

The authorities' strategy centers on adopting the euro (the program's exit strategy) in 2014. Although greater than expected fiscal space allows them to reverse some crisis-related consolidation measures (including by cutting VAT in July and plans to reduce PIT starting next year), progress on the Fiscal Responsibility Law and agreement to the Fiscal Compact is evidence of the authorities' continued commitment to budget discipline. The authorities are considering decentralizing funding of social assistance to reduce benefit dependency and to save money for the central government. They recognize that greater product market flexibility is needed to thrive under a fixed exchange rate, and are preparing an action plan in response to the recently commissioned Competitiveness Report.

Staff's views: Staff supports the program's exit strategy of euro adoption and urged the authorities to meet the Maastricht criteria sustainably. Given the increase in domestic demand, staff recommended saving most of the revenue overperformance, and deferring major changes to the tax code or spending increases to the annual budget. However, in line with Fifth Review recommendations, staff supported modest spending increases in areas that have adjusted the most, and to pay for targeted wage increases in the public sector to retain qualified staff. Staff supported the goal of gradually reducing the labor tax burden, but not by legislating pre-announced substantial personal income tax cuts outside the budget cycle and without specifying offsetting measures. While recognizing the need to increase work incentives (by cutting marginal tax rates for low-earners), staff urged the authorities not to decentralize social assistance funding as this could jeopardize the social safety net, and suggested that any reform await the results of a World Bank and DG Employment study due later this year.

Discussions were held in Riga May 7–15. The mission met with Prime Minister Dombrovskis; Finance Minister Vilks; Bank of Latvia (BoL) Governor Rimšēvičs; Head of the Financial and Capital Market Commission (FCMC) Zakulis; senior officials in these institutions and other government agencies; coalition and opposition political parties; social partners including the trade unions and local governments; foreign ambassadors; media; and financial institution and other private sector representatives.

Team: The staff team comprised Mark Griffiths (head), Bertrand Gruss, Magnus Saxegaard (all EUR), Alvar Kangur (FAD), and Sergi Lanau (SPR). David Moore and Agnese Bukovska (Resident Representative's Office) assisted the mission. The team worked closely with staff of the European Commission, European Central Bank, World Bank, and the Swedish authorities. Gundars Davidsons (OED) attended some meetings.

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I. CONTEXT

1. **Latvia's economy has emerged from the crisis more resilient and within reach of the Maastricht criteria for euro adoption, the program's exit strategy.** Fiscal consolidation of more than 15 percent of GDP reduced the budget deficit to 3.5 percent of GDP (ESA95) in 2011; the current account deficit, which reached 22 percent of GDP before the crisis, declined to 1.2 percent of GDP in 2011 as the economy cooled and competitiveness improved; and the financial sector, destabilized by the collapse of Parex Bank in late-2008 and deteriorating asset quality, is well-capitalized and has returned to profitability. As a result, Latvia has been able to return to international capital markets and is well-placed to meet the Maastricht criteria.

2. **The economy grew by 5.5 percent in 2011, the third fastest in the EU (Figure 1).** Although the economy decelerated somewhat toward the end of last year, stronger than expected demand for Latvian exports ensured that domestic demand, in particular private investment, continued to strengthen. However, the net export contribution turned increasingly negative in 2011 given the high import content of exports and investment. In the first quarter of 2012 the economy has continued its strong recovery, expanding by 6.9 percent year-on-year (1.1 percent quarter-on-quarter, seasonally adjusted). Compared to the fourth quarter of 2011, industrial production and retail sales are 1.7 and 3.5 percent higher (seasonally adjusted), suggesting that Europe's slowdown has had less impact on Latvia's economy than feared at the Fifth Review.

3. **Unemployment remains high at more than 16 percent, but rising employment suggests the labor market has started to improve (Figure 2).** Employment increased by 30,000 in 2011 after falling by 160,000 in 2009–10, and the unemployment rate decreased to 16.4 percent. However, more than half the unemployed have been out of work for more than a year. Thus, even though the worst of the crisis has passed, demand for safety net services will likely persist. Despite the high unemployment, wages have started to increase in the private sector, but mainly for the higher-skilled.

4. **Increases in world commodity prices have raised headline inflation, but core inflation remains low (Figure 2).** Inflation jumped to 4.2 percent in 2011, due to higher commodity prices, but has been falling steadily since mid-2011, reaching 2.3 percent at end-May. A negative output gap and high unemployment should keep core inflation—currently around 1.4 percent—low, and contribute to a gradual decline in headline inflation.

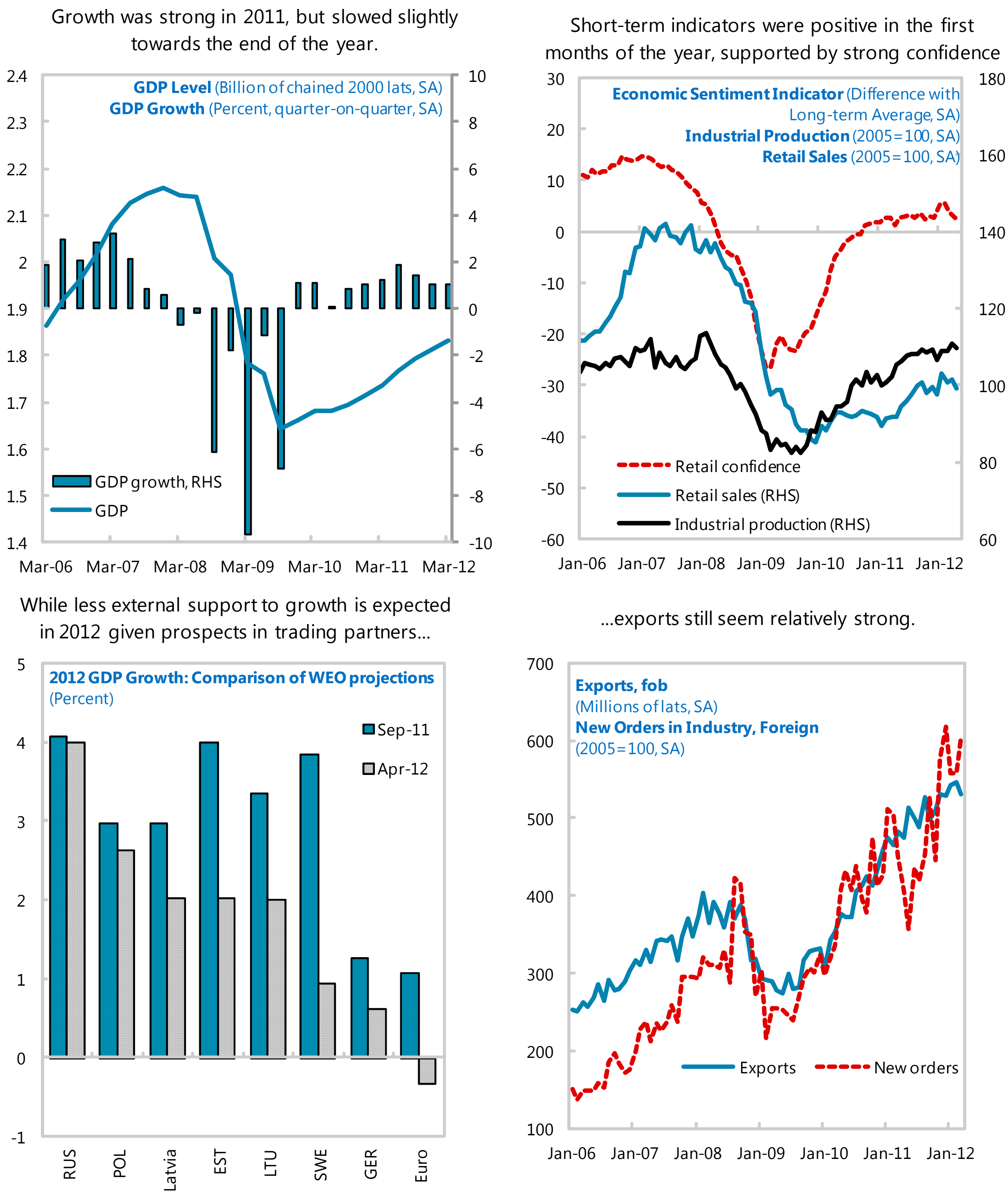
5. **The budget deficit has fallen steadily, and is on track to meet the Maastricht deficit criterion (Figure 3).** Last year's deficit is estimated at 3.5 percent of GDP (ESA95), well below program targets. Higher direct taxes and dividends from public enterprises, slow EU funds absorption, and savings on unemployment benefits helped offset higher local government spending, as well as the cost of bailing out airBaltic (0.4 percent of GDP) and of selling the commercial part of Mortgage and Land Bank (MLB). This strong performance has continued into the first quarter of 2012, with revenue collections exceeding projections by around L46 million (staff estimates that approximately L26 million of this is a permanent increase in revenues) and lower than expected interest and social benefit payments.

6. Latvia's strong implementation of the recently completed SBA has improved market confidence and facilitated a successful return to international capital markets (Figures 4 and 5). Since mid-2011 Latvia has issued one 5 and one 10-year dollar-denominated Eurobond with combined face value of $1.5 billion, and at an average yield only slightly above 5 percent. This has partially offset the decline in international reserves—which stand at €5.4 billion or 4.5 months of imports—resulting from deleveraging by foreign-owned banks. Following the recent S&P upgrade, all three major rating agencies now rate Latvia at investment grade, which should bode well for further market access. In light of this strong performance, CDS spreads fell back to around 250 basis points in April, before rising again with the recent round of Euro Area tensions.

7. Lower funding costs have made banks profitable, but reluctance to expand lending should keep any economic recovery under control (Figures 6 and 7). Excluding Parex (whose banking license was removed in March) and Latvijas Krajbanka (closed in November 2011 following the discovery of fraud, and finally declared bankrupt in May) bank profits increased to L97.5 million in 2011, compared to a loss of L228.7 million in 2010. Capital injections and improving asset quality have strengthened capital. The system CAR now stands at 18.1 percent (14.9 percent tier 1), substantially above the 8 percent regulatory minimum. Liquidity is gradually declining but remains adequate. Credit demand should recover as confidence improves and balance sheets strengthen, but foreign banks are continuing to delever in an attempt to reduce their loan-to-deposit ratio (above 175 percent at end-2011), with some banks repatriating funds to their parent banks as loans in Latvia are repaid, rather than making new loans.

8. Notwithstanding this record of stabilization and recovery, Latvia faces many challenges and vulnerabilities. Strong domestic demand relative to trading partners is likely to worsen the trade balance, and capital outflows are likely to persist due to deleveraging and the sharp increase in global risk aversion. Together with the need to repay the international support package, this will put pressure on international reserves. At the same time, a lack of skilled labor could become a constraint to growth and put pressure on wages unless the long-term unemployed reenter the labor market, while the reliance on bank lending (as opposed to other forms of financing) could limit investment if deleveraging continues. The authorities also face the more fundamental challenge of fostering inclusive growth to ensure that Latvia's improved economic prospects lead to sustained decreases in inequality and poverty. Although an integral part of the program, this has not been a political priority, so far.

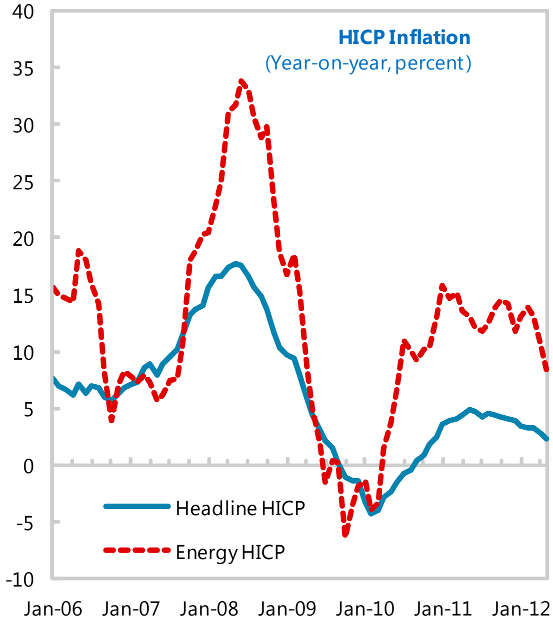
Figure 1. Latvia: Real Sector, 2006–12



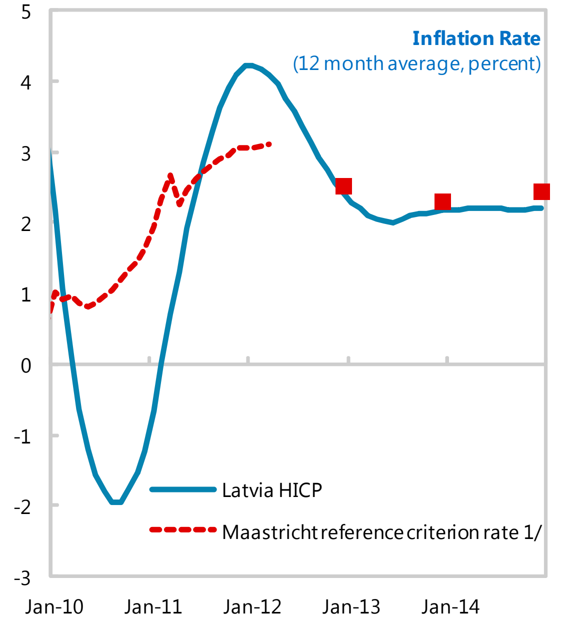
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 2. Latvia: Inflation and the Labor Market, 2006–12

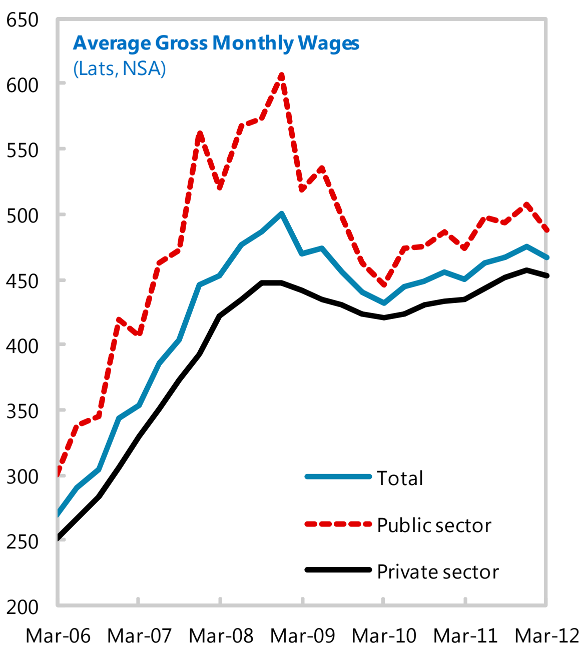
Inflation is moderating but only gradually given oil price developments...



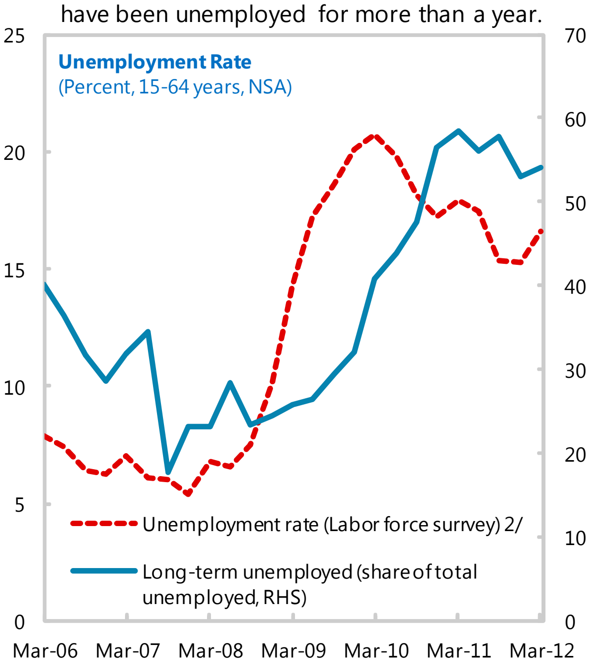
which represents a risk to fulfilling the Maastricht inflation criterion in 2012.



The labor market is slowly recovering...



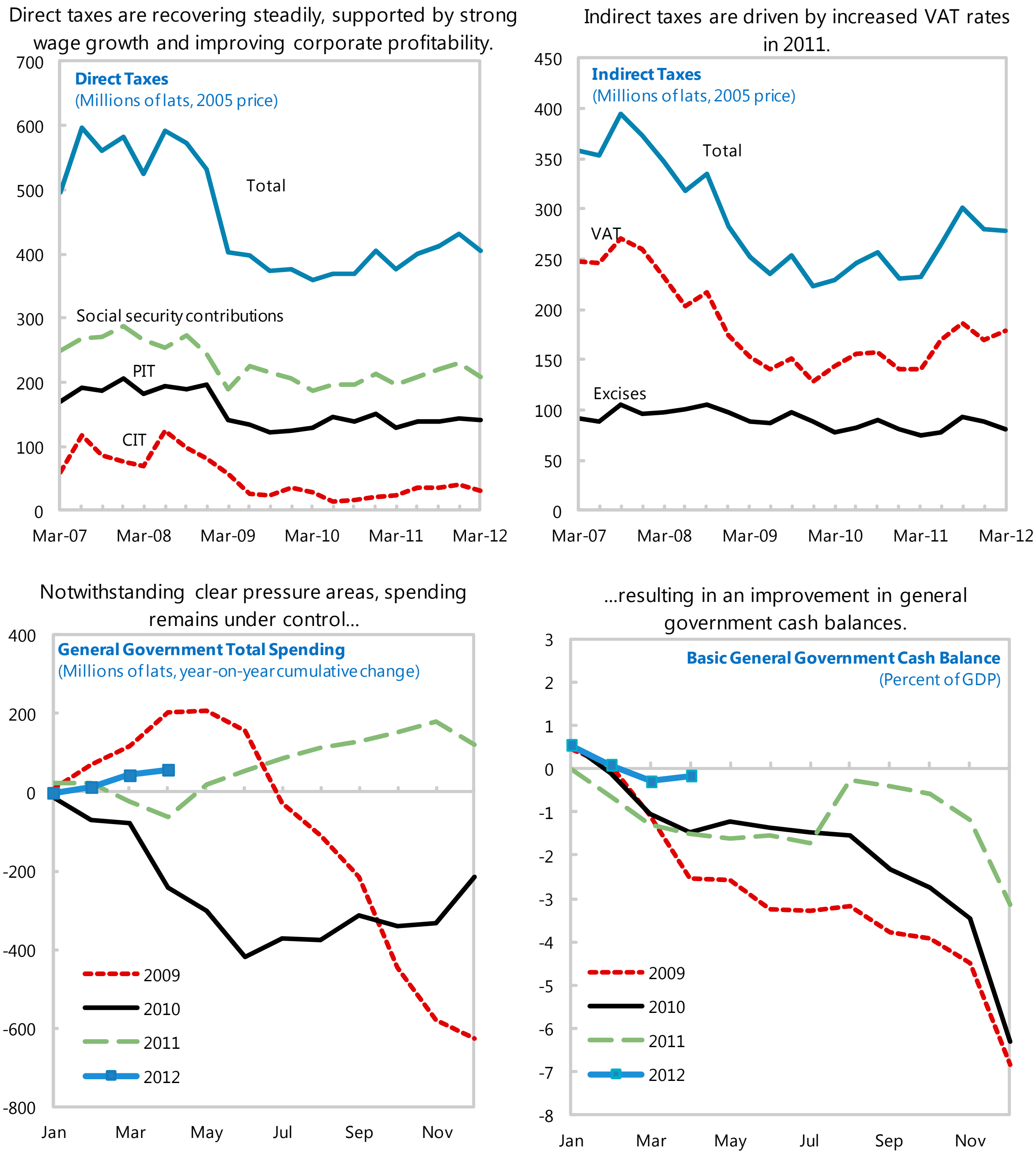
but unemployment is still high, and more than half have been unemployed for more than a year.



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

1/ The forecast of the Maastricht criterion reference rate is based on April 2012 WEO projections.
2/ Unemployment data for 2011 was revised in compliance with the population census; data before 2011 has not yet been revised.

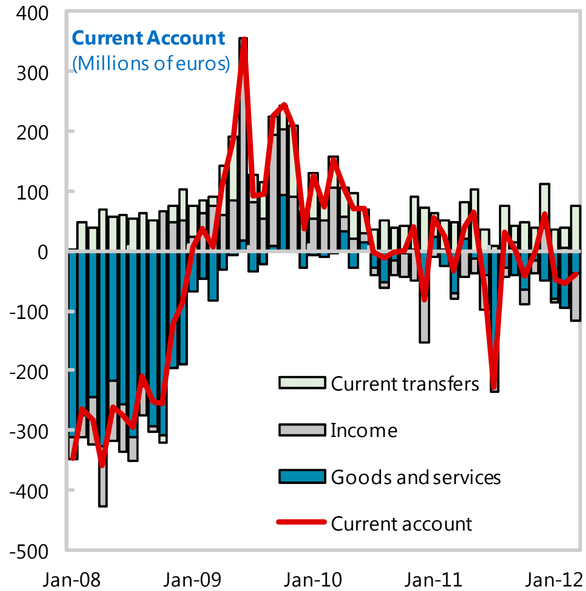
Figure 3. Latvia: Fiscal Developments, 2007–12



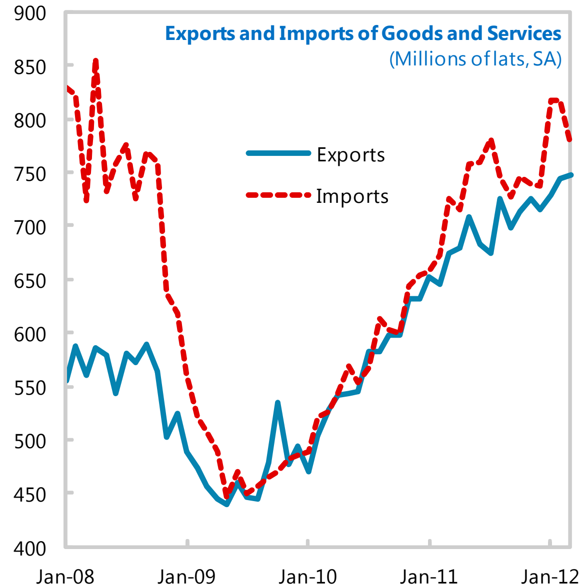
Sources: Latvian authorities; and IMF staff estimates.

Figure 4. Latvia: Balance of Payments, 2006–12

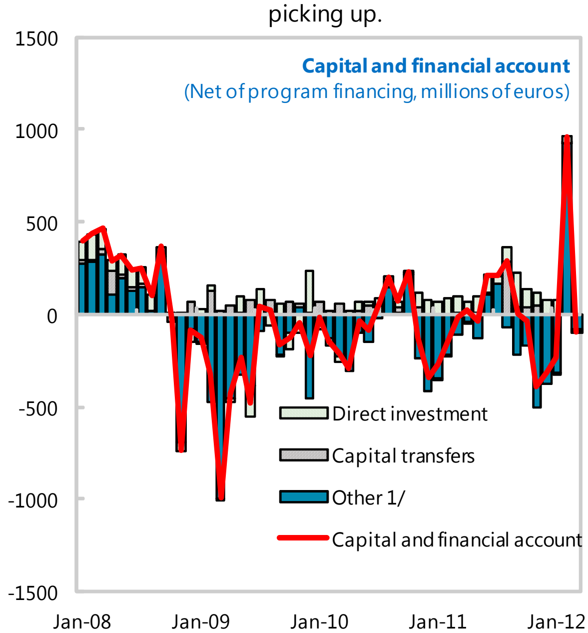
The current account is trending toward a deficit, as trade deficits re-emerge.



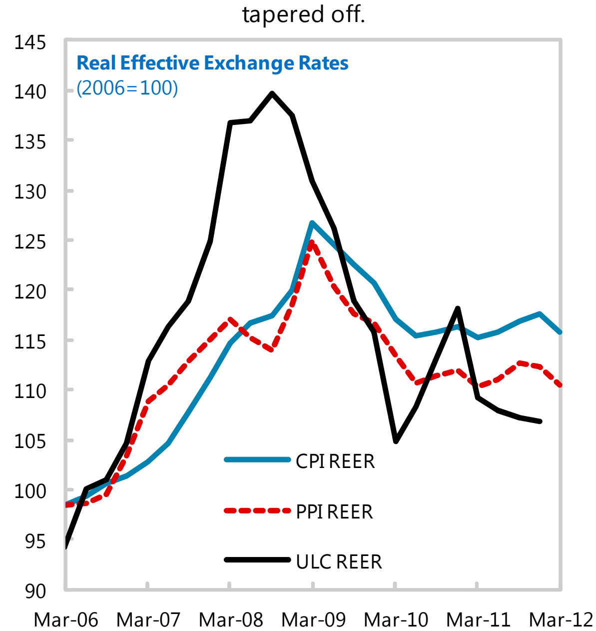
Imports are increasing faster than exports due to a recovery in domestic demand and re-exports.



Bank deleveraging is intensifying, but FDI is also picking up.

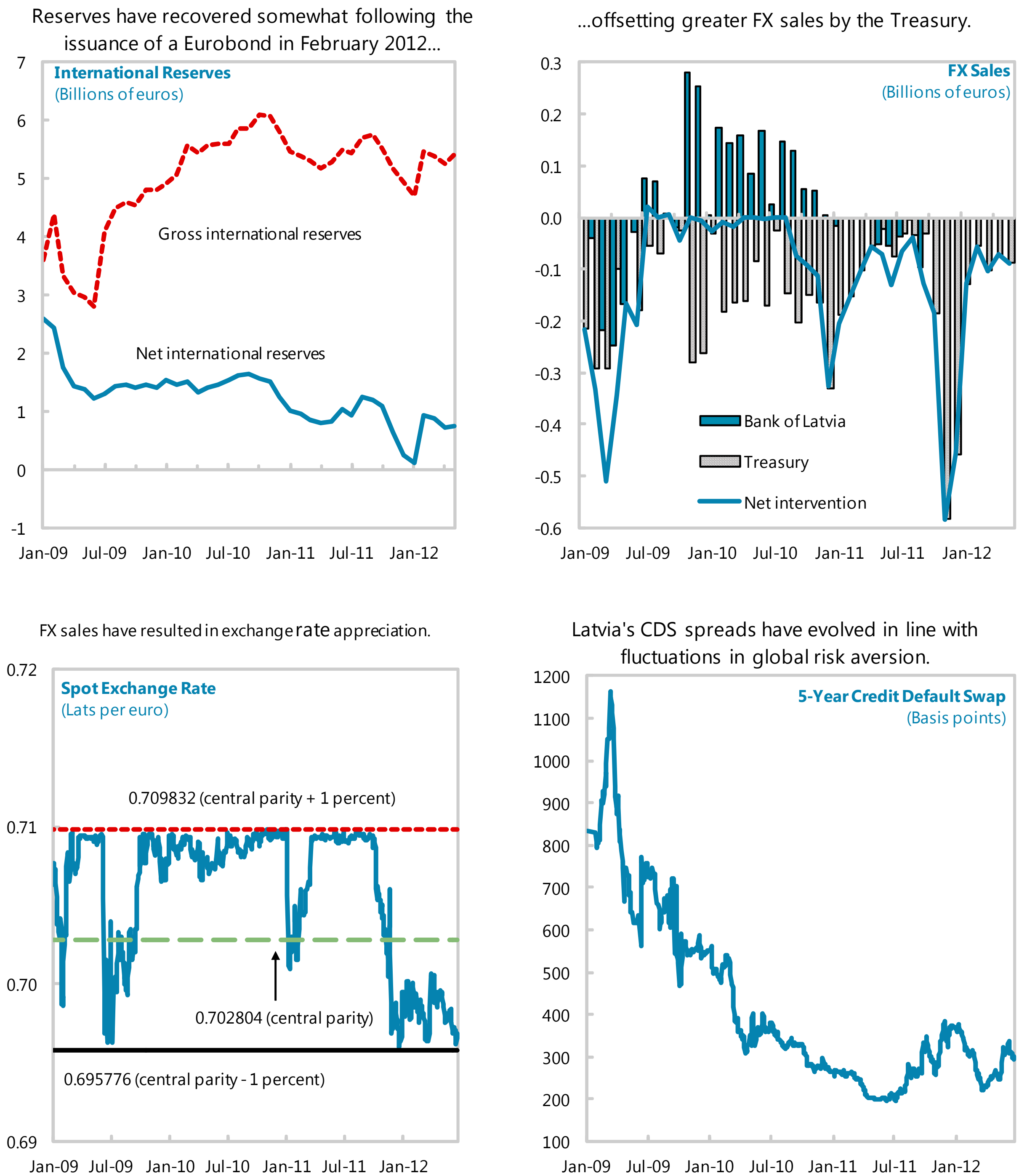


The sharp improvement in competitiveness has tapered off.



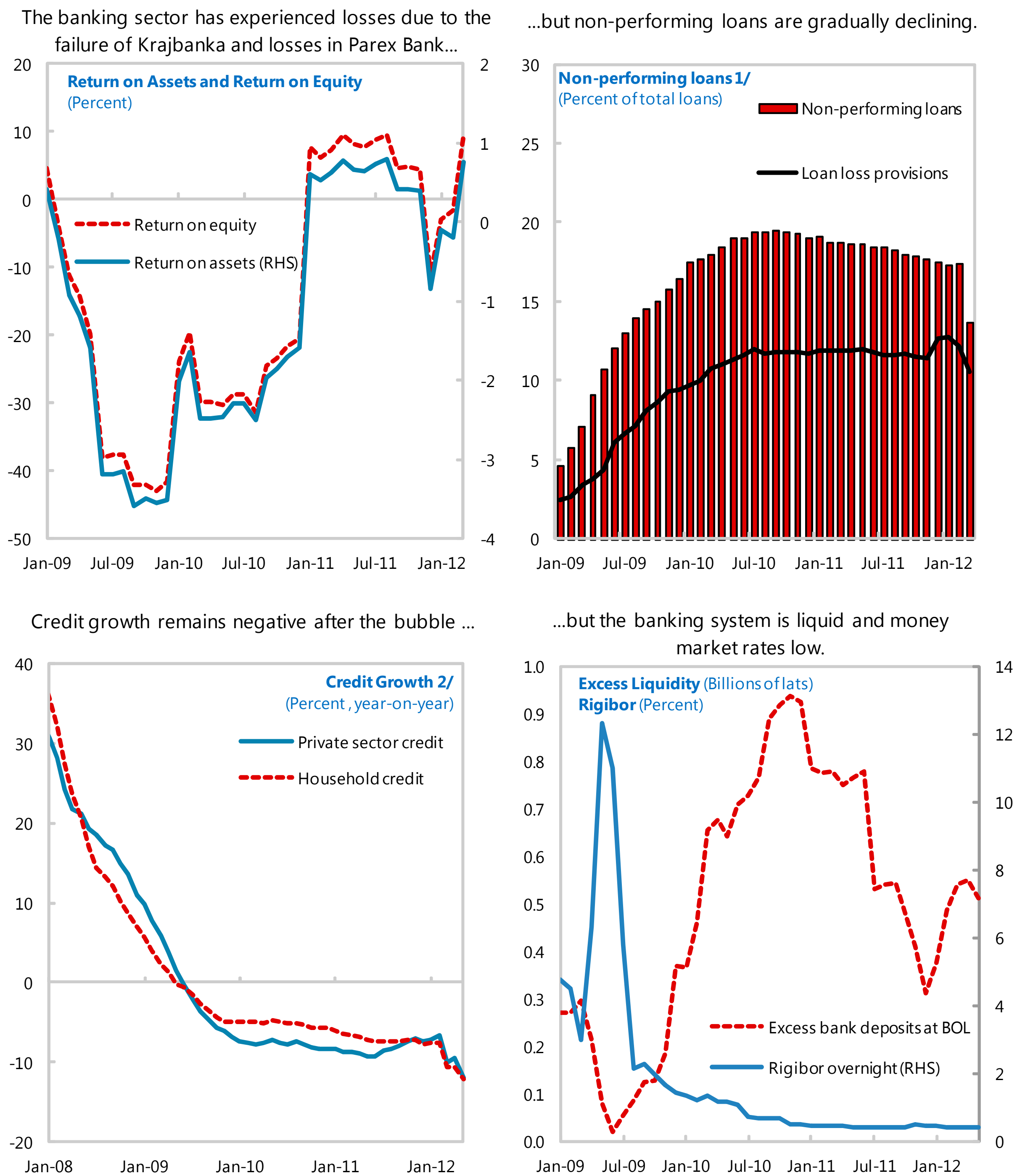
Sources: Bank of Latvia; ECB; and IMF staff calculations.
1/ Other is the sum of other investment and portfolio investment and derivatives. In February 2012, the increase is driven by the issuance of a $1 billion Eurobond.

Figure 5. Latvia: International Reserves and Financial Market Developments, 2009–12



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

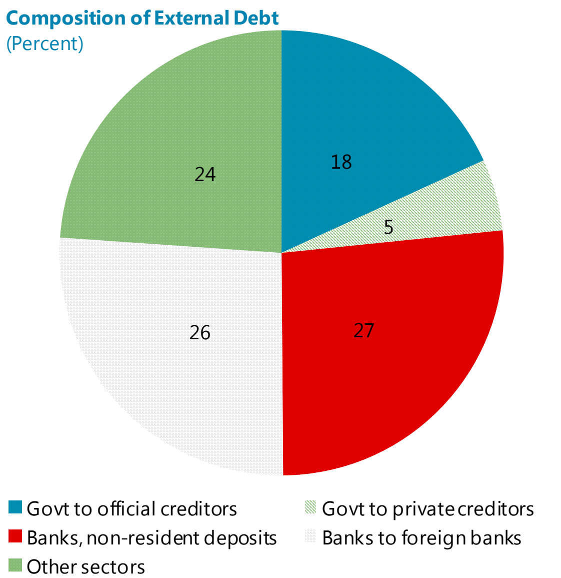
Figure 6. Latvia: Banking Sector Developments, 2007-12



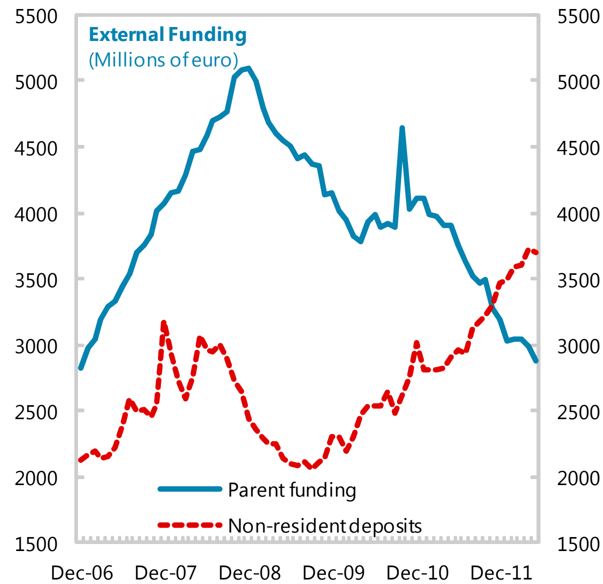
Source: Bank of Latvia; Bloomberg; FCMC; and IMF staff calculations.
1/ March data exclude Parex Bank which lost its banking license in March 2012.
2/ Data from March 2012 onwards excludes Parex Bank and from May 2012 excludes Latvijas Krajbanka, which lost its banking licence in May 2012.

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

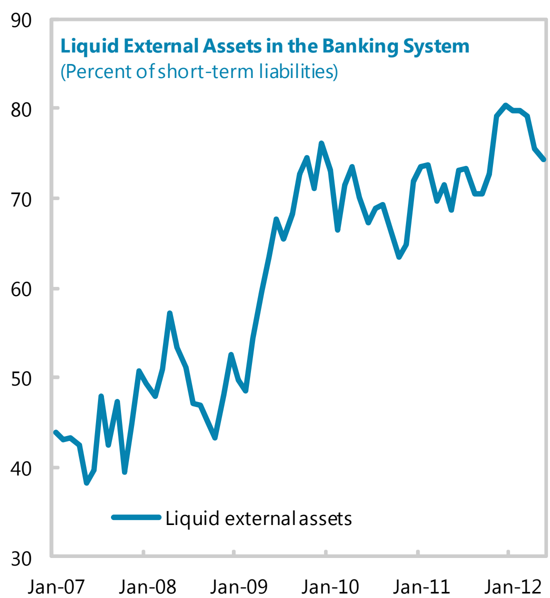
Banks account for more than half of external debt and some rely heavily on potentially unstable non-resident deposits to fund themselves.



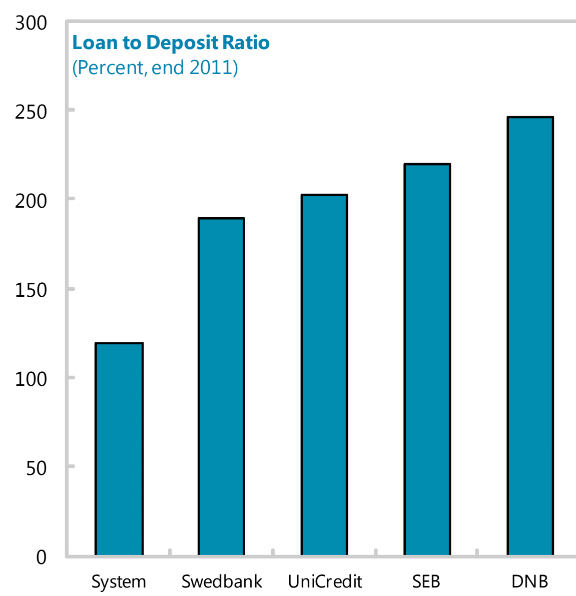
Nordic banks are deleveraging quickly but in other banks non-resident deposits are increasing fast.



However, banks are holding more FX liquid assets than before the crisis



Despite heavy deleveraging, foreign-owned banks still display high loan-to-deposit ratios.



Sources: Bank of Latvia; and banks' annual reports.

II. Policy Discussions

9. Discussions centered on policies that would continue to reduce external vulnerabilities and safeguard Latvia's ability to repay the Fund, implementation of key structural reforms (including protection of the social safety net), and meeting the Maastricht criteria and making Latvia better prepared for euro adoption.

A. Macroeconomic Outlook

10. With external shocks having less of an impact than anticipated at the Fifth Review, the macroeconomic outlook has improved (Tables 1 and 14):

- Strong base effects and robust preliminary first quarter data suggest the economy will grow by 3.5 percent in 2012, one percentage point higher than projected at the Fifth Review. Improving consumer sentiment and strong retail sales suggest that growth in private consumption will remain strong, offsetting an expected slowdown in private investment due to slower credit growth and the still-negative fiscal impulse. Growth could end up higher given the momentum of domestic demand and that, so far, growth in Latvia's main trading partners has been strong despite problems in the Euro Area periphery. Against this, the recent intensification of the Euro Area crisis will affect growth prospects in Latvia's trading partners and dampen demand for Latvian exports. The authorities believe that growth in 2012 is likely to end up at around 4 percent, and broadly agree with the balance of risks.

- Slower growth, emerging skill shortages and a lack of internal labour mobility means employment growth is expected to slow this year, with the unemployment rate stabilizing. The World Bank and the Ministry of Welfare are conducting a study of long-term unemployment and associated tax, benefit and employment policies (including social assistance), which is expected to include proposals on how to prevent poverty traps and stimulate employment. Staff will discuss the preliminary findings of this report (the first draft is only due November) during the Article IV consultation later this year, and urged the authorities not to introduce social assistance reform (including making local authorities responsible for financing benefits) until the study is completed.

- Inflation is set to fall to 2.4 percent in 2012 and decline further in 2013 as the temporary effect of higher global oil prices is offset by the 1 percentage point cut in VAT. Higher world commodity prices are the main risk to inflation.

- The current account deficit is expected to increase to 2.2 percent of GDP, driven by imports related to domestic investment, and increasing foreign bank profitability (which worsens the income account). The increasing share of the tradable sector in investment suggests that export capacity could be slowly expanding. On the other hand, if growth in Latvia continues to surprise on the upside, or Latvia's trading partners decelerate more than expected, the current account deficit could widen further. In the past, rapid growth in Latvia has led to current account deterioration, and this remains an important risk to the projections.

B. Program Exit Strategy—Euro Adoption

11. **Staff and the authorities agreed that, despite recent tensions in the Euro Area, euro adoption remains highly beneficial for Latvia.** Applying for Euro adoption is a political decision that has to be made by the Latvian authorities. However, aside from being a treaty requirement, staff believes Euro adoption would help remove exchange rate risk and reduce vulnerabilities stemming from currency mismatches, lower interest rates, and enhance financial sector stability (compared to the fixed exchange rate, where the BoL's ability to provide liquidity is more constrained). These reasons explain why euro adoption has been the exit strategy of the program. While Latvia's recent record shows its readiness for adjustment under the fixed exchange rate, the authorities need to continue to implement the reforms necessary to thrive within a currency union. Staff stressed the need for further improvements in competitiveness to limit external imbalances, and in labour and product markets to ensure relative prices are sufficiently flexible to allow the economy to adjust to shocks. The authorities agreed and pointed to their development of an action plan to implement the recommendations of the recently-completed Competitiveness Report as evidence of their commitment to structural reforms.

12. **The 2012 ESA fiscal deficit is expected to fall to about 2 percent of GDP, better than the budget projections and well below the 3 percent Maastricht criterion.** As a result of higher than expected GDP growth and revenue overperformance in the first quarter, revenue projections for the year have been increased by L88 million (0.6 percent of GDP), while social benefit spending estimates are lower. However, there are also spending pressures: (i) an additional L10 million for health spending in the first quarter with further spending needs expected for the rest of the year; (ii) road maintenance (underfunded in the 2012 budget and for much of the program); (iii) higher than expected pension outlays due to continuation of the early retirement option; and (iv) additional spending by local governments (e.g. in Riga City).

13. **The authorities stressed their commitment to deliver a 0.5 percent of GDP structural improvement in the fiscal balance in 2013**, consistent with the SGP and the Fiscal Compact. They are mindful that the 2013 budget represents the first test of their ability to maintain budget discipline outside the international support program:

- Although the structural fiscal balance (excluding one-off costs such as second pillar pensions and financial sector restructuring) remains in deficit, in principle the envisaged 0.5 percent of GDP improvement in the structural balance in 2013 should be contractionary.

- Preparation of measures to achieve the necessary structural deficit reduction is still at a very early stage, but the authorities' tentative plans include: (i) nominal freezes on wages and goods and services spending, (ii) eliminating social health and transport components of the social safety net; (iii) further health spending cuts; (iv) no new investment projects; and (v) an increase in real estate taxes. With the exception of the increase in real estate taxes, staff cautioned that these policies could exaggerate existing structural bottlenecks, and worsen growth and inequality.

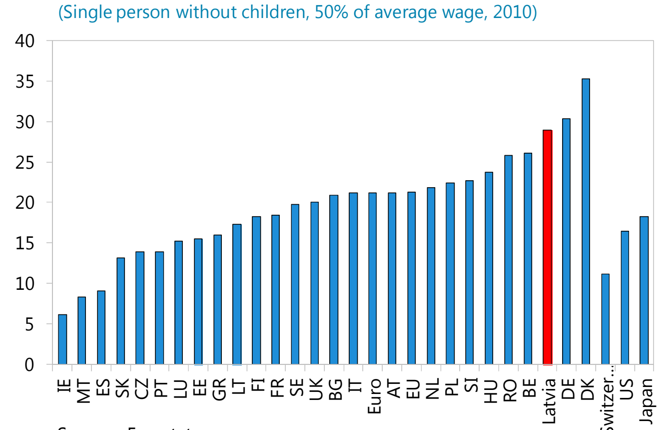
- The authorities will reduce VAT by 1 percentage point from end-June 2012 and the personal income tax (PIT) by 5 percentage points by 2015. While the PIT rate cuts were only presented as intentions during the mission, after the mission the government quickly passed legislation to cut the PIT rate by 1 percentage point to 24 percent in 2013, with further 2 percentage point cuts in both 2014 and 2015. The full year VAT cost is around 0.3 percent of GDP; the planned 5 percentage point cut in PIT would cost 1.1 percent of GDP. The authorities argued that the cut in VAT is intended to partially reverse earlier crisis-related increases and to bring the VAT rate in line in neighboring countries. The more medium-term PIT cuts are aimed at boosting competitiveness and stimulating employment by reducing the labour tax wedge.

- Given the still-negative structural balance and the strength of domestic demand, staff recommended instead that the bulk of the current revenue overperformance be saved. Staff also argued against implementing major changes to the tax code or spending increases in the middle of the year. Consistent with the spirit of the Fiscal Compact and adoption of a medium-term budgeting framework aimed at enhancing predictability, such changes would be better introduced at the time of the annual budget, when the full range of spending pressures and tax policy reforms can be more fully considered. Indeed, it was hard to see how these pre-announced tax cuts could be consistent with the Fiscal Compact, without any offsetting measures.

- However, consistent with its Fifth Review assessment, during the mission staff supported modest additional spending in areas that have adjusted the most and which were underfunded in the 2012 budget (health, road maintenance, infrastructure spending), and to pay for targeted wage increases in the public sector to stem the loss of highly qualified staff. Staff supported the goal of cutting labour taxes to stimulate employment but, given high marginal tax rates for low-income workers and to promote inclusion, its long-standing recommendations include: (i) raising the tax-free threshold rather than cutting the headline rate; (ii) introducing a progressive personal income tax; and (iii) introducing tax credits for net new hires, especially the long-term unemployed. Higher consumption and real estate taxes (combined with a more accurate property register) could finance these. However, the government's subsequent decision to pass legislation cutting taxes (present and future) would take away room for these modest spending increases, as well as the scope for reducing the tax wedge on low income workers, which compared to the rest of the EU is very high.

Tax Rate, Low Wage Earner

(Single person without children, 50% of average wage, 2010)



Sources: Eurostat

14. Though the authorities are committed to the goals of the fiscal compact, they face medium-term fiscal challenges. The need for additional spending in underfunded areas and the gradual removal of crisis-related consolidation measures—including restoration of second pillar pension contributions, removal of the freeze on pensions, reduction in SOE payout ratios, higher interest payments as international support is replaced by market financing—suggests that without further consolidation measures the fiscal deficit will remain above 2 percent of GDP (ESA95) until 2015. Passage of legislation in May cutting personal income tax rates by 5 percentage points by 2015, without specifying how this would be paid for, will add to these pressures. The authorities recognized these challenges, but reiterated their commitment to identify additional measures (as needed) to fulfill the fiscal compact and meet their medium-term fiscal objective of structural budget balance.

15. The authorities believe they are also on track to meeting the Maastricht inflation and interest rate criteria, although there are significant uncertainties:

- Current projections for other EU countries suggest that Latvia's inflation rate would fall below the reference rate by the end of the first quarter of 2013, just ahead of the EC and ECB's assessment of Latvia's convergence, which is expected in May (see Figure 2).

- However, the margin is tight, and uncertainty surrounding the forecasts is high (both for inflation in Latvia, but especially for inflation in the other EU-27 countries). Moreover, while the fixed exchange rate provides a stable medium-term anchor, it makes short-term inflation harder to control. Should commodity prices increase again, Latvia's inflation would likely increase more than the reference rate (given their relatively high weight in Latvia's basket). And low or negative inflation in some EU countries could drag down the reference rate.

16. There are additional uncertainties over how the Maastricht inflation and interest rate reference values are determined:

- The Maastricht reference values are calculated using inflation and long-term interest rates in the three 'best performers' in the EU in terms of price stability. This has been interpreted as the three countries with the lowest inflation rates. However, outliers are sometimes excluded. For example in 2010, when Estonia was applying to join the euro, Ireland was excluded because its inflation rate was significantly below that of the other 'best performers'. In the 2012 convergence assessment, Ireland is included as an inflation 'best performer', but excluded from the interest rate criterion because it has difficulties obtaining market access. Since the selection of outliers does not follow a precise rule, it is difficult for the authorities to predict the exact reference value that will be used.

- In meetings with EC and ECB representatives during the mission, the authorities expressed concern that the treatment of outliers could make the criteria difficult to meet. For example, under plausible scenarios, two of the 'best performers' next year could be program countries with deflation but without market access (and so could be dropped from the interest rate reference value, leaving only one country for this calculation). This would lower the inflation and interest rate reference values and make the criteria harder to meet. EC and ECB representatives sought to assure the authorities that the criteria would be applied fairly, based on economic judgment, and suggested that strong policy implementation was the best way to ensure the Maastricht criteria for euro adoption are met sustainably.

C. External Vulnerabilities and Risks to Fund Resources

17. Latvia faces the twin challenges of repaying international creditors while reducing vulnerabilities associated with high external debt. Over the next four years Latvia needs to issue external debt to be able to repay €3.9 billion—75 percent of reserves—to official creditors and Eurobond holders. At the same time, Latvia faces the medium-term challenge of reducing the vulnerabilities posed by an external debt to GDP ratio of more than 140 percent of GDP and weak reserve cover ratios (reserves as a share of maturing external debt plus current account deficit stand at about 38 percent).

18. Under a baseline in which the euro area crisis does not intensify significantly, Latvia's capacity to repay the Fund should remain adequate:

- Repayments to the Fund (€1.1 billion in total) are concentrated in 2012–13 (around 7–9 percent of reserves each year, Table 13); EC repayments (€2.2 billion, around 18–23 percent of reserves each year) come due in 2014–15; a €400 million Eurobond comes due in 2014.

- Latvia plans to issue around €3.8 billion (in addition to the €1.1 billion issued since the middle of last year) in 2013-4 to meet these repayments and bolster international reserves. This plan to replace official debt with debt issued on the private market is ambitious by emerging market standards, but strong demand for the two Eurobonds issued since mid-2011, the low level of public debt (around 40 percent of GDP) and improving credit ratings suggest it should be feasible, provided market conditions are not extreme.

19. However, Latvia's external position could be vulnerable to a further increase in global risk aversion, non-resident deposit outflows, and possible deterioration in the current account:

- A strong intensification of the Euro Area crisis or rising tensions in international capital markets could complicate the borrowing program (despite Latvia's relatively strong fundamentals), and could prompt Nordic parent banks to accelerate deleveraging.

- A decline in confidence in the Latvian banking system could slow, or even reverse, non-resident deposit inflows. The authorities recognize that non-resident deposits are volatile, but argued that political uncertainty in the CIS, problems in competing financial centers, and Latvia's EU membership should ensure their continued growth.

- Slower growth in Latvia's trading partners could worsen the current account and put pressure on reserves. While recognizing that this was a risk, the authorities argued that their focus on improving competitiveness would ensure continued export growth, while continued bank deleveraging would prevent an unsustainable resurgence of domestic demand.

20. Staff encouraged the authorities to bring forward Eurobond issuance, subject to market conditions, to contain these risks. Early issuance would smooth the borrowing profile and provide a reserve cushion. While recognizing the risk that capital markets could seize up, the authorities argued that their issuance plan already struck a balance between building precautionary international reserves and limiting interest payments.

21. For the medium term, the authorities should aim at reducing vulnerabilities associated with high external debt, but without derailing the recovery:

- The program made progress reducing flow vulnerabilities, including reducing the current account and fiscal deficits. However, gross external debt has increased compared to before the crisis—largely due to borrowing from the Fund and the EC—and is projected to remain above 100 percent of GDP over the medium-term. More than half of this is banking system liabilities, including debt to Nordic parent banks and non-resident deposits (Figure 7). While much of this debt has been used to accumulate foreign assets—net external debt has fallen from 57 to 45 percent of GDP in the past three years—the large stock of external debt still makes Latvia vulnerable to swings in confidence.

- Continued deleveraging by Nordic parent banks seems likely, given loan-to-deposit ratios above 150 percent, close to €6 billion (112 percent of reserves) in liabilities to parent banks, and a lack of credit demand. In 2011, liabilities to parent banks fell by €1.8 billion. In addition, a preference for managing liquidity centrally has led these banks to accumulate large amounts of foreign assets, which they use to repay loans to their parents. While these repayments reduce external debt, international reserves and credit supply fall.

- Parent banks assured staff they intended to maintain a strong presence in Latvia, and that the main reason behind the deleveraging was a lack of credit demand. The Latvian authorities echoed this, suggesting that Latvia's growth prospects and profitable investment projects would lead to a resumption of lending, at least to corporates. While it is difficult to disentangle supply and demand factors (e.g. stricter lending standards and higher lending rates restrict the supply of credit, but banks may perceive that the demand for credit has then fallen), staff recommended that the authorities work closely with the Nordic supervisory authorities to ensure that the process of deleveraging proceeds gradually, so there is time to develop alternative sources of external financing and to make sure the balance of payments is protected.

- Non-resident deposits are a mixed blessing. Although a significant source of foreign exchange at a time when Nordic banks are deleveraging, non-resident deposits are a short-term liability and an important source of vulnerability. In the 12 months following August 2008, non-resident deposits fell nearly 30 percent (more than €1.8 billion or about 40 percent of international reserves). This was a key factor prompting the authorities to approach the Fund and the EC for emergency support. Adding to the risks is that although banks report significant external assets, the quality of these assets is harder to verify than the quality of domestic assets (last year's failure of Latvijas Krajbanka was triggered by the discovery that €140 million of assets in correspondent accounts turned out to be encumbered).

- To address these risks since mid-2011 the authorities have required banks reliant on non-resident business to maintain additional capital. They also looked forward to the introduction of new prudential tools under Basel III—in particular the liquidity-coverage-ratio (which only counts 75 percent of the balances on correspondent accounts as liquid assets) and the capital add-on to address systemic risk—which they believed would help them better capture the risk inherent in non-resident banks.

- To offset possible declines in bank financing over the medium term, staff discussed options for deepening capital market. The authorities are preparing a strategy paper which incorporates most of the World Bank's FSAP recommendations, but expressed skepticism that there was sufficient demand for a corporate bond market or a vibrant equity market in Latvia. The recently completed Competitiveness Report suggests that many domestic firms resist the stringent transparency requirements of a stock exchange listing. This lack of transparency also deters potential outside investors.

D. Structural Reform and Competitiveness

Fiscal Policy

22. The authorities have made significant changes to the Fiscal Responsibility Law (FRL) to comply with the Fiscal Compact. Staff welcomed the introduction of a rule based on the structural fiscal balance, but noted that it would be challenging to operationalize and would require a clear methodology for estimating potential output and structural fiscal balances. Staff welcomed the intention to appoint a fiscal council but emphasized the importance of respecting the council's independence, and suggested expanding the council's mandate to cover not just ex post compliance with the fiscal rule, but assessment of independent macroeconomic forecasts, costing of new measures and assessment of their consistency with budget targets. For example, an effective fiscal council should be consulted ahead of the recent VAT and PIT cuts, and given time to make an assessment before submitted for legislation. Compliance should be monitored two times a year (coinciding with budget preparation and the European Semester) to facilitate ex-ante control.

23. Staff recommended postponing legislative changes to the system of social assistance until after the World Bank and DG Employment's evaluation of long-term unemployment (and associated tax, benefit and employment policies):

- The authorities are considering splitting the GMI (guaranteed minimum income) into two parts: (i) a subsistence benefit (financed by municipalities) targeted to alleviate absolute poverty, and (ii) an activation benefit (co-financed from the state budget) conditional on participation in a program to facilitate reintegration into the labour market.

- World Bank and IMF Staff cautioned that further decentralizing the funding of poverty benefits would likely result in less spending on the needy in the poorest municipalities where demand for social assistance is the highest. Limited implementation capacity in poorer municipalities would further exacerbate these differences. Finally, given the lack of information about how the current benefit system and employment programs are working, reforms introduced now would not be evidence-based. Staff therefore urged the authorities to postpone any large-scale reforms until after the World Bank and DG Employment evaluation.

24. Staff welcomed the decision to gradually increase the retirement age from 62 to 65 starting in 2014. World Bank simulations suggest this—as well as the decision to increase the minimum required insurance period and to eliminate supplementary pensions for new pensioners—will reduce the fiscal deficit by 0.5–1.5 percent of GDP per year between 2020 and 2030. At the same time, the decision to extend the early retirement option for another year will increase budgetary outlays, and could reduce labour force participation, and should thus not be continued into 2013.

25. airBaltic continues to lose money (L54 million or 0.4 percent of GDP in 2011 and an expected L39 million in 2012), and may become subject to a state-aid investigation by DG Competition. The state took over the airline in late 2011; so far the state has provided L58 million in equity-like instruments (0.4 percent of GDP) and a further L25 million loan will be made later this year. airBaltic is implementing a new business plan that aims to return to profitability by 2014, and the authorities are actively looking for a strategic investor. However, litigation by the former private shareholder and the possibility of a state aid investigation may make airBaltic less attractive to potential investors. The authorities argue that DG Competition is likely to view the injection of government funds favorably since it was originally designed as a joint investment with the private investor, who later found itself in an unsustainable financial position. However, in staff's view, aside from state aid issues, the economic case for these continued subsidies, after a period of unprecedented fiscal adjustment, is difficult to make.

Financial Sector Policies

26. The authorities are keen to learn the lessons from the failure of Latvijas Krajbanka and have taken steps to strengthen financial sector supervision.

- An independent audit of correspondent accounts held by other banks, as well as an investigation by the FCMC, did not reveal any discrepancies that would suggest the assets in these accounts are unduly encumbered or unavailable for other reasons. As a result, the authorities are confident the fraudulent activities in Latvijas Krajbanka are not present in other banks. At the same time, the FCMC has strengthened its examination of correspondent accounts as part of their on-site inspections.

- The decision to liquidate Latvijas Krajbanka, instead of transferring its assets and liabilities to an acquiring bank, has revealed the challenges of implementing the bank resolution framework introduced under the program. In particular, market conditions in late-2011 meant it was difficult to find an acquiring bank, while the discovery of fraud meant potential acquiring banks needed time to verify the quality of Krajbanka's assets. Staff suggested that in future it would be important that the regulator take a proactive approach to identifying potential problem banks, once-identified to monitor them intensively, and to do the necessary preparations (including asset valuation) prior to a decision to intervene in a bank.

27. The authorities are pushing ahead with sale of the commercial part of MLB:

- Adverse market conditions resulted in lower-than-expected bids for the commercial part of the bank. At the same time, weaker bids mean that a significant share of the balance sheet may be transferred to the Latvian Privatization Agency (LPA) and managed by Parex for a more gradual workout. The government is expected to approve the deal in mid-June 2012, with final settlement likely to take place toward the end of this year.

- Staff welcomed the progress made in implementing the MLB sales strategy, but encouraged the authorities to sell all commercial assets (rather than transfer them to the LPA) unless there is clear evidence that the bids are well-below market value. Once the commercial part of MLB is sold, staff urged the authorities to move quickly to merge the remaining part with other institutions to create a single development institution, and to remove MLB's banking license. The strategy for the consolidation of development finance institutions is scheduled to be completed by end-August, and the authorities indicated that all options—including whether the development institution should have a banking license—were being considered.

Competitiveness

28. Further reorientation toward the tradable sector is necessary to ensure that Latvia remains competitive under its fixed exchange rate. Wage restraint and deflation have resulted in significant competitiveness improvements since late-2008, with the CPI-based and ULC-based REER depreciating by 8 and 23 percent. However, since mid-2010 the improvement in competitiveness has slowed. At the same time, staff estimates the structural current account deficit is around 5 percent of GDP, Latvia's price level still seems high for its level of income, and unemployment remains a significant problem. In staff's view, solving these challenges will require further competitiveness improvements before and after Euro adoption in order to reorient the economy towards the tradable sector and ensure that Latvia is able to thrive in the Euro Area.

29. Staff and the authorities agreed that with limited scope for further wage cuts, competitiveness improvements will depend on productivity improvements and structural reform:

- Building on the recently-completed Competitiveness Report, staff argued that structural reforms should focus on: (i) increasing labour productivity by improving the quality of education; (ii) strengthening the investment climate; and (iii) increasing product market competition to ensure productivity gains translate into competitiveness improvements. Given limited implementation capacity, staff urged the authorities to prioritize a few reforms that are likely to have a big impact on competitiveness and which can be implemented relatively quickly.

- On **labour productivity**, staff recommended that the authorities consider higher education reform, including concentrating resources in fewer institutions, opening up professorships to foreign academics, making it easier for classes to be taught in foreign languages, and improving the targeting of student tuition financing. The authorities are also investigating options for better matching vocational education to employers' needs, and for facilitating apprenticeships for people receiving vocational training.

- On strengthening the **investment climate**, staff encouraged the authorities to focus their efforts on improving governance, including by ensuring that the State Revenue Service (SRS) has the necessary resources and institutional capacity to combat the grey economy—recent plans to hire more auditors are especially welcome, but will require higher salaries—and by developing a strategy to improve the efficiency of the judicial system. The authorities are proposing to improve the governance of state-owned enterprises (SOEs), including by partially centralizing the ownership of these enterprises (currently owned by various Ministries), and by requiring SOEs to publish quarterly financial information and generally to increase transparency.

- The crisis (which left many small firms bankrupt) has resulted in declining **product market competition**, with large retail chains dominant. Staff urged the authorities to quickly appoint a new head of the competition council and ensure that the council vigorously enforces existing antitrust legislation. The authorities agreed that increasing product market competition was important, but noted the difficulty in attracting qualified personnel to work in the competition council given low public sector pay.

III. Staff Appraisal

30. The economy is recovering strongly despite headwinds from the Euro Area crisis. A recovery in domestic demand resulted in 5.5 percent growth last year, the third fastest in the EU. Despite an expected slowdown in export growth and private investment, strong first quarter data suggests growth this year could reach 3.5 percent or even higher, provided there is no strong intensification of the Euro Area crisis. However, the slowdown in growth, possible skill shortages, and a lack of internal labour mobility means the unemployment rate is unlikely to fall rapidly, underlining the importance of a strong social safety net and policies to stimulate employment. With the impact of the recent increase in global oil prices receding, inflation is set to fall to 2.4 percent. Depending on inflation in other EU countries, this may be consistent with meeting the Maastricht inflation criterion.

31. Strong revenue performance is likely to deliver a budget deficit of about 2 percent of GDP (ESA95) in 2012, well-below the Maastricht deficit criterion. There is already pressure for additional spending, in particular in areas that have adjusted most and where funding in the 2012 budget was limited. However, the decision to cut taxes has likely reduced fiscal space for accommodating these pressures. To the extent there is fiscal space left, there could be a case for some modest additional spending in areas such as health and road maintenance, and some extra funding to stem the loss of highly qualified government staff to the private sector. But any spending increases would need to be limited and well targeted; major changes are best left to the annual budget cycle.

32. The authorities' decision to cut the VAT and personal income tax (from 2013) could weaken the current account and make it harder to achieve targeted improvements in the structural fiscal balance and to meet commitments under the fiscal compact. Given the strong recovery in domestic demand, pressures to reverse crisis-related spending cuts, and the still-negative structural balance, cutting taxes and loosening fiscal policy seems premature. Pre-announcing large tax cuts outside the annual budget process and without specifying offsetting measures is imprudent and raises questions about consistency with the fiscal compact. To minimize fiscal costs, labour tax cuts could also be targeted more effectively at the long-term unemployed or new hires: rather than cutting the headline rate, raising the personal income tax threshold would have been of greater benefit to low-income workers. To sustain the impressive fiscal consolidation during the program, next year's budget should include structural reforms and should not rely on spending cuts that are across the board and unlikely to be sustained, or on cuts that will exacerbate inequality and weaken growth.

33. The authorities should ensure that planned reforms to the fiscal framework safeguard Latvia's fiscal sustainability and maintain a strong social safety net. The changes made to the Fiscal Responsibility Law to bring it into line with the Fiscal Compact—including the introduction of a structural fiscal balance rule and a 'fiscal council'—are welcome. However, more work is needed to operationalize the fiscal rule, and care must be taken to ensure that the council maintains its independence and has a sufficiently broad mandate to ensure both ex-ante and ex-post control over the budget. Planned changes to the system of social assistance should avoid further decentralizing funding given the lack of resources in poorer municipalities, and should await the results of the World Bank and DG Employment study into long-term unemployment which is due later this year.

34. **The authorities should focus their efforts on meeting the Maastricht inflation and interest rate criteria in a sustainable manner.** While current projections suggest that under normal conditions the reference values would have a fair chance of being met, the future path of global commodity prices, possible deflation in some Euro Area countries, and the treatment of outliers when measuring the criteria creates greater than usual uncertainty. However, given Latvia's strong performance in containing core inflation, the authorities' best approach is to work hard to meet the criteria sustainably.

35. **Provided terms are reasonable, bringing forward external bond issuance would help guard against an unexpected worsening of Latvia's external position.** Latvia's capacity to repay the Fund remains adequate but the possibility of further bank outflows, a strong intensification of the Euro Area crisis, and possible deterioration in the current account creates risks. Although there is an interest rate cost, issuing external bonds ahead of time would help insure against these risks.

36. **The strength of Latvia's external position depends critically on the pace of deleveraging by Nordic parent banks.** The pace of deleveraging is expected to decline this year as Nordic banks approach their target loan-to-deposit ratios and credit demand recovers. But if this relatively benign scenario does not materialize, reserve adequacy would deteriorate. The Latvian supervisory authorities should remain in close contact with their Nordic counterparts to ensure deleveraging proceeds gradually, so there is time to develop alternative sources of external financing.

37. **The FCMC should strengthen their supervision of the non-resident banking sector.** The additional capital requirements for banks reliant on non-resident business are welcome, but they have been insufficient to stem the inflow of short-term non-resident deposits. The increasing size of the non-resident banking system could pose risks to the financial system and be a potential drain on international reserves, unless short-term liabilities are matched by equally liquid foreign assets. The FCMC should make full use of the Basel III liquidity-coverage-ratio and consider increasing the capital add-on for banks concentrating on non-resident deposits. The FCMC's decision to strengthen supervision of correspondent accounts—where non-resident deposit banks hold most of their liquid assets—should also help contain risk in the non-resident banking system and prevent a recurrence of the problems that led to the failure of Latvijas Krajbanka.

38. **The authorities are close to completing the sale of the commercial part of MLB.** Although bids for the bank's commercial assets were lower than expected, the authorities should proceed with the sale of all asset bundles unless there is clear evidence that bids are

well-below market value. Once the sale is completed, the authorities should remove MLB's banking license and merge it to create a single development finance institution.

39. To be competitive in the Euro Area it is critical that the authorities implement productivity-enhancing structural reforms and improve competitiveness. The recently-completed Competitiveness Report provides a roadmap for how to improve Latvia's competitiveness in an environment where scope for further wage cuts is limited. Scope exists for improving the quality of education to improve labour productivity, improving governance (including in state-owned enterprises) and strengthening the legal system to boost the investment climate, and increasing competition in product markets. The authorities should draw up a short list of critical reforms, and set out clear responsibilities for their implementation.

40. Latvia's performance under the first six months of post-program monitoring has been impressive. The economy has rebounded strongly from its recession in 2008–09, the fiscal deficit has improved more than expected, and international reserves have been replenished thanks to Latvia's successful return to international capital markets last year. While important challenges remain, this strong program implementation has allowed Latvia to move closer to the program's exit strategy of euro adoption.

Table 1. Latvia: Selected Economic Indicators, 2008–12

	2008	2009	2010	2011		2012	
				Fifth Rev.	Est.	Fifth Rev.	Proj.
National accounts	(percentage change, unless otherwise indicated)						
Real GDP	-3.3	-17.7	-0.3	4.5	5.5	2.5	3.5
Private consumption	-5.8	-22.6	0.7	3.5	4.4	2.4	4.5
Gross fixed capital formation	-13.8	-37.4	-18.1	19.8	27.9	8.5	9.5
Exports of goods and services	2.0	-14.1	11.5	14.3	12.6	5.5	4.8
Imports of goods and services	-10.8	-33.3	11.5	18.6	20.7	6.5	7.3
Nominal GDP (billions of lats)	16.1	13.1	12.7	13.8	14.2	14.4	14.9
Nominal GDP (billions of euros)	22.7	18.6	18.1	19.7	20.3	20.5	21.2
GDP per capita (thousands of euros)	10.0	8.2	8.0	8.8	9.1	9.2	9.5
Savings and Investment							
Gross national saving (percent of GDP)	18.0	29.2	22.9	24.3	24.4	24.8	24.6
Gross capital formation (percent of GDP)	31.2	20.5	19.9	24.6	25.6	25.5	26.8
Private (percent of GDP)	26.4	16.1	16.0	18.4	19.6	20.4	20.7
HICP inflation							
Period average	15.3	3.3	-1.2	4.3	4.2	2.4	2.4
End-period	10.4	-1.4	2.4	3.9	3.9	2.4	1.9
Labor market							
Unemployment rate (LFS definition; period average, percent) 1/	7.8	17.3	19.0	16.4	16.4	15.3	15.4
Real gross wages	4.4	-6.8	-2.3	0.3	0.0	0.2	0.9
	(percent of GDP, unless otherwise indicated)						
Consolidated general government 2/							
Total revenue	35.6	36.2	36.2	36.9	35.9	37.8	37.2
Total expenditure	39.0	43.3	42.6	40.7	39.0	39.0	38.6
Basic fiscal balance	-3.4	-7.1	-6.4	-3.9	-3.1	-1.2	-1.4
ESA balance	-4.2	-9.7	-8.2	-4.0	-3.5	-2.1	-2.0
General government gross debt	17.2	32.9	39.9	39.1	37.8	40.3	38.7
Money and credit							
Credit to private sector (annual percentage change)	11.0	-6.9	-8.4	-5.6	-7.4	0.1	-3.8
Broad money (annual percentage change)	-3.9	-1.9	9.8	1.1	1.5	8.3	7.9
Residents' FX deposits (percent of total deposits)	48.6	55.6	50.3	54.0	51.7	55.1	53.0
Treasury Bill rate (365 days, eop, percent)	11.0	10.2	1.8	3.0	1.7	…	…
Money market rate (one month, eop, percent)	13.3	2.7	0.6	1.1	1.1	…	…
Balance of payments							
Gross official reserves (billions of euros)	3.7	4.8	5.8	5.2	4.9	5.3	5.1
(In months of prospective imports)	5.4	5.9	5.6	4.8	4.4	4.6	4.2
(percent of broad money and non-resident deposits)	31.2	41.7	43.6	37.5	34.8	35.2	33.0
Current account balance	-13.2	8.7	3.0	-0.3	-1.2	-0.7	-2.2
Trade balance	-17.9	-7.1	-7.1	-9.5	-9.8	-10.2	-11.4
Gross external debt	130.9	156.8	165.6	146.5	144.8	137.9	140.7
Net external debt 3/	57.5	58.8	53.6	42.0	44.8	34.9	39.0
Exchange rates							
Lats per euro (period average) /4	0.71	0.70	0.70	0.70	0.70	…	…
Lats per U.S. dollar (period average)	0.48	0.51	0.53	0.51	0.50	…	…
REER (period average; CPI based, 2000=100)	104.5	110.2	103.6	…	103.8	…	…

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

1/ Revised by +0.8 percentage points in 2011 in compliance with population census; data before 2011 has not been revised yet.
2/ National definition. Includes economy-wide EU grants in revenue and expenditure.
3/ Gross external debt minus gross external debt assets.
4/ Lat is pegged to the euro at 1 EUR = 0.702804 LVL rate, with ±1 percent band.

Table 2. Latvia. Macroeconomic Framework, 2010-17

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
	(percentage change, unless otherwise indicated)							
National accounts								
Real GDP	-0.3	5.5	3.5	3.6	4.2	4.2	4.0	4.0
Consumption	-1.0	3.8	3.8	3.2	3.2	3.3	3.1	3.1
Private consumption	0.7	4.4	4.5	3.6	3.6	3.6	3.4	3.4
Public consumption	-7.9	1.1	0.5	1.0	1.5	1.5	1.5	1.5
Gross fixed capital formation	-18.1	27.9	9.5	8.0	7.9	7.8	7.2	6.8
Stockbuilding (contribution to growth)	5.5	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	11.5	12.6	4.8	6.2	6.1	6.1	6.2	6.2
Imports of goods and services	11.5	20.7	7.3	6.9	6.1	6.2	6.0	5.9
Contributions to growth								
Domestic demand	0.1	10.7	5.6	4.8	4.9	4.9	4.7	4.6
Net exports	-0.5	-5.2	-2.1	-1.1	-0.7	-0.8	-0.7	-0.5
HICP inflation								
Period average	-1.2	4.2	2.4	2.2	2.2	2.2	2.2	2.2
End-period	2.4	3.9	1.9	2.1	2.2	2.2	2.2	2.2
Labor market								
Unemployment rate (LFS definition; period average, percent) 1/	19.0	16.4	15.4	14.0	12.5	11.4	10.5	9.9
Employment (period average, percent change)	-3.6	3.3	1.3	1.2	1.2	1.0	0.6	0.5
Real gross wages	-2.3	0.0	0.9	1.0	0.9	0.7	0.4	0.1
	(percent of GDP)							
Consolidated general government 2/								
Total revenue	36.2	35.9	37.2	34.8	33.3	31.7	31.2	30.8
Total expenditure	42.6	39.0	38.6	36.9	36.1	34.0	32.8	31.9
Basic fiscal balance	-6.4	-3.1	-1.4	-2.1	-2.8	-2.2	-1.6	-1.1
Fiscal balance (including restructuring costs)	-7.3	-3.1	-1.3	-2.1	-2.8	-2.3	-1.5	-1.0
General government gross debt	39.9	37.8	38.7	41.4	39.3	36.0	36.8	34.7
Saving and investment								
Gross national saving	22.9	24.4	24.6	24.5	24.5	24.9	25.3	25.6
Private	24.8	20.9	19.4	20.0	20.1	20.2	19.7	19.1
Public 3/	-1.9	3.5	5.2	4.5	4.4	4.7	5.6	6.4
Foreign saving 4/	-3.0	1.2	2.2	3.1	3.6	3.8	4.0	4.1
Gross capital formation	19.9	25.6	26.8	27.5	28.1	28.7	29.3	29.7
Private	16.0	19.6	20.7	22.1	22.5	23.2	23.5	23.6
Public	4.0	6.0	6.1	5.4	5.7	5.5	5.7	6.1
External sector								
Current account balance	3.0	-1.2	-2.2	-3.1	-3.6	-3.8	-4.0	-4.1
Net IIP	-80.3	-71.9	-67.7	-64.8	-62.4	-60.7	-59.6	-58.7
Gross external debt	165.6	144.8	140.7	136.6	127.6	118.8	115.4	109.4
Net external debt 5/	53.6	44.8	39.0	34.1	30.2	27.2	24.8	22.6
Memorandum items:								
Gross official reserves (billions of euros)	5.8	4.9	5.1	5.8	5.4	4.9	5.4	5.3
Nominal GDP (billions of lats)	12.7	14.2	14.9	15.7	16.7	17.7	18.8	19.9
Nominal GDP (billions of euros)	18.1	20.3	21.2	22.4	23.8	25.2	26.7	28.3

Sources: Latvian authorities; and IMF staff estimates.

1/ Revised by +0.8 percentage points in 2011 in compliance with population census; data before 2011 has not been revised yet.
2/ National definition. Includes economy-wide EU grants in revenue and expenditure.
3/ Includes 2nd pillar contributions and privatization receipts, excludes bank restructuring costs.
4/ Current account deficit (+ indicates a surplus)
5/ Gross external debt minus gross external debt assets.

Table 3. Latvia: General Government Operations, 2010-13

	2010	2011		2012		2013
	Actual	Fifth Review	Actual	Fifth Review	Proj.	Proj.
	(millions of lats)					
Total revenue and grants	4,607	5,104	5,087	5,453	5,541	5,474
Tax revenue	3,403	3,841	3,879	4,054	4,109	4,129
Direct Taxes	2,074	2,284	2,328	2,392	2,440	2,438
Corporate Income Tax	112	187	196	211	211	232
Personal Income Tax	779	779	792	812	836	846
Social Security Contributions	1,093	1,210	1,230	1,252	1,279	1,228
Real Estate and Property Taxes	90	107	110	116	113	133
Indirect Taxes	1,329	1,558	1,550	1,662	1,670	1,691
VAT	825	964	959	1,029	1,044	1,046
Excises	458	479	482	509	501	519
Other indirect taxes	46	114	110	125	125	126
Non Tax, self-earned and other revenue	604	519	545	553	586	576
Non-tax revenues	383	302	331	336	363	346
Self-earned revenues	213	217	210	216	218	225
Others	9	0	5	0	5	5
EU and miscellaneous funds	600	744	663	846	846	769
Total expenditure 1/	5,424	5,640	5,521	5,626	5,749	5,806
Current expenditure	5,034	5,016	4,935	5,114	5,152	5,276
Primary Current Expenditure	4,855	4,804	4,731	4,856	4,909	5,010
Remuneration	1,087	1,065	1,131	1,072	1,104	1,127
Goods and Services	691	633	731	625	648	662
Subsidies and Transfers	2,937	2,951	2,742	2,971	2,967	3,020
Subsidies to companies and institutions	1,178	1,312	1,114	1,341	1,365	1,417
E.U. funds related subsidies	784	723	717	743	737	761
Social Support	1,745	1,626	1,610	1,616	1,588	1,589
Pensions	1,252	1,173	1,207	1,173	1,196	1,194
Other	493	453	403	443	392	395
International cooperation	15	13	18	14	14	14
Payments to EU budget	121	126	131	139	139	150
Net lending and other current expenditure	18	28	-4	50	51	52
Interest	180	212	205	258	242	265
Capital expenditure	390	625	586	512	597	530
E.U. funds related capital expenditure	141	425	242	321	415	321
National capital expenditure	249	200	344	192	182	209
Basic fiscal balance	-817	-537	-434	-173	-207	-331
Restructuring costs	118	-11	10	14	-11	5
Bank restructuring costs	102	-68	-47	14	-11	5
AirBaltic	16	57	57	0	0	0
Fiscal balance	-935	-526	-444	-187	-196	-336
Financing (net)	935	526	444	187	196	336
Domestic financing	146	227	80	-111	-98	-217
External financing	756	299	285	299	295	554
Errors and omissions	32	0	79	0	0	0
Net lending	14	28	-11	50	50	50
ESA correction	-242	-45	-49	-180	-144	-117
ESA balance	-1045	-553	-494	-303	-301	-399

Table 3. Latvia: General Government Operations, 2010-13 (concluded)

	2010	2011		2012		2013
	Actual	Fifth Review	Actual	Fifth Review	Proj.	Proj.
	(percent of GDP)					
Total revenue and grants	36.2	36.9	35.9	37.8	37.2	34.8
Tax revenue	26.7	27.8	27.4	28.1	27.6	26.3
Direct Taxes	16.3	16.5	16.4	16.6	16.4	15.5
Corporate Income Tax	0.9	1.4	1.4	1.5	1.4	1.5
Personal Income Tax	6.1	5.6	5.6	5.6	5.6	5.4
Social Security Contributions	8.6	8.7	8.7	8.7	8.6	7.8
Real Estate and Property Taxes	0.7	0.8	0.8	0.8	0.8	0.8
Indirect Taxes	10.4	11.3	10.9	11.5	11.2	10.8
VAT	6.5	7.0	6.8	7.1	7.0	6.7
Excises	3.6	3.5	3.4	3.5	3.4	3.3
Other indirect taxes	0.4	0.8	0.8	0.9	0.8	0.8
Non Tax, self-earned and other revenue	4.7	3.7	3.9	3.8	3.9	3.7
EU and miscellaneous funds	4.7	5.4	4.7	5.9	5.7	4.9
Total expenditure 1/	42.6	40.7	39.0	39.0	38.6	36.9
Current expenditure	39.5	36.2	34.9	35.4	34.6	33.6
Primary Current Expenditure	38.1	34.7	33.4	33.6	33.0	31.9
Remuneration	8.5	7.7	8.0	7.4	7.4	7.2
Goods and Services	5.4	4.6	5.2	4.3	4.4	4.2
Subsidies and Transfers	23.1	21.3	19.4	20.6	19.9	19.2
Subsidies to companies and institutions	9.2	9.5	7.9	9.3	9.2	9.0
E.U. funds related subsidies	6.2	5.2	5.1	5.1	5.0	4.8
Social Support	13.7	11.7	11.4	11.2	10.7	10.1
International cooperation	0.1	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	1.0	0.9	0.9	1.0	0.9	1.0
Net lending and other current expenditure	0.1	0.2	0.0	0.3	0.3	0.3
Interest	1.4	1.5	1.4	1.8	1.6	1.7
Capital expenditure	3.1	4.5	4.1	3.5	4.0	3.4
E.U. funds related capital expenditure	1.1	3.1	1.7	2.2	2.8	2.0
National capital expenditure	2.0	1.4	2.4	1.3	1.2	1.3
Basic fiscal balance	-6.4	-3.9	-3.1	-1.2	-1.4	-2.1
Restructuring costs	0.9	-0.1	0.1	0.1	-0.1	0.0
Bank restructuring costs	0.8	-0.5	-0.3	0.1	-0.1	0.0
AirBaltic	0.1	0.4	0.4	0.0	0.0	0.0
Fiscal balance	-7.3	-3.8	-3.1	-1.3	-1.3	-2.1
Memorandum items						
ESA balance	-8.2	-4.0	-3.5	-2.1	-2.0	-2.5
ESA balance less bank restructuring 2/	-5.9	-3.7	-3.2	-2.1	-2.0	-2.5
ESA cyclically adjusted balance	-5.0	…	-1.5	…	-0.6	-1.6
ESA structural balance 3/	-4.4	…	-2.3	…	-1.6	-1.6
General government debt	39.9	39.1	37.8	40.3	38.7	41.4
Nominal GDP (In billions of lats)	12.7	13.8	14.2	14.4	14.9	15.7

Sources: Latvian authorities; and IMF staff estimates.

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

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

3/ In computing structural balances partial diversion of second pillar pension contributions to the state budget and part of bank restructuring costs are treated as one-offs.

Table 4. Latvia: Fiscal Balances and Debt, 2006-12

	2006	2007	2008	2009	2010	2011	2012
			(percent of GDP)				
Fiscal balances							
Basic fiscal balance (excl. bank restructuring)	-0.6	0.6	-3.4	-7.1	-6.4	-3.1	-1.4
Alternative fiscal balances							
(i) Authorities' definition							
plus net lending	…	0.0	0.0	0.3	0.1	0.0	0.3
Basic fiscal balance, authorities' definition	…	0.6	-3.4	-6.8	-6.3	-3.1	-1.1
(ii) Adjustment for 2nd pillar contribution diversion							
less gain from 2nd pillar contributions < 8 percent	0.0	0.0	0.0	1.2	1.6	1.6	1.6
Fiscal balance, adjusted for pension diversion 1/	-0.6	0.6	-3.4	-8.3	-8.1	-4.6	-3.0
(iii) Adjustment for EU-related operations							
less revenues from EU	2.3	3.1	2.7	4.1	4.7	4.7	5.7
plus EU-related spending	4.1	3.6	4.3	6.1	7.3	6.8	7.7
Non-EU basic balance	1.2	1.1	-1.8	-5.0	-3.9	-1.0	0.7
(iv) Primary balance							
plus interest	0.6	0.4	0.4	1.2	1.4	1.4	1.6
Primary basic balance	-0.1	0.9	-3.2	-6.4	-5.0	-2.0	0.0
(v) Recognition of bank restructuring costs							
less bank restructuring costs	0.0	0.0	4.2	0.8	0.8	-0.3	-0.1
Overall balance 2/	-0.6	0.6	-7.5	-7.8	-7.3	-2.7	-1.3
(vi) Program-relevant ESA balance							
ESA definition less bank restructuring	-0.5	-0.3	-4.2	-8.6	-5.9	-3.2	-2.0
(vii) ESA deficit (relevant for euro adoption)							
plus ESA bank restructuring	0.0	0.0	0.0	1.1	2.3	0.3	0.0
ESA deficit	-0.5	-0.3	-4.2	-9.7	-8.2	-3.5	-2.0
Public debt							
Gross debt	9.9	7.8	17.2	32.9	39.9	37.8	38.7
of which foreign currency-denominated	5.2	4.4	9.9	25.6	32.6	31.8	32.2
Net debt (debt less government deposits)	7.5	4.7	13.2	23.0	31.4	32.6	32.3
Net debt if no more bank restructuring	7.5	4.7	13.2	23.0	31.4	32.6	32.4

Sources: Latvian authorities; and IMF staff estimates.
1/ Definition used at First Review.
2/ 2011 excludes non-bank restructuring costs.

Table 5. Latvia: Statement of Government Operations, 2010-13 1/

	2010	2011	2012	2013	2010	2011	2012	2013
	Actual		Proj.		Actual		Proj.	
	(millions of lats)				(percent of GDP)			
Revenue	**4592**	**5074**	**5528**	**5460**	**36.0**	**35.8**	**37.1**	**34.7**
Taxes	2347	2649	2830	2901	18.4	18.7	19.0	18.5
Taxes on income, profits, and capital gains	891	989	1048	1077	7.0	7.0	7.0	6.9
Taxes on payroll and workforce	….	0	0	0	….	0.0	0.0	0.0
Taxes on property	90	110	113	133	0.7	0.8	0.8	0.8
Taxes on goods and services	1340	1519	1633	1654	10.5	10.7	11.0	10.5
Taxes on international trade and transactions	17	21	23	23	0.1	0.1	0.2	0.1
Other taxes	9	10	14	14	0.1	0.1	0.1	0.1
Social contributions	1093	1230	1279	1228	8.6	8.7	8.6	7.8
Grants	600	663	846	769	4.7	4.7	5.7	4.9
Other revenue	552	532	572	562	4.3	3.8	3.8	3.6
Expenditure	**5508**	**5529**	**5674**	**5746**	**43.2**	**39.0**	**38.1**	**36.6**
Expense	**5131**	**4957**	**5091**	**5231**	**40.3**	**35.0**	**34.2**	**33.3**
Compensation of employees	1087	1131	1156	1168	8.5	8.0	7.8	7.4
Wages and salaries	846	888	901	911	6.6	6.3	6.1	5.8
Social contributions	241	243	255	258	1.9	1.7	1.7	1.6
Use of goods and services	688	731	723	713	5.4	5.2	4.9	4.5
Consumption of fixed capital	0	0	0	0	0.0	0.0	0.0	0.0
Interest	177	205	242	265	1.4	1.4	1.6	1.7
Subsidies	1171	1114	1203	1294	9.2	7.9	8.1	8.2
Grants	0	18	25	28	0.0	0.1	0.2	0.2
Social benefits	1744	1610	1613	1605	13.7	11.4	10.8	10.2
Other expense	263	149	130	157	2.1	1.1	0.9	1.0
Property expense other than interest	0	0	0	0	0.0	0.0	0.0	0.0
Miscellaneous other expense	263	149	130	157	2.1	1.1	0.9	1.0
Current	145	138	140	152	1.1	1.0	0.9	1.0
Capital	118	11	-11	5	0.9	0.1	-0.1	0.0
Bank restructuring costs	102	-47	-11	5	0.8	-0.3	-0.1	0.0
AirBaltic	16	57	0	0	0.1	0.4	0.0	0.0
Other	0	0	0	0	0.0	0.0	0.0	0.0
Net acquisition of nonfinancial assets	**377**	**572**	**583**	**515**	**3.0**	**4.0**	**3.9**	**3.3**
Gross Operating Balance	**-539**	**117**	**436**	**228**	**-4.2**	**0.8**	**2.9**	**1.5**
Net lending (+) / borrowing (-)	**-916**	**-455**	**-146**	**-286**	**-7.2**	**-3.2**	**-1.0**	**-1.8**
Net acquisition of financial assets	**-148**	**-445**	**261**	**467**	**-1.2**	**-3.1**	**1.8**	**3.0**
Domestic	-148	-445	261	467	-1.2	-3.1	1.8	3.0
Foreign	0	0	0	0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	**768**	**10**	**408**	**753**	**6.0**	**0.1**	**2.7**	**4.8**
Domestic	14	-275	113	200	0.1	-1.9	0.8	1.3
Foreign	754	285	295	554	5.9	2.0	2.0	3.5

1/ Data on fiscal operations presented in GFSM 2001 format.

Table 6. Latvia: Public Sector Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	7.8	17.2	32.9	39.9	37.8	**38.7**	**41.4**	**39.3**	**36.0**	**36.8**	**34.7**	**-0.3**
o/w foreign-currency denominated	4.4	9.9	25.6	32.6	31.8	32.2	34.1	30.9	26.8	26.9	24.0	
2 Change in public sector debt	-2.1	9.4	15.7	7.0	-2.1	0.9	2.7	-2.2	-3.3	0.8	-2.1	
3 Identified debt-creating flows (4+7+12)	-3.9	6.6	11.6	10.7	-0.5	-0.5	0.1	0.3	0.0	-0.5	-1.1	
4 Primary deficit	-1.0	3.0	5.9	5.0	1.6	-0.2	0.4	0.9	0.3	-0.3	-0.8	
5 Revenue and grants	36.3	35.6	36.2	36.2	35.9	37.2	34.8	33.3	31.7	31.2	30.8	
6 Primary (noninterest) expenditure	35.3	38.6	42.2	41.2	37.5	37.0	35.3	34.2	32.0	30.9	30.0	
7 Automatic debt dynamics 2/	-2.5	-0.2	5.0	4.9	-2.0	-0.2	-0.4	-0.6	-0.4	-0.1	-0.2	
8 Contribution from interest rate/growth differential 3/	-2.1	-0.3	5.1	2.3	-2.6	-0.2	-0.4	-0.6	-0.4	-0.1	-0.2	
9 Of which contribution from real interest rate	-1.3	-0.5	1.4	2.2	-0.6	1.1	1.0	1.1	1.2	1.3	1.2	
10 Of which contribution from real GDP growth	-0.7	0.2	3.8	0.1	-2.0	-1.3	-1.3	-1.6	-1.5	-1.4	-1.4	
11 Contribution from exchange rate depreciation 4/	-0.4	0.1	-0.2	2.6	0.5	...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.4	3.8	0.7	0.8	-0.1	-0.1	0.0	0.0	0.0	-0.1	-0.1	
13 Privatization receipts (negative)	-0.4	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (bank recapitalization, AirBaltic)	0.0	4.2	0.8	0.9	0.1	-0.1	0.0	0.0	0.0	-0.1	-0.1	
16 Residual, including asset changes (2-3) 5/	1.8	2.8	4.1	-3.7	-1.6	1.4	2.7	-2.5	-3.2	1.3	-1.0	
Public sector debt-to-revenue ratio 1/	21.4	48.3	90.7	110.3	105.1	103.9	118.9	118.1	113.6	117.8	112.4	
Gross financing need 6/	0.3	9.0	15.9	12.0	6.5	4.8	6.8	11.0	9.7	4.3	7.4	
in billions of U.S. dollars	0.1	3.0	4.1	2.9	1.8	1.3	2.0	3.4	3.2	1.7	3.1	
Scenario with key variables at their historical averages 7/						**38.7**	**41.2**	**38.4**	**35.0**	**36.4**	**35.2**	**-1.9**
Scenario with no policy change (constant primary balance) in 2012-2017						**38.7**	**40.8**	**37.5**	**33.7**	**34.7**	**33.2**	**-0.3**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.6	-3.3	-17.7	-0.3	5.5	3.5	3.6	4.2	4.2	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	4.7	5.6	5.4	4.2	4.0	4.5	4.6	4.9	5.2	5.6	5.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-16.0	-7.4	6.7	6.4	-1.4	3.0	2.7	2.8	3.3	3.8	3.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	10.7	-2.2	1.2	-8.6	-1.7	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	20.7	13.0	-1.2	-2.2	5.4	1.5	1.9	2.1	2.0	1.8	1.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.2	5.5	-10.0	-2.7	-3.8	2.0	-1.3	0.9	-2.4	0.5	0.9	
Primary deficit	-1.0	3.0	5.9	5.0	1.6	-0.2	0.4	0.9	0.3	-0.3	-0.8	

1/ The coverage refers to the general government; gross debt is used throughout.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi$ (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Table 7. Latvia: Medium-Term Balance of Payments, 2010−17

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
	(millions of euros)							
Current account	540	-243	-469	-688	-865	-962	-1,065	-1,171
Trade balance (fob)	-1,280	-1,999	-2,419	-2,614	-2,743	-2,878	-3,060	-3,223
Exports	6,873	8,639	9,111	9,628	10,220	10,833	11,538	12,295
Imports	8,153	10,639	11,529	12,242	12,962	13,711	14,598	15,518
Services	1,107	1,324	1,342	1,399	1,491	1,586	1,690	1,808
Credit	2,787	3,189	3,363	3,669	3,894	4,128	4,397	4,685
Debit	1,680	1,865	2,022	2,270	2,403	2,542	2,707	2,877
Income	59	-189	-185	-189	-250	-284	-283	-340
Compensation of employees	430	466	488	513	540	568	598	616
Investment income	-371	-655	-673	-702	-790	-853	-880	-956
Current transfers	654	622	793	716	637	615	587	584
of which: EU (net)	373	301	454	350	236	171	96	59
Capital and financial account	-1,011	-629	954	1,947	1,704	1,715	1,712	1,134
Capital account	352	429	544	488	479	430	402	416
Financial account	-1,363	-1,057	411	1,459	1,224	1,285	1,310	718
Direct investment	270	1,048	807	746	745	786	832	882
of which: equity capital	480	650	621	600	587	615	647	683
Portfolio investment	-165	-468	430	1,114	784	588	336	-440
of which: general government	-2	226	763	1,300	975	750	500	-313
Financial derivatives	-168	112	0	0	0	0	0	0
Other investment	-1,300	-1,750	-827	-401	-305	-89	142	276
Assets	-662	-512	-659	-319	-296	-263	-239	-204
Liabilities	-639	-1,238	-168	-82	-9	174	381	480
Banks, short-term	…	…	577	206	263	316	405	422
Banks, long-term	…	…	-645	-335	-260	-210	-110	-57
Errors and omissions	96	-128	0	0	0	0	0	0
Overall balance	-375	-999	485	1,259	839	754	647	-37
Financing	375	999	-485	-1,259	-839	-754	-647	37
Change in reserve assets (+ denotes decline)	-725	906	-141	-746	399	573	-567	116
IMF (net)	300	0	-340	-510	-237	-66	0	0
Purchases	300	0	0	0	0	0	0	0
Repurchases	0	0	-340	-510	-237	-66	0	0
Other official financing (net)	800	94	-3	-2	-1,002	-1,260	-80	-80
Disbursements	800	100	0	0	0	0	0	0
Repayments	0	-6	-3	-2	-1,002	-1,260	-80	-80

Table 7. Latvia: Medium-Term Balance of Payments, 2010−17 (concluded)

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
Memorandum items:	(percent of GDP, unless otherwise indicated)							
Current account	3.0	-1.2	-2.2	-3.1	-3.6	-3.8	-4.0	-4.1
Trade balance (fob)	-7.1	-9.8	-11.4	-11.7	-11.5	-11.4	-11.4	-11.4
Exports	38.0	42.5	43.0	43.1	43.0	42.9	43.2	43.4
Imports	45.0	52.4	54.5	54.8	54.5	54.3	54.6	54.8
Services	6.1	6.5	6.3	6.3	6.3	6.3	6.3	6.4
Credit	15.4	15.7	15.9	16.4	16.4	16.4	16.4	16.5
Debit	9.3	9.2	9.5	10.2	10.1	10.1	10.1	10.2
Income	0.3	-0.9	-0.9	-0.8	-1.1	-1.1	-1.1	-1.2
Compensation of employees	2.4	2.3	2.3	2.3	2.3	2.3	2.2	2.2
Investment income	-2.0	-3.2	-3.2	-3.1	-3.3	-3.4	-3.3	-3.4
Current transfers	3.6	3.1	3.7	3.2	2.7	2.4	2.2	2.1
of which: EU (net)	2.1	1.5	2.1	1.6	1.0	0.7	0.4	0.2
Net FDI	1.5	5.2	3.8	3.3	3.1	3.1	3.1	3.1
Export G&S growth (value, fob, percent change)	20.3	22.5	5.5	6.6	6.1	6.0	6.5	6.6
Import G&S growth (value, fob, percent change)	12.1	27.2	8.4	7.1	5.9	5.8	6.5	6.3
Export G&S price increase (percent change)	7.1	8.9	0.6	0.4	0.1	-0.1	0.3	0.3
Import G&S price increase (percent change)	6.3	5.3	1.0	0.2	-0.2	-0.4	0.4	0.4
Gross reserves (billions of euros)	5.8	4.9	5.1	5.8	5.4	4.9	5.4	5.3
(in months of prospective imports)	5.6	4.4	4.2	4.6	4.0	3.4	3.5	3.3
Reserve cover 1/	41.7	39.4	38.1	39.2	36.5	34.4	35.0	33.9
Banks' short-term liabilities (billions of euros)	7.7	7.2	7.8	8.0	8.2	8.5	9.0	9.4
Reserves (percent of short-term external debt)	60.3	53.2	50.9	56.6	51.3	44.1	47.0	43.9
Gross external debt (billions of euros)	30.0	29.4	29.8	30.5	30.3	30.0	30.9	31.0
Medium- and long-term (billions of euros)	20.4	20.1	19.8	20.3	19.7	19.0	19.3	18.9
Short-term (billions of euros)	9.6	9.3	10.0	10.3	10.6	11.0	11.5	12.1
Net external debt (billions of euros) 2/	9.7	9.1	8.3	7.6	7.2	6.9	6.6	6.4
Gross external debt	165.6	144.8	140.7	136.6	127.6	118.8	115.4	109.4
Medium- and long-term	112.6	99.0	93.5	90.6	83.1	75.2	72.2	66.7
Short-term	53.0	45.8	47.1	46.0	44.5	43.6	43.2	42.7
Net external debt 2/	53.6	44.8	39.0	34.1	30.2	27.2	24.8	22.6
Nominal GDP (billions of euros)	18.1	20.3	21.2	22.4	23.8	25.2	26.7	28.3
U.S. dollar per euro (period average)	1.33	1.39	…	…	…	…	…	…
Lats per euro (period average)	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70

Sources: Latvian authorities; and IMF staff estimates.

1/ Gross reserves in percent of total short-term liabilities and amortization minus the current account surplus.

2/ Gross external debt minus gross external debt assets.

Table 8. Latvia: External Debt Dynamics, 2010-17

	2010	2011	2012	2013	2014	2015	2016	2017
	(billions of euros)							
Gross external debt	30.0	29.4	29.8	30.5	30.3	30.0	30.9	31.0
Public 1/	6.0	6.5	6.9	7.7	7.4	6.8	7.1	6.7
Short-term	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Long-term	5.9	6.4	6.8	7.6	7.3	6.6	7.0	6.6
Private	24.0	22.9	22.9	22.9	23.0	23.2	23.7	24.3
Banks	15.6	13.9	13.9	13.7	13.7	13.8	14.1	14.5
Short-term	7.7	7.2	7.8	8.0	8.2	8.5	9.0	9.4
Long-term	7.9	6.7	6.1	5.8	5.5	5.3	5.2	5.1
Corporate	5.8	6.0	5.9	6.0	6.0	6.1	6.3	6.4
Short-term	1.8	2.0	2.1	2.2	2.2	2.3	2.5	2.6
Long-term	4.0	4.0	3.9	3.8	3.8	3.8	3.8	3.8
Other	2.6	3.0	3.1	3.1	3.2	3.2	3.3	3.4
	(percent of GDP)							
Gross external debt	165.6	144.8	140.7	136.6	127.6	118.8	115.4	109.4
Public	33.2	32.1	32.7	34.4	31.0	26.8	26.7	23.7
Short-term	0.7	0.6	0.6	0.6	0.5	0.5	0.5	0.4
Long-term	32.5	31.5	32.1	33.8	30.5	26.3	26.3	23.3
Private	132.4	112.7	108.0	102.3	96.6	92.0	88.7	85.7
Banks	86.0	68.6	65.5	61.4	57.8	54.8	52.9	51.2
Short-term	42.4	35.4	36.7	35.6	34.6	33.9	33.5	33.1
Long-term	43.6	33.2	28.8	25.8	23.2	21.0	19.4	18.1
Corporate	32.1	29.3	28.1	26.9	25.4	24.3	23.4	22.6
Short-term	10.0	9.8	9.9	9.8	9.4	9.3	9.2	9.2
Long-term	22.1	19.6	18.2	17.1	16.0	15.0	14.2	13.5
Other	14.4	14.8	14.4	13.9	13.4	12.8	12.3	11.9
	(debt dynamics, change in debt to GDP ratio)							
Total Debt to GDP	8.9	-20.8	-4.2	-4.0	-9.0	-8.8	-3.4	-6.0
Due to change in debt	4.9	-2.8	1.8	3.4	-0.9	-1.4	3.2	0.5
Due to nominal GDP	4.0	-18.0	-5.9	-7.5	-8.1	-7.4	-6.6	-6.5
Public Debt to GDP	7.4	-1.1	0.6	1.7	-3.3	-4.3	-0.1	-3.0
Due to change in debt	6.7	2.5	1.9	3.4	-1.3	-2.4	1.4	-1.5
Due to nominal GDP	0.7	-3.6	-1.3	-1.7	-2.0	-1.8	-1.5	-1.5
Private Debt to GDP	1.5	-19.7	-4.7	-5.7	-5.7	-4.6	-3.3	-3.0
Due to change in debt	-1.9	-5.3	-0.1	0.0	0.4	1.1	1.8	2.0
Due to nominal GDP	3.4	-14.4	-4.6	-5.7	-6.1	-5.6	-5.1	-5.0
Memorandum items:								
Nominal GDP (billions of euros)	18.1	20.3	21.2	22.4	23.8	25.2	26.7	28.3

Sources: Latvian authorities and IMF staff estimates.

1/ Debt of general government, including Bank of Latvia.

Table 9. Latvia: External Debt Sustainability Framework, 2007-17
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	128.4	130.9	156.8	165.6	144.8			**140.7**	**136.6**	**127.6**	**118.8**	**115.4**	**109.4**	**-6.3**
2 Change in external debt	13.7	2.6	25.8	8.9	-20.8			-4.2	-4.0	-9.0	-8.8	-3.4	-6.0	
3 Identified external debt-creating flows (4+8+9)	-12.2	1.5	23.3	-0.2	-20.9			-6.4	-5.3	-5.1	-4.5	-3.8	-3.7	
4 Current account deficit, excluding interest payments	18.4	7.8	-13.2	-6.9	-2.0			-1.2	-0.3	0.1	0.2	0.5	0.6	
5 Deficit in balance of goods and services	20.6	13.9	1.1	1.0	3.3			5.1	5.4	5.3	5.1	5.1	5.0	
6 Exports	41.6	42.3	43.3	53.4	58.3			58.9	59.5	59.4	59.3	59.6	59.9	
7 Imports	62.2	56.2	44.4	54.3	61.6			64.0	64.9	64.6	64.4	64.7	64.9	
8 Net non-debt creating capital inflows (negative)	-6.8	-1.4	2.5	-1.2	-4.1			-3.8	-3.6	-3.4	-3.3	-3.3	-3.5	
9 Automatic debt dynamics 1/	-23.8	-4.9	34.0	7.9	-14.8			-1.4	-1.4	-1.8	-1.4	-1.0	-0.9	
10 Contribution from nominal interest rate	4.1	5.4	4.6	3.9	3.2			3.4	3.4	3.6	3.6	3.5	3.5	
11 Contribution from real GDP growth	-8.3	3.9	28.4	0.5	-8.1			-4.8	-4.8	-5.4	-5.0	-4.5	-4.4	
12 Contribution from price and exchange rate changes 2/	-19.6	-14.2	1.0	3.5	-9.9			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	26.0	1.0	2.6	9.1	0.1			2.3	1.3	-3.9	-4.3	0.4	-2.3	
External debt-to-exports ratio (in percent)	308.7	309.6	362.2	310.4	248.6			238.7	229.7	214.9	200.5	193.6	182.6	
Gross external financing need (in billions of euros) 4/	14.9	19.5	11.0	9.6	13.9			12.5	13.3	14.9	14.9	14.1	15.5	
in percent of GDP	71.4	85.7	59.2	53.2	68.4	10-Year	10-Year	59.3	59.6	62.5	59.0	52.8	54.7	
Scenario with key variables at their historical averages 5/								**142.8**	**141.3**	**135.2**	**128.8**	**126.6**	**122.2**	**-9.9**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	9.6	-3.3	-17.7	-0.3	5.5	3.9	8.9	3.5	3.6	4.2	4.2	4.0	4.0	
GDP deflator in euros (change in percent)	20.6	12.4	-0.7	-2.2	6.4	4.9	8.1	0.8	1.9	2.1	2.0	1.8	1.9	
Nominal external interest rate (in percent)	4.7	4.6	2.9	2.4	2.1	3.1	0.9	2.4	2.6	2.8	3.0	3.1	3.2	
Growth of exports (euro terms, in percent)	24.5	10.6	-16.4	20.3	22.5	12.7	12.8	5.5	6.6	6.1	6.0	6.5	6.6	
Growth of imports (euro terms, in percent)	23.5	-1.7	-35.5	19.4	27.2	12.1	19.7	8.4	7.1	5.9	5.8	6.5	6.3	
Current account balance, excluding interest payments	-18.4	-7.8	13.2	6.9	2.0	-5.6	10.4	1.2	0.3	-0.1	-0.2	-0.5	-0.6	
Net non-debt creating capital inflows	6.8	1.4	-2.5	1.2	4.1	3.2	2.7	3.8	3.6	3.4	3.3	3.3	3.5	

Source: IMF staff estimates.

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in euro terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

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

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Latvia: Bank of Latvia Balance Sheet, 2008-12

	2008	2009	2010	2011	2012
	Actual			Est.	Proj.
	(billions of Lats, current exchange rate)				
Reserve money	2.1	1.9	2.6	2.4	2.3
Currency issued	1.0	0.8	0.9	1.2	1.2
Reserves at the BoL	1.1	1.1	1.7	1.2	1.1
Required reserves	1.1	0.9	0.8	1.0	0.8
Deposit facility	0.0	0.3	0.9	0.2	0.3
Net foreign assets 1/	2.3	3.3	4.0	3.4	3.6
Foreign assets	2.7	3.4	4.1	3.5	3.6
Foreign liabilities	0.4	0.1	0.0	0.1	0.0
Net domestic assets	-0.2	-1.4	-1.4	-1.1	-1.3
Net credit to government	-0.6	-1.3	-1.1	-0.7	-0.9
Net credit to banks (excluding deposit facility)	0.6	0.1	0.0	0.0	0.0
Net credit to other sectors	0.0	0.0	-0.1	0.0	0.0
Other items, net	-0.2	-0.3	-0.3	-0.3	-0.3
	(billions of Lats, program exchange rate for actual figures)				
Net foreign assets	2.3	3.3	4.0	3.4	…
minus disbursments of program funds	0.4	2.3	3.0	3.0	…
minus SDR allocation	…	0.1	0.1	0.1	…
Program net international reserves	1.9	0.9	0.8	0.3	…
Base money 2/	2.1	1.6	1.8	2.2	…
minus program net international reserves	1.9	0.9	0.8	0.3	…
Program net domestic assets	0.2	0.7	1.0	1.9	…
Memorandum items:					
Base money 2/	2.1	1.6	1.8	2.2	2.0
Net foreign assets (percent of base money)	110.5	201.3	222.7	158.2	180.3
Net foreign assets (percent of reserve money)	110.4	174.3	153.6	145.8	158.1
Net foreign assets (percent of M2)	67.3	112.2	112.6	93.7	92.8
Net foreign assets (percent of broad money)	39.3	56.9	63.1	53.0	51.2
Broad money multiplier	2.8	3.1	2.4	2.8	3.1

Sources: Bank of Latvia; and IMF staff estimates.

1/ Includes Treasury foreign assets deposited at the BoL.

2/ Excludes banks' deposits at deposit facility.

Table 11. Latvia: Monetary Survey, 2008-12

	2008	2009	2010	2011	2012
	Actuals			Est.	Proj.
	(billions of Lats)				
Broad money	5.9	5.8	6.4	6.5	7.0
Lats broad money (M2)	3.5	3.0	3.6	3.7	3.9
Currency in circulation	0.9	0.7	0.8	1.0	1.1
Lats deposits	2.6	2.3	2.8	2.6	2.8
Resident foreign exchange deposits	2.5	2.9	2.8	2.8	3.1
Net foreign assets	-5.9	-3.0	-1.2	-0.2	-0.1
Bank of Latvia	2.3	3.3	4.0	3.4	3.6
Domestic money banks	-8.2	-6.3	-5.3	-3.7	-3.7
Net domestic assets	11.8	8.8	7.6	6.7	7.1
Domestic credit	14.3	12.2	11.2	11.0	10.6
Credit to government, net	-0.4	-1.5	-1.4	-0.7	-0.7
Credit to public corporations	0.4	0.4	0.5	0.4	0.4
Credit to private sector	14.3	13.3	12.2	11.3	10.8
Other items, net	-2.4	-3.4	-3.6	-4.3	-3.5
Sources of funds of deposit money banks	18.2	16.3	16.4	15.2	15.6
Resident deposits	5.1	5.2	5.6	5.4	5.9
Non-resident deposits	3.5	3.3	4.2	4.9	5.5
Liabilities to foreign financial institutions	9.3	7.4	6.5	4.7	4.0
Other foreign liabilities	0.4	0.6	0.1	0.1	0.3
Uses of funds of deposit money banks	18.2	16.3	16.4	15.2	15.6
Reserves	1.2	1.2	1.8	1.3	1.2
Cash in vault	0.2	0.1	0.1	0.1	0.1
Required reserves	1.1	0.9	0.8	1.0	0.8
Deposit facility	0.0	0.3	0.9	0.2	0.3
Domestic credit	14.3	13.4	12.3	11.8	11.5
Foreign assets	4.9	4.9	5.6	6.1	6.1
Other items, net	-2.2	-3.1	-3.3	-4.0	-3.1
	(annual percentage change)				
Broad money	-3.9	-1.9	9.8	1.5	7.9
Net foreign assets	-31.9	48.9	59.6	81.6	66.9
Bank of Latvia	-16.0	42.1	21.7	-14.8	4.3
Domestic money banks	-13.6	23.2	17.1	30.3	0.1
Net domestic assets	11.2	-25.4	-13.9	-11.8	5.4
Domestic credit	9.7	-14.5	-8.1	-1.5	-4.1
Credit to government, net	-323.3	-298.5	2.9	53.6	-3.2
Credit to public corporations	52.5	3.8	19.9	-8.3	-1.0
Credit to private sector	11.0	-6.9	-8.4	-7.4	-3.8
	(percent of GDP, unless otherwise indicated)				
Memorandum items:					
Lats broad money (M2)	21.6	22.6	28.1	25.9	25.9
Broad money	36.9	44.5	50.2	45.8	47.0
Currency in circulation	5.4	5.1	6.3	7.3	7.2
Residents' FX deposits (percent of total deposits)	48.6	55.6	50.3	51.7	53.0
Domestic credit	88.8	93.4	88.0	78.0	71.2
Private sector credit	88.7	101.6	95.5	79.6	72.9
Nominal GDP (billions of lats)	16.1	13.1	12.7	14.2	14.9

Sources: Bank of Latvia; and IMF staff estimates.

Table 12. Latvia: Financial Soundness Indicators, 2007-12
(In percent, unless otherwise indicated)

	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Mar-12 7/
Commercial banks						
Capital Adequacy						
Regulatory capital to risk-weighted assets	11.1	11.8	14.6	14.6	17.4	18.1
Regulatory Tier I capital to risk-weighted assets*	9.8	10.5	11.5	11.5	14.2	14.9
Capital and reserves to assets	7.9	7.3	7.4	7.3	7.5	7.9
Asset Quality						
Annual growth of bank loans	37.2	11.2	-7.0	-7.1	-8.1	-11.5
Loans past due over 30 days		7.8	20.3	21.5	19.9	16.6
Loans past due over 90 days	0.8	3.6	16.4	19.0	17.5	13.7
Loans past due over 90 days net of loan loss provisions to capital		13.6	67.6	65.3	40.4	24.2
Loan loss provisions to loans past due over 90 days		61.3	57.4	61.6	72.3	77.1
Loan loss provisions to total loans		2.2	9.4	11.7	12.6	10.6
Share of loans in total assets, banks dealing with residents 1/	80.4	82.5	76.4	74.7	76.2	76.1
Share of loans in total assets, banks dealing with non-residents 1/	48.9	51.7	52.4	46.4	40.1	38.5
Earnings and Profitability						
ROA (after tax)	2.0	0.3	-3.5	-1.6	-0.9	0.8
ROE (after tax)	24.3	4.6	-41.6	-20.4	-11.2	9.5
Net interest income to total income	32.5	30.1	23.3	19.0	20.9	24.3
Noninterest expenses to total income	32.3	47.5	114.5	93.5	86.7	67.5
Trading income to total income	7.8	5.6	8.6	5.4	6.5	8.3
Personnel expenses to noninterest expenses	31.5	21.3	8.5	11.9	11.9	16.1
Income from operations with non-residents to total income						
Banks dealing with residents 1/	13.0	13.7	21.0	25.7	18.8	14.7
Banks dealing with non-residents 1/	49.2	48.0	44.8	46.6	52.3	49.4
Liquidity						
Liquid assets to total assets	25.0	21.6	21.1	27.3	27.4	28.7
Liquid assets to short term liabilities	55.7	52.8	62.8	67.9	63.9	63.2
Customers deposits to (non-interbank) loans	68.2	58.8	61.9	77.5	84.1	91.4
Sensitivity to Market Risk						
Net open positions in FX to capital 2/	5.4	6.3	4.1**	4.2**	3.2***	3.2
Net open positions in EUR to capital	3.2	3.7	3.0**	2.8**	1.8***	1.5
FX assets to total assets	79.7	80.5	82.7	80.6	81.1	80.6
FX deposits to total deposits	70.7	69.4	74.5	72.6	73.5	74.6
FX liabilities to total liabilities 2/	81.7	81.1	83.8	81.6	79.1	79.5
FX loans to total loans 2/	81.8	85.0	87.1	88.9	86.3	86.6
Nonfinancial Enterprises 3/						
Total debt to equity	202.0	217.6	281.2	264.5	...	...
Return on equity	31.1	14.4	1.7	-0.1	...	...
Earnings to interest expenses	496.7	225.9	24.1	169.6	655.6	...
Households						
Household debt to GDP	42.4	41.1	48.1	46.3	38.3	36
Household debt service to GDP 4/	2.48	2.72	2.52	1.97	1.60	1.57
Real Estate Markets						
Real estate prices annual growth rate 5/	-7.3	-37.1	-39.6	7.6	-1.0	0.3
Residential real estate loans to total loans 6/	31.6	30.5	31.3	32.1	31.9	32.7
Commercial real estate loans to total loans 6/	17.8	19.5	19.9	18.0	16.8	...
Memorandum Items						
Number of banks dealing with residents 1/	9	14	15	15	17	15
Number of banks dealing with non-residents 1/	14	13	12	14	13	14
Assets of banks dealing with residents/Total banking system assets 1/	60.8	63.9	78.4	66.6	63.3	59.6
Assets of banks dealing with non-residents/Total banking system assets 1/	39.2	36.1	21.6	33.4	36.7	40.4

Sources: Latvian Central Statistical Bureau; BoL; FCMC; Latvian Leasing Association; and IMF staff calculations.
*Regulatory Tier 1 capital to risk weighted assets as from Dec_2009 is calculated as Tier 1 capital (including deduction)/risk-weighted assets
**Excluding Parex Bank.
*** Excluding Parex Bank and Latvijas Krājbanka.
1/ Banks dealing with residents (non-residents) are defined as banks in which non-resident non-MFI deposits are below (above) 20 percent of their assets.
2/ Including euro-denominated positions.
3/ Data is not annualized and not comparable to yearly figures due to different sample (for 3, 6, 9 and 12 months respectively);
Starting from Q2 2010 data used in calculatons is adjusted to full coverage of the nonfinancial enterprises.
4/ Interest payments only.
5/ Prices of typical standard apartments in Riga. Source: Real estate company Latio.
6/ Loans to residents only to total loans (including loans to non-residents).
7/ March data exclude Parex Bank which lost its banking license in March 2012.

Table 13. Latvia: Indicators of Fund Credit, 2009-16
(millions of SDRs)

	2009	2010	2011	2012	2013	2014	2015	2016
Stock, existing	713.8	982.2	982.2	692.3	257.2	56.1	0.0	0.0
Obligations, existing	11.2	21.8	26.9	311.7	446.7	203.5	56.4	0.0
Repurchase	0.0	0.0	0.0	290.0	435.1	201.1	56.1	0.0
Charges	11.2	21.8	26.9	21.7	11.6	2.4	0.4	0.0
Stock of existing Fund credit								
In percent of quota	502.3	691.2	691.2	487.2	181.0	39.5	0.0	0.0
In percent of GDP	4.3	6.2	5.5	3.8	1.3	0.3	0.0	0.0
In percent of exports of goods and services	9.8	11.7	9.4	6.5	2.3	0.5	0.0	0.0
In percent of gross reserves	16.1	19.7	23.3	16.0	5.2	1.2	0.0	0.0
Obligations to the Fund from existing Fund drawings								
In percent of quota	7.8	15.3	18.9	219.4	314.4	143.2	39.7	0.0
In percent of GDP	0.1	0.1	0.2	1.7	2.3	1.0	0.3	0.0
In percent of exports of goods and services	0.2	0.3	0.3	2.9	3.9	1.7	0.4	0.0
In percent of gross reserves	0.3	0.4	0.6	7.2	9.0	4.4	1.4	0.0

Source: IMF staff estimates.

Table 14: Latvia: Quarterly Projections

	2012									
	end-March		end-June		end-Sep		end-Dec		annual average	
	Fifth Rev.	Est.	Fifth Rev.	Proj.	Fifth Rev.	Proj.	Fifth Rev.	Proj.	Fifth Rev.	Proj.
Real GDP (percentage change, year-on-year)	3.5	6.9	2.0	3.9	2.1	2.6	2.5	2.2	2.5	3.5
Inflation (percentage change, year-on-year)	3.2	3.3	1.9	2.5	2.0	1.9	2.3	2.0	2.4	2.4
Gross international reserves of the Bank of Latvia (billions of euro)	5.3	5.4	5.2	5.5	5.7	5.9	5.3	5.2	…	…
Primary non-EU cash fiscal balance (millions of lats) 1/ 2/	91	101	183	230	372	428	365	415	…	…
Total revenue and grants (millions of lats) 1/	1,375	1,247	2,829	2,727	4,137	4,043	5,450	5,563	…	…
Total expenditures (millions of lats) 1/ 2/	1,340	1,293	2,727	2,709	3,901	3,920	5,561	5,699	…	…

Source: IMF staff calculations agreed with the Bank of Latvia and the Latvian Ministry of Finance.
1/ Cumulative from the beginning of the fiscal year. Figures based on IMF calculations and methodology.
2/ Excludes net lending.

Table 15. Latvia: Selected Vulnerability Indicators, 2007–12

	2007	2008	2009	2010	2011	2012 1/	Latest Observation
Key economic and market indicators							
Real GDP growth (y-o-y, percent)	9.6	-3.3	-17.7	-0.3	5.5	…	*Q4, 2011*
HICP inflation (y-o-y, percent)	10.1	15.3	3.3	-1.2	4.2	2.8	*Apr-12*
Short-term (ST) interbank rate, 1-month RIGIBOR (eop, percent)	6.8	13.3	2.7	0.6	1.1	0.4	*Apr-12*
Eurobond secondary market spread (bps, eop)	74	648	505	307	332	199	*Mar-12*
Exchange rate (lats per U.S. dollar, eop)	0.48	0.50	0.49	0.54	0.54	0.53	*Apr-12*
Exchange rate (lats per U.S. dollar, period average)	0.51	0.48	0.51	0.53	0.50	0.54	*Apr-12*
External sector							
Exchange rate regime		Pegged to the euro (+/-1% band)					
Current account balance (percent of GDP)	-22.4	-13.2	8.7	3.0	-1.2	…	*Q4, 2011*
Net FDI inflows (percent of GDP)	6.8	3.1	0.6	1.5	5.2	…	*Q4, 2011*
Exports (percentage change of US$ value)	35.9	18.8	-20.9	14.6	28.4	…	*Q4, 2011*
Real effective exchange rate index (2000=100, period average)	95.1	104.5	110.2	103.6	103.8	…	*Q4, 2011*
Gross international reserves (GIR, US$ billion)	5.8	5.0	7.0	7.7	6.5	7.0	*Apr-12*
GIR in percent of ST debt at remaining maturity (RM) excluding non-resident deposits	96.0	36.7	62.6	104.7	65.0	…	*Q4, 2011*
GIR in percent of ST debt at RM including banks' non-resident FX deposits	38.8	22.5	38.2	57.0	36.2	…	*Q4, 2011*
Net international reserves (NIR, eop, US$ billion)	5.7	3.9	2.0	1.6	0.4	0.9	*Apr-12*
Total gross external debt (ED, percent of GDP)	128.1	130.0	156.5	165.2	144.8	…	*Q4, 2011*
ST external debt (original maturity, percent of total ED)	43.2	33.5	24.6	32.6	31.6	…	*Q4, 2011*
ST external debt (remaining maturity, percent of total ED)	61.3	42.3	34.9	45.5	41.1	…	*Q4, 2011*
Private sector	60.2	40.4	34.4	45.1	39.5	…	*Q4, 2011*
Public sector	1.1	1.9	0.6	0.4	1.6	…	*Q4, 2011*
ED of domestic private sector (percent of total ED)	96.0	91.6	83.5	79.9	77.8	…	*Q4, 2011*
Total gross external debt (percent of exports)	438.4	437.5	514.4	444.1	248.6	…	*Q4, 2011*
Gross external financing requirement (US$ billion) 2/	29.0	40.5	21.7	18.1	27.7	…	*Q4, 2011*
Public sector (PS) 3/							
Basic balance (excluding bank restructuring costs; percent of GDP)	0.6	-3.4	-7.1	-6.4	-3.1	-0.3	*Q1, 2012*
Primary basic balance (percent of GDP)	0.9	-3.2	-6.4	-5.0	-2.0	0.3	*Q1, 2012*
Gross PS financing requirement (percent of GDP) 4/	0.3	9.0	15.9	12.0	6.7	1.4	*Q1, 2012*
General government gross debt (percent of GDP)	7.8	17.2	32.9	39.9	37.8	38.6	*Q1, 2012*
Financial sector (FS) 5/							
Capital adequacy ratio (percent)	11.1	11.8	14.6	14.6	17.4	18.1	*Mar-12*
Overdue loans (percent of total loans) 6/	0.8	3.6	16.4	19.0	17.5	13.7	*Mar-12*
Provisions (percent of overdue loans)	64.9	61.3	57.4	61.6	72.3	77.1	*Mar-12*
Return on average assets (percent)	2.0	0.3	-3.5	-1.6	-0.9	0.8	*Mar-12*
Return on equity (percent)	24.2	4.6	-41.6	-20.4	-11.2	9.5	*Mar-12*
Residents' FX deposits (percent of total resident deposits)	70.7	69.4	74.5	72.6	73.5	74.6	*Mar-12*
FX loans to residents (percent of total loans to residents)	81.8	85.0	87.1	88.9	86.3	86.6	*Mar-12*
Credit to private sector (percent change, year-on-year) 7/	33.0	11.0	-6.9	-8.4	-7.4	-10.1	*Mar-12*
Memorandum item:							
Nominal GDP (billions of U.S. dollars)	28.7	33.5	25.9	24.0	28.3	…	*Q4, 2011*

Sources: Latvian authorities; and IMF staff estimates.

1/ Latest observations as indicated in the last column.

2/ Current account deficit plus amortization of external debt.

3/ Public sector covers general government.

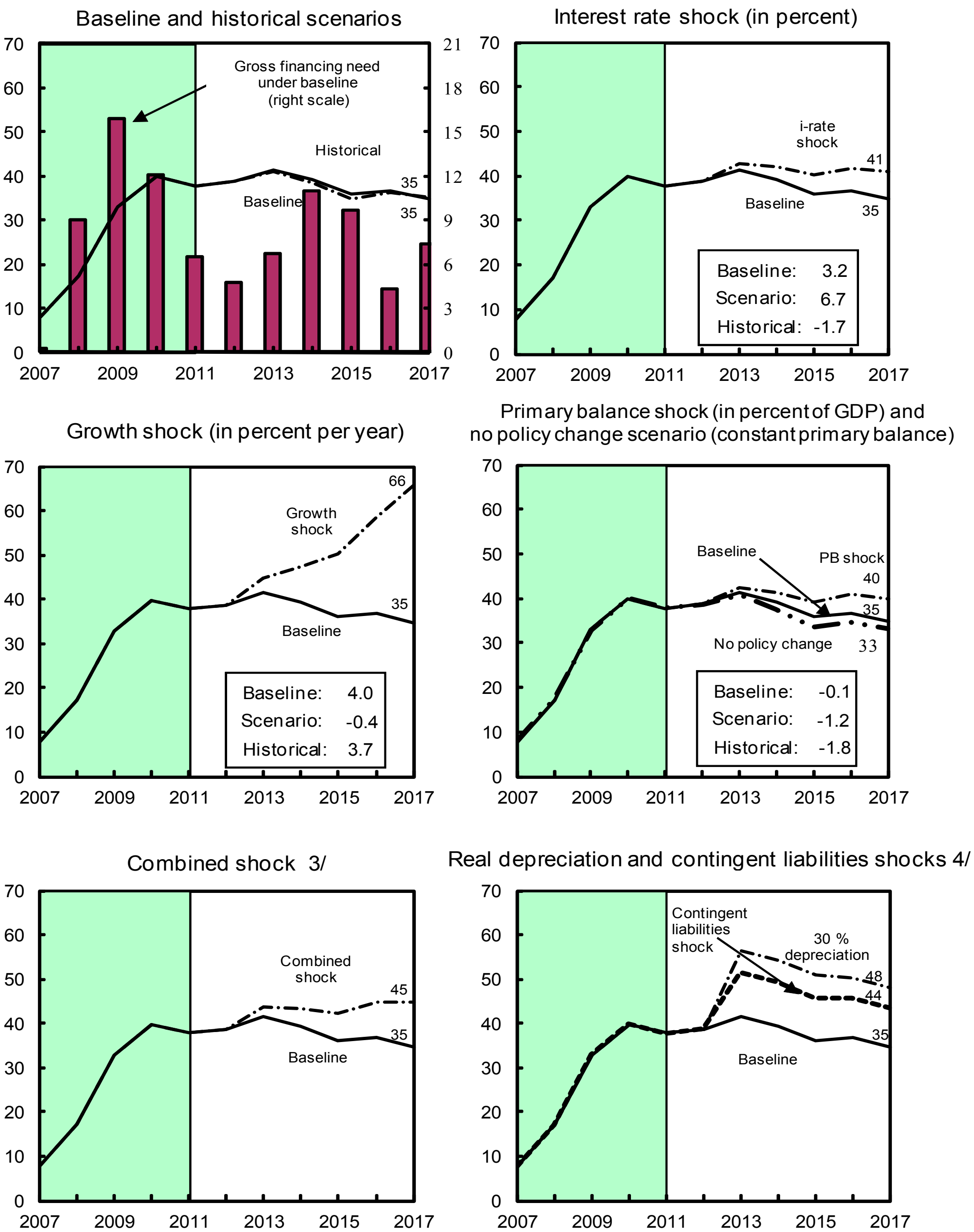
4/ Overall balance plus debt amortization.

5/ Financial sector includes commercial banks.

6/ 90-days overdue.

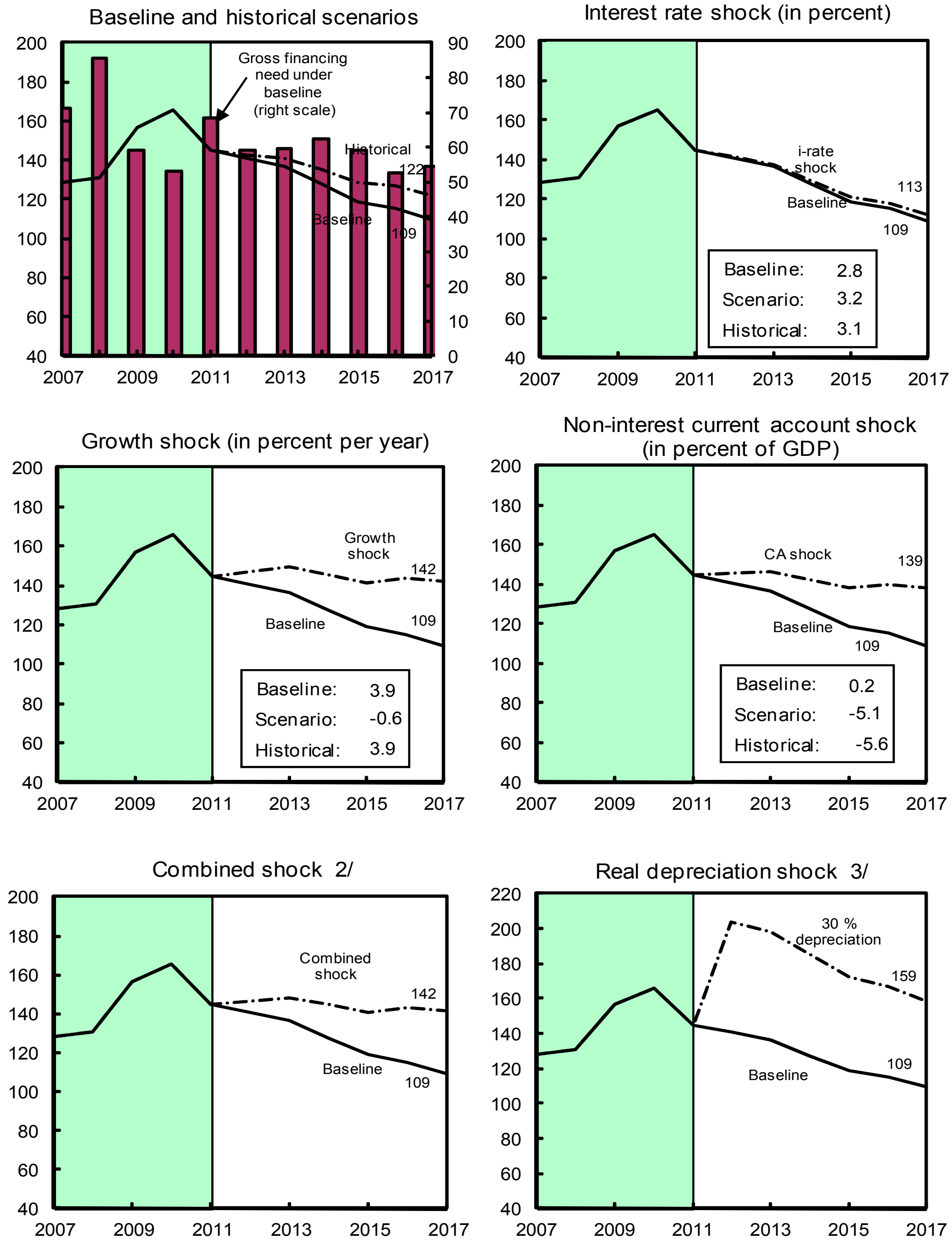
7/ Total loans less loans to the public sector and transit loans, provided to both residents and non-residents.

Figure 8. Latvia: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt 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 primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 9. Latvia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: IMF 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2012.

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IMF Executive Board Concludes First Post-Program Monitoring Discussions with the Republic of Latvia

On July 11, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the First Post-Program Monitoring Discussions with the Republic of Latvia.[1]

Background

Latvia's economy has been recovering strongly since 2010, following the deep downturn in 2008–09. Real GDP growth of 5.5 percent in 2011 was underpinned by export growth and a recovery in domestic demand. The growth momentum has continued into 2012 despite deteriorating external conditions, and the economy is expected to expand by 3.5 percent this year. The unemployment rate has receded from its peak of more than 20 percent in 2010, but remains high at more than 16 percent. Half of the unemployed have been out of work for more than a year. Higher commodity prices pushed headline inflation to 4.2 percent in 2011, but core inflation remains low and headline inflation is projected to decline to 2.4 percent in 2012. The current account balance, which swung from a pre-crisis deficit of more than 20 percent of GDP to significant surplus in 2009, was contained to a deficit of 1.2 percent of GDP in 2011. Gross external debt declined to 145 percent of GDP in 2011 from its peak of 165 percent in 2010, while net external debt stands at 45 percent of GDP.

Latvia successfully completed its EU-IMF-supported program in December 2011. As part of the program, Latvia implemented fiscal consolidation measures of more than 15 percent of GDP. As a result, the general government deficit has declined from nearly 10 percent of GDP in 2009 to 3.5 percent of GDP in 2011. This year, strong revenue growth is expected to reduce the fiscal deficit to around 2 percent of GDP, while general government debt is expected to stabilize

[1] Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

around 40 percent of GDP. Although the Latvian parliament approved a one percentage point cut in VAT effective July and cuts in personal income tax rates for 2013–15, the approval of the Fiscal Compact is evidence of the authorities' continued commitment to budget discipline.

Strong program implementation has facilitated a return to market financing, with Latvia issuing $1.5 billion in benchmark international bonds since mid-2011. All three major rating agencies now rate Latvia as investment grade.

The financial sector is well capitalized and has returned to profitability, but foreign-owned banks continue to deleverage. The authorities have made progress with the sale of the commercial part of Mortgage and Loan Bank (MLB) and have taken steps to strengthen financial sector supervision in the wake of the November 2011 failure of Latvijas Krajbanka.

Executive Board Assessment

Executive Directors welcomed Latvia's economic recovery since the crisis. Growth has been strong, inflation is low, the budget deficit has declined steadily, and the foreign reserves position has strengthened. The authorities' determined policy implementation has facilitated Latvia's successful return to international capital markets and enabled it to move closer to euro adoption. Given the still existing challenges and vulnerabilities, Directors urged continued commitment to sound policies and implementation of structural reforms in order to boost productivity, enhance competitiveness, and reduce unemployment and poverty.

Directors commended the remarkable fiscal consolidation and emphasized the need for continued prudence to maintain fiscal and debt sustainability. They welcomed ratification of the EU Fiscal Compact, which demonstrates the authorities' commitment to long-term fiscal stability. Directors generally concurred that the recently adopted legislation to cut the personal income tax and VAT rates might be hard to reconcile with the need for modest spending increases and will have an impact on the current account deficit. They stressed that any major changes to tax code or spending increases should be consistent with the Fiscal Compact and the medium-term framework, and should be introduced at the time of the annual budget. Directors also encouraged the authorities to identify offsetting measures and recommended raising the tax-free income threshold and introducing tax credits for new hires.

Directors underscored the need to tackle Latvia's high unemployment rate. They urged the authorities to build a strong social safety net, while strengthening incentives to return to work, and to improve education to reduce skill mismatches. Directors cautioned that further decentralizing funding of social assistance and cuts in social expenditure could worsen inequality and undermine growth. They saw merit in postponing changes to social assistance until the joint Ministry of Welfare and World Bank study of long-term unemployment is completed.

Directors noted that the financial sector is well capitalized and has returned to profitability. They welcomed the additional capital requirements for banks reliant on non-resident business and the decision to strengthen supervision of correspondent accounts. Directors encouraged the supervisory authorities to work closely with their Nordic counterparts to ensure deleveraging proceeds gradually. Issuing international bonds ahead of time could also help guard against external risks.

Directors encouraged the authorities to meet the Maastricht criteria sustainably and to introduce well-prioritized structural reforms. They stressed that measures to boost productivity will be critical to ensure that Latvia remains competitive under its fixed exchange rate regime and later with the euro. The focus should be on increasing product market competition, improving governance, including in state-owned enterprises, and strengthening the legal system to encourage investment.

Latvia: Selected Economic Indicators, 2009–12

	2009	2010	2011	2012 Proj
Real Economy				
Real GDP (percentage change)	-17.7	-0.3	5.5	3.5
HICP inflation (percentage change, period average)	3.3	-1.2	4.2	2.4
Unemployment rate (period average, percent) 1/	17.3	19.0	16.4	15.4
Nominal GDP (billions of lats)	13.1	12.7	14.2	14.9
Public Finance 2/	(percent of GDP, unless otherwise indicated)			
Total Revenue	36.2	36.2	35.9	37.2
Total Expenditure	43.3	42.6	39.0	38.6
Basic fiscal balance	-7.1	-6.4	-3.1	-1.4
ESA balance	-9.7	-8.2	-3.5	-2.0
General government gross debt	32.9	39.9	37.8	38.7
Balance of payments				
Trade balance	-7.1	-7.1	-9.8	-11.4
Current account balance	8.7	3.0	-1.2	-2.2
Gross official reserves (billions of euros)	4.8	5.8	4.9	5.1
Gross external debt	156.8	165.6	144.8	140.7
Net external debt 3/	58.8	53.6	44.8	39.0
Exchange rates				
Lats per U.S. dollar (average)	0.506	0.530	0.501	...
Lats per euro (average)	0.704	0.704	0.697	...
REER (period average; CPI based, 2000=100)	110.2	103.6	103.8	...
(percent change, + denotes appreciation)	5.5	-6.0	0.2	...
Money and Credit				
Broad money (percentage change)	-1.9	9.8	1.5	7.9
Credit to private sector (percentage change)	-6.9	-8.4	-7.4	-3.8
Treasury Bill rate (365 days, eop, percent)	10.2	1.8	1.7	...
Money market rate (one month, eop, percent, annualized)	2.7	0.6	1.1	...

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

1/ LFS definition. Revised by +0.8 percentage points in 2011 in compliance with population census; data before 2011 has not been revised yet.

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

3/ Gross external debt minus gross external debt assets.

Statement by Mr. Benny Andersen, Executive Director for Latvia and Mr. Gundars Davidsons, Advisor to Executive Director July 11, 2012

1. The economy is rebounding from the recession

Latvia's economy is recovering strongly, though recent trends, shaped by external demand dynamics, suggest a gradual slowdown. The current government, led by the same Prime Minister who started off the process of consolidation, can now reap the harvest sown in 2009. All through 2011, the GDP, government revenues and export figures continued to surprise on the upside. After a 5.5 percent GDP growth in 2011, a 6.9 percent growth number in the first quarter of 2012 kept the economy at the top of the list of EU growth performance. The conservative end-2011 projections did not materialize and the export sector demonstrated a remarkable resilience through the first months of 2012. The recent trends in exports figures, however, point to a slowdown in the second half of 2012. Due to a rebound in investment, the net export has become negative, but a significant widening of the current account is not expected. Ongoing deleveraging and subdued real estate sector will make it difficult to re-run the 2004-2007 experience in the foreseeable future.

The roots of the strong recovery can be tracked down to the frontloaded fiscal adjustment in 2009. The Latvian authorities believe that the speed of adjustment was the key reason behind the success of Latvia's Stand-By Arrangement. The decisive actions taken in the summer of 2009, when the authorities chose to follow a more frontloaded fiscal adjustment path than the "program scenario" suggested in the First Review report, pulled the Latvian economy out of a tailspin. Some sectors of the economy, like manufacturing exports, returned to growth already at the end of 2009 and continued to grow at impressive rates over the next two years. However, weak confidence, nourished by the doomsday scenarios prophesied by influential economic pundits and investment bank analysts delayed the rebound in investment and domestic demand. Presently, the economy is experiencing a belated revival of those GDP components, finally contributing to the output growth.

The Latvian authorities believe that their experience could help to better understand the process of adjustment under a fixed exchange rate. It seems that at the outset of the program, neither the economic nor political dynamics of adjustment under a fixed exchange were sufficiently understood. The authorities believe that the quality of future programs would benefit from more in-depth studies of the assumptions and models behind the sizable forecast errors of many parties making projections or just commenting on Latvia's economy in 2009 and 2010. We are pleased to note that the recent joint IMF/Bank of Latvia conference reviewing Latvia's experience has been successful in provoking some discussion of those issues.

2. Euro adoption on January 1, 2014 remains the authorities' strategic goal

The authorities expect to meet the Maastricht fiscal deficit criterion confidently. The 2011 fiscal deficit figures came in considerably below the previously set target. For 2012, both the authorities and staff forecast a deficit figure of 2 percent, well below the 3 percent Maastricht criterion, though strong revenue performance in the first half of the year indicates that the final deficit figure could be even lower.

The authorities are taking steps to establish a framework safeguarding fiscal sustainability. In May, the EU Fiscal Compact was ratified by parliament. The authorities are on their way to make the Fiscal Responsibility Law (FRL), incorporating key features of the Fiscal Compact, operational by the end of October 2012. This will ensure that starting from the 2014 – 2016 period the budget Framework Law will be drafted in accordance with the FRL rules.

In line with their obligations under the EU Fiscal Compact, the Latvian authorities intend to reduce the structural deficit by 0.5 percent of GDP annually. Mindful of the fiscal effect of the cuts in personal income tax (PIT) the Latvian authorities have already identified some offsetting measures; first, real estate property reform, which is expected to be completed in 2013 and, as suggested by staff, will include a substantial improvement of property valuation; and second, excise taxes on tobacco will be raised and brought in line with EU minimal requirements. The government is committed to initiate additional measures, if necessary, to ensure that the fiscal deficit remains in line with the planned path of the structural deficit. With regards to the PIT cuts, we note staff's preference for raising the PIT allowance threshold. The authorities have always carefully considered the equity dimension of their decisions, which is also reflected in the fact that the Gini coefficient has improved during the crisis.[1] Nevertheless, the final choice was strongly advocated by members of the business community who believed that cutting the PIT rate would allow them to attract and retain better-qualified employees.

Inflation remains on a downward path, in line with the authorities' plans. The peg has helped to keep the inflation rate low, and with the headline inflation at 2.2 percent and core inflation at 1.1 (May figures), the Maastricht criterion seems to be within reach. We agree with staff that there is some uncertainty surrounding the choice of the Maastricht inflation and interest rate reference values. Nevertheless, since the authorities are confident that the European Commission and the ECB will apply Maastricht criteria in an economically meaningful manner, they also believe that Latvia's prospects of meeting the criteria are good.

3. Strengthening of the financial supervision is underway

The Financial and Capital Market Commission is taking measures to minimize the risks associated with the non-resident banking business model. While recognizing the problem, the authorities believe that the risk is not as significant as perceived by staff. After the demise of Parex, the non-resident banking sector is largely isolated from the rest of the economy. Their usual business model involves a bank, not active in the domestic market, attracting deposits from non-residents and mostly investing in high quality and high liquidity assets

[1] Source: *Eurostat*

abroad. Recognizing that the quality of those assets is difficult and time-consuming to verify, the authorities are introducing measures to limit the risks. They have already introduced additional capital requirements for banks focused on non-residents. The New Liquidity Framework, in particular the Liquidity Coverage Ratio (LCR), will impose strengthened requirements for liquidity positions of banks by preventing excessive maturity mismatches and encouraging the diversification of funding. Close monitoring of LCR including in each significant currency, and monitoring of the Net Stable Funding Ratio (NSFR) will begin in 2013.

In order to ensure that the process of deleveraging proceeds in an orderly manner, the authorities intend to cooperate closely with the Nordic supervisory authorities. As staff, we expect the deleveraging process to continue. The framework of supervisory colleges as well as other Nordic Baltic cooperation structures will be instrumental in facilitating the process of cooperation.

The authorities are pleased to have successfully found buyers for a large share of the Mortgage and Land Bank commercial assets. The authorities do not intend to sell the remaining assets at prices significantly below market value, and if no reasonably priced offer is received, the assets will be transferred to the Latvian Privatization Agency for a more gradual workout.

4. Looking forward, tackling the high unemployment rate and improving competitiveness are authorities' key priorities

A significant reduction in the level of unemployment can only be achieved with the help of properly targeted labor market measures. The unemployment rate remains high. Paradoxically, the rate of employment is also high, exceeding pre-bubble figures before 2003.[2] The bubble has induced a permanent rise in the participation rate and presently the economy is struggling to absorb this surplus labor, which has been activated and consequently released by the trade and real estate related sectors. The Latvian authorities are currently looking into policy options to stimulate employment, and the joint diagnostic report by the World Bank and Ministry of Welfare is expected to provide the necessary analytical underpinning for future decisions.

We concur with staff that future competitiveness improvements will depend on productivity-enhancing reforms. The authorities do not expect the near 7 percent output growth rates to last. Deceleration in export markets will inevitably slow output growth. Continued deleveraging and sluggish credit growth will continue to weigh on domestic demand, leaving productivity improvements in tradable industries as the key source of growth.

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[2] Source: *Eurostat*

Education and governance reforms, increasing product market competition, and strengthening the legal system will be essential to keep the economy competitive. Staff's suggestions on productivity-enhancing reforms are very much in line with the authorities' views. Some necessary, though probably not sufficient, steps in reforming those areas have already been made. An outside evaluation of the higher education study programs and science performance is already ongoing. With regards to the product market competition, the authorities have strengthened the Competition Council: a new head of the Council was recently appointed and it seems that the increased payroll has helped to slow staff turnover. Improving the management of state owned enterprises is another priority. It is expected that a new system of management of State-owned-enterprises will become operational in the beginning of 2013. Those reforms are the first steps in building a more dynamic and competitive economy.