Latvia

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The economic downturn has worsened several country risk metrics over the past year but we expect that the worsening is largely temporary. The EU's recovery package has improved the medium-term growth prospects which will help put the relatively low government debt on a downward trajectory again. Meanwhile, most aggregate banking sector risk metrics have continued to improve.

Country Risk Analysis

Recent economic developments

Economy crawling back after 2020 slowdown. Following a slowdown in growth in 2019, real GDP contracted 3.6% last year, largely due to very weak household spending. Although the slowdown was significant in a historical perspective it was much less severe than initially feared and milder than in many other European economies. This was at least partly due to more resilient exports than expected. A new wave of infections in 2021 halted an ongoing recovery and GDP fell 2.2% yoy in the first quarter according to the first estimate.

Unemployment rose. The economic contraction raised the unemployment rate to 8.1% (from 6.3%) on average for the year. Similar to the slowdown in growth, this was a smaller rise than during the global financial crisis. Although the rate probably peaked in early 2021, it should remain high in the near-term.

Swift wage growth but virtually flat inflation. The cooling of the labour market was reflected in a slower pace of wages hikes. Still, average wages rose 6.2%, only slightly less than in 2019. The high increases probably to a large extent reflect an ongoing shift in employment towards higher value-added sectors. In general, wage levels are still low in an EU perspective. On the inflation front, wage hikes were overshadowed by lower energy prices and cooling economic activity, resulting in price rises of 0.2% last year. Following negative inflation since August, prices rose recently. A hike in minimum wages in 2021 should contribute to a continued steady pace of overall wage increases.

Current account returned to a surplus. The smaller than expected fall in exports is partly a reflection of strong and competitive manufacturing exports. Although exports fell, imports fell even more on the back of the collapse in household spending. A positive trade balance thus helped to shift the current account balances into positive (3% of GDP). Preliminary data suggests that the country gained export market shares last year, alleviating possible fears of a loss of competitiveness.

External debt rose as the government borrowed. Gross external debt which has fallen markedly over the past decade rose last year as the government borrowed abroad. Meanwhile, the private sector continued to deleverage. The debt/GDP ratio at about 115% of GDP is high compared to most country risk peers. Most observers expect that the rise was temporary and that the downward trend will continue in 2021. In net nominal terms external debt continued to decline in 2020.

Banking sector showed resilience in the downturn. Solid fundamentals of the banking system enabled it to whether the downturn well. Aggregate vulnerability indicators reflect capitalization and liquidity at historically high levels while the share of non-performing loans has fallen over the past year. The share of non-resident deposits of total banking deposits also continued down. This is important as it reduces some of the risks relating to AML/CTF issues in the sector.

Economic policies

Budget deficit was moderate but could rise further in 2021. Latvia has a strong fiscal framework and a long track record of sticking to strict fiscal targets. With the economy contracting less than feared, the impact on public finances has also been more moderate than expected. Relatively resilient government revenues helped limit the rise in the general government deficit to 4.5% of GDP. Extended support to households and businesses in 2021 will keep the deficit elevated. The 2021 budget had an initial 3.9% of GDP deficit target. Since then, however, substantial further stimulus measures have been announced leading SEB to expect a deficit closer to 8% of GDP.

Government debt higher for a few years, but still affordable. A low initial level of indebtedness and the ECB's ongoing asset purchases has allowed the government to finance its expansionary policies at historically low costs and at long maturities. Both domestic and foreign sources have been sought, including the issuance of a Eurobond. Government debt rose to 43.5% of GDP (Maastricht definition) last year. This is still lower than the limits set by the Fiscal Discipline Law (60%) and lower than among most peers. Debt affordability ratios such as interest payments as a share of revenues are also lower than most peers. On the other hand, contingent liabilities stemming from the debt of state-owned enterprises such as AirBaltic are non-negligible.

Sovereign rating agencies keep rating. One of the major sovereign credit rating agencies introduced a negative outlook at the onset of the pandemic in 2020 but reversed it to stable later in the year as the economy showed resilience and uncertainty diminished. The other agencies have remained on the sidelines.

Economic and institutional factors

Institutions and governance are broadly in line with country risk peers. Most World Bank indicators of governance are broadly in line with risk class peers, although corruption related indicators tend to be weaker. On the latter point, most indicators have largely been moving sideways in the past few years. Institutional quality is also at par with most peers with Latvia ranking 47 of 141 economies in World Economic Forum's index measuring institutional quality. As to the quality of the business climate, Latvia leads most country risk peers according to its ranking in the World Bank's Ease of Doing Business index. This being said, Latvia often compares unfavourably with risk class peers when it comes to the extent of the shadow economy. Although estimates relating to the size of the informal economy are subject to some uncertainty, we see it as a weakness when we assess the economy's resilience.

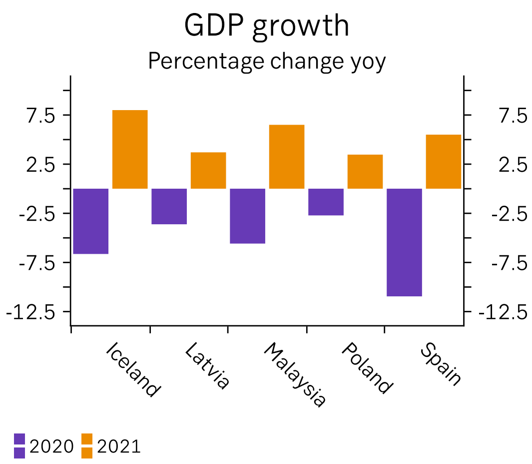
Income levels on the low side compared to country risk peers. Broad indicators of the level of human development are slightly weaker than in similarly rated economies. This is partly due to income levels. These are on the low side compared to country risk peers, despite relatively high growth rates in the past, and a continued convergence toward average nominal GDP per capita levels in the EU.

Political developments

Limited domestic political risk. Many observers characterize the political system as very fragmented with strong political divisions and frequent changes of government. Nevertheless, policy making is considered relatively effective which, for example, was demonstrated during the global financial crisis. A five-party coalition headed by New Unity (JV) is governing the country since 2019. Parliamentary elections are due in October 2022.

Outlook

Recovery in sight. The near-term economic outlook is attached with a high degree of uncertainty depending on the evolution of the pandemic and the speed of the vaccination process. So far Latvia's vaccination rate significantly lags regional peers. Nevertheless, we expect that GDP growth accelerates to 3.7% this year before gaining more than 5% in 2022. Household spending which dropped sharply last year is expected to provide a boost on the back of accumulated high savings and pent-up demand. The central bank recently hiked its growth forecasts but sees slightly lower growth in 2021 than us, although a more rapid pick-up in 2022. We expect a continued gradual convergence towards per capita income levels of the EU which would be consistent with a better country risk.



Source: SEB and Oxford Economics

Fiscal balances to improve in the medium term. Although the expected increase in the budget deficit in 2021 should push government debt to an all-time high level, the government's track record of fiscal prudence leaves us and most other observers confident that measures will be taken to put the debt ratio on a declining trend in 2022.

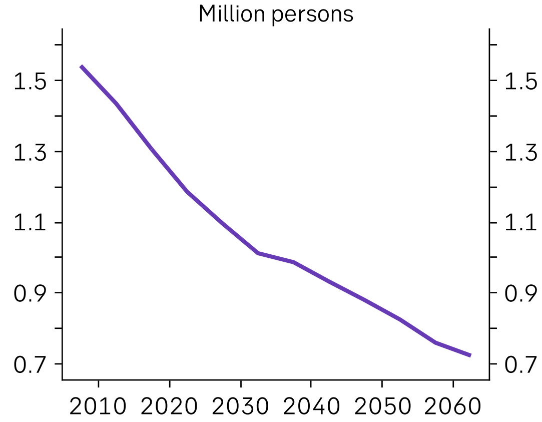
Ample EU funding to remain important fuel for growth. The flow of EU funding, an important fuel for investment activity, is expected to continue at solid levels in the medium term. Financing available under the Multiannual Financing Framework (MFF) for 2014-2020 still remains. In addition, contrary to previous expectations of lower EU funding for all three Baltic economies, Latvia will be eligible for significant amounts of grants also in the medium term under the new MFF and the EU's NGEU recovery package. Contrary to the EU's structural funds, the recovery facility, aimed mainly at investments in green and digital transitions, will not require any co-financing. Latvia has submitted a request for EUR 1.82 bn of the 2 bn in grants available under the recovery facility to support the recovery plan. The ultimate impact on economic growth will depend on the type of investments implemented. Some analysts have argued that Latvia's previous capacity to absorb EU funds and the size of the financing make it likely that the country could end up among the EU members that benefit the most from the support, growth-wise.

External risks: Geopolitical environment and recovery in foreign demand. A key external risk is the exposure to political and security risk in Latvia's geographical neighbourhood. Although any military intervention by Russia is considered a tail risk event, other forms of low intensity political pressures and cyber-attacks which destabilises the economy cannot be ruled out. A mitigating development is Latvia's increasing integration into EU and other multilateral cooperative frameworks such as the OECD. Another external risk to the growth outlook relates to the small size and openness of the economy. Although the export share of GDP at about 60% is lower than in Estonia and Lithuania, the economy is vulnerable to changes in global demand. In 2020, more than two thirds of exports went the EU while about 14% of exports were bought by Russia.

Decreasing and ageing population implies long-term risks. The population has continued to decline over the past few years, despite some decline in net migration. The decline in the overall population in 2019 was among the largest in the EU percentage wise. Some projections point to a decline in the working age population by about 40% by 2060. All else equal, this would reduce potential economic growth and hold back per capita incomes. The simultaneous ageing of the population adds to this challenge by weighing on productivity and on public finances. Policies aimed at raising employment could milden the impact of the declining work age population. However, any meaningful improvement would most likely require turning the net migration trend. Developments in Estonia seem to indicate that net migration declines as the country's income level rises.

Working age population (15-64)

Million persons

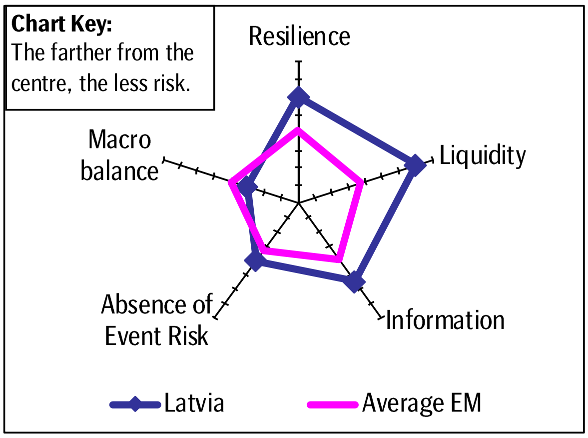


Source: United Nations Department of Economic & Social Affairs (UNDESA)

Maintaining competitiveness is another challenge. The shrinking labour supply is expected to lead to a tightening of labour market conditions, including to higher wage growth, when the economy has firmly recovered from the downturn. In order to maintain competitiveness and hence export growth, this will require a pick-up in productivity growth, for example that new jobs are increasingly being created in higher value-added sectors. With the need for raising productivity in mind, observers are likely to keep an eye on the quality of the EU funded investments planned under the NGEU in the coming years.

Latvia: Risk Profile

Key figures	**2021**
Population (mn)	1,9
GDP/capita (USD)	20 026
Real GDP (% chg)	3,7
Inflation (%)	1,7
Current Account Balance (% of GDP)	0,8
Reserves/imports (months)	1,9
Budget balance (% of GDP)	-8,1
Government debt (% of GDP)	48



External Ratings:
Fitch: A- / Neg.
Moody's: A3 / Stable
S&P: A+ / Stable

Peers:
Iceland
Spain
Malaysia

Graph: Resilience to shocks stem from a favourable business climate, strong political institutions, and prudent fiscal and monetary policies. Although event risk has risen it still compares favourably to other EMs.

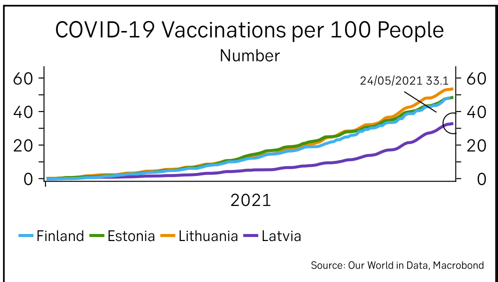
Latvia: Key Economic Indicators

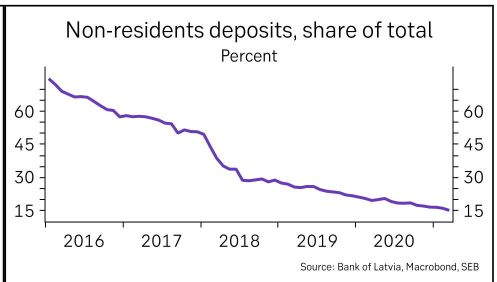
Macroeconomic	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
GDP real (% chg)	4,4	4,2	2,0	-3,6	3,7	5,2	3,1	2,9
GDP (USD bn)	30,5	34,4	34,1	33,5	37,5	40,1	43,0	46,1
GDP/capita (USD)	15 734	17 918	17 867	17 709	20 026	21 553	23 361	25 245
Investments/GDP (%)	20,4	21,1	20,6	21,5	20,5	20,1	19,7	19,3
Trade/GDP (%)	129	120	125	123	119	117	113	109
Money & Prices								
CPI inflation (%)	2,9	2,5	2,8	0,1	1,7	2,4	1,9	2,0
Money, M2 (% change)	3,4	14,5	6,2	13,7	8,9	6,0	5,2	4,9
Interest rates (%)	-0,3	-0,3	-0,4	-0,5	-0,5	-0,4	-0,4	-0,2
Exchange Rate (USD)	0,89	0,85	0,89	0,88	0,85	0,85	0,83	0,81
Oil price (Brent, USD)	54	71	64	42	67	62	60	61
Government Finances								
Budget balance/GDP (%)	-0,8	-0,7	-0,6	-4,5	-8,1	-3,7	-0,9	-0,9
Govt debt/GDP (%)	40,0	37,2	36,9	43,5	48,2	47,2	43,6	42,1
Balance of Payments (USD bn)								
Current account	0,4	-0,1	-0,2	1,0	0,3	0,6	0,6	0,6
(% of GDP)	1,3	-0,3	-0,7	3,0	0,8	1,4	1,4	1,4
Exports of goods	19,4	20,2	20,7	20,1	21,7	23,2	24,1	24,8
Imports of goods	19,9	21,2	21,8	21,1	22,8	23,8	24,5	25,3
Other current account flows	0,9	0,8	0,9	2,0	1,4	1,1	1,1	1,1
Net FDI	0,6	0,7	1,0	1,0	1,1	1,1	1,2	1,3
Debt service requirement	6,2	6,6	6,4	6,6	6,7	6,8	7,1	7,3
Net other capital flows	1,9	3,0	3,7	1,7	2,6	8,4	9,0	9,9
External Debt & Liquidity (USD bn)								
Reserves	4,2	3,9	4,0	4,7	6,1	6,8	7,7	8,6
Gross external debt	36,6	37,2	37,9	38,6	39,2	39,8	40,4	41,0
o/w short term debt	11,1	11,2	11,4	11,6	11,8	12,0	12,2	12,4
percent of GDP	120	108	111	115	104	99	94	89

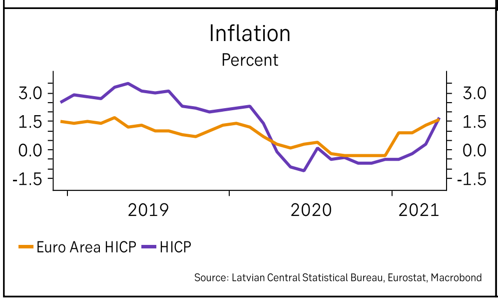
Source: Oxford Economics and SEB.

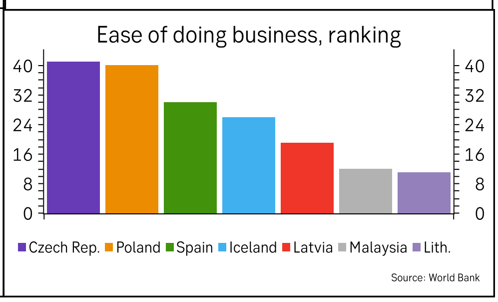
Rating history (end of year)				
Fitch	A-	A-	A-	A-
Moodys	A3	A3	A3	A3
S&P	A-	A	A	A+

Other:
Type of government: Parliamentary democracy
Next elections: Presidential 2023, Parliamentary 2022
Other:
Latest PC deal
Latest IMF arrangements: 2008 SBA, concluded 2011









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