Republic of Latvia: 2022 Article IV Consultation-Press Release and Staff Report

INTERNATIONAL MONETARY FUND

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REPUBLIC OF LATVIA

August 2022

2022 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2022 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on June 15, 2022, with the officials of the Republic of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 12, 2022.
- An **Informational Annex** prepared by the IMF staff.

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

Selected Issues

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

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Washington, D.C.

IMF Executive Board Concludes 2022 Article IV Consultation with the Republic of Latvia

FOR IMMEDIATE RELEASE

Washington, DC – **August 23, 2022:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia and endorsed the staff appraisal without a meeting.

Latvia managed the COVID-19 shock relatively well overall. With the improved health conditions, real GDP rebounded by 4.5 percent in 2021, thus exceeding its pre-crisis level, thanks to strong consumption and investment supported by significant fiscal support. Economic activity continued to be resilient during the first quarter of 2022, surprising on the upside (6.7 percent year-on-year), as households drew down savings accumulated during the pandemic to finance private consumption.

Latvia’s economy is vulnerable to the fallout from the war, although its exposures have weakened appreciably in recent years. Vulnerabilities come mainly from trade exposure to Russia, notably Latvia’s high dependence on imported Russian gas until recently. International sanctions imposed on Russia and Belarus create additional uncertainty. The spillover effects from the war are already manifested in spikes in energy and food prices, supply disruptions, refugee inflows, and increased budgetary pressures. The government has also provided crucial support (including access to social benefits, education, housing, and language training) for the almost 33,000 Ukrainian refugees in Latvia. Although the refugee influx has fiscal costs, it could benefit Latvia’s economy by increasing labor supply.

Growth is projected to slow to 2.5 percent, or about 1½ percentage points lower than the forecast before the war, as the negative confidence shock reduces private investment and trade, and high inflation weighs on private consumption growth. In the medium-term private sector confidence is expected to be lifted, causing a recovery in economic growth. Economic activity is not expected to be affected by interrupted gas supplies, as the government has secured gas reserves. Inflation is forecasted to remain elevated at 14.5 percent in 2022 (period average) due to high energy and food prices and continued supply bottlenecks. Price pressures are expected to ease in the medium term as oil, gas, and food prices decline. The balance of risks is tilted to the downside. Further intensification of the war in Ukraine and stricter sanctions against Russia could lead to yet more prolonged disruptions in Latvia’s trade and finance, as well as a disruption of gas supplies. Inflation could remain elevated for longer if energy and food price shocks and supply constraints persist. An upward pressure on wages could trigger a wage-price spiral and lead to a further deterioration in external competitiveness. On the upside, faster economic recovery could be supported by a quick

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

resolution to the war, easing of supply bottlenecks, and swift implementation of structural reforms.

Executive Board Assessment[2]

The economy fared relatively well during the pandemic. With the improved health conditions, real GDP rebounded in 2021, exceeding its pre-crisis level thanks to strong consumption and investment, as well as significant fiscal support.

However, the war in Ukraine is having major repercussions for Latvia's economy. Vulnerabilities come mainly from trade exposure to Russia, notably Latvia's high dependence on imported Russian gas until recently. The spillover effects from the war are already manifested in spikes in energy and food prices, supply disruptions, refugee inflows, and increased budgetary pressures.

The war in Ukraine constitutes the dominant downside risk to Latvia's economic outlook. Growth is projected to slow in 2022, as high inflation starts to weigh on private consumption and the negative confidence shock reduces private investment. Inflation is forecasted to remain elevated due to continued high energy and food prices and lingering supply bottlenecks. Average inflation is projected to peak this year before declining in 2023. In the medium term, output is projected to rebound somewhat, supported by higher domestic demand and an increase in EU-financed capital spending. Key downside risks include disruptions of gas supplies and a further surge in energy and food prices, which would hurt output and intensify inflationary pressures.

Fiscal policy should be flexible and stand ready to respond to the changing circumstances. Given the unusually high uncertainty, fiscal policy must be flexible in the short term. Notably, automatic stabilizers should provide a first line of defense, while fiscal policy remains attuned to short-term developments. Any revenue overperformance owing to higher inflation should be saved under the baseline scenario. If the economic environment worsens, high-quality discretionary spending should be used to provide fiscal stimulus and protect the vulnerable. Contingency plans are advisable in case the crisis is more prolonged and the need for policy response is larger than envisaged.

Fiscal support to alleviate the impact of high energy prices should be well-targeted. A large portion of the support already provided was not targeted. Scarce public resources should be used to target energy support measures to the most vulnerable. Broad-based measures not only reduce available resources that could otherwise be used to support the most vulnerable groups, but also add to inflationary pressures and discourage conservation efforts. Over the medium term, it is advisable to allow the pass-through of international energy prices to domestic consumers and adjust utility prices in line with the change in costs: higher prices will encourage necessary innovation and investment to boost energy efficiency.

Although the financial sector has so far been resilient to the pandemic, the spillovers of the war warrant close monitoring. The banking sector entered the crisis with comfortable capital and liquidity positions. However, with the war in Ukraine, the real-financial feedback

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

loop requires close monitoring. Supervisors should take a risk-based approach, conduct relevant stress tests, and prepare contingency plans.

Corporate recapitalization and an improved insolvency regime could help revive bank credit. The authorities should focus on assessing the size of the corporate equity gap and developing policy options to support SMEs and micro firms. The implementation of EU Restructuring Directive needs to be expedited.

Macroprudential policy should stand ready to respond to changing housing market conditions. Given the new risks caused by the war, the frequent reviews of macroprudential measures should continue to ensure the right balance between financial stability and the need for credit in the economy.

The authorities should continue to build on their commendable progress in strengthening their AML/CFT framework. They rightly placed a renewed emphasis on emerging risks (including sanctions evasion) and enhanced risk-based supervision of banks. The FCMC should expedite the refocusing of the business models of the banks formerly servicing foreign clients.

The highly uncertain environment calls for strengthened management of the RRP. The more protracted disruptions to global supply chains and the rising costs of materials will likely complicate the execution of the RRP. The government should, therefore, devise strong contingency plans. Latvia’s structural transformation hinges on the timely achievement of the RRP’s milestones and targets.

Measures to enhance energy security should be compatible with Latvia’s green transition goals. In the near term, stepping up crisis preparedness and contingency planning should be a top priority. The authorities have already implemented measures to ensure uninterrupted gas supplies in the near term. In the medium term, diversification of supplies, and boosting investment in clean energy would significantly enhance energy security. The authorities should avail themselves of the support available under NGEU and RePowerEU to facilitate this process.

Adverse demographic developments and skill mismatches call for a comprehensive response. The declining population and shortages of qualified workforce are viewed as the main constraints to long-term growth. The use of targeted labor market policies should be combined with the reforms of the business environment. Over time, the focus should gradually shift to facilitating the reallocation of workers to new jobs.

Efforts to reduce inequality and promote social inclusion should continue. The authorities are taking a range of measures to improve outcomes, along with reforms and investments to improve education and infrastructure in the regions, with support from the RRF. Adjustments to the pension system should be accompanied by increased investment in the health sector. In this regard, forceful implementation of the new health care strategy could help.

Pressing ahead with the digitalization agenda is key to boosting productivity and innovation. Efforts should be targeted at improving the digital infrastructure, building human capacity, and creating an environment through regulations and incentives.

Latvia: Selected Economic Indicators, 2019–23

	2019	2020	2021	2022	2023
				Proj.	
National Accounts					
Real GDP	2.5	-3.8	4.5	2.5	2.7
Private consumption	0.2	-7.4	4.8	2.8	3.0
Public consumption	3.4	2.6	4.4	2.0	3.0
Gross capital formation	10.1	-0.8	23.6	-4.4	2.9
Gross fixed capital formation	6.9	0.2	2.9	0.9	4.0
Exports of goods and services	2.1	-2.2	6.2	-1.8	3.5
Imports of goods and services	3.0	-2.5	13.5	-2.8	3.8
Nominal GDP (billions of euros)	30.6	29.5	32.9	38.0	41.8
GDP per capita (thousands of euros)	16.0	15.4	17.4	20.1	22.2
Savings and Investment					
Gross national saving (percent of GDP)	22.6	24.6	24.3	23.5	23.1
Gross capital formation (percent of GDP)	23.3	21.7	27.2	25.6	25.1
Private (percent of GDP)	19.3	17.4	23.3	21.0	21.0
HICP Inflation					
Period average	2.7	0.1	3.2	14.5	7.5
End-period	2.1	-0.5	7.9	16.1	3.9
Labor Market					
Unemployment rate (LFS; period average, percent)	6.3	8.1	7.6	7.4	7.2
Real gross wages	4.3	6.1	8.2	-7.0	-1.3
Consolidated General Government 1/					
Total revenue	37.2	38.5	38.3	35.8	35.9
Total expenditure	37.6	42.3	43.8	41.4	38.2
Basic fiscal balance	-0.4	-3.8	-5.6	-5.6	-2.4
ESA balance	-0.6	-4.5	-7.3	-6.2	-2.4
General government gross debt	36.7	43.3	45.7	45.5	43.4
Money and Credit					
Credit to private sector (annual percentage change)	-2.3	-4.4	11.9	...	...
Broad money (annual percentage change)	6.0	-3.9	11.6	...	...
Balance of Payments					
Current account balance	-0.7	2.9	-2.9	-2.2	-2.0
Trade balance	-8.6	-5.1	-7.4	-13.8	-6.7
Gross external debt	116.8	124.8	112.0	103.8	97.5
Net external debt 2/	17.9	13.6	11.8	12.1	12.9
Exchange Rates					
U.S. dollar per euro (period average)	1.12	1.14	1.18	...	...
REER (period average; CPI based, 2005=100)	122.5	124.2	124.7	...	...
Terms of trade (annual percentage change)	0.9	2.9	1.5	-0.6	0.2

Sources: Latvian authorities; Eurostat; and IMF staff calculations.
1/ National definition. Includes economy-wide EU grants in revenue and expenditure.
2/ Gross external debt minus gross external assets.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

July 12, 2022

KEY ISSUES

Context. The economy fared relatively well during the pandemic, but the war in Ukraine is another major shock. The key vulnerabilities are Latvia's significant reliance on imported gas from Russia until recently, the impact of high international energy prices on inflation and economic activity, and refugee inflows. Thus far, almost 33,000 refugees have entered Latvia. Parliamentary elections later this year may put pressure on the government budget.

Outlook and risks. The war will negatively affect both potential and actual growth with the output gap remaining negative. Growth in 2022 is now projected at 2.5 percent, or about 1½ percentage points lower than the forecast before the war started. Inflation is forecasted to persist due to high energy prices and continued supply bottlenecks. In the medium-term, output is expected to rebound, supported by higher domestic demand and an increase in EU-financed capital spending.

Key Policy Recommendations

- **Fiscal policy:** Fiscal policy should be flexible and stand ready to respond to changing circumstances. Targeted, temporary, and timely support should be provided to the most vulnerable individuals and viable firms to support the recovery. Also, planned investment under the Recovery and Resilience Plan (RRP) should be accelerated to boost growth and productivity.

- **Financial sector policies:** Close monitoring of spillovers from the war should continue, supported by risk assessments and tailored stress tests. Reforms to bolster sound credit provision to the economy need to advance further. The authorities should continue to strengthen the AML/CFT framework.

- **Structural policies:** Labor market policies should aim to reduce skill mismatches and facilitate job creation and reallocation. Reforms in digital transformation should be advanced to boost productivity and growth. Investment in energy security and digital and green technologies will help foster a sustainable recovery and mitigate scarring from the war.

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

Discussions were held in Riga during June 1–15, 2022. The team comprised Bernardin Akitoby (head), Bogdan Lissovolik, Keyra Primus, and Rossen Rozenov (all EUR) and Carlos Acosta (LEG). Ms. Allika (OED) also joined the discussions. Ritzy Dumo, Rafaela Jarin, and Sadhna Naik supported the mission. The mission met with Bank of Latvia Governor Kazāks, senior representatives of the Ministry of Finance, other senior officials, trade unions, and private sector representatives.

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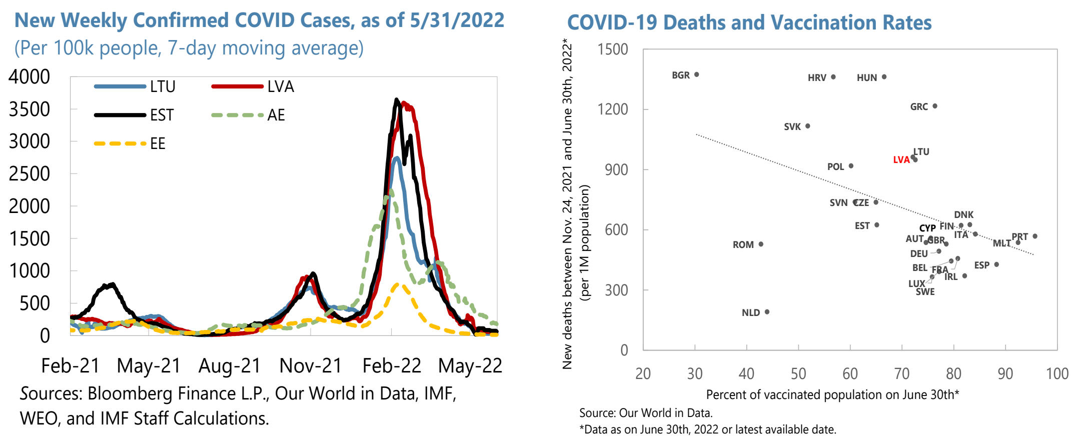
CONTEXT

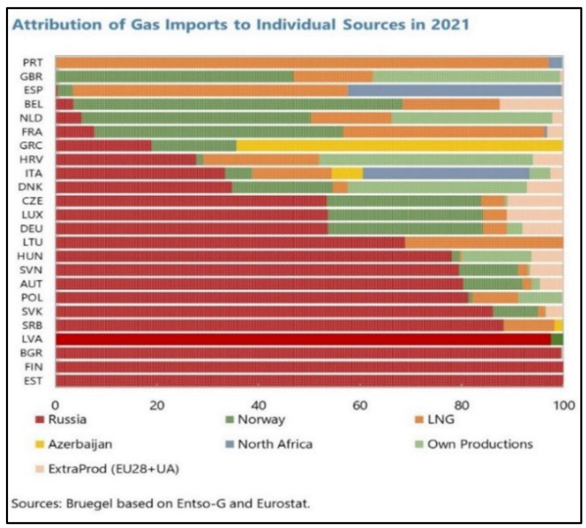
1. **The COVID-19 crisis has subsided.** Despite the increase in cases, progress on vaccination helped to reduce hospitalization and mortality rates. About 70 percent of Latvia's population had been fully vaccinated by end-May 2022. Although the pandemic has exacted a relatively high toll, the coordinated and comprehensive policy response has mitigated its economic impact (see below).

Text Figure 1. COVID-19 Cases, Vaccination, and Deaths



2. **The parliamentary elections will take place this year in October.** The political landscape has become more fragmented. The five-party ruling coalition shrank to four parties last year and lost absolute parliamentary majority. Political observers believe that inflation, together with the war in Ukraine and the energy crisis, will top voters' concerns. The elections may put pressure on the government budget.

3. **Latvia had significant trade relations with Russia before the war in Ukraine started (Annex II).** Latvia was particularly vulnerable because of its high dependence on imported Russian oil and gas until recently. Russia provided 75–100 percent of Latvia's gas needs, although the dependence in overall energy was smaller (about 26 percent). Russia accounted for 6–9 percent of Latvia's trade flows, representing about 6 percent of value-added.



4. **The government has provided crucial support to the Ukrainian refugees.** As of June 13, almost 33,000 refugees have entered Latvia. So far, residence documents have been given to 25,433 refugees, of which 19,187 of them received humanitarian visas. Support measures for the refugees

include access to social benefits, education, housing, and language training. Although the refugee influx has fiscal costs, it could benefit Latvia's economy by increasing labor supply.

RECENT DEVELOPMENTS

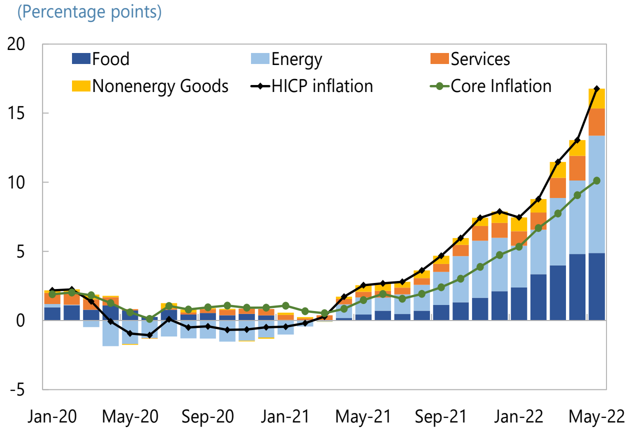
5. **Latvia's economy has made a robust recovery from the pandemic.** Owing to strong fiscal support, real GDP rebounded by 4.5 percent in 2021, driven by consumption and investment. The pace of recovery was uneven across sectors. While the manufacturing sector, especially export-oriented industries, registered strong growth, recovery in contact-intensive sectors (services), which were hit hard by the COVID-19 restrictions, remained anemic. GDP growth for Q1:2022 surprised on the upside (6.7 percent year-on-year), as households drew down savings accumulated during the pandemic to finance consumption.

6. **Inflation accelerated due to high energy and food prices and lingering supply disruptions.** Inflation surged to 7.9 percent year-on-year at end-2021 and increased further to 16.8 percent in May—the highest level since 2009—mostly driven by increases in energy and food prices, whose share in the CPI basket remains higher than in the euro area overall. Core inflation accelerated to 10.1 percent year-on-year, as the second-round effects of energy prices were broad-based and much stronger than projected. The surge in inflation is already weighing on household income. Business surveys suggest that global supply chain disruptions continue to affect Latvia.

Text Figure 2. Inflation

Inflation Decomposition

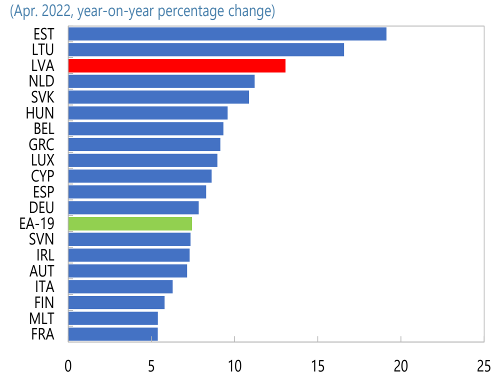
(Percentage points)



Sources: Eurostat, Haver Analytics, and IMF Staff Calculations.

Harmonized CPI

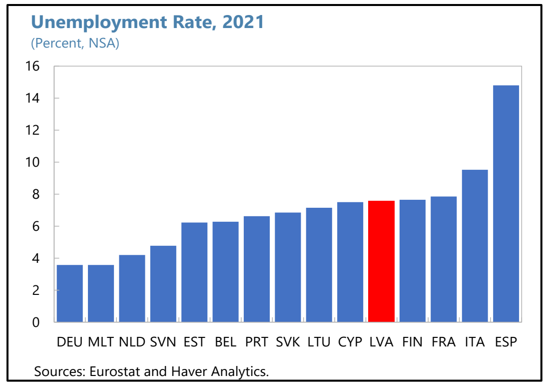
(Apr. 2022, year-on-year percentage change)



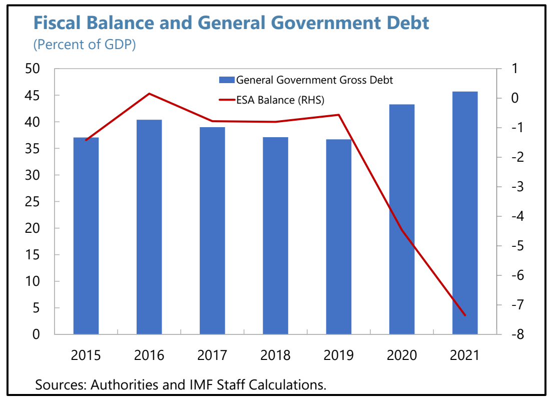
Sources: Eurostat and Haver Analytics.

7. **Unemployment declined but remained above its pre-pandemic level.** Latvia still records the highest unemployment among Baltic states (7.6 percent in 2021). Yet, the vacancy rate is high and labor market shortages continued to persist, reflecting skills mismatches. Meanwhile, wage growth accelerated to 11.6 percent in 2021, reflecting a large minimum wage increase and public sector wage hikes.

8. The external current account swung to a deficit. The current account balance moved from a surplus in 2020 to a deficit of 2.9 percent of GDP in 2021, as imports of goods and services rebounded after the lockdown. Overall, Latvia's external position in 2021 is assessed to be in line with the levels implied by fundamentals and desirable policies (Annex III). Trade data through April 2022 show that Latvia has been successful in reorienting its trade from Russia and gaining new markets for some of its exports.



9. The fiscal deficit in 2021 widened due to COVID-related spending. The overall deficit increased to 7.3 percent of GDP in 2021, from 4.5 percent of GDP in 2020, driven by COVID-related spending. The revenue performance was robust, supported by strong collections of VAT and corporate income tax. Public debt increased to 45.7 percent in 2021 (Annex V).



10. The financial sector has been resilient but bank credit to corporates has remained weak. Despite the pandemic, the banking sector remains well-capitalized and liquid. Bank profitability has recovered, almost reaching pre-COVID-19 levels last year. The total NPL ratio continued on a downward trend, reaching 2.5 percent at end-2021. Bank deposits were boosted by household savings, which grew by about 10 percent in 2021. While credit to households accelerated, corporate lending remained weak.

11. The war in Ukraine and related sanctions[1] on Russia will reshape the economic outlook in the short-to-medium term.

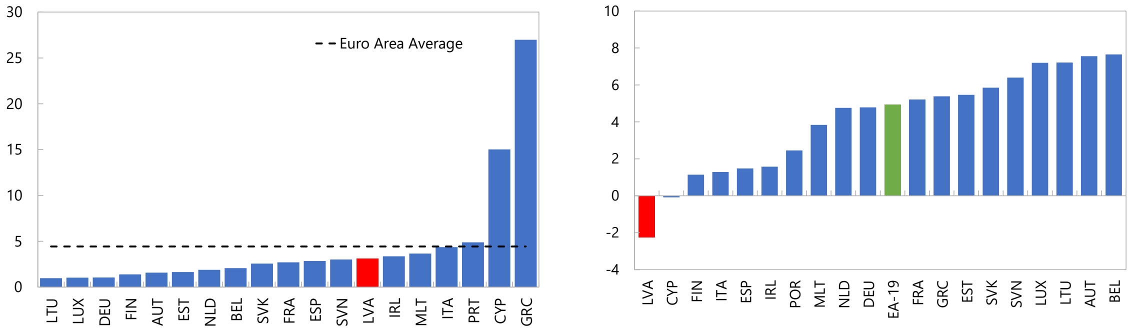
- The war will negatively affect both potential and actual growth with the output gap remaining negative. Growth in 2022 is now projected at 2.5 percent, or about 1½ percentage points lower than the forecast before the war. Private consumption growth is projected to decline as high inflation weighs on households' real incomes. The public investment ratio will remain broadly constant, supported by the RRP, while the negative confidence shock is projected to reduce private investment and trade. The supply disruptions and the surging costs of capital and labor could dampen investment somewhat. It is assumed that credit growth will stabilize at low positive levels after a long period of negative growth. Inflation is forecasted to persist at 14.5 percent in

[1] In line with the recently revised Institutional View on the liberalization and management of capital flows, some of the sanctions imposed on Russia can be capital flow management measures (CFMs) imposed for national and international security reasons.

Text Figure 3. Non-Performing Loans and Credit Growth

Non-Performing Loans in the Euro Area, 2020
(As a percentage of total gross loans)

Credit Growth, 2021Q4
(Year-on-year percentage change)



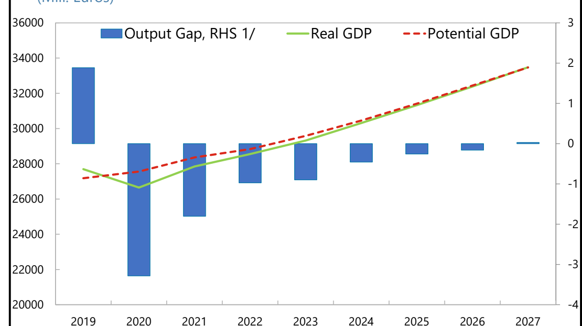
Sources: IMF Financial Soundness Indicators Database and Haver Analytics.

Source: European Central Bank.

2022 (period average) due to high energy and food prices and continued supply bottlenecks. However, in 2023, reflecting the WEO's projected decline in energy and food prices, end-of-period inflation is projected to decline below 5 percent like in the other Baltic countries.

- In the medium term, staff's projections assume that the war will continue without resolution but that its intensity subsides starting from 2023. As the economy adapts, private sector confidence will be lifted, causing a recovery in economic growth. An increase in EU-financed capital spending is also expected to support medium-term growth. Despite Latvia's high trade exposure to Russia, the impact of the war on its medium-term growth would be mitigated by steps already taken to secure energy independence and find alternative markets for exports. The negative output gap is projected to gradually close over the medium term. Inflation is projected to ease in 2023 as oil, gas, and food prices decline.

Real and Potential GDP
(Mill. Euros)



Sources: World Economic Outlook and IMF Staff Estimates.
1/ Measured as a percent of potential GDP.

- The impact of the war on long-term growth will likely be mild. Latvia has already taken proactive measures to eliminate its dependence on Russian gas, by finding alternative supplies. Moreover, the planned medium-term investment will further enhance energy security. However, the heightened geopolitical uncertainty could raise the country's risk premium.

12. **The balance of risks is tilted to the downside (Annex I).** Further intensification of the war in Ukraine and stricter sanctions against Russia could lead to yet more prolonged disruptions in Latvia's trade and finance, as well as a disruption of gas supplies. A sharp increase in refugees could strain institutional capacity and create spending pressures. Inflation could remain elevated for longer if energy and food price shocks and supply constraints persist. Workers could demand higher wages and that may raise further the cost of labor and trigger a wage-price spiral. In turn, an upward

pressure on wages could lead to a further deterioration in external competitiveness. On the health front, new variants of the COVID-19 virus and re-introduction of containment measures could dampen growth. On the upside, faster economic recovery could be supported by a quick resolution to the war, effective treatment for the virus, quick disbursements of EU funds, easing of supply bottlenecks, and swift implementation of structural reforms.

Authorities' Views

13. **The authorities broadly agreed with staff's economic outlook and risks.** For 2022, the central bank forecasts real GDP growth at 2.9 percent and inflation at 14.8 percent. As the geopolitical situation stabilizes and consumer and business confidence improve, they expect the economy to rebound in 2023–2024. The authorities concurred with staff's analysis on the impact of the war on the medium- to long- term growth and inflation. They expect the ongoing discussions about the minimum wage to exert upward pressure on wage growth. They stressed that the challenge would be to avoid a wage-price spiral and further deterioration in external competitiveness. At the same time as there is no automatic wage indexation mechanism and wage setting is largely decentralized in Latvia, this limits the likelihood of second-round effects on inflation.

POLICY DISCUSSIONS

14. **Tackling the spillovers of the war in Ukraine is now the dominant policy challenge facing the authorities.** In the short term, fiscal policy needs to mitigate the impact of higher energy prices on the most vulnerable and deal with spending pressures due to the war, while improving the composition of spending towards public investment to ensure energy security and support the recovery and resilience of the economy. The spillovers of the war to the financial sector warrant close monitoring and contingency plan preparedness. In the longer term, the overriding policy priority is to accelerate the structural transformation of the economy and make it more inclusive. Notably, policies should (i) facilitate labor reallocation, (ii) address long-standing challenges of inclusiveness, and (iii) accelerate the transition towards a greener and smarter growth.

A. Fiscal Policy: Supporting the Recovery and Alleviating the Spillovers from the War

15. **Despite the negative growth impact of the war, the structural fiscal balance is projected to strengthen by about 1 percent of GDP this year,** to a deficit of 5.8 percent, as most COVID-related spending will be phased out. COVID-related spending is projected to decline from 6.4 percent of GDP in 2021 to 1.8 percent of GDP in 2022. While the decline in COVID-19 spending is essentially automatic given that it is demand driven and is justified by the expected waning impact of the virus, it will nevertheless exert some negative fiscal impulse. Offsetting this, other discretionary spending is projected to increase to cushion the impact of higher energy prices (about 1.1 percent of GDP) and support refugees (about 0.3 percent of GDP). Capital spending is also projected to increase, financed by the NGEU funds. Meanwhile, the government tax revenue ratio is projected to

decline by 1½ percentage points of GDP because of the weaker growth, a decline in other indirect taxes, and an increase in the non-taxable minimum in the personal income tax which causes revenue in this category to decline. Overall, public debt is projected at 45.5 percent of GDP in 2022 and will subsequently decline to below 40 percent of GDP in the medium-term (Annex V).

16. Fiscal support to alleviate the impact of high energy prices should be temporary, timely, and targeted. The government quickly deployed time-bound support to cushion the impact of high energy prices on households. The support measures included temporary support to households, lower electricity charges, and reduction in mandatory fees (Table 1). A large portion of this support was not targeted. Also, a policy package that relied more on income transfers through the social safety net and less on blunting the signal from higher prices would have been preferable. Given the measures already introduced, the mission advised the authorities to:

- Ensure that measures are temporary and targeted to low-income, and possibly middle-income, households as these are least able to manage sharp increases in energy and food prices. Support should be provided through efficient schemes that target the vulnerable.
- Over the medium-term, let price signals operate to allow the full pass-through of international fuel prices to domestic consumers and adjust utility prices in line with the change in costs.
- Avoid using measures that cause disruption to tax policy and undermine commitments to the green transition.

Text Table 1. Fiscal Policy Response to Rising Energy Prices

Measure	Percent of GDP
Compensation of service and other fees	0.5
Support for protected users (10 euros)	0.0
Reduction of the mandatory procurement component in 2022	0.0
State budget grant to local government	0.1
Monthly support of EUR 20 to seniors and persons with disabilities	0.2
Monthly support of EUR 50 for families with children	0.2
Monthly support of EUR 20 to qualified pensioners of the Ministry of Defense	0.0
Total	**1.1**

17. The fiscal stance in 2022 and 2023 is strongly influenced by temporary measures. Given that the decline in the overall deficit this year is driven by the unwinding of demand-driven COVID-19 relief measures that likely have muted multipliers, while discretionary current spending and investment are slated to rise, it is difficult to assess whether fiscal policy is truly procyclical. In any case, given high inflation and the rising debt ratio, the anticipated decline in the headline deficit is not unwelcome. Going forward, as the ECB tightens monetary policy, it could still be too loose from a purely Latvian perspective and therefore fiscal policy would need to be tighter to help reduce inflationary pressures. For 2023, the overall fiscal deficit will further decline to 2.4 percent, as the temporary measures to alleviate the impact of high energy prices and the COVID-19 relief measures continue to be phased out.

18. Given that Latvia has some fiscal space, fiscal policy should be flexible, transparent, and stand ready to respond to the changing circumstances. The authorities should:

Support Fiscal Flexibility:

- *Allow automatic stabilizers to operate*. Given high uncertainty, automatic stabilizers should provide a first line of defense, while fiscal policy remains attuned to short-term developments.
- *Allow fiscal policy to remain flexible*. In the event that ongoing or existing shocks lead to a material worsening of the environment, the authorities should be prepared to boost high-quality discretionary spending in response, offsetting some of the decline in COVID-related spending (or reauthorizing COVID-19 spending should the pandemic worsen).
- *Develop contingency plans*. The authorities should devise contingency plans in case the crisis is more prolonged and the need for policy response is larger than envisaged.

Rebuild Fiscal Buffers:

- *Reprioritize spending*. Contain non-priority spending (e.g., goods and services and untargeted support) to relieve inflationary pressure and free up fiscal resources to support higher spending associated with the war in Ukraine. In carrying out this rationalization, the authorities should be mindful that the wage bill relative to GDP is below the euro area average and there is a critical need to attract and retain skilled staff, including in the health sector.
- *Review the pension system*. Demographic pressures from the ageing and declining population would cause gross social contributions to fall. Therefore, adjustments are required to the pension system to ensure sufficient reserves. Safety nets should also be strengthened to reduce old-age poverty.

Address Structural Issues:

- *Prioritize planned investment for the green transition and strengthen energy security*. Continue with the planned investments supported by the EU funds to enable Latvia's structural transformation into a greener, smarter, and more inclusive economy. Investment to strengthen energy security should be prioritized.
- *Increase investment in the health sector*. Given the low healthcare spending (¶*33*), more funding will be required to address critical needs in the health sector.
- *Strengthen governance standards*. Careful monitoring and transparency of COVID-19 related transactions is crucial, including transparency in procurement, independent auditing (with audited reports published), and investigations of potential misuse of funds. Addressing GRECO's recommendations should also be prioritized in order to strengthen Latvia's anticorruption framework.

Authorities' Views

19. The authorities broadly agreed with staff's fiscal policy advice. Fiscal policy will nimbly respond to the changing conditions, given that the general SGP escape clause remains active. The medium-term anchor of a structural deficit of 0.5 percent of GDP remains appropriate, pending the reform of the EU fiscal rules. Regarding the targeting of fiscal support, the authorities are committed to improving the targeting of the upcoming energy support packages. On the security needs stemming from the war in Ukraine, defense spending is projected to increase to 2.5 percent of GDP by 2025. A white paper on pension reforms will be finalized soon, with proposals to address pension adequacy and sustainability. On health sector reforms, a recently adopted public health strategy is being implemented.

20. To contribute to market stabilization, support measures are being implemented to ensure access to finance for entrepreneurs and to improve the economic situation. For instance, the Equity Fund is proposed to continue operation until 2023 (for adjusting business model of viable companies) and an investment fund (loans with capital rebate) is being implemented to stimulate corporate investments into new products.

21. They noted that governance and transparency reforms continue to progress. Since the 2020 GRECO report, efforts are underway to address the remaining measures and a report will be submitted soon. Steps have been taken to strengthen transparency in public procurement, by amending the procurement law and adopting a procurement strategy (2022–2024). The government is also committed to reducing efficiency gaps in the public investment management process. This is particularly important given the large EU resources Latvia is expected to receive in the short-to-medium term.

B. Financial Sector Policies: Balancing Risks and Resilience

22. The war in Ukraine and related sanctions pose new risks to the financial sector (Annex II). While Latvia used to have banks with ties to Russia, their shareholding links and client relationships have been severed over the past decade. Based on its database on the origins of bank deposits, the Financial and Capital Market Commission (FCMC) estimates that Russian deposits in Latvian banks now account for only 1 percent of total deposits following AML/CFT reforms,[2] but broader economic ties with Russia could make Latvian financial institutions vulnerable. Sectors whose activity is at some risk from the war (transportation, energy, construction, agriculture, domestic trade, and manufacturing) account for more than one-half of Latvia's corporate loans and about a fifth of total domestic loans.

23. Consequently, the spillovers of the war to the financial sector warrant close monitoring and contingency plan preparedness. Supervisors should continue frequent monitoring of banks' sectoral portfolios and conduct related risk assessments and tailored stress tests to identify specific vulnerabilities. Moreover, the ongoing process of integration of the FCMC into the structure of the Bank of Latvia should be leveraged for better understanding of these new risks and devising an

[2] Financial and Capital Market Commission (FCMC): https://www.fktk.lv/en/news/press-releases/fcmc-latvian-banks-currently-have-frozen-about-eur-8-million-in-sanctions-against-russia-imposed-by-the-eu-and-ofac/

integrated policy response. The mission welcomed the authorities' efforts to step up contingency plans to mitigate risks from cyberattacks.

24. Faster progress on corporate reforms could help bolster bank lending. Latvia's decade-long credit-less recovery has been unusually protracted reflecting both supply and demand factors, in the context of relatively high lending interest rates in the Baltic countries relative to the euro-area (see Selected Issues Paper). Analytical work suggests that some of the key factors explaining Latvia's situation include: (i) small size of corporate borrowers; (ii) high risk due to relatively weak corporate balance sheets as reflected in a high corporate equity gap in Latvia;[3] and (iii) still-inefficient insolvency procedures (despite ongoing progress). Priority reforms include:

- *Corporate recapitalization*: While welcoming the existing recapitalization fund of 0.3 percent of GDP for large enterprises, the mission advised the authorities to assess the scope for supporting SMEs and micro firms, which form most of the corporate sector.
- *Insolvency processes*: To compliment ongoing progress in improving insolvency regime, faster implementation of the EU restructuring directive will simplify debt restructuring through out-of-court and hybrid procedures.

25. Macroprudential policy should remain flexible considering high uncertainty. After augmenting their macro-prudential toolkit in mid-2020 with several borrower-based measures, the authorities broadened the scope of these tools to cover credit institutions of other EU countries operating in Latvia with or without local branches. Although real estate prices increased, they appeared to be in line with wage growth and remained less buoyant than in the other Baltic countries. However, housing prices could surge, if the already-low supply of housing is further constrained by the rising costs of capital, labor and materials, and delays in the construction sector due the spillovers of the war. A close monitoring of these developments is warranted, so that macroprudential policy can be re-calibrated accordingly in a timely manner. Credit risks could emerge due to the elevated share of high variable-interest loans to both households and non-financial corporations (87 and 94 percent of outstanding loans respectively).

26. Latvia continues to make significant progress in strengthening its AML/CFT framework. Building on recent legislative amendments to the AML/CFT framework, the authorities should continue to improve their understanding of risks, including those related to the abuse of virtual assets. The enhanced risk-based supervision of banks and gatekeepers should be effectively implemented. As regards sanctions against Russia, the authorities have actively engaged with banks by leveraging the technical expertise and the know-how acquired in the AML/CFT reforms. Continued progress in strengthening the AML/CFT framework is expected to help manage ML/TF, regulatory, reputational and other risks that may arise from sanctions evasion, particularly in the current geopolitical context. The reform aimed at banks formerly serving foreign clients (BSFCs) should continue to be executed to further reduce reputational and other risks for the financial

[3] See IMF/WP 21/56

system. Latvia should continue following up on its plans to further strengthen the effectiveness of its regime. Regional Fund TA on AML/CFT will also help deepen the reform agenda.

Authorities' Views

27. The authorities agreed with staff's analysis and advice. Regarding the war in Ukraine, the authorities confirmed that direct bank exposures to Russia, Belarus, and Ukraine are low and mostly limited to a few smaller banks. Therefore, they expect the negative effects of the war on financial stability to propagate mainly through confidence and macroeconomic channels. However, macroeconomic stress test showed that the banking's sector's ability to absorb shocks remains good.

28. The authorities emphasized that Latvia's decade-long credit-less business cycle was characterized by not only low credit demand or some remaining institutional bottlenecks, but also conservative bank lending policy. The financial market in Latvia is rather concentrated, and there is evidence of market segmentation and relatively high borrowing costs. Diversifying access to finance and promoting competition in the banking sector could stimulate lending and help finance various investment needs of the economy.

29. The authorities stressed that since the last Article IV, Latvia has continued to sustain tangible and positive progress in AML/CFT reforms. The new amendments to the legal framework, which came into force in July 2021, enhanced the AML/CFT framework, while promoting compliance of national regulations with international standards (FATF recommendations and EU Legislation). Notably, these amendments and efforts on improvements of AML/CFT framework (i) promote a risk-based approach that has helped reduce AML/CFT risk exposure; (ii) improve the efficiency of the reporting system of suspicious transactions; (iii) introduced new IT tools and methodologies to reduce administrative burden for the authorities and AML/CFT Obliged Entities. Finally, the Latvian authorities have been ensuring the enforcement of regulatory provisions on sanctions compliance in a coordinated manner, in particular, the sanctions related to the war in Ukraine.

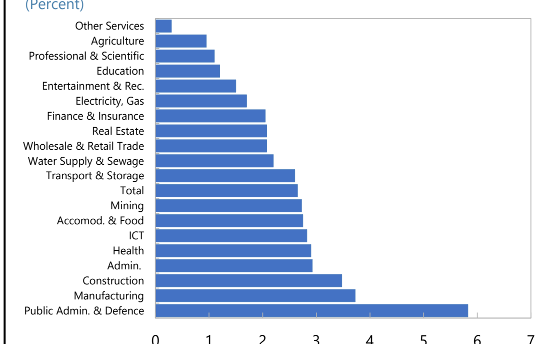
C. Structural Policies: Investing for a Sustainable and Inclusive Recovery and Growth

30. The authorities should use the current energy crisis to accelerate investment in energy security. In the near term, stepping up crisis preparedness and contingency planning should be a top priority. High energy prices are also helping to promote energy conservation. Demand for natural gas is expected to decline further as some district heating plants are switching to biomass and investments in renewable energy sources (RES) are picking up. Steps have been taken to simplify the administrative procedures for solar and wind projects and investors' interest has surged. The authorities have established a robust system to monitor activities on the gas market, created a strategic gas reserve, and developed contingency plans which protect households in case of disruptions. In the medium term, diversification of supplies, including through expanding LNG import capacity, strengthening network connections, and boosting investment in clean energy would enhance energy security, and the authorities should make full use of opportunities afforded to them under NGEU and the RePowerEU initiatives both to finance these expenditures and to facilitate private investment in energy security. Since Latvia no longer import gas from Russia, a potential Russian gas shut-off would not have a direct impact. Efforts to increase energy security should ideally be made compatible with the green transition.

31. Improving efficiency and investing in renewable energy would bring Latvia closer to achieving its climate goals. Latvia has committed to reducing greenhouse gas (GHG) emissions by 65 percent by 2030 (relative to 1990) and is on track to meeting this goal, supported by the RRF and other EU and national financing instruments. Agriculture, energy, and transport remain the main source of GHG emissions, comprising about two-thirds of the total. The share of renewable energy in energy consumption is already above 40 percent vs. a target of 50 percent by 2030; it is likely that this target will be exceeded, given the push for investment in RES in response to the current energy crisis. To achieve its climate goals, Latvia needs to reduce reliance on fossil fuels, including by increasing the level and coverage of carbon prices. In particular, a carbon pricing mechanism could be considered for sectors not covered by the EU ETS. Stepping up investments in sustainable mobility and renovation of buildings, including projects funded by the RRF (EUR 676 million or 37 percent of the total allocation), would help reduce emissions and improve energy efficiency, thus supporting the green transition.

32. Targeted labor market policies could help reduce skill mismatches and facilitate job creation and reallocation. The declining population presents challenges to long-term growth and the government has put in place a range of programs to enhance employment. Given the declining take-up of Active Labor Market Policy (ALMP) programs, the authorities may want to review these programs and propose adjustments, if needed, to make them more effective in reducing mismatches and facilitating labor reallocation across sectors and regions. ALMPs should be supplemented with measures aimed at improving the business environment, stimulating entrepreneurship, and strengthening the social safety net to support those who are unable to return to work. Given that spending on ALMPs is well below the EU average, there is scope for their expansion, but support should remain targeted. Consideration should also be given to easing the access of migrant workers to the labor market.

Vacancy Rate by Sector, 2021
(Percent)



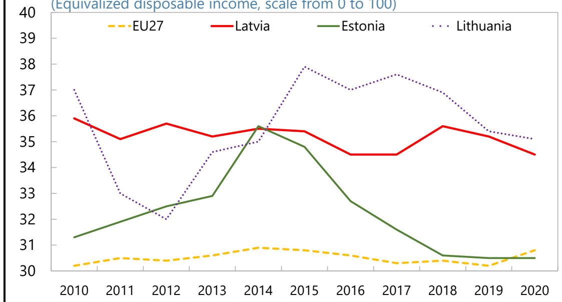
Sources: Statistics Latvia and Haver Analytics.

33. Reducing inequality should remain high on the policy agenda. Income inequality in Latvia is among the highest in the EU and largely reflects weaker social protection in comparison with peers. For example, healthcare spending per capita represents about half of the OECD average and housing investment as a share of GDP is the lowest in OECD countries.[4] Vast regional differences

[4] OECD Economic Surveys: Latvia 2022.

in employment opportunities are an important contributor to inequality. The RRP contains measures to improve the adequacy of minimum income benefits, old-age pensions, and support to people with disabilities, along with reforms and investments to improve education and infrastructure in the regions. It envisages about EUR 182 million (10 percent of the total allocation) to healthcare and EUR 370 million (20 percent of total) to reducing disparities.

Income Inequality: Gini Index
(Equivalized disposable income, scale from 0 to 100)



Source: Eurostat.
Note: The equivalized disposable income is the total income of a household that is available for spending or saving, divided by the number of household members weighted by age.

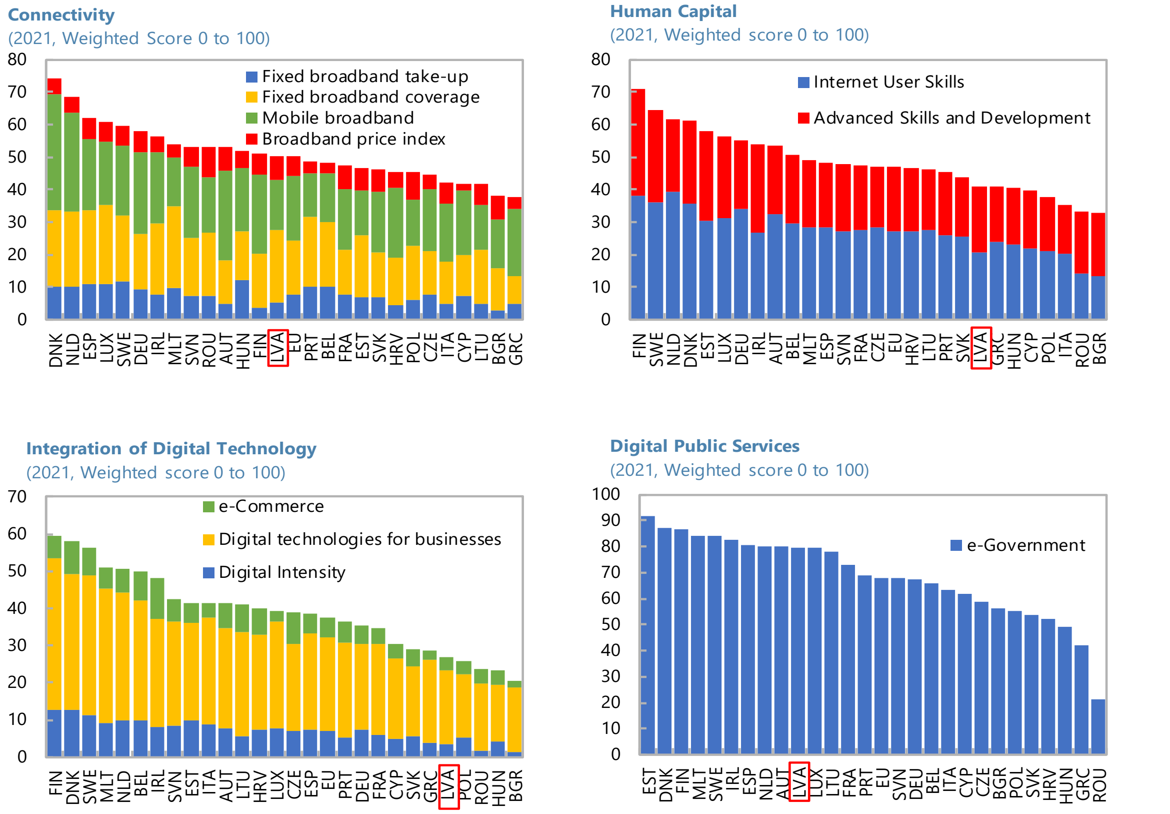
34. Pressing ahead with the digitalization agenda could boost productivity and growth (Annex VI). Given Latvia's mixed scores on the EU's Digital Economy and Society Index (DESI) (panel chart on the next page), the mission urged the authorities to accelerate the implementation of the digitalization agenda under the RRP, including measures aimed at acquisition of basic and advanced digital skills, support for the digitization of business process and creation of high-tech products and services. Investment in VHCN "last-mile" infrastructure will address the problem of bringing fast internet connection to end-users in rural areas, thus helping reduce the digital divide. Efforts to address cybersecurity risks are welcome, given the increased risks related to Russia's invasion of Ukraine.

Authorities' Views

35. The authorities noted that efforts to achieve energy security would enhance Latvia's green transition. The authorities have stopped buying natural gas from Russia and have relied on imports of LNG to build up reserves, which currently are considered sufficient to avoid disruptions in gas supply to consumers in the coming heating season. In addition, a significant decrease in demand for natural gas has taken place since the beginning of the year. This, together with accelerated investments in renewable energy sources, would help reduce GHG emissions. Steps taken to reduce the carbon footprint of transport include incentives for electric and plug-in vehicles and improvements in public transportation. They noted that the current environment of high energy prices is not conducive to increasing carbon taxation.

36. Strengthened ALMPs and other reforms would help reduce unemployment. Regular external evaluations of ALMPs take place to inform future policy changes. Training continues to be a key tool for reducing skills mismatches, with a focus on digital skills. The authorities expect that a recent reform of municipalities will increase employment opportunities in the regions. A program for start-ups has been upgraded to provide financing to successful projects after one year. Finally, to facilitate the hiring of third-country workers, the waiting period for employers has been reduced and the wage requirement could be modified.

Text Figure 4. Internet Access and Digitalization



Source: European Commission, Digital Scoreboard.

37. The authorities reconfirmed their commitment to greater inclusiveness. Amendments to the minimum income legislation would improve the adequacy of benefits by linking them to the median disposable income with annual indexations. Measures to assist people with disabilities include improved accessibility of buildings, transport benefits, and provision of health and education services. The ongoing family benefit reform would make the benefits more targeted. Regional inequalities in education are being addressed by increasing the financing per student in disadvantaged municipalities. The new health strategy has an important regional dimension as well.

38. An action plan for Latvia's digital transformation strategy is being worked out. Building on the success in digital public services, the government will now focus on enhancing digital skills, facilitating the digitization of business, improving connectivity, and supporting innovation. The implementation of the RRP's digital component is on track, with all milestones for 2022 expected to be met. Significant investments are envisaged for the development of "middle-mile" and "last-mile" connections and 5G frequencies have been allocated to all three mobile operators. A recent surge in malicious cyber activity has prompted the strengthening of the cybersecurity framework, with special attention to critical infrastructure.

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39. The economy fared relatively well during the pandemic. With the improved health conditions, real GDP rebounded in 2021, exceeding its pre-crisis level thanks to strong consumption and investment, as well as significant fiscal support.

40. However, the war in Ukraine is having major repercussions for Latvia's economy. Vulnerabilities come mainly from trade exposure to Russia, notably Latvia's high dependence on imported Russian gas until recently. The spillover effects from the war are already manifested in spikes in energy and food prices, supply disruptions, refugee inflows, and increased budgetary pressures.

41. The war in Ukraine constitutes the dominant downside risk to Latvia's economic outlook. Growth is projected to slow in 2022, as high inflation starts to weigh on private consumption and the negative confidence shock reduces private investment. Inflation is forecasted to remain elevated due to continued high energy and food prices and lingering supply bottlenecks. Average inflation is projected to peak this year before declining in 2023. In the medium term, output is projected to rebound somewhat, supported by higher domestic demand and an increase in EU-financed capital spending. Key downside risks include disruptions of gas supplies and a further surge in energy and food prices, which would hurt output and intensify inflationary pressures.

42. Fiscal policy should be flexible and stand ready to respond to the changing circumstances. Given the unusually high uncertainty, fiscal policy must be flexible in the short term. Notably, automatic stabilizers should provide a first line of defense, while fiscal policy remains attuned to short-term developments. Any revenue overperformance owing to higher inflation should be saved under the baseline scenario. If the economic environment worsens, high-quality discretionary spending should be used to provide fiscal stimulus and protect the vulnerable. Contingency plans are advisable in case the crisis is more prolonged and the need for policy response is larger than envisaged.

43. Fiscal support to alleviate the impact of high energy prices should be well-targeted. A large portion of the support already provided was not targeted. Scarce public resources should be used to target energy support measures to the most vulnerable. Broad-based measures not only reduce available resources that could otherwise be used to support the most vulnerable groups, but also add to inflationary pressures and discourage conservation efforts. Over the medium term, it is advisable to allow the pass-through of international energy prices to domestic consumers and adjust utility prices in line with the change in costs: higher prices will encourage necessary innovation and investment to boost energy efficiency.

44. Although the financial sector has so far been resilient to the pandemic, the spillovers of the war warrant close monitoring. The banking sector entered the crisis with comfortable capital and liquidity positions. However, with the war in Ukraine, the real-financial feedback loop requires close monitoring. Supervisors should take a risk-based approach, conduct relevant stress tests, and prepare contingency plans.

45. Corporate recapitalization and an improved insolvency regime could help revive bank credit. The authorities should focus on assessing the size of the corporate equity gap and developing policy options to support SMEs and micro firms. The implementation of EU Restructuring Directive needs to be expedited.

46. Macroprudential policy should stand ready to respond to changing housing market conditions. Given the new risks caused by the war, the frequent reviews of macroprudential measures should continue to ensure the right balance between financial stability and the need for credit in the economy.

47. The authorities should continue to build on their commendable progress in strengthening their AML/CFT framework. They rightly placed a renewed emphasis on emerging risks (including sanctions evasion) and enhanced risk-based supervision of banks. The FCMC should expedite the refocusing of the business models of the banks formerly servicing foreign clients.

48. The highly uncertain environment calls for strengthened management of the RRP. The more protracted disruptions to global supply chains and the rising costs of materials will likely complicate the execution of the RRP. The government should, therefore, devise strong contingency plans. Latvia's structural transformation hinges on the timely achievement of the RRP's milestones and targets.

49. Measures to enhance energy security should be compatible with Latvia's green transition goals. In the near term, stepping up crisis preparedness and contingency planning should be a top priority. The authorities have already implemented measures to ensure uninterrupted gas supplies in the near term. In the medium term, diversification of supplies, and boosting investment in clean energy would significantly enhance energy security. The authorities should avail themselves of the support available under NGEU and RePowerEU to facilitate this process.

50. Adverse demographic developments and skill mismatches call for a comprehensive response. The declining population and shortages of qualified workforce are viewed as the main constraints to long-term growth. The use of targeted labor market policies should be combined with the reforms of the business environment. Over time, the focus should gradually shift to facilitating the reallocation of workers to new jobs.

51. Efforts to reduce inequality and promote social inclusion should continue. The authorities are taking a range of measures to improve outcomes, along with reforms and investments to improve education and infrastructure in the regions, with support from the RRF. Adjustments to the pension system should be accompanied by increased investment in the health sector. In this regard, forceful implementation of the new health care strategy could help.

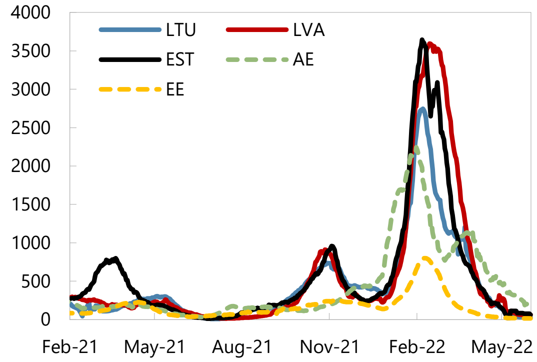
52. Pressing ahead with the digitalization agenda is key to boosting productivity and innovation. Efforts should be targeted at improving the digital infrastructure, building human capacity, and creating an environment through regulations and incentives.

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

Figure 1. Latvia: COVID-19 Developments

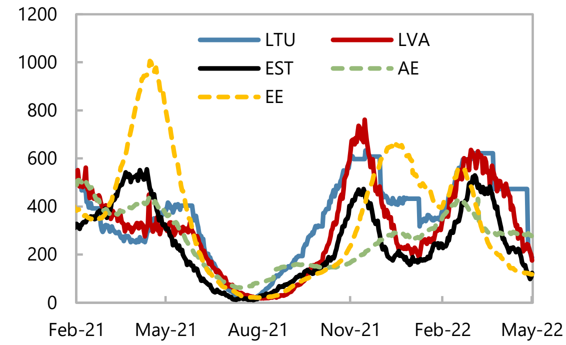
Latvia was hit hard by the Delta and Omicron waves.

New Weekly Confirmed COVID Cases, as of 5/31/2022
(Per 100k people, 7-day moving average)



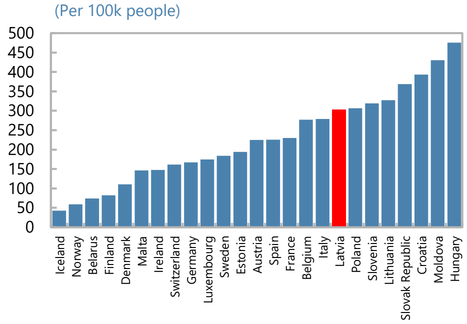
Hospitalization rates increased fast…

Daily Hospitalizations Occupancy, as of 5/1/2022
(Patients per 1 million people)



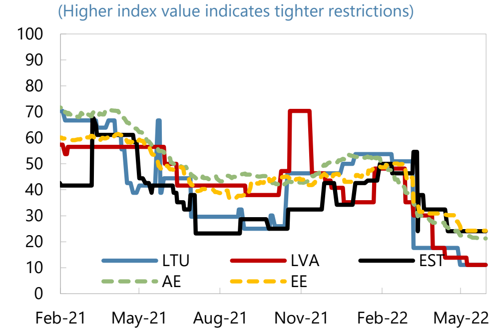
…and human costs have been high.

Cumulative Deaths, as of 5/31/2022
(Per 100k people)



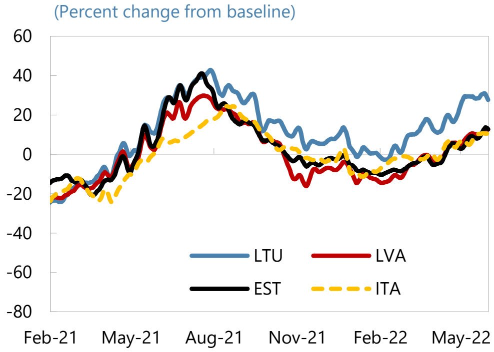
Containment measures increased when infections rose, but they have since ease…

Stringency Index, as of 5/31/2022
(Higher index value indicates tighter restrictions)



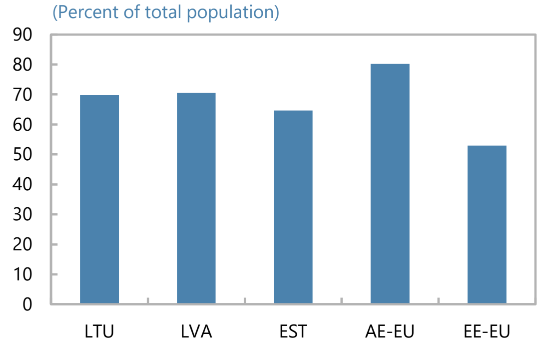
…facilitating mobility.

Mobility, as of 6/2/2022
(Percent change from baseline)



The vaccination rollout is broadly in line with peers.

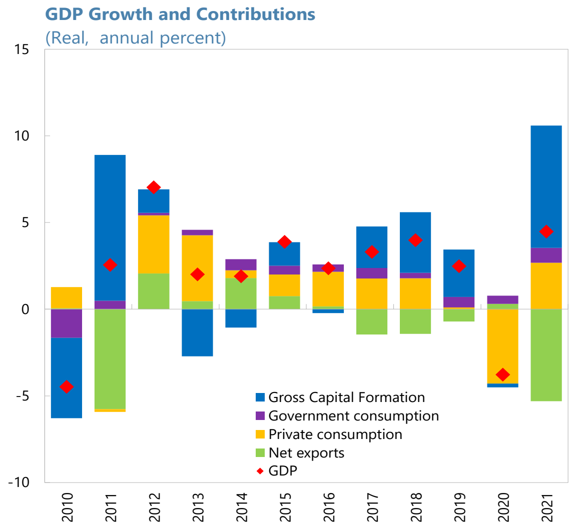
Vaccinations, as of 5/31/2022
(Percent of total population)



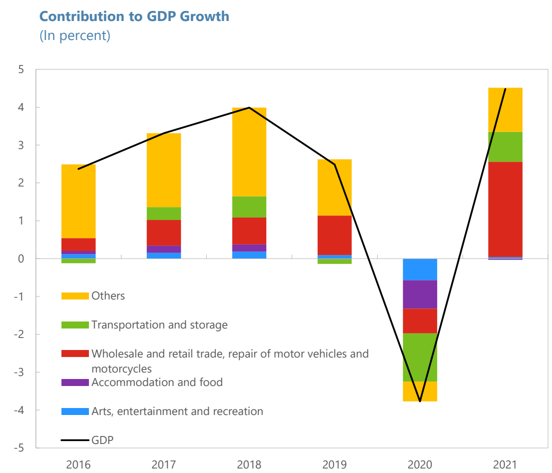
Sources: Bloomberg Finance L.P.; ECDC; Our World in Data, Worldometers; Google; IMF, WEO; and IMF staff calculations.
Note: AE refers to advanced European countries and EE refers to emerging European countries.

Figure 2. Latvia: Macroeconomic Developments

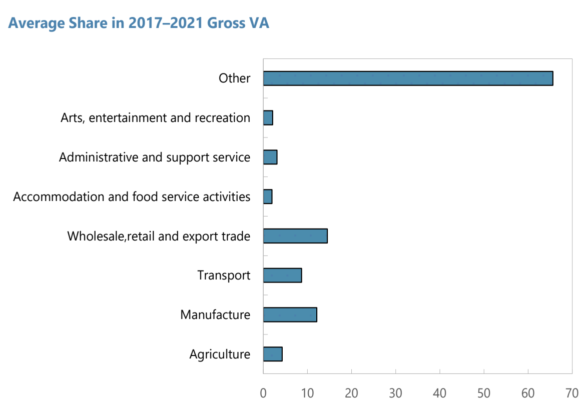
GDP growth rebounded, led by investment.



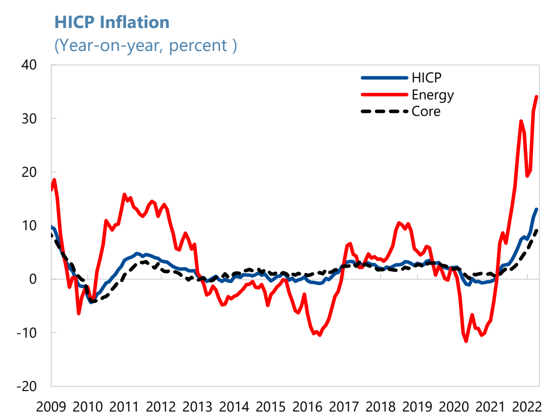
High-touch sectors absorbed the brunt of the shock…



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



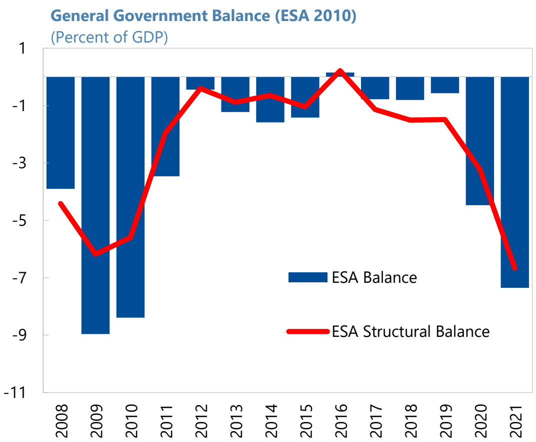
High energy prices caused inflation to spike.



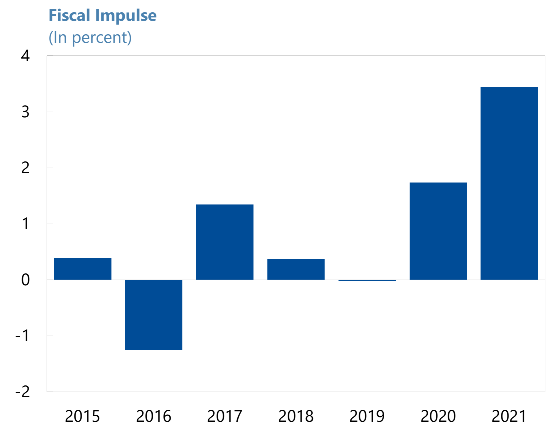
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 3. Latvia: Fiscal Developments

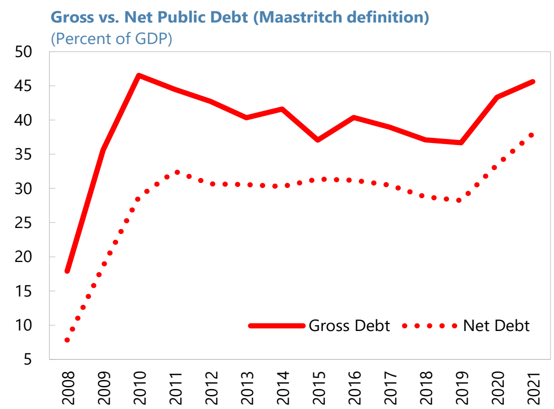
Fiscal balances have deteriorated…



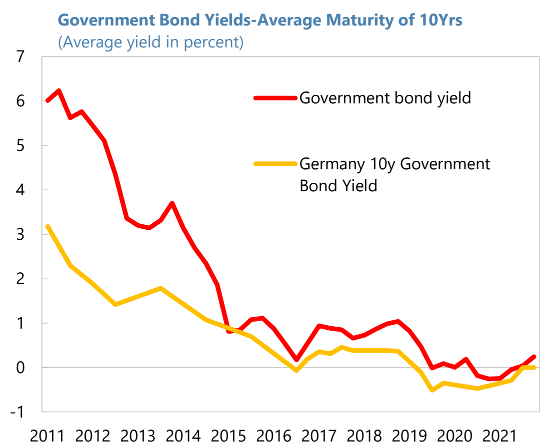
…as significant crisis relief measures were deployed.



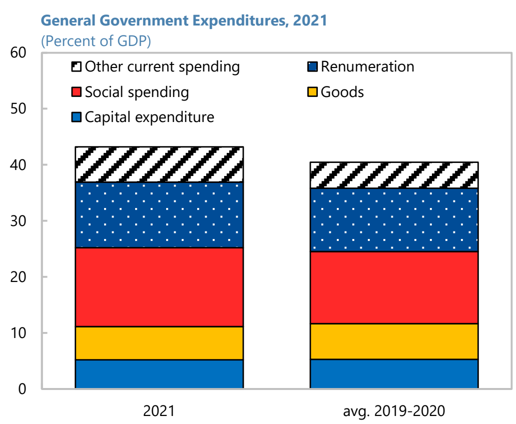
Public debt has increased…



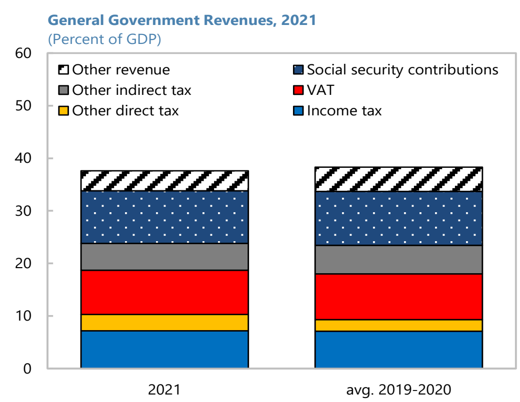
…amid strong market access at favorable conditions.



Social spending has increased…

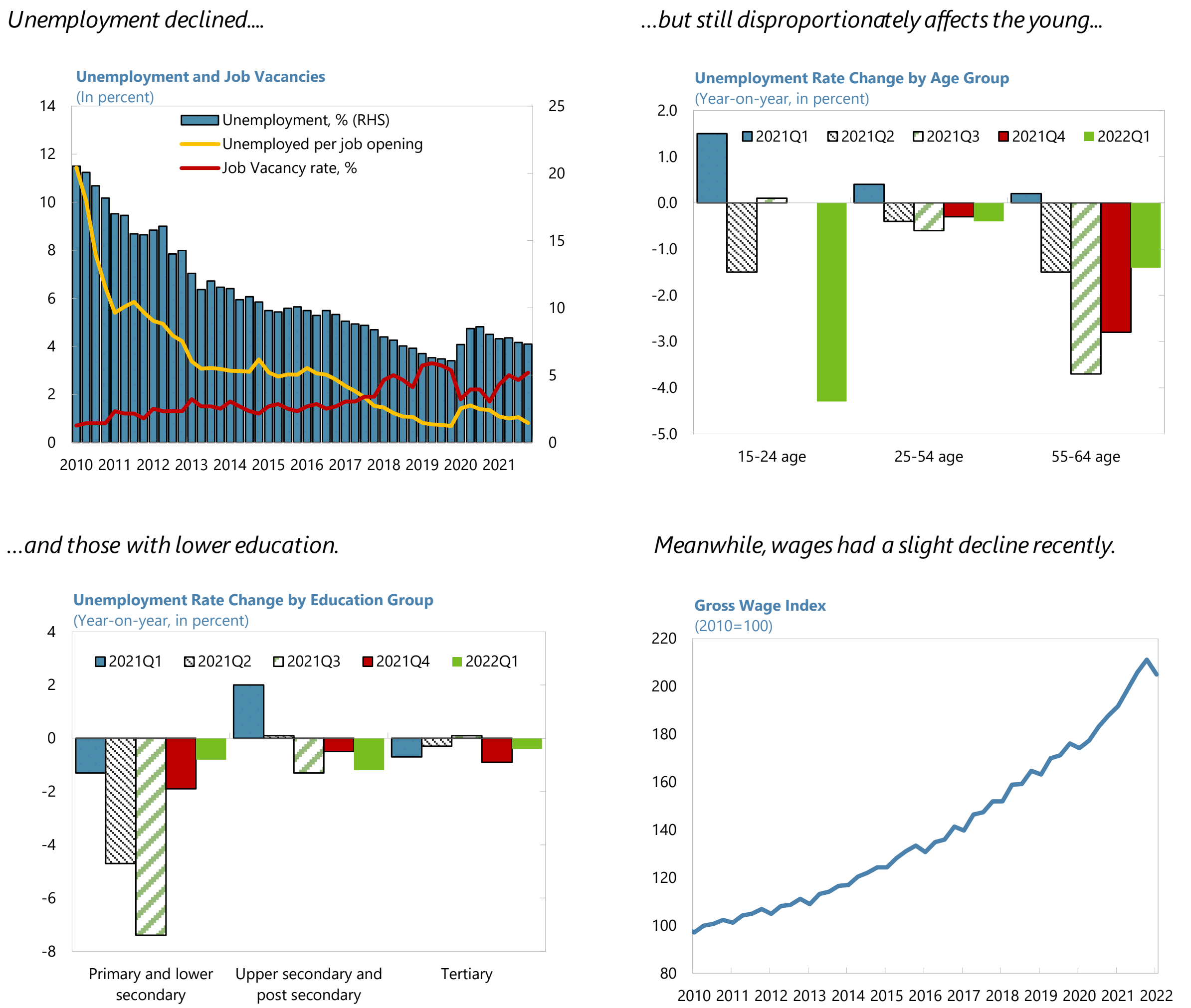


…while revenue sources held up.



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

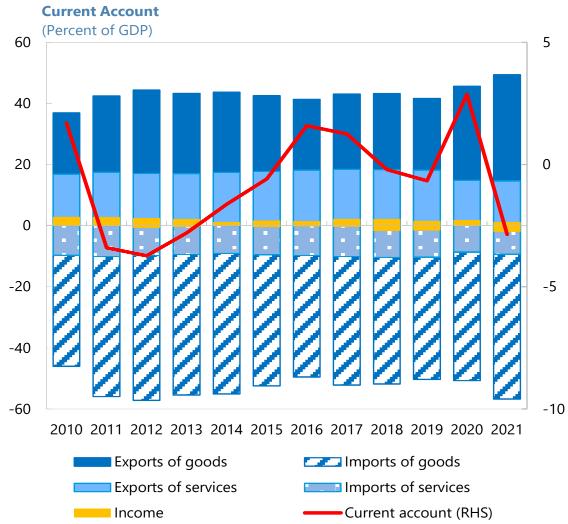
Figure 4. Latvia: Labor Market



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

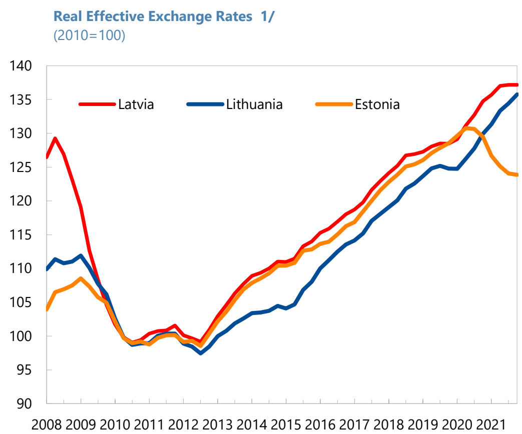
Figure 5. Latvia: Balance of Payments

The current account swung into a deficit in 2021…

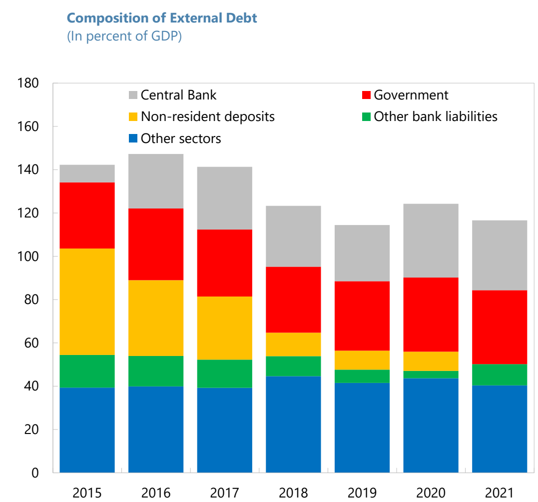


… despite an increase in export volumes.

External competitiveness held up in 2021.



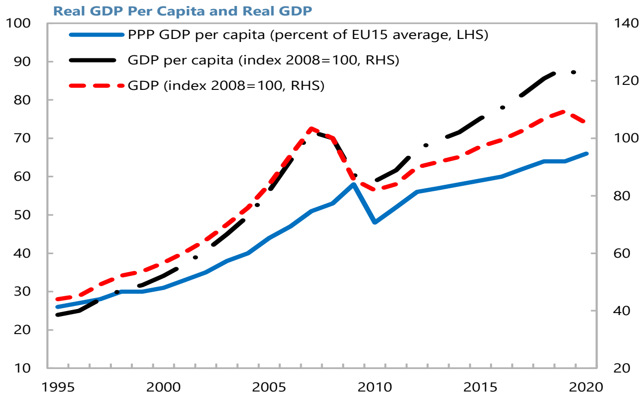
Total external debt burden decreased.



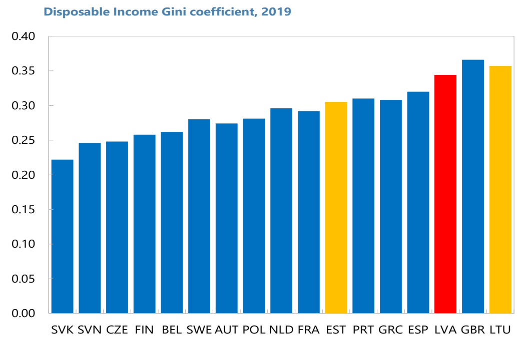
Sources: Bank of Latvia; Statistics Latvia; European Commission; and IMF staff calculations.
1/ Real effective exchange rates are based on IC–37 countries for ULC.

Figure 6. Latvia: Inequality and Poverty Indicators

GDP per capita remains below Western Europe.

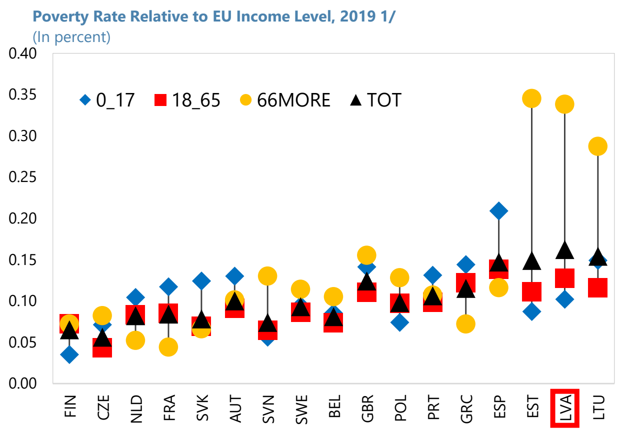


Income inequality is one of the highest in the EU.



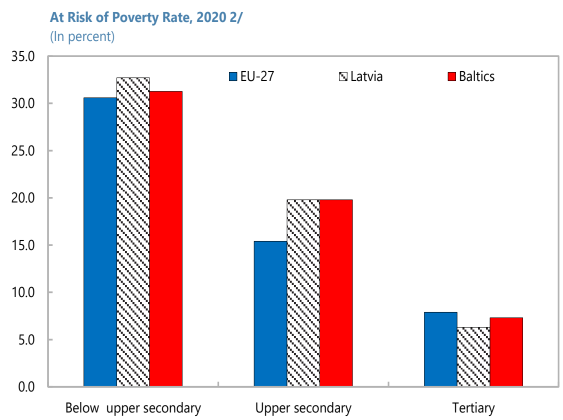
1/ Data for Poland and Finland is 2018

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



1/ Data for Poland and Finland is 2018

.... and those with lower education.

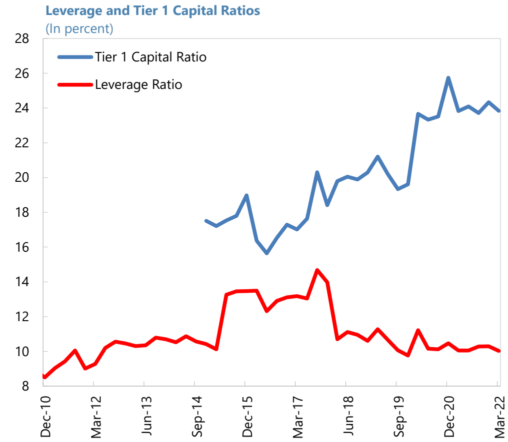


2/ Active population aged 25-64.

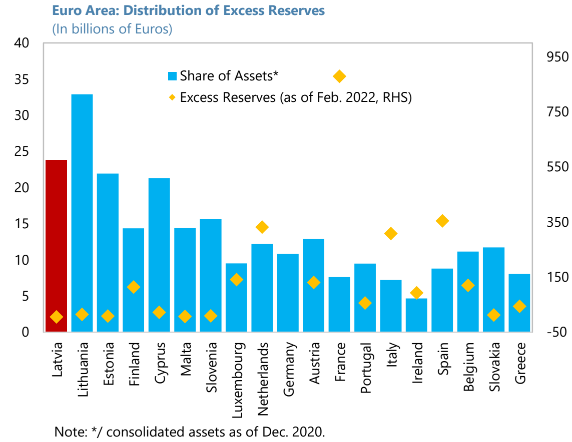
Sources: OECD (2021), Poverty rate (indicator); Eurostat; and IMF staff calculations.

Figure 7. Latvia: Banking Sector Developments

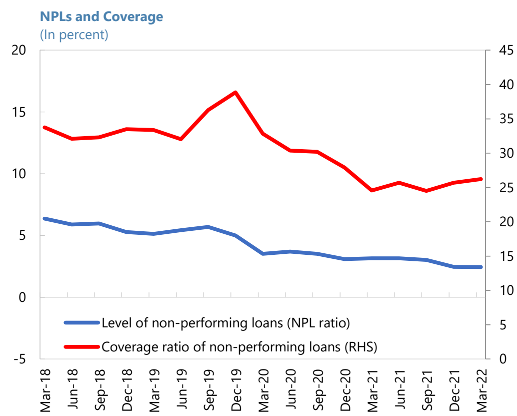
Banks hold high capital buffers...



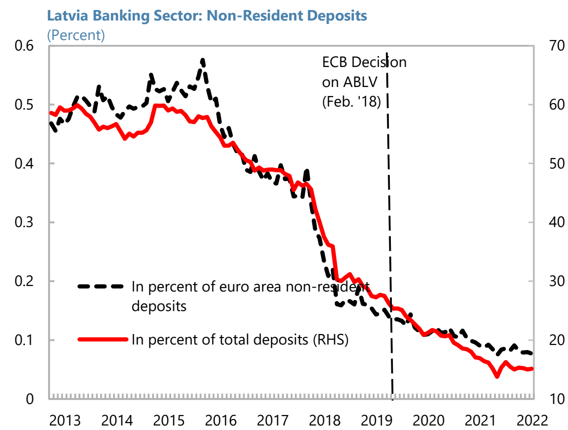
...and excess reserves relative to assets are the second highest in the euro-area.



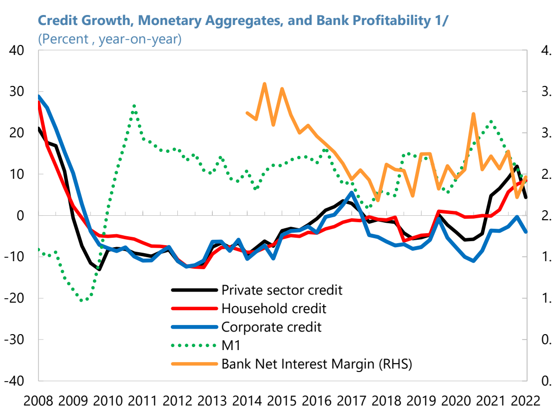
The asset quality in bank lending books continues to improve.



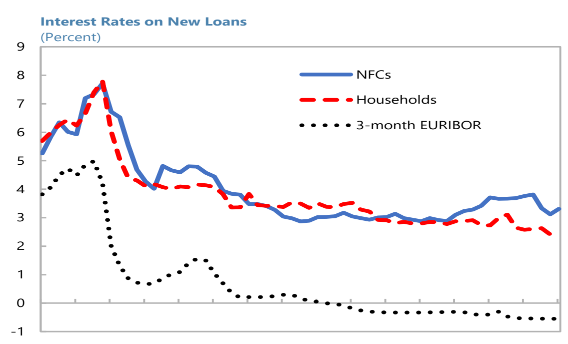
The retrenchment of non-resident deposits reduces the risk of money laundering.



Interest margins have increased...



...and lending rates remain well above the cost of funding.

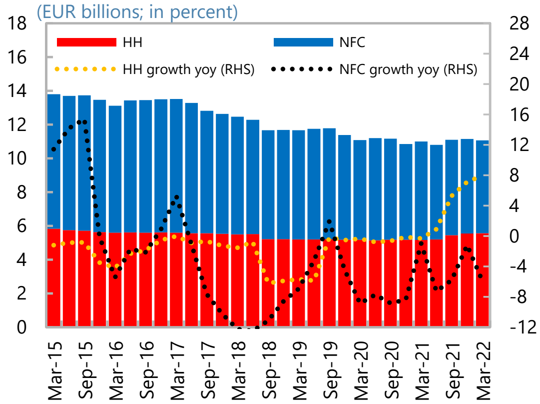


Sources: Bank of Latvia; ECB; FCMC; Haver Analytics; and IMF staff calculations.
1/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

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

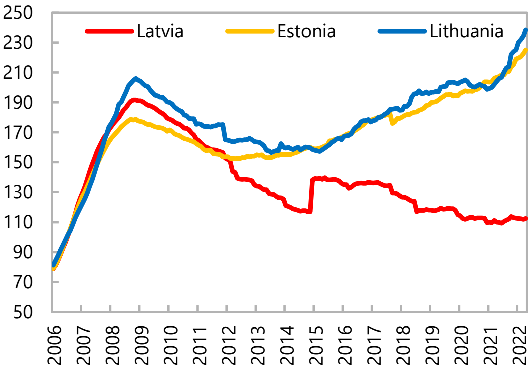
Bank lending remain relatively unchanged in Latvia...

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



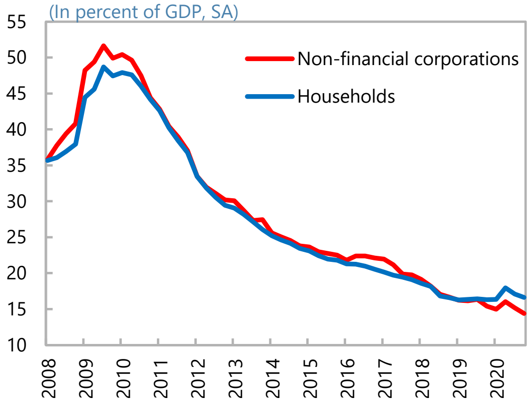
...and still lags Baltic peers.

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



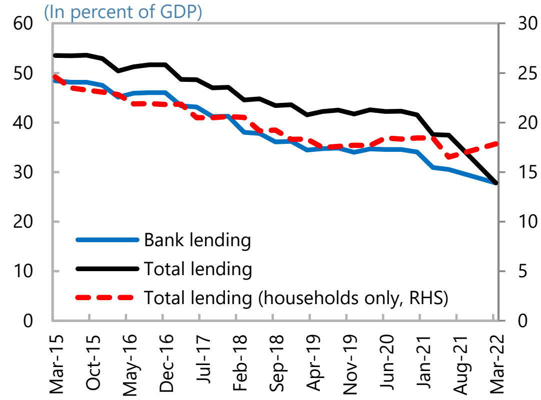
Although household credit appears more resilient than that of non-financial corporates...

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



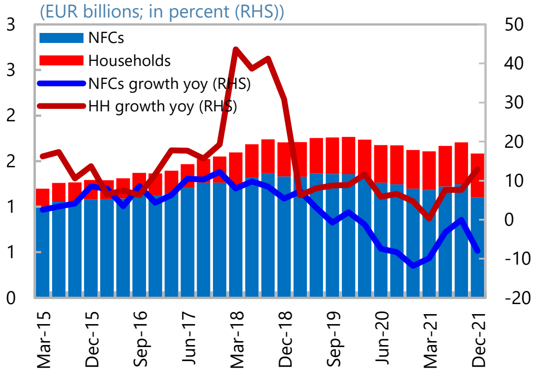
...total lending to residents still declined recently.

Latvia Credit to Residents
(In percent of GDP)



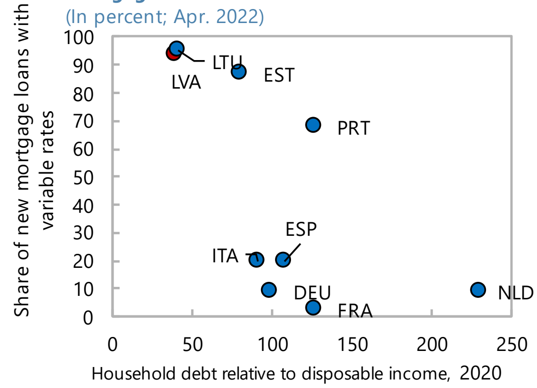
Non-bank lending to households increased.

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



Mortgage credit has a vulnerability due to high share of variable interest rates.

Household Debt and Share of Variable Rate Mortgages
(In percent; Apr. 2022)

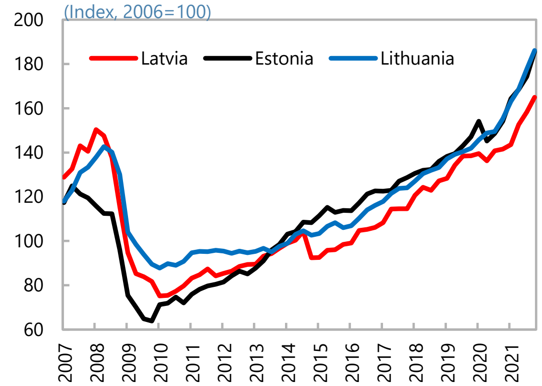


Sources: Bank of Latvia; ECB; FCMC; CSB, and IMF staff calculations.

Figure 9. Latvia: Housing Market Indicators

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

Housing Price Index
(Index, 2006=100)

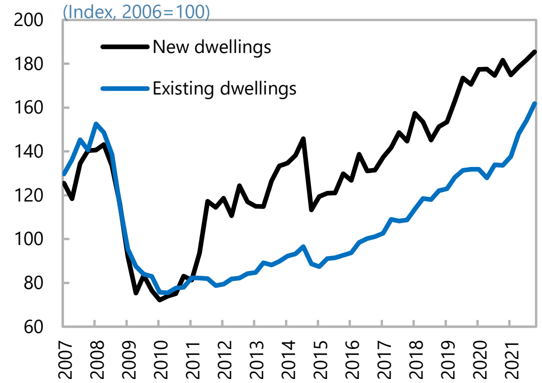


...and on average in line with wage growth.

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

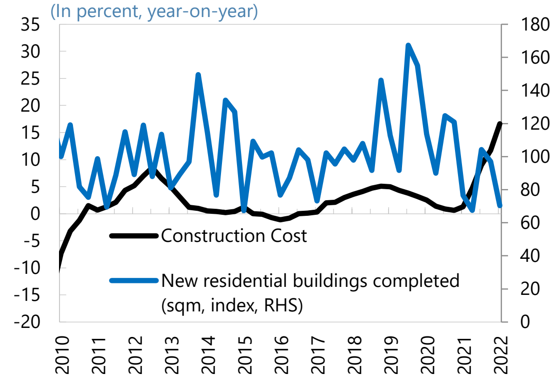
With prices for new dwellings rising particularly rapidly...

Residential Property Prices
(Index, 2006=100)



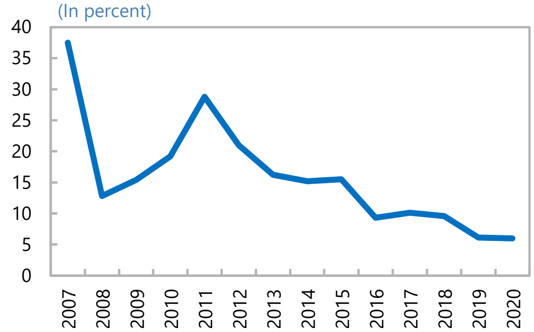
...and construction activity being volatile.

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



Housing is becoming gradually more affordable...

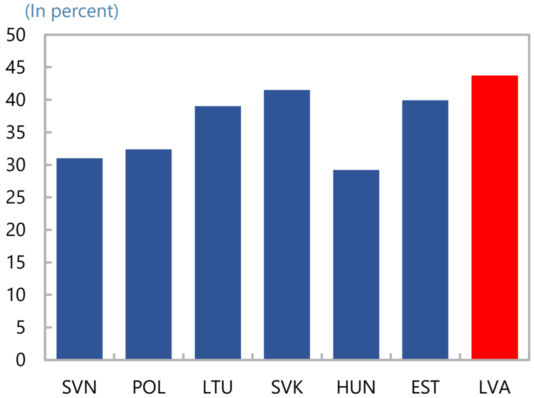
Housing Cost Burden Rate
(In percent)



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

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

Household Loan-to-Value Ratio
(In percent)



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

Table 1. Latvia: Selected Economic Indicators, 2019–23

	2019	2020	2021	2022	2023
				Proj.	
National Accounts	(Percentage change, unless otherwise indicated)				
Real GDP	2.5	-3.8	4.5	2.5	2.7
Private consumption	0.2	-7.4	4.8	2.8	3.0
Public consumption	3.4	2.6	4.4	2.0	3.0
Gross capital formation	10.1	-0.8	23.6	-4.4	2.9
Gross fixed capital formation	6.9	0.2	2.9	0.9	4.0
Exports of goods and services	2.1	-2.2	6.2	-1.8	3.5
Imports of goods and services	3.0	-2.5	13.5	-2.8	3.8
Nominal GDP (billions of euros)	30.6	29.5	32.9	38.0	41.8
GDP per capita (thousands of euros)	16.0	15.4	17.4	20.1	22.2
Savings and Investment					
Gross national saving (percent of GDP)	22.6	24.6	24.3	23.5	23.1
Gross capital formation (percent of GDP)	23.3	21.7	27.2	25.6	25.1
Private (percent of GDP)	19.3	17.4	23.3	21.0	21.0
HICP Inflation					
Period average	2.7	0.1	3.2	14.5	7.5
End-period	2.1	-0.5	7.9	16.1	3.9
Labor Market					
Unemployment rate (LFS; period average, percent)	6.3	8.1	7.6	7.4	7.2
Real gross wages	4.3	6.1	8.2	-7.0	-1.3
Consolidated General Government 1/	(Percent of GDP, unless otherwise indicated)				
Total revenue	37.2	38.5	38.3	35.8	35.9
Total expenditure	37.6	42.3	43.8	41.4	38.2
Basic fiscal balance	-0.4	-3.8	-5.6	-5.6	-2.4
ESA balance	-0.6	-4.5	-7.3	-6.2	-2.4
General government gross debt	36.7	43.3	45.7	45.5	43.4
Money and Credit					
Credit to private sector (annual percentage change)	-2.3	-4.4	11.9	...	...
Broad money (annual percentage change)	6.0	-3.9	11.6	...	...
Balance of Payments					
Current account balance	-0.7	2.9	-2.9	-2.2	-2.0
Trade balance	-8.6	-5.1	-7.4	-13.8	-6.7
Gross external debt	116.8	124.8	112.0	103.8	97.5
Net external debt 2/	17.9	13.6	11.8	12.1	12.9
Exchange Rates					
U.S. dollar per euro (period average)	1.12	1.14	1.18	...	...
REER (period average; CPI based, 2005=100)	122.5	124.2	124.7	...	...
Terms of trade (annual percentage change)	0.9	2.9	1.5	-0.6	0.2

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

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

2/ Gross external debt minus gross external assets.

Table 2. Latvia: Macroeconomic Framework, 2019–27

	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Proj			
	(Percentage change, unless otherwise indicated)								
National Accounts									
Real GDP	2.5	-3.8	4.5	2.5	2.7	3.4	3.4	3.4	3.4
Consumption	0.9	-5.0	4.7	2.6	3.0	3.0	3.0	3.0	3.0
Private consumption	0.2	-7.4	4.8	2.8	3.0	3.0	3.0	3.0	3.0
Public consumption	3.4	2.6	4.4	2.0	3.0	3.0	3.0	3.0	3.0
Gross capital formation	10.1	-0.8	23.6	-4.4	2.9	3.2	3.3	3.4	3.4
Gross fixed capital formation	6.9	0.2	2.9	0.9	4.0	4.4	4.5	4.5	4.5
Exports of goods and services	2.1	-2.2	6.2	-1.8	3.5	3.5	2.6	2.6	2.6
Imports of goods and services	3.0	-2.5	13.5	-2.8	3.8	3.0	2.3	2.3	2.3
Contributions to growth									
Domestic demand	3.4	-4.0	10.6	0.4	3.2	3.3	3.4	3.4	3.4
Net exports	-0.7	0.3	-5.3	0.9	-0.5	0.1	0.0	0.0	0.0
HICP Inflation									
Period average	2.7	0.1	3.2	14.5	7.5	3.2	2.6	2.5	2.5
End-period	2.1	-0.5	7.9	16.1	3.9	2.6	2.6	2.5	2.5
Labor Market									
Unemployment rate (LFS, percent)	6.3	8.1	7.6	7.4	7.2	7.1	6.9	6.7	6.5
Employment (period average, percent)	0.1	-1.9	-3.2	-0.9	0.7	0.8	0.8	0.8	0.8
Real gross wages	4.3	6.1	8.2	-7.0	-1.3	2.6	3.1	3.0	3.1
	(Percent of GDP)								
Consolidated General Government 1/									
Total revenue	37.2	38.5	38.3	35.8	35.9	35.3	35.0	34.9	34.9
Total expenditure	37.6	42.3	43.8	41.4	38.2	37.3	36.9	35.7	35.3
ESA balance	-0.6	-4.5	-7.3	-6.2	-2.4	-1.8	-0.9	-0.7	-0.4
ESA structural balance	-1.5	-3.2	-6.7	-5.8	-2.0	-1.7	-0.8	-0.7	-0.4
General government gross debt	36.7	43.3	45.7	45.5	43.4	42.5	41.7	39.8	37.8
Saving and Investment									
Gross national saving	22.6	24.6	24.3	23.5	23.1	23.0	23.1	23.3	23.5
Foreign saving	0.7	-2.9	2.9	2.2	2.0	1.8	1.5	1.1	0.7
Gross capital formation	23.3	21.7	27.2	25.6	25.1	24.8	24.6	24.4	24.2
External Sector									
Current account balance	-0.7	2.9	-2.9	-2.2	-2.0	-1.8	-1.5	-1.1	-0.7
Net IIP	-40.1	-34.7	-28.1	-28.0	-26.9	-26.8	-26.5	-25.8	-24.8
Gross external debt	116.8	124.8	112.0	103.8	97.5	93.1	88.1	81.0	76.8
Net external debt 2/	17.9	13.6	11.8	12.1	12.9	14.0	14.9	15.5	15.7
Memorandum Items:									
Nominal GDP (billions of euros)	30.6	29.5	32.9	38.0	41.8	44.4	47.1	49.8	52.7
Output gap (percent)	1.9	-3.3	-1.8	-1.0	-0.9	-0.5	-0.3	-0.2	0.0
Potential output growth (percent)	2.4	1.4	2.9	1.7	2.6	2.9	3.2	3.3	3.2
Terms of trade (annual percentage change)	0.9	2.9	1.5	-0.6	0.2	-0.1	0.4	0.4	0.3

Sources: Latvian authorities; and IMF staff calculations.
1/ National definition. Includes economy-wide EU grants in revenue and expenditure.
2/ Gross external debt minus gross external assets.

Table 3. Latvia: General Government Operations, 2019–27 1/

	2019	2020	2021	2022	2023	2024	2025	2026	2027
				Projections					
				(percent of GDP)					
Revenue	37.2	38.5	38.3	35.8	35.9	35.3	35.0	34.9	34.9
Taxes	20.1	20.7	21.0	19.5	19.4	19.3	19.4	19.3	19.4
Personal Income Tax	6.3	6.2	5.9	5.5	5.5	5.5	5.5	5.5	5.6
Corporate Income Tax	0.1	0.7	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Property Tax	0.7	0.8	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Value-added tax	8.6	8.6	8.4	8.4	8.5	8.5	8.6	8.6	8.6
Excise tax	3.5	3.6	3.4	3.2	3.1	2.9	2.9	2.9	2.9
Other taxes	0.8	0.8	1.8	0.8	0.8	0.8	0.8	0.8	0.8
Social Contributions	9.4	9.9	9.5	9.5	9.5	9.5	9.5	9.5	9.5
Grants	4.3	4.4	4.2	3.9	4.6	4.3	3.8	3.8	3.8
Other Revenue	3.4	3.5	3.5	3.0	2.5	2.2	2.2	2.2	2.2
Expenditure	37.6	42.3	43.8	41.4	38.2	37.3	36.9	35.7	35.3
Expense	33.7	38.1	40.0	36.8	34.1	33.3	33.1	32.3	32.1
Compensation of Employees	8.5	9.2	8.9	8.2	8.2	8.4	8.4	8.5	8.5
Use of goods and services	4.9	5.0	4.7	4.9	4.3	4.2	4.2	3.9	3.9
Interest	0.9	0.9	0.8	0.5	0.6	0.5	0.5	0.5	0.5
Subsidies	7.6	9.4	9.5	10.1	8.5	8.2	8.1	8.0	8.0
Grants	1.1	1.3	1.4	1.1	1.0	1.0	1.0	1.0	1.0
Payments to EU budget	1.0	1.1	1.2	1.0	0.9	0.9	0.9	0.9	0.9
International organizations	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Social Support	10.6	12.3	14.6	12.0	11.5	10.9	10.9	10.4	10.1
Pensions	7.2	8.6	7.7	7.6	7.5	7.4	7.4	7.2	7.1
Other	3.4	3.7	6.9	4.4	4.0	3.5	3.5	3.1	3.0
Other expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Acquisition of Nonfinancial Assets	3.9	4.2	3.9	4.6	4.2	4.0	3.8	3.3	3.3
Gross Operating Balance	3.6	0.4	-1.7	-1.0	1.8	2.0	1.8	2.6	2.9
Net Lending/Borrowing	-0.4	-3.8	-5.6	-5.6	-2.4	-2.0	-1.9	-0.7	-0.4
Domestic financing	-3.0	1.5	1.6	0.8	0.3	0.7	1.4	2.4	0.4
External financing	3.3	2.3	3.9	4.8	2.0	1.3	0.6	-1.7	0.0
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items									
ESA balance 2/	-0.6	-4.5	-7.3	-6.2	-2.4	-1.8	-0.9	-0.7	-0.4
ESA structural balance	-1.5	-3.2	-6.7	-5.8	-2.0	-1.7	-0.8	-0.7	-0.4
General government debt	36.7	43.3	45.7	45.5	43.4	42.5	41.7	39.8	37.8
Nominal GDP (billions of euros)	30.6	29.5	32.9	38.0	41.8	44.4	47.1	49.8	52.7

Sources: Latvia authorities and IMF staff estimates.
1/ Fiscal accounts are on a cash basis as provided by the authorities.
2/ ESA refers to the European System of Accounts (ESA).

Table 4. Latvia: Medium-Term Balance of Payments, 2019–27

	2019	2020	2021	2022	2023	2024	2025	2026	2027
				Projections					
	(Percent of GDP, unless otherwise indicated)								
Current Account	-0.7	2.9	-2.9	-2.2	-2.0	-1.8	-1.5	-1.1	-0.7
Goods and services (fob)	-0.7	1.2	-2.1	-1.8	-1.7	-1.5	-1.0	-0.6	-0.3
Goods (fob)	-8.6	-5.1	-7.4	-13.8	-6.7	-6.6	-6.3	-6.1	-5.7
Exports	41.6	45.6	49.4	39.3	43.6	41.6	39.9	38.3	37.4
Imports	-50.3	-50.6	-56.8	-53.1	-50.3	-48.2	-46.2	-44.4	-43.2
Services	7.9	6.2	5.3	12.0	4.9	5.1	5.3	5.5	5.4
Credit	18.2	14.9	14.7	22.1	14.5	14.6	14.8	14.9	14.6
Debit	-10.3	-8.6	-9.3	-10.1	-9.6	-9.5	-9.5	-9.4	-9.2
Primary Income	-1.5	0.0	-1.9	-1.6	-1.6	-1.6	-1.6	-1.6	-1.5
Compensation of employees	2.2	1.8	1.8	1.5	1.5	1.4	1.4	1.4	1.4
Investment income	-4.3	-2.7	-4.1	-3.2	-3.2	-3.1	-3.0	-3.0	-2.9
Secondary Income	1.5	1.7	1.2	1.2	1.4	1.3	1.1	1.1	1.1
Capital and Financial Account	0.2	-4.4	3.3	2.2	2.0	1.8	1.5	1.1	0.7
Capital account	1.5	1.8	1.4	0.9	1.1	0.9	0.8	0.8	0.8
Financial account	1.2	6.2	-1.8	-1.3	-0.9	-0.9	-0.7	-0.3	0.1
Direct investment	2.9	2.2	5.1	1.7	1.6	1.5	1.4	1.3	1.2
Portfolio investment and financial derivatives	1.7	-13.5	-1.7	3.3	0.5	-0.1	-0.4	-3.3	-0.9
of which: general government net issuance	3.3	-1.1	1.9	5.3	2.4	1.8	1.5	-1.4	0.9
Other investment	-6.2	6.5	-1.1	-3.7	-1.1	-0.5	-0.3	2.3	-0.4
Reserve assets	0.3	-1.5	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	0.4	1.6	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent change, unless otherwise indicated)								
Goods and Services									
Export value (fob)	2.3	-2.9	18.3	10.9	4.0	2.8	3.0	3.1	3.3
Import value (fob)	2.4	-5.9	24.5	10.5	4.2	2.4	2.3	2.4	2.7
Export volume	2.1	-2.2	6.2	-1.8	3.5	3.5	2.6	2.6	2.6
Import volume	3.0	-2.5	13.5	-2.8	3.8	3.0	2.3	2.3	2.3
Gross Reserves (billions of euros)	4.0	4.3	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Gross External Debt (billions of euros)	35.8	36.8	36.8	39.5	40.8	41.4	41.5	40.3	40.5
Medium- and long-term (billions of euros)	21.5	20.9	20.6	22.6	23.3	23.5	23.1	22.1	22.3
Short term (billions of euros)	14.3	15.9	16.2	16.9	17.5	17.9	18.3	18.3	18.2
Net External Debt (billions of euros) 1/	5.5	4.0	3.9	4.6	5.4	6.2	7.0	7.7	8.3
Gross External Debt (percent of GDP)	116.8	124.8	112.0	103.8	97.5	93.1	88.1	81.0	76.8
Medium and long term (percent of GDP)	70.2	70.9	62.7	59.4	55.7	52.8	49.2	44.3	42.4
Short term (percent of GDP)	46.6	53.9	49.3	44.4	41.8	40.3	38.9	36.7	34.5
Net External Debt (percent of GDP) 1/	17.9	13.6	11.8	12.1	12.9	14.0	14.9	15.5	15.7
Memo Items									
Nominal GDP (billions of euros)	30.6	29.5	32.9	38.0	41.8	44.4	47.1	49.8	52.7
U.S. dollar per euro (period average)	1.12	1.14	1.18	...	...	...	...	...	...

Sources: Latvian authorities; and IMF staff calculations. Methodologies are based on BPM6.

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

Table 5. Latvia: Financial Soundness Indicators, 2015–21
(In percent, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021
Core FSIs							
Regulatory capital to risk-weighted assets	21.8	20.4	20.8	22.3	21.7	26.8	24.3
Tier 1 capital to risk-weighted assets	19.3	17.7	18.8	20.6	20.6	26.0	23.6
Nonperforming loans net of provisions to capital	5.8	27.3	23.2	23.2	26.8	15.7	13.0
Capital to assets (leverage ratio)	9.0	8.5	9.7	11.1	8.5	9.3	8.6
Nonperforming loans to total gross loans	4.6	6.3	5.5	5.3	5.0	3.1	2.5
Provisions to nonperforming loans	79.3	45.4	43.3	39.7	44.4	40.3	45.0
Return on assets	1.4	1.6	1.0	1.1	0.6	0.8	1.3
Return on equity	12.2	14.5	6.7	9.0	4.9	7.5	12.5
Interest margin to gross income	52.5	41.4	45.0	46.4	48.2	51.4	50.0
Noninterest expenses to gross income	48.6	54.9	66.1	67.9	69.8	70.2	64.2
Liquid assets to total assets	35.7	57.2	67.1	58.2	50.9	56.0	59.3
Liquid assets to short-term liabilities	46.5	80.8	86.2	75.1	84.0	87.3	100.9
Net open position in foreign exchange to capital	2.3	3.5	2.1	1.0	5.2	1.3	0.5
Additional FSIs							
Large exposures to capital	216.4	204.6	113.8	102.8	83.8	78.5	75.8
Gross asset position in financial derivatives to capital	5.0	6.7	1.7	2.8	4.7	2.1	5.0
Gross liability position in financial derivatives to capital	4.8	6.2	1.9	2.7	4.6	2.5	4.5
Trading income to total income	11.6	18.8	9.6	5.4	9.5	5.4	6.6
Personnel expenses to noninterest expenses	58.7	40.8	39.7	40.3	40.3	41.5	41.9
Customer deposits to total (noninterbank) loans	157.0	106.5	96.3	86.0	88.1	94.2	89.7
FX loans to total loans	27.7	...	...	...	...	...	...
FX liabilities to total liabilities	40.6	...	...	...	...	...	...
Residential real estate loans to total gross loans	23.6	20.3	20.4	22.6	23.2	23.4	23.0
Commercial real estate loans to total gross loans	12.6	17.2	15.6	18.4	19.7	19.8	18.6

Source: IMF Financial Soundness Indicators.

Annex I. Risk Assessment Matrix[1]

Source of Risks, Likelihood, and Time Horizon	Impact on Latvia	Recommended Policy Response
High (short to medium term) **Russia's invasion of Ukraine leads to escalation of sanctions and other disruptions.** Sanctions on Russia are broadened to include oil, gas, and food sectors. Russia is disconnected almost completely from the global financial system and large parts of the trading system. This, combined with Russian countersanctions and secondary sanctions on countries and companies that continue business with Russia, leads to even higher commodity prices, refugee migration, tighter financial conditions, and other adverse spillovers, which particularly affect LICs and commodity-importing EMs.	**High** The sanctions against Russia could lead to disruptions in Latvia's trade and finance. The war could further increase risks to economic and investor confidence and make the inflow of refugees disorderly. Almost 33,000 refugees have arrived in the country already and substantially more can follow.	Deploy additional discretionary fiscal support. Prioritize such support in key security-related areas and the integration of refugees. Further enhance the anti-corruption and AML/CFT frameworks to protect the financial sector.
High (short term) **Rising and volatile food and energy prices.** Commodity prices are volatile and trend up amid supply constraints, war in Ukraine, export restrictions, and currency depreciations. This leads to short-run disruptions in the green transition, bouts of price and real sector volatility, food insecurity, social unrest, and acute food and energy crises (especially in EMDEs with lack of fiscal space).	**High** High international energy and volatile food prices are the key driver of inflation in Latvia. The Russia-Ukraine war will cause commodity and food prices to rise further.	Participate in European policy responses. Diversify energy supply and reduce dependence on energy from Russia. Provide incentives to boost domestic food production and diversify the supply of food.
Medium (short to medium term) **Outbreaks of lethal and highly contagious Covid-19 variants.** Rapidly increasing hospitalizations and deaths due to low vaccine protection or vaccine-resistant variants force more social distancing and/or new lockdowns. This results in extended supply chain disruptions and a reassessment of growth prospects, triggering capital outflows, financial tightening, currency depreciations, and debt distress in some EMDEs.	**Medium** The outbreak of new vaccine-resistant variants could lead to a contraction in economic activity through nationwide lockdowns. Risks are mitigated by a strong public balance sheet and significant financial system buffers.	Participate in global and European policy responses. Continue efforts to increase vaccinations. Use fiscal space to provide support to vulnerable households and viable firms. Mitigate "social scarring" through targeted policies to reduce poverty and inequality gaps.
Medium (medium term) **De-anchoring of inflation expectations in the U.S. and/or advanced European economies.** Worsening supply-demand imbalances, higher commodity prices (in part due to war in Ukraine), and higher nominal wage growth lead to persistently higher inflation and/or inflation expectations, prompting central banks to tighten policies faster than anticipated.	**Medium** High and persistent inflation could raise inflation expectations. Risks of de-anchoring is moderate as there is no clear evidence of a wage price spiral.	Participate in ECB policy discussions. Provide fiscal support to protect low income and possibly middle-income households against rising energy prices. Use macroprudential tools should overheating emerge in the housing market.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Source of Risks, Likelihood, and Time Horizon	Impact on Latvia	Recommended Policy Response
High (short to medium term) **Geopolitical tensions and de-globalization.** Intensified geopolitical tensions, security risks, conflicts, and wars cause economic and political disruptions, fragmentation of the international monetary system, production reshoring, a decline in global trade, and lower investor confidence.	**High** A protracted Russia-Ukraine war would weigh on activity in trading partners causing external demand to fall, keep inflation elevated, worsen supply chain disruptions, and weaken confidence.	Provide discretionary fiscal support. Reduce energy dependence. Seek alternative markets for exports.
Medium (short to medium term) **Cyberthreats**. Cyberattacks on critical physical or digital infrastructure (including digital currency platforms) trigger financial instability or widespread disruptions in socio-economic activities.	**Medium** Latvia is susceptible to cyber-attacks from geopolitical tensions and this risk could rise given the planned increases in reliance on ICT processes and innovation.	Participate in global and European defenses against cyber-attacks. Continue strong efforts to improve national cyber-security by allocating sufficient fiscal resources and through vigilant regulation.
Medium (short to medium term) **Risks from AML/CFT issues.** If progress is not maintained, banks could come under pressure from financial markets' perceptions of AML/CFT concerns, including in the broader Nordic region, or tighter global financial conditions with lower risk appetite.	**Medium** Curtailed credit supply, confidence loss, pressures on correspondent banking relationships, AML/CFT setbacks in local affiliates, and sanctions on financial institutions could weigh on the Latvian financial sector.	Further strengthen the AML/CFT framework. Preserve high capitalization and liquidity. Step up cross-border supervision, including cooperation with home-country authorities. Persevere with business model transformations of banks formerly servicing foreign clients. Forcefully implement the sanctions regime.

Annex II. War in Ukraine—Spillover Channels to Latvia's GDP

Latvia is vulnerable to the fallout from the war, although its exposures—which derive from geographical proximity and historical ties to Russia and Ukraine—have weakened appreciably in recent years. Energy dependence on Russian imports remains a critical area and there is some reliance on other imported inputs. International sanctions imposed on Russia and Belarus create additional uncertainty. The shock transmission channels include both demand and supply-side effects. Overall, the adverse impact of the war on growth in 2022 is estimated at around 1½ percentage points. This Annex mainly focuses on the effects of the war on reducing output, although it will also have significant effects on increasing Latvia's inflation and the import bill.

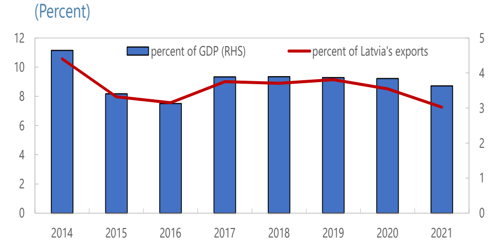
A. Exposures

1. Latvia's cross-border exposures to the war span external trade in goods and services, investment, and financial sector areas.

- **Trade in goods and services.** Latvia has some dependence on trade in goods and services with Russia, but it has been substantially reducing reliance on this trade in recent years, particularly in services and some goods exports. There remains substantial dependence on certain goods exports and imports.
    - *Trade in goods.* Latvia has moderate dependence on trade in goods with Russia (fluctuating in recent years in the range of 6–9 percent of Latvia's trade flows), while its respective links with Ukraine (1 to 1.5 percent of trade) and Belarus are small (Figure 1).
        - *Exports*. Russia is Latvia's fifth most important export destination. Its share in exports gradually declined since 2014, reaching 7 percent in 2021 (Text Figure 1). Key exports include alcoholic beverages, machinery, and pharmaceuticals, where Russia remains the destination of 20 percent or more of Latvia's respective exports (text figure).

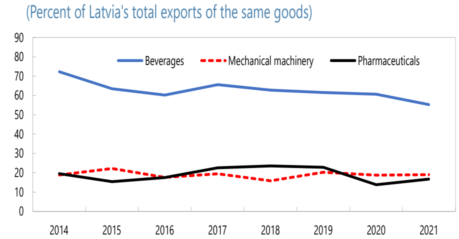
Text Figure 1. Latvia's Exports of Goods to Russia

Latvia's Goods Exports to Russia (2014-21)
(Percent)



Source: Central Staistical Bureau of Latvia and IMF Staff Calculations.

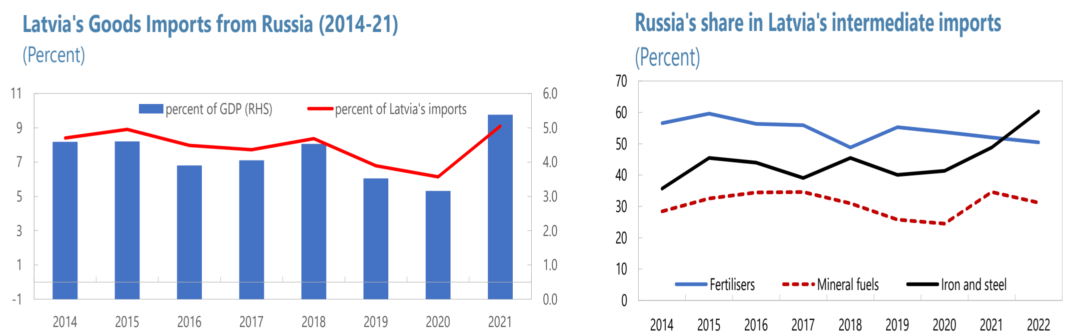
Largest Exports by Latvia to Russia
(Percent of Latvia's total exports of the same goods)



Source: Central Staistical Bureau of Latvia and IMF Staff Calculations.

- *Imports*. Russia is the fourth-largest source of Latvia's imports: in 2021, these imports accounted for 9 percent of Latvia's total imports, and mainly comprised mineral fuels, steel, fertilizers, and wood. The decline in the dependence on Russian imports through 2020 was reversed in 2021, mainly due to the sharp rise in imported energy prices (Text Figure 2). Dependence on imports of certain intermediate inputs, notably fertilizers, steel, and mineral fuels has been high and relatively stable (text figure). Within the category of mineral fuels, Latvia's dependence on imports of Russian gas stands out and was 80–100 percent depending on the year. However, dependence on overall energy imports from Russia is lower since Latvia produces its own electricity and imports it mainly from the EU countries.

Text Figure 2. Latvia's Imports of Goods from Russia

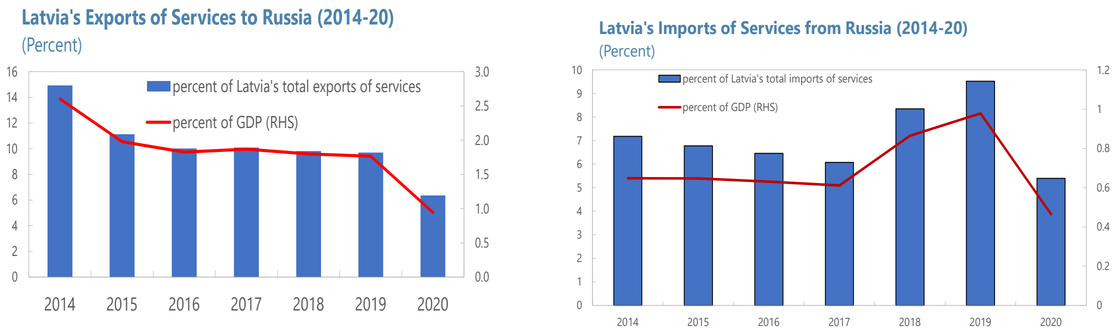


Source: Central Statistical Bureau of Latvia and IMF Staff Calculations.

Source: Central Statistical Bureau of Latvia.

- *Trade in services*. There is some dependence on trade in tourism, transport, insurance, financial, and other business services. However, this dependence has been reduced perceptibly across all services segments in recent years (Text Figure 3). As regards sub-categories of services, Russian tourists accounted for about 10 percent of foreign visitors to Latvia in 2018; this share fell sharply, to below 2 percent in 2020. Latvia's dependence on imports of services has been reduced less sharply than for exports, but this category has been smaller in size, accounting for some ½ percent of GDP (text figure).

Text Figure 3. Exports and Imports of Services to/from Russia

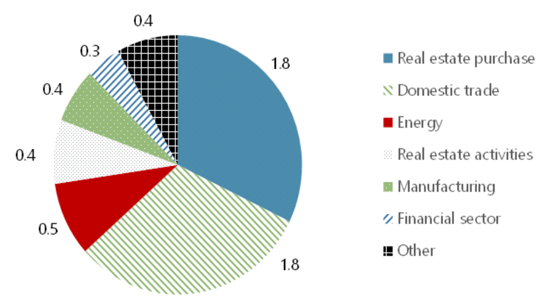


Source: Eurostat and IMF Staff Calculations.

Source: Eurostat and IMF Staff Calculations.

- **FDI.** Russia's inward FDI stock at end-2021 is assessed at around 5½ percent of GDP, and Latvia's outward FDI to Russia is negligible at 0.3 percent of GDP. Russia's inward FDI is dominated by the real estate and domestic trade sectors, with more moderate dependence in energy supply and manufacturing sectors.

Russia's FDI Stock in Latvia by Sector, 2021
(percent of GDP)



Source: Central Statistical Bureau of Latvia

- **Financial sector.** Russian resident deposits in Latvian banks now account for only 1 percent of total deposits following AML/CFT reforms. Deposits and transaction volumes with Russian clients have been reduced by 70-90 percent since 2014. However, economic sectors whose activity is at some risk from the war (transportation, energy, construction, agriculture, domestic trade, and manufacturing) account for more than one-half of corporate loans and a fifth of total domestic loans.

- **Sanctions.** International/EU sanctions require a freezing of the funds of sanctioned legal and individual persons from Russia and Belarus and bans on payments for goods and services and on transactions with financial instruments. Sanctions have also been imposed on several Russian banks and therefore entail a cessation of payments between Latvian banks and those financial institutions. Some EUR 8 million in sanctioned funds (less than 0.1 percent of deposits) were initially frozen by the Latvian regulator as of mid-March 2022.

B. Channels of Macro-Impact on Growth

2. **Exposures are a static measure of dependence on the fall-out from the war.** In practice, the impact would evolve over time and could be higher (if there are adverse interaction effects) or lower (if exposures are mitigated by policies) than the size of exposures would indicate. The effects are likely to be larger in the short term but would abate as the economy adapts to the shock. Within an internally consistent framework, the main channels of the GDP impact would be the following:

- **Reduced exports of goods and services.** The expected sharp reduction in the exports of goods and services, whether due to sanctions or trade restraints, will be mirrored in the demand-side GDP impact. The impact would be mitigated if exports are re-channeled to alternative markets. It will materialize with some lag, as it could take time to unwind existing contractual transactions (e.g., if they do not fall under the sanctions). The mission assumes that in 2022 a substantial part of the reduction falls on Latvia's exports of machinery and equipment and pharmaceuticals, which are more tailored to the specificities of markets and would be more difficult to reallocate. The potential effects from reduced exports of alcoholic beverages on the Latvian economy would be reduced because of the large role of re-exports for these products. Also, there would be knock-on effects from the impact of the war on trading partner growth, particularly among the EU countries, that would in turn reduce demand for Latvian exports.

- **Increased supply bottlenecks. The adverse output effects from import disruptions would** operate through supply-side linkages. A disorderly reduction in imports will cause a decline through production chains, which will be particularly concentrated in manufacturing, but would also impact other sectors that rely on inputs from Russia and Ukraine (fertilizers for agriculture, wood and steel for construction, energy for various industries, etc.). A key specific vulnerability is a potential insufficiency of natural gas, given Latvia's high dependence and the extensive use of gas for electricity generation. Such a scenario will have to internalize Latvia's extensive regional linkages with the Baltic countries as well as Finland and Poland with respect to gas and broader energy supply. Supply-side bottlenecks could also cause more protracted high inflation.

- **Increased input/energy prices.** Even when imports can be substituted, they would come at a cost of higher prices, including higher global prices through the affected markets. In Latvia, the effects from the war would be dominated by those from higher energy prices, which would alter profitability and viability of all energy-using activities as well as increase inflation.

- **Deteriorating confidence.** The confidence shocks are likely to reduce output through lower investment (including by undercutting operations and profitability of the corporate sector) and consumption (including through lower future growth and higher inflation). Adverse effects on financial intermediation and perceived risks from AML/CFT would amplify those effects.

- **Fiscal policies. The needs of greater security-related spending, increased support to cushion the** impact of high energy prices, and the cost of managing refugees will require a fiscal expansion. Although these measures would support the vulnerable population and limit adverse output effects by increasing consumption, they will take away valuable fiscal space and not fully offset the fallout of the war on activity.

- **Impact on GDP growth.** The mission estimates that the drag on growth from the war in 2022 (net of the effects of fiscal support) would amount to about 1½ percentage points. The estimated distribution of the effects is however preliminary and highly uncertain: as of May 2022, the effects of the war have been largely reflected in the confidence indicators, while 2022 first-quarter GDP (growth of 6.7 percent, y/y) and foreign trade turnover through April (growth of 37 percent y/y) have continued to be quite strong, likely reflecting the lags involved as described above.

C. Sectoral Output Effects

3. On the supply side, the output effects of the war would mainly be distributed across the following sectors:

- **Industry and Manufacturing** are sectors that have high susceptibility to export demand and supply chain problems, which reflects the relatively large size and interconnectedness of enterprises in these sectors. In March 2022, business sentiment in industry turned negative, and continued to decline, albeit at a slower pace, through May. Corporates, particularly in food and pharmaceuticals have been among the first firms to announce staff redundancies due to the war.

- **Transportation, as Latvia is a significant transit point for Russian cargoes. Business executives** estimate that if Russian transit is eliminated, port traffic could decline by over 50 percent and railroad traffic by over 80 percent.

- **Construction** is vulnerable as it depends on the supply of Russian iron, steel, bitumen, and wood. While these inputs can be procured from alternative suppliers, the re-orientation would take time and the cost would be higher. In March 2022, business sentiment in the construction sector dropped sharply and continued to be weak through May.

- **Retail trade** would feel the effect of reduced supply of certain consumer goods from Russia, Belarus, and Ukraine, including food (sunflower seeds), furniture, and garments.

- **Agriculture** would have to limit output due to shortages of fertilizers and seeds, which are supplied from Russia and Ukraine.

- **Real estate** sector activity would be impacted by uncertainty over the status of ownership of Russian residents' substantial assets in the sector.

- **The energy** sector would see lower electricity generation as a result of reduced and more costly inputs due to imported oil and gas.

Figure 1. Exports and Imports from Belarus, Russia, and Ukraine

Sources: UN Comtrade Database and IMF Staff Calculations.

Annex III. External Sector Assessment

Overall Assessment: *The external position of Latvia in 2021 was broadly in line with the level implied by fundamentals and desirable policies. The current account (CA) balance returned to a moderate deficit position after a temporary COVID-19 related improvement in 2020.*
Potential Policy Responses: *In the short term, fiscal policy should continue to play a key role in responding to the pandemic and mitigating the impact from the war in Ukraine. Macroprudential policies should focus on preventing/containing real estate imbalances and reducing financial sector risks. Structural policies to increase the resilience of the economy to future shocks, including increasing capital investment and health spending would help mitigate risks of long-term scarring and prevent accumulation of future imbalances. Improving adequacy and targeting of the social safety net could reduce accumulation of large precautionary savings. Efforts to foster green and digital transformation should help address other important challenges.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Both foreign assets and liabilities continued to increase in 2021 in nominal terms, but liabilities declined in terms of GDP. Gross assets increased from 138 to 140 percent of GDP, and gross liabilities fell from 173 to 168 percent of GDP. The asset increase was more than explained by direct investment, while the liability decrease was driven by other investment. The NIIP continued to improve, reaching -28 percent of GDP in 2021, from -35 percent of GDP in 2020. Gross external debt declined from 125 percent of GDP in 2020 to 112 percent of GDP at end-2021, thereby returning to the medium-term downward path that was observed since the peak of 147 percent of GDP in 2016.
Assessment. The current NIIP does not imply risks to external sustainability. The NIIP has been on an improving medium-term trend, which is expected to continue.

2021 (% GDP)	NIIP: -28	Gross Assets: 140	Debt Assets: 100	Gross Liab.: 168	Debt Liab.: 112

Current Account

Background. The current account balance swung from a surplus of 2.9 percent of GDP in 2020 to a deficit of 2.9 percent of GDP in 2021. Imports of goods rebounded strongly (by 25 percent in nominal terms) from the compressed 2020 levels caused by the weak domestic demand during the COVID-19 crisis. While exports of goods also exhibited solid growth (21 percent), the deficit in the goods balance deteriorated from 5.1 percent in 2020 to 7.4 percent in 2021. Both services exports and imports recovered from the 2020 troughs, but the former grew more strongly, resulting in a further deterioration of the services surplus from 6.2 percent of GDP in 2020 to 5.3 percent of GDP in 2021. Primary income account reversed the improvement that was observed in 2020, moving from a balance to a deficit of 1.9 percent of GDP, as outward dividends payments and reinvested earnings recovered. Secondary income account surplus also declined by 0.5 percent of GDP.

Latvia: EBA-lite Model Results, 2021

	CA model 1/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**-2.9**	
Cyclical contributions (from model) (-)	0.1	
COVID-19 adjustor (-) 2/	-0.2	
Additional temporary/statistical factors (-)	0.0	
Natural disasters and conflicts (-)	-0.2	
Adjusted CA	**-2.6**	
CA Norm (from model) 3/	**-3.1**	
Adjusted CA Norm	**-3.1**	
CA Gap	**0.5**	**2.0**
o/w Relative policy gap	3.1	
Elasticity	-0.43	
REER Gap (in percent)	**-1.2**	**-4.8**

1/ Based on the EBA-lite 3.0 methodology
2/ Additional cyclical adjustment to account for the temporary impact of the tourism (0.2 percent of GDP).
3/ Cyclically adjusted, including multilateral consistency adjustments.

Assessment. Overall, the current account position is assessed to be in line with the levels implied by fundamentals and desirable policies. The EBA-lite CA model results suggest a CA gap of 0.5 percent of GDP in 2021, and the gap attributed to policies amounts to 3.1 percent of GDP. This mainly reflects Latvia's lower public health expenditure

and smaller fiscal policy gap compared to the world. The COVID-19 adjustor offsets the temporary decline in tourism activity. The current account balance is projected to remain in a moderate deficit position over the medium term.
Real Exchange Rate
Background. The REER appreciated by 0.4 percent in 2021. From 2015 to 2021, the REER appreciated by 6.5 percent. The competitiveness has been gradually declining as wage growth has exceeded productivity growth, against the backdrop of the aging population and the resulting labor supply shortages. The gross wage growth has accelerated in 2021 to 11.6 percent, reflecting a large hike in the minimum wage, progressively more tight labor market, and sizable public wage increases in some sectors. **Assessment.** The preferred EBA-lite CA model suggests an undervaluation of about 1.2 percent. The EBA-lite REER Index model finds a somewhat larger under-valuation of 4.8 percent, although this model seems less granular and more constrained in identifying Latvia-specific issues due to the need to partially rely on euro-area-wide indicators of common monetary policy.
Capital and Financial Accounts: Flows and Policy Measures
Background. The capital account balance was 1.4 percent of GDP, mainly reflecting the transfer of funds from the EU. The level is in line with the average over the past few years. The financial account (BPM6 methodology) decreased from 6.2 percent of GDP in 2020 to -1.8 percent of GDP in 2021. Direct and portfolio investment inflows were the main drivers of this change, being partially offset by other investment. **Assessment.** Risks related to capital flows are assessed to be small.
FX Intervention and Reserves Level
Background. The Euro has the status of a global reserve currency. Thus, reserves held by euro area economies are typically low by standard metrics (14.8 percent of GDP for Latvia as of end-2021). **Assessment.** Reserve level is assessed to be adequate.

Annex IV. External Debt Sustainability Assessment

1. **Latvia's gross external debt increased marginally in nominal terms in 2021 but it declined markedly as a share of GDP, from 125 to 112 percent.** General government debt increased by EUR 1.1 billion. Monetary and financial institutions' foreign deposits, excluding the Bank of Latvia (BoL), declined by about EUR 400 million from 2020 to 2021, while the BoL's foreign deposits increased by EUR 576 million. Financial sector's external debt fell sharply by more than EUR 1 billion. External debt of non-financial corporations and households declined by almost EUR 200 million.

2. **Under the baseline, gross external debt is projected to continue to decline over the medium term.** External debt is projected to decline from around 112 percent in 2021 to 76.8 percent of GDP in 2027. The current account balance excluding interest payments is projected to be -0.6 percent of GDP in 2027, above the debt stabilizing level (-4.2 percent of GDP). Gross financing needs are projected to increase moderately.

3. **External debt seems broadly resilient to various shocks.** Under most shocks and the historical scenario, Latvia's external debt-to-GDP ratio would be near or below its 2021 level over the projection horizon until 2027.

Table 1. Latvia: External Debt Sustainability Framework (2017–27)

(Percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2017	2018	2019	2020	2021			2022	2023	2024	2025	2026	2027	Debt-stabilizing non-interest current account 6/
Baseline: External debt	141.3	123.3	116.8	124.8	112.0			**103.8**	**97.5**	**93.1**	**88.1**	**81.0**	**76.8**	**-4.2**
Change in external debt	-5.9	-18.1	-6.5	8.0	-12.8			-8.2	-6.3	-4.4	-5.0	-7.2	-4.1	
Identified external debt-creating flows (4+8+9)	-12.3	-13.0	-7.8	-0.6	-15.5			-2.2	-2.1	-2.7	-2.8	-3.0	-3.0	
Current account deficit, excluding interest payments	-3.3	-1.6	-1.4	-4.7	1.6			0.7	0.5	0.3	0.0	-0.3	-0.6	
Deficit in balance of goods and services	0.6	0.7	0.7	-1.2	2.1			1.8	1.7	1.5	1.0	0.6	0.3	
Exports	61.6	61.5	59.8	60.4	64.1			61.4	58.1	56.2	54.7	53.2	52.0	
Imports	62.2	62.2	60.5	59.3	66.2			63.2	59.8	57.7	55.7	53.9	52.3	
Net non-debt creating capital inflows (negative)	-2.0	-2.2	-3.0	-2.3	-5.0			-1.7	-1.6	-1.5	-1.4	-1.3	-1.2	
Automatic debt dynamics 1/	-7.0	-9.2	-3.4	6.3	-12.0			-1.2	-1.0	-1.6	-1.5	-1.4	-1.3	
Contribution from nominal interest rate	2.0	1.8	2.0	1.8	1.3			1.5	1.5	1.5	1.5	1.4	1.3	
Contribution from real GDP growth	-4.5	-5.0	-3.1	4.5	-4.8			-2.7	-2.5	-3.1	-2.9	-2.8	-2.6	
Contribution from price and exchange rate changes 2/	-4.5	-6.0	-2.4	0.0	-8.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.4	-5.0	1.3	8.6	2.7			-6.0	-4.2	-1.6	-2.2	-4.2	-1.1	
External debt-to-exports ratio (in percent)	229.6	200.5	195.2	206.6	174.8			169.0	167.8	165.7	161.2	152.1	147.8	
Gross external financing need (in billions of US dollars) 4/	21.8	25.2	19.8	17.1	22.8			19.9	20.7	21.8	22.5	23.5	21.6	
in percent of GDP	71.7	73.1	57.7	51.0	58.6	10-Year	10-Year	48.6	45.9	44.8	43.2	42.3	36.6	
Scenario with key variables at their historical averages 5/								**103.8**	**100.7**	**97.2**	**92.2**	**84.4**	**80.0**	**-3.6**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	3.3	4.0	2.5	-3.8	4.5	2.8	2.8	2.5	2.7	3.4	3.4	3.4	3.4	
GDP deflator in US dollars (change in percent)	5.1	8.7	-2.8	1.8	10.7	1.0	7.8	2.9	7.2	4.2	3.5	3.1	2.7	
Nominal external interest rate (in percent)	1.5	1.4	1.6	1.5	1.2	1.9	0.6	1.4	1.6	1.6	1.7	1.7	1.7	
Growth of exports (US dollar terms, in percent)	12.2	12.9	-3.0	-1.0	22.7	4.6	10.1	1.1	4.1	4.3	4.0	3.8	3.7	
Growth of imports (US dollar terms, in percent)	14.0	13.0	-3.0	-4.1	29.1	4.1	12.3	0.8	4.3	3.8	3.2	3.1	3.1	
Current account balance, excluding interest payments	3.3	1.6	1.4	4.7	-1.6	1.8	1.8	-0.7	-0.5	-0.3	0.0	0.3	0.6	
Net non-debt creating capital inflows	2.0	2.2	3.0	2.3	5.0	2.4	1.3	1.7	1.6	1.5	1.4	1.3	1.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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

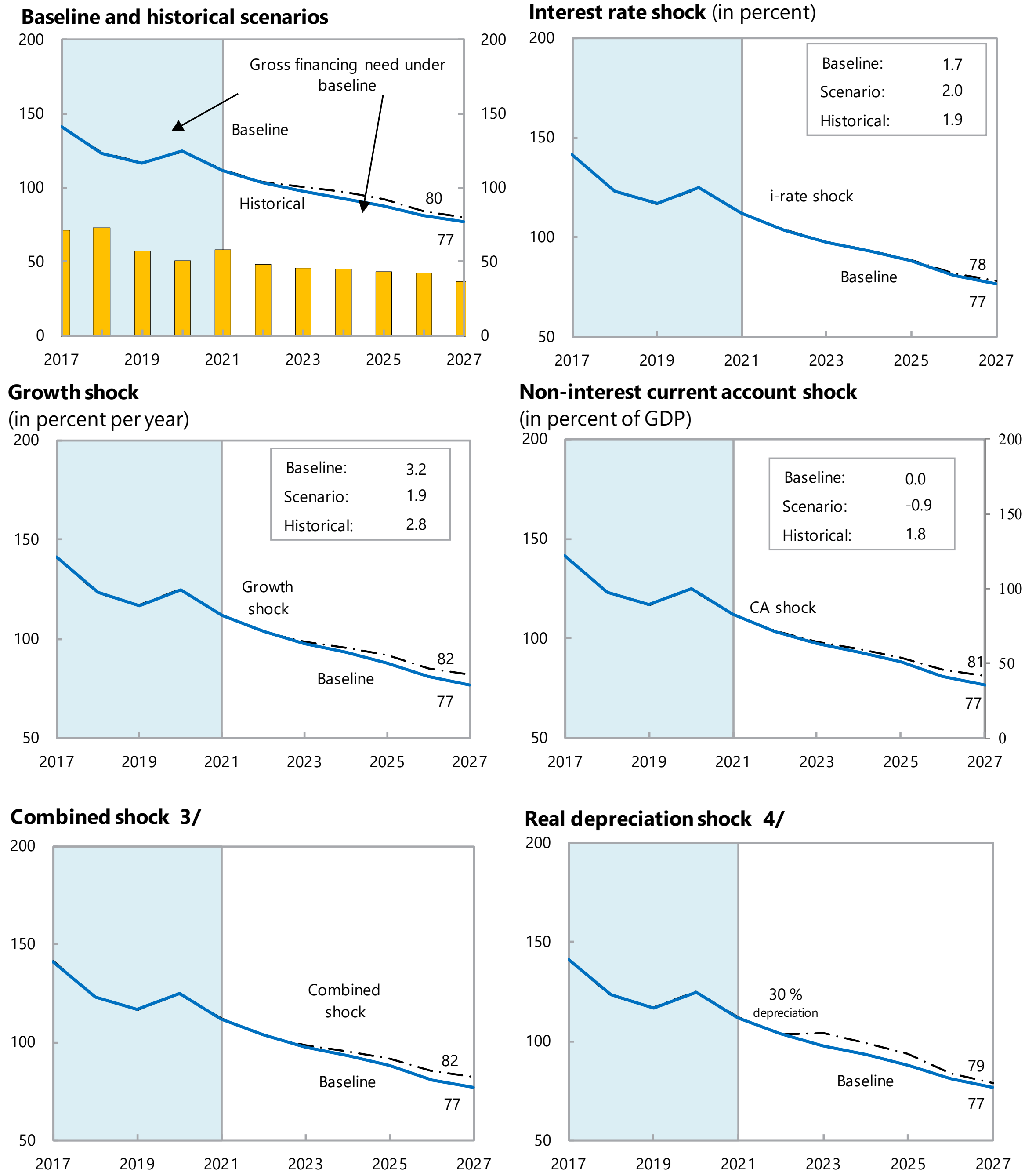
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

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

(In percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2021.

Annex V. Public Sector Debt Sustainability Assessment

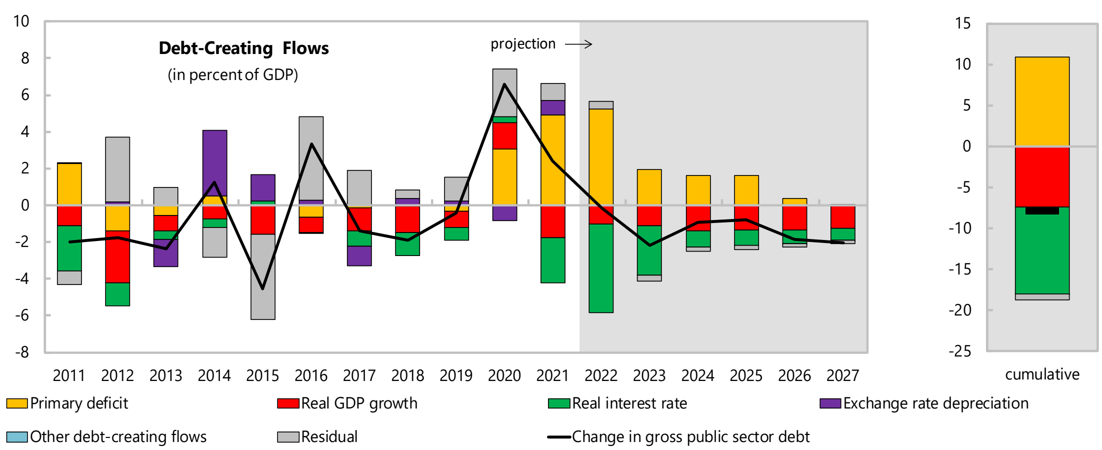
Table 1. Latvia: Public Sector DSA—Baseline Scenario
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of June 21, 2022		
	2011-2019 [2/]	2020	2021	2022	2023	2024	2025	2026	2027	Sovereign Spreads		
Nominal gross public debt	39.9	43.3	45.7	45.5	43.4	42.5	41.7	39.8	37.8	EMBIG (bp) 3/		110
Public gross financing needs	6.3	9.1	10.9	7.3	6.3	5.5	5.9	6.9	7.7	5Y CDS (bp)		69
Real GDP growth (in percent)	3.3	-3.8	4.5	2.5	2.7	3.4	3.4	3.4	3.4	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.7	-0.1	6.8	12.8	7.1	2.8	2.5	2.4	2.3	Moody's	A3	A3
Nominal GDP growth (in percent)	6.1	-3.9	11.6	15.7	10.0	6.3	6.0	5.9	5.8	S&Ps	A+	A+
Effective interest rate (in percent) [4/]	3.4	2.3	2.0	0.9	0.8	0.7	0.5	0.6	0.7	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027	cumulative	debt-stabilizing
Change in gross public sector debt	-1.1	6.6	2.4	-0.1	-2.2	-0.9	-0.8	-1.9	-2.0	-7.9	primary
Identified debt-creating flows	-1.7	4.0	1.5	-0.6	-1.9	-0.7	-0.6	-1.7	-1.8	-7.2	balance [9/]
Primary deficit	0.0	3.1	4.9	5.3	1.9	1.6	1.6	0.4	0.1	10.9	-1.9
Primary (noninterest) revenue and grants	36.3	38.3	38.1	35.6	35.7	35.2	34.8	34.8	34.8	210.9	
Primary (noninterest) expenditure	36.2	41.4	43.0	40.9	37.7	36.8	36.4	35.2	34.8	221.8	
Automatic debt dynamics [5/]	-1.7	0.9	-3.5	-5.8	-3.8	-2.3	-2.2	-2.1	-1.9	-18.0	
Interest rate/growth differential [6/]	-2.1	1.7	-4.2	-5.8	-3.8	-2.3	-2.2	-2.1	-1.9	-18.0	
Of which: real interest rate	-0.8	0.3	-2.5	-4.8	-2.7	-0.9	-0.8	-0.7	-0.6	-10.6	
Of which: real GDP growth	-1.3	1.4	-1.7	-1.0	-1.1	-1.4	-1.3	-1.3	-1.3	-7.4	
Exchange rate depreciation [7/]	0.4	-0.8	0.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.6	2.6	1.0	0.4	-0.3	-0.3	-0.2	-0.2	-0.2	-0.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

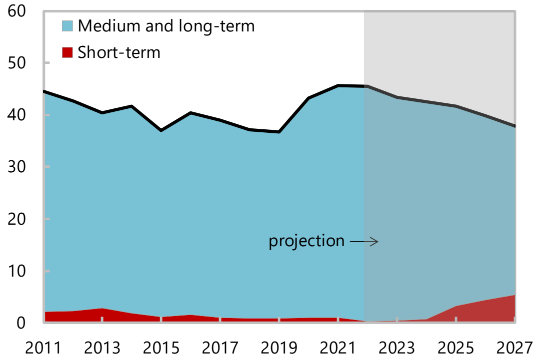
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

Figure 1. Public Debt Sustainability Analysis – Composition of Public Debt and Alternative Scenario

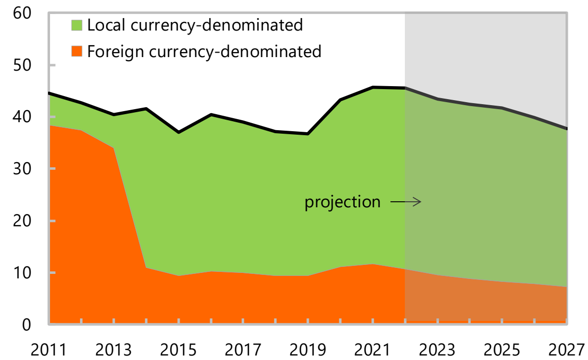
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

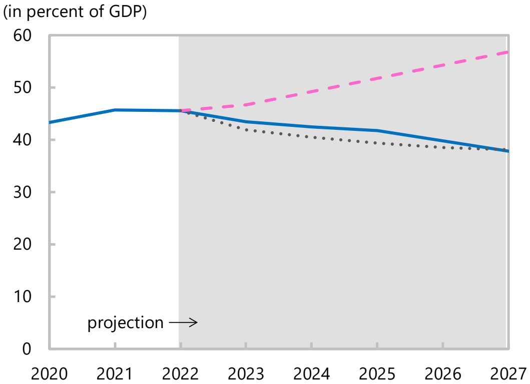


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

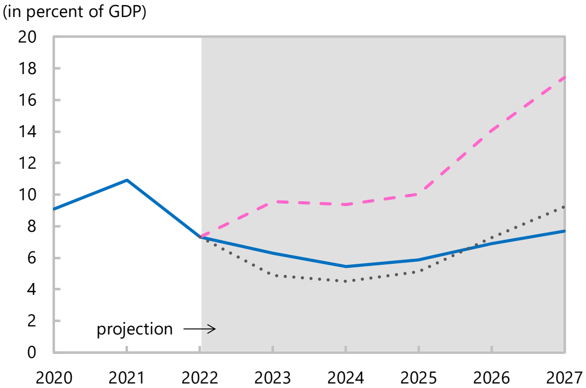
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	2.5	2.7	3.4	3.4	3.4	3.4
Inflation	12.8	7.1	2.8	2.5	2.4	2.3
Primary Balance	-5.3	-1.9	-1.6	-1.6	-0.4	-0.1
Effective interest rate	0.9	0.8	0.7	0.5	0.6	0.7
Constant Primary Balance Scenario						
Real GDP growth	2.5	2.7	3.4	3.4	3.4	3.4
Inflation	12.8	7.1	2.8	2.5	2.4	2.3
Primary Balance	-5.3	-5.3	-5.3	-5.3	-5.3	-5.3
Effective interest rate	0.9	0.8	0.7	0.5	0.7	0.8

Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	2.5	2.8	2.8	2.8	2.8	2.8
Inflation	12.8	7.1	2.8	2.5	2.4	2.3
Primary Balance	-5.3	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	0.9	0.8	1.3	1.5	2.1	2.8

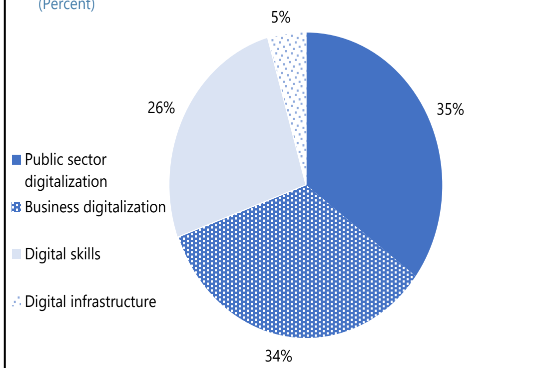
Source: IMF staff.

Annex VI. Accelerating Latvia's Digital Transformation

Latvia has achieved good progress in several dimensions of digitalization, notably in connectivity and the use of public services, but faces challenges in others. Indicators of digital skills and business digitalization fall short of the EU averages; improvements in these areas would help reduce labor market mismatches and raise productivity. The authorities have adopted a comprehensive digital transformation strategy and their Recovery and Resilience Plan (RRP) contains investments and reforms addressing the main challenges. A recent surge in malicious cyber activity has prompted strengthening of the cybersecurity framework.

1. **Digitalization is a key pillar in Latvia's development strategy.** The digital transformation is changing profoundly the economy and people's lives. This was particularly evident during the COVID-19 pandemic with the sharp increase in the use of online services and remote work. Latvia's Digital Transformation Guidelines 2021–2027 (henceforth, "the guidelines") set the long-term priorities and the framework for the country's digital development. The guidelines cover all major aspects of digitalization – telecommunications infrastructure, digital skills and education, digital public services, business digitalization and innovation capabilities, and digital security. An action plan is currently being prepared, with specific tasks and milestones. Reforms and investments to accelerate digitalization are supported by national and EU funding. In particular, Latvia's National Recovery and Resilience Plan (RRP) envisages EUR 365 million for digital transformation.

Allocation of Funding for Digitalization under the RRF
(Percent)



Source: Latvian Authorities.

2. **Latvia has achieved substantial progress in developing the digital infrastructure, but "last-mile" connections remain a challenge.** The country's overall connectivity score in the EU's Digital Economy and Society Index (DESI) is 50.4, slightly above the EU average. In certain areas like fast broadband coverage and very high-capacity networks (VHCN), Latvia outperforms most of its peers. However, "last-mile" connections in rural areas remain a challenge due to low commercial interest. The government is stepping in to address the issue. With financing from the RRF of EUR 4 million, 1,500 households and businesses will get access to VHCN services. Another EUR 18.4 million from the European Regional Development Fund are earmarked for "middle-mile" and "last-mile" network infrastructure that would provide access to another 6,000 entities. Stakeholders—municipalities, businesses, and NGOs—are actively involved in the planning process to ensure the optimal use of public funds. Another area where Latvia is lagging behind other EU countries is 5G readiness. The government has auctioned the 700MHz and the 3,6GHz bands to all three mobile operators, with coverage conditions attached to the 700MHz band's use rights. Mobile operators should deploy 800 base stations by 2031, with at least 61, close to the TEN-T roads, and 21 along the Via Baltica corridor.

3. Significant efforts are focused on closing the digital skills gap. Shortage in digital skills, both at the basic and advanced levels, is a major setback to advancing the digital transformation. The DESI scores indicate that only 43 percent of the adults have basic digital skills vs. 56 percent on average in the EU, and 24 percent have above basic skills (31 percent EU average). Low interest in STEM disciplines is expected to increase further labor market tensions as some estimates suggest that the shortage of specialists in these disciplines may reach 14 thousand by 2027, or five times the current number of graduates per year.[1] Against this backdrop, the guidelines set an ambitious goal of increasing the share of adult population with basic skills to 70 percent and that with skills above basic to 45 percent. To meet these goals, the government is updating school curricula and placing emphasis on the use of technologies in education and development of the digital skills of teachers. Encouraging adult learning is another important element of the strategy for increasing digital literacy, including through design and financing of training programs in close cooperation with employers and NGOs. A large network of digital agents—government officials, teachers, librarians and journalists, has been created to help people make the transition from on-site services to digital services; this is particularly useful in the regions and for "hard-to-reach" target groups like seniors and people with disabilities.

4. New initiatives are aimed at increasing further the use of digital public services. The government's past efforts to promote the use of digital technologies in public services have paid off and Latvia's DESI scores in this area exceed the EU averages in all categories. Notwithstanding the progress, the goal is to increase the use of e-government services to 95 percent (from the current 83 percent). This would be achieved through various measures, including creation of centralized government platforms with standardized support functions, ensuring cross-border access to public administration services and increasing the availability and sharing of public data, among others. A Federal Cloud would provide computing and data management infrastructure for the administration. Digital tools are provided free of charge to citizens and businesses (Mobile eSignature, eID, Digital Post). To encourage their use, starting from 2023, digital identification tools would gradually become mandatory for citizens, while Digital Post will become mandatory for businesses from the beginning of the same year.

5. Greater use of digital technologies by businesses and fostering innovation should help productivity. The outbreak of COVID-19 had a significant impact on the way firms do business and many companies in Latvia did not have the necessary infrastructure and skills to adjust to the new reality. Although according to DESI, the e-commerce turnover increased from 5 to 7 percent between 2020 and 2021, it is still well below the EU average (12 percent). Only 15 percent of companies use of e-invoices and 18 percent use cloud solutions compared to 32 percent and 26 percent in the EU, on average. The main obstacles to the digitalization of businesses are the costs and lack of skills and motivation. The government aims to provide a full support cycle for the digital transformation of business through grants for IT solutions, raising awareness and digital maturity, fostering digital export promotion skills, support for investments in new products, and creation of a

[1] OECD Economic Surveys: Latvia 2022, p.89

suitable business environment (e-receipts, e-invoices). The RRP contains a number of investments in this regard, including support for the establishment of Digital Innovation Hubs, grants for digitization of processes and functions in enterprises, grants for research and development of digital products and services, as well as various measures targeted at development of advanced digital skills. In addition, tax incentives are available for start-ups in ICT and investment in R&D.

6. Reforms are being launched to strengthen cybersecurity. Cyber-attacks have intensified since the Russian invasion of Ukraine. Despite the increase in number, there have been few incidents without major impact. The authorities have responded to the surge in malicious activity by a set of measures. These include guidelines for increasing resilience, information seminars, active monitoring and data back-up, and requests for information sharing with the private sector. In addition, international cooperation has strengthened through active information sharing with the EU, NATO and use of bilateral channels. A recent cybersecurity governance reform envisages the establishment of a National Cybersecurity Center which will be responsible for policy making, monitoring of cyber risks and resolution of incidents, ensuring compliance with the minimum security requirements for ICT, raising awareness of cyber risks in society, and implementation of EU legislation in the area. Special attention is given to critical infrastructure. The government works actively with entities falling into this category, especially in the energy sector, to design and perform resilience tests, and develop business continuity plans.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 12, 2022

Prepared by | The European Department

CONTENTS

FUND RELATIONS

(As of May 31, 2022)

Membership Status: Joined May 19, 1992; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	332.30	100.00
Fund holdings of currency (Exchange Rate)	320.24	96.37
Reserve Tranche Position	12.39	3.73

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	439.32	100.00
Holdings	439.32	100.00

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

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

Projected Payments to Fund:

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

	Forthcoming		
	2022	2023	2024
Principal	0.00	0.00	0.00
Charges/Interest	0.01	0.01	0.01
Total	0.01	0.01	0.01

Exchange Rate Arrangement:

As of January 1, 2014, the currency of Latvia is the euro. The exchange rate arrangement of the euro area is free floating. Latvia participates in a currency union (EMU) with 18 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies. Prior to 2014, the currency of Latvia was the lat, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ±1 percent band. On January 1, 2005, the lat was re-pegged to the euro at the rate 1 euro = 0.702804 lats, and on April 29, 2005, Latvia entered ERM II, maintaining the previous band width. Latvia has accepted the obligations under Article VIII, Sections 2(a), 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions and multiple currency practices. Exchange restrictions maintained for security reasons have been notified to the Fund for approval most recently in January 2022 (see EBD/22/5, January 27, 2022). Latvia is in the process of updating its notifications.

Previous Article IV Consultation:

Latvia is on the 12-month consultation cycle. The last Article IV consultation was concluded on August 27, 2021 (IMF Country Report No. 21/194). The Executive Board assessment is available https://www.imf.org/en/Publications/CR/Issues/2021/08/31/Republic-of-Latvia-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-465002

Safeguards Assessment:

The safeguards assessment completed on July 8, 2009 concluded that the Bank of Latvia (BoL) operates robust internal audit and control systems. The assessment recommended clarifying the respective roles of the BoL and the Treasury in holding, managing, and reporting to the Fund audited international reserves data. It also recommended amendments to the mandate of the BoL's audit committee and improvements to the financial statements' disclosures. The authorities have already taken steps to implement these recommendations, notably by establishing a formal arrangement between the BoL and the Treasury, revising the audit committee charter and expanding the existing accounting framework.

FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) during February 14–28, 2001. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (Country Report No. 02/10). An AML/CFT assessment mission took place during March 8–24, 2006, and the report was sent to the Board on May 23, 2007. A joint IMF-World Bank mission conducted an FSAP Update during February 27–March 9, 2007. A World Bank mission conducted an FSAP development module during November 8–18, 2011.

ROSC Modules

Standard/Code assessed	**Issue date**
Code of Good Practices on Fiscal Transparency	March 29, 2001
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002
Basel Core Principles for Effective Banking Supervision	January 2, 2002
CPSS Core Principles for Systemically Important Payment Systems	January 2, 2002
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002
IAIS Core Principles	January 2, 2002
OECD Corporate Governance Principles	January 2, 2002
Data Module	June 23, 2004

Latvia: Technical Assistance (2009–22)				
Dept.	**Project**	**Action**	**Timing**	**Counterpart**
FAD	Revenue Administration	Mission	January 2009	Ministry of Finance
MCM	Bank Resolution	Mission	January 2009	FCMC, Bank of Latvia
FAD	Public Financial Management	Mission	March 2009	Ministry of Finance
MCM LEG	Debt Restructuring	Mission	March 2009	Ministry of Finance, FCMC
LEG	Legal Aspects of P&A Transactions	Mission	Feb–March 2009	FCMC
MCM	Bank Intervention Procedures and P&A	Mission	March 2009	FCMC
FAD	Public Financial Management	Mission	April-May 2009	Ministry of Finance
FAD	Revenue Administration	Mission	July 2009	Ministry of Finance
FAD	Public Financial Management	Resident Advisor	July 2009–June 2010	Ministry of Finance
FAD	Cash Management	Mission	July–Aug. 2009	Ministry of Finance
MCM	Mortgage and Land Bank	Mission	Sept. 2009	Ministry of
MCM	Deposit Insurance	Mission	Sept. 2009	Finance; FCMC
MCM	Liquidity Management	Mission	November 2009	Bank of Latvia
LEG	Bank Resolution Legal Framework	Mission	January 2010	FCMC
FAD	Tax Policy	Mission	February 2010	Ministry of Finance
LEG	Bank Resolution Legal Framework	Mission	February 2010	FCMC
LEG	Corporate and Personal Insolvency Law	Mission	March 2010	Ministry of Justice
FAD	Public Financial Management	Mission	April 2010	Ministry of Finance
LEG	Corporate and Personal Insolvency Law	Mission	April 2010	Ministry of Justice
MCM	Stress Testing	Mission	June 2010	Bank of Latvia
FAD	Expenditure Policy	Mission	August 2010	Ministry of Finance
FAD	Revenue Administration	Mission	Sept. 2010	Ministry of Finance
LEG	Legal Framework for Foreclosure Procedures	Missions	November 2010	Ministry of Justice
FAD	Public Financial Management	Mission	Feb–March 2011	Ministry of Finance
FAD	Tax Administration	Mission	June 2011	Ministry of Finance
MCM	Bank Resolution	Mission	July 2012	FCMC
FAD	Expenditure Rationalization	Mission	October 2012	Ministry of Finance
LEG	Insolvency Reform	Mission	May-Dec. 2018	Ministry of Justice
LEG	Insolvency Reform	Mission	February 2019	Ministry of Justice
LEG	AML/CFT Supervision and Financial Flows Analysis	Mission	June 2022	FIU; Bank of Latvia; FCMC

Resident Representative Post: Mr. David Moore was appointed Resident Representative from June 11, 2009 to June 11, 2013.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund for surveillance purposes is adequate (A).

National Accounts: The Central Statistical Bureau of Latvia (CSB) compiles and publishes quarterly national accounts with the production, expenditure, and income approaches on a regular and timely basis. Data are compiled in accordance with the European System of National and Regional Accounts (ESA 2010). Since September 2011, national accounts are calculated with the NACE rev. 2 classifications, determined by the European Commission. However, there are discrepancies between the GDP estimates based on production and those based on expenditure. The statistical discrepancy is included in changes in inventories on the expenditure side.

The underlying data for the production approach is obtained primarily through a survey of businesses and individuals and is supplemented by data from labor force surveys and administrative sources. The CSB believes that the basic data understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.

Government finance statistics: Fund staff is provided quarterly with monthly information on revenues and expenditures of the central and local governments and special budgets. With some limitations, the available information permits the compilation of consolidated accounts of the general government. The Government Finance Statistics database in the IMF's eLibrary website contains cash data in the GFSM 2001 format. Quarterly general government data on an accrual basis are provided through Eurostat for the International Financial Statistics on a timely basis.

Monetary statistics: The monetary and financial statistics (MFS) for Latvia are reported by ECB and published in the IFS. The monetary and financial data cover balance sheet data for the central bank and other depository corporations (ODCs) using Euro Area wide and national residency criteria.

Financial sector surveillance: Latvia reports all 12 core and 13 encouraged financial soundness indicators (FSIs) for deposit takers on a quarterly basis. Also, one FSIs for non-financial corporations and two FSIs for real estate markets are reported on a quarterly basis. Latvia reports data on several series and indicators of the Financial Access Survey (FAS), including the two indicators—the number of ATMs per 100,000 adults and the number of commercial bank branches per 100,000 adults—adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Balance of payments: The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000. The data collection program is a mixed system, with surveys supplemented by monthly information from the international transactions reporting system

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

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

Reporting to STA: The authorities are reporting data for the Fund's International Financial Statistics, Government Finance Statistics Yearbook, the Direction of Trade Statistics, and the Balance of Payments Statistics Yearbook.

Latvia: Table of Common Indicators Required for Surveillance

(As of June 21, 2022)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	June 21, 2022	June 21, 2022	D	D	D
International Reserve Assets and Reserve Liabilities of the MonetaryAuthorities[1]	April 2022	April 2022	M	M	M
Reserve/Base Money	April 2022	April 2022	M	M	M
Broad Money	April 2022	April 2022	M	M	M
Central Bank Balance Sheet	April 2022	April 2022	M	M	M
Consolidated Balance Sheet of the Banking System	April 2022	April 2022	M	M	M
Interest Rates[2]	April 2022	April 2022	M	M	M
Consumer Price Index	May 2022	May 2022	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	December 2021	April 2022	Q	Q	M
Revenue, Expenditure, Balance and Composition of Financing[3]——Central Government	December 2021	April 2022	M	Q	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 2021	April 2022	M	Q	M
External Current Account Balance	April 2022	April 2022	M	M	M
Exports and Imports of Goods and Services	April 2022	April 2022	M	M	M
GDP/GNP	Q1 2022	May 2022	Q	Q	Q
Gross External Debt	Q4 2021	Q4 2021	Q	Q	Q
International Investment Position[6]	Q4 2021	Q4 2021	Q	Q	Q

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

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

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

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

[5] Including currency and maturity composition.

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

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