IMF Country Reports 23/330

Republic of Latvia: 2023 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the Republic of Latvia

INTERNATIONAL MONETARY FUND

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IMF Country Report No. 23/330

REPUBLIC OF LATVIA

September 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LATVIA

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 2023 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 11, 2023, consideration of the staff report that concluded the Article IV consultation with the Republic of Latvia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 11, 2023, following discussions that ended on June 13, 2023, 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 13, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Latvia.

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

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR23/311

IMF Executive Board Concludes 2023 Article IV Consultation with the Republic of Latvia

FOR IMMEDIATE RELEASE

Washington, DC – September 12, 2023: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia.

Latvia is facing an inflation shock, slow growth, and geopolitical challenges. After averaging 17.2 percent in 2022, headline inflation remained elevated at 12.3 percent y/y in May, largely driven by high energy and food price increases. Core inflation also accelerated to 12.4 percent y/y in May, as the second-round effects of energy prices were broad-based and much stronger than anticipated. The tight labor markets will continue to push up wages, thereby adding to inflationary pressures. Real GDP growth slowed to 2.8 percent in 2022 from 4.3 percent in 2021, largely reflecting lower increase in inventories and slower fixed investment growth. The government will have to continue to deal with the spillovers in the Baltic region from the Russian invasion of Ukraine and the impact of sanctions imposed on Russia and Belarus, the cost-of-living crisis, and energy security.

These short-term concerns are adding to the long-term policy challenge of sustaining the income convergence process. Latvia's income convergence has already been lagging the other Baltic countries. The geopolitical situation and high inflation will likely depress investment and productivity, with serious implications for future prosperity. To secure high long-term growth in a low inflation environment, Latvia needs to lift productivity, increase investment, and overcome skilled labor shortages.

Amid high uncertainty, the outlook is for lower growth, and the balance of risks is tilted to the downside. Real GDP growth is projected to slow to 0.9 percent in 2023, as high inflation weighs on consumption and external demand declines. Headline inflation is projected to decline to 10.4 percent in 2023 but will likely remain elevated for some time. The main risks stem from an escalation of the war and associated sanctions, which could result in renewed increases in energy prices, energy supply disruptions in Europe, and weaker external demand. Global financial conditions could further tighten, with spillovers to Latvian banks and domestic credit growth. Over the medium term, growth is projected to rebound, underpinned by reforms, a rebound in consumption, and public investment.

[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.

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USA

Executive Board Assessment[2]

Executive Directors welcomed Latvia's economic resilience and notable progress in energy security in the face of unprecedented shocks. They noted that Latvia is facing a difficult environment with high inflation, slow growth and labor shortages, and geopolitical headwinds. In that context, Directors emphasized the need to lower inflation in the near term, while sustaining the income convergence with European peers and paving the way for the green transition and digital transformation.

Directors concurred that fiscal policy should help contain inflationary pressures and create fiscal space to increase spending in social sectors and support public investment over the medium term. They recommended pursuing a tighter fiscal stance in 2023, including by better targeting energy support measures. Such efforts would help to reduce the cash deficit, while allowing the full pass-through of international fuel prices to domestic consumers. Looking ahead, fiscal policy should remain flexible and adapt if adverse risks materialize.

Directors agreed that fiscal reforms should focus on growth-enhancing tax measures, coupled with policies to improve public investment management and to safeguard the sustainability of the pension system. Carbon tax reforms for emissions not covered by the EU Emissions Trading System could also be considered to mitigate climate change and generate revenues.

While welcoming the financial sector's resilience, Directors underscored that tighter financial conditions warrant close monitoring and contingency plans. They encouraged vigilance of risks stemming from the housing market and urged the authorities to continue regular risk-based monitoring of banks' asset quality and liquidity. Directors welcomed the authorities' decision to gradually raise the countercyclical capital buffer rate. Noting Latvia's significant progress with the AML/CFT framework, they encouraged the authorities to keep the momentum and pursue further improvements. Implementing the newly adopted Anti-Corruption Plan and National Strategy is also important.

Directors encouraged the authorities to accelerate structural reforms to build resilience and lift long-term growth, including by implementing the National Recovery and Resilience Plan. Further enhancing energy security, boosting investment in clean energy, and facilitating the transition to renewable energy would be important. Directors also encouraged advancing reforms to mitigate the impact of an aging population, address skill mismatches, and boost high-skilled labor supply. They also emphasized the need to strengthen Latvia's digital transformation to help reduce labor shortages and support productivity.

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

Table 1. Latvia: Selected Economic Indicators, 2019–24

	2019	2020	2021	2022	2023	2024
						Proj.
National Accounts	(Percentage change, unless otherwise indicated)					
Real GDP	2.6	-2.3	4.3	2.8	0.9	2.7
Private consumption	0.2	-4.6	8.1	8.1	2.0	2.8
Public consumption	3.9	2.4	4.4	2.8	1.0	2.7
Gross capital formation	10.1	-0.4	19.2	-1.7	-0.8	2.7
Gross fixed capital formation	6.9	-2.6	2.9	0.7	0.9	3.8
Exports of goods and services	2.1	-0.3	5.9	9.1	-0.2	3.0
Imports of goods and services	3.1	-0.3	15.3	11.7	-0.5	3.0
Nominal GDP (billions of euros)	30.7	30.3	33.6	39.1	43.3	46.3
GDP per capita (thousands of euros)	16.0	15.9	17.8	20.8	23.1	24.8
Savings and Investment						
Gross national saving (percent of GDP)	22.4	24.5	20.9	19.4	21.1	21.4
Gross capital formation (percent of GDP)	23.0	21.9	25.1	25.8	24.1	23.6
Private (percent of GDP)	19.1	17.7	21.4	22.5	20.5	20.0
HICP Inflation						
Headline, period average	2.7	0.1	3.2	17.2	10.4	3.4
Headline, end-period	2.1	-0.5	7.9	20.7	4.4	4.1
Core, period average	2.7	1.1	2.0	11.3	11.0	5.0
Core, end-period	1.9	0.9	4.7	15.2	7.5	4.2
Labor Market						
Unemployment rate (LFS; period average, percent)	6.3	8.1	7.6	6.9	6.7	6.6
Nominal wage growth	7.2	4.2	11.1	7.5	9.3	8.0
Consolidated General Government 1/	(Percent of GDP, unless otherwise indicated)					
Total revenue	37.2	37.5	37.4	36.5	36.2	37.4
Total expenditure	37.6	41.2	42.8	40.3	40.1	39.3
Basic fiscal balance	-0.4	-3.7	-5.4	-3.7	-3.9	-1.9
ESA fiscal balance	-0.6	-4.4	-7.1	-4.4	-3.7	-2.5
General government gross debt	36.5	42.0	43.7	40.8	40.5	39.7
Money and Credit						
Credit to private sector (annual percentage change)	-2.3	-4.4	11.9	7.0	...	...
Broad money (annual percentage change)	8.0	13.1	9.2	5.1	...	...
Balance of Payments						
Current account balance	-0.6	2.6	-4.2	-6.4	-3.0	-2.2
Trade balance	-8.6	-5.1	-8.3	-11.5	-7.1	-6.6
Gross external debt	116.7	121.4	109.6	100.6	99.6	98.3
Net external debt 2/	18.1	13.4	10.2	8.1	8.2	7.4
Exchange Rates						
U.S. dollar per euro (period average)	1.12	1.14	1.18	1.05	...	...
REER (period average; CPI based, 2005=100)	123.0	124.5	125.1	129.7	...	...
Terms of trade (annual percentage change)	0.9	2.8	1.6	-0.4	-0.6	0.8

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 2023 ARTICLE IV CONSULTATION

July 13, 2023

KEY ISSUES

Context. Latvia is facing an inflation shock, slow growth, and geopolitical challenges, while the long-term policy concern is to sustain the income convergence process. Headline inflation has surged over the past year in Latvia, measuring 12.3 percent y/y in May, while core inflation increased to 12.4 percent y/y in May. The new government, which took office in December 2022, will also have to continue to deal with the spillovers in the Baltic region from the Russian invasion of Ukraine and the impact of sanctions imposed on Russia and Belarus, the cost-of-living crisis, energy security, and the expected slowdown in growth. To secure high long-term growth in a low-inflation environment, Latvia needs to address three structural issues: (i) low productivity, (ii) low investment, and (iii) skilled labor shortages.

Outlook and Risks. Growth is projected to slow to 0.9 percent in 2023 from 2.8 percent in 2022, as high inflation weighs on consumption and external demand declines. High energy prices, driven by the war, are expected to have an impact on the level of productivity[1]. Headline inflation is projected to retreat to 10.4 percent in 2023, reflecting falling energy prices and weakening demand. Given the lagged pass-through of energy prices, core inflation is projected to measure 11 percent in 2023. Amid high uncertainty, the balance of risks is tilted to the downside. The main risks stem from an escalation of the war and associated sanctions, which could result in renewed increases in energy prices, energy supply disruptions in Europe, and weaker external demand. Global financial conditions could further tighten, with spillovers to Latvian banks and domestic credit growth.

Key Policy Recommendations

Fiscal Policy

- In light of high inflation, staff recommends a tighter fiscal stance in 2023, both based on the ESA[2] cyclically adjusted fiscal balance (which shows a fiscal contraction), and the government's cash budget (which currently does not).
- Better targeting of energy support measures would help reduce the cash deficit, while allowing the full pass-through of international fuel prices to domestic consumers.

[1] EUR REO, April 2023.

[2] ESA refers to European System of Accounts.

- Fiscal policy should remain flexible. Given high uncertainty, materialization of a negative demand shock simultaneously lowering growth and inflation could call for more limited fiscal adjustment compared to the baseline.
- Medium-term fiscal reforms should address structural challenges related to low productivity, low investment, and declining labor supply. Key reforms include improving public investment management, reforming the pension system, and reducing labor taxes.

Financial Sector Policies

- Continued monitoring of financial sector vulnerabilities is warranted, given heightened risks, including from recent global financial tensions. Notably, a regular, risk-based monitoring of banks' asset quality and liquidity should continue, supported by tailored stress tests.
- Facilitating early restructuring and out-of-court settlement between households and banks can help address potential problems resulting from households' variable and rising mortgage interest rate obligations, while the social protection system can provide support for the most vulnerable.
- While the current macroprudential stance is broadly appropriate, consideration could be given to increasing capital-based measures (for instance, a positive neutral countercyclical capital buffer requirement), to further build resilience and avoid a procyclical move later.
- Building upon the significant progress made thus far, the authorities should continue to strengthen the AML/CFT framework and implement the country's Anti-Corruption Plan and National Strategy.

Structural Policies

- Structural policies should facilitate the green transition, reduce skill shortages, and boost productivity.
- Latvia should continue to enhance energy security and boost investment in clean energy. Swift implementation of planned measures to address climate change is critical to facilitate the transition to renewable energy.
- Accelerating corporate recapitalization and improving the insolvency regime could help boost investment.
- Reforms to boost high-skilled labor supply are important, given the aging population and emigration. Strengthening the digital transformation would help address labor shortages and support productivity.
- The regulatory burden in product and services markets could further be reduced to support investment and firm growth.

Approved by
Helge Berger (EUR) and Bergljot Barkbu (SPR)

Discussions were held in Riga during May 31–June 13, 2023. The team comprised Bernardin Akitoby (head), Bingjie Hu, and Keyra Primus (all EUR) and Gregor Schwerhoff (RES). Carlos Acosta and Bonolo Namethe (all LEG) participated virtually in meetings. Inese Allika (OED) also joined the discussions. Kelly MacKinnon and Sadhna Naik supported the mission. The mission met with Bank of Latvia Governor Kazāks, parliamentary secretary for the ministry of finance, chairman of the budget and finance (taxation) committee of the parliament, officials from the ministry of energy and climate, other senior officials, and private sector representatives.

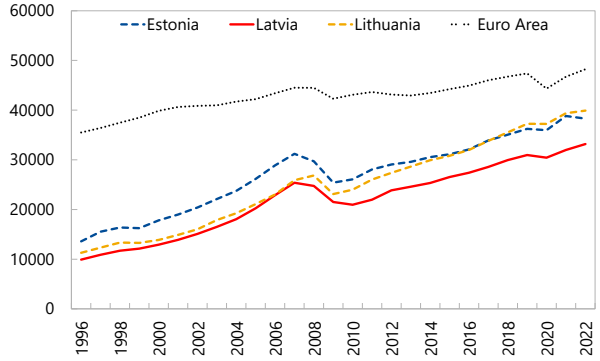
CONTENTS

ANNEXES

CONTEXT

1. Latvia is facing an inflation shock, slow growth, and geopolitical headwinds. Headline inflation has surged over the past year in Latvia, quadrupling the rate in the lowest-inflation euro area members. Avoiding a wage-price spiral and loss in competitiveness is a key challenge.[3] The new government, which took office in December 2022, will also have to continue to deal with the spillovers in the Baltic region from the Russian invasion of Ukraine and the impact of sanctions imposed on Russia and Belarus,[4] the cost-of-living crisis, energy security, and the expected slowdown in growth.

GDP Per Capita
(in PPP 2017 international dollars)

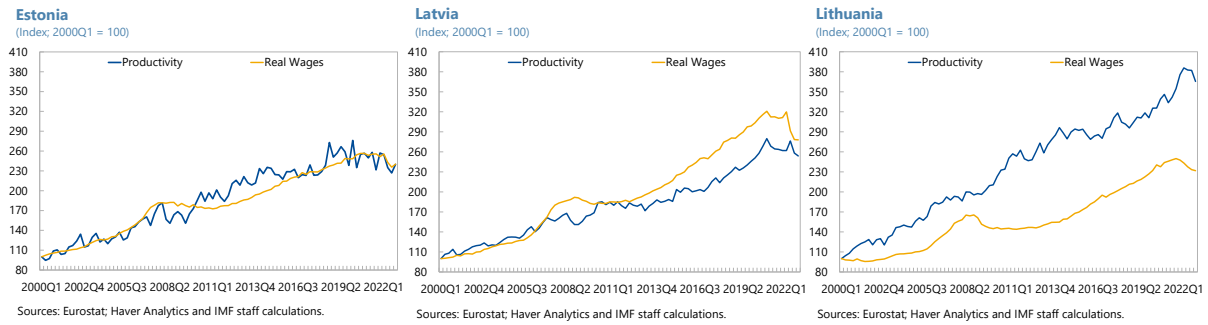


Sources: World Economic Outlook, IMF; and IMF staff calculations.

2. These short-term concerns are adding to the long-term policy challenge of sustaining the income convergence process. The geopolitical situation and high inflation will likely depress investment and productivity, with serious implications for future prosperity. Latvia's income convergence has already been lagging the other Baltic countries. To secure high long-term growth in a lower inflation environment, Latvia needs to address three structural challenges.

- **Low productivity:** In contrast to Lithuania and Estonia, productivity growth was not in line with real wage growth, thereby depressing competitiveness of the manufacturing sector (Text Figure 1).[5] Boosting productivity would help support higher wage income while reducing inflationary pressure.

Text Figure 1. Manufacturing Productivity and Wages



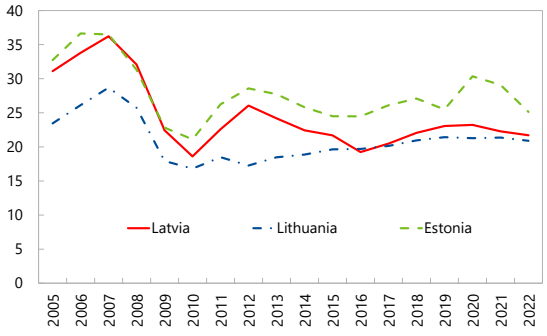
Sources: Eurostat; Haver Analytics and IMF staff calculations.

- **Low investment:** Because of weak investment after the GFC, Latvia fell behind Estonia while Lithuania caught up (Text Figure 2). While the average investment to GDP ratio is at par with the more matured advanced economies, Latvia needs much higher investment to sustain the

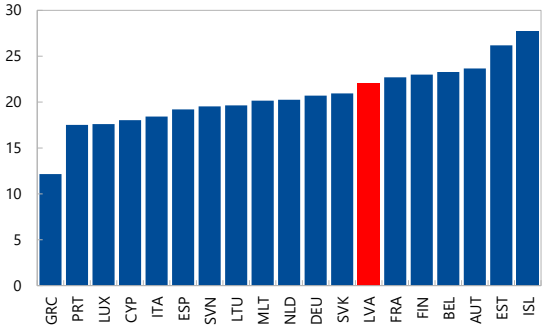
[3] See Annex VI.
[4] See IMF Country Report No. 22/277 (Annex II) for further discussion on the spillover channels of the war in Ukraine on Latvia.
[5] For more details on competitiveness in Latvia see Matvejevs, O. and Mirosnikovs, M., "Price and Non-price Competitiveness of Latvian Export", Latvijas Banka, Working Paper (forthcoming, 2023).

convergence. Raising public and private investment would support higher productivity and incomes.[6]

Text Figure 2. Investment to GDP Ratio



Sources: Haver Analytics; and IMF staff calculations.

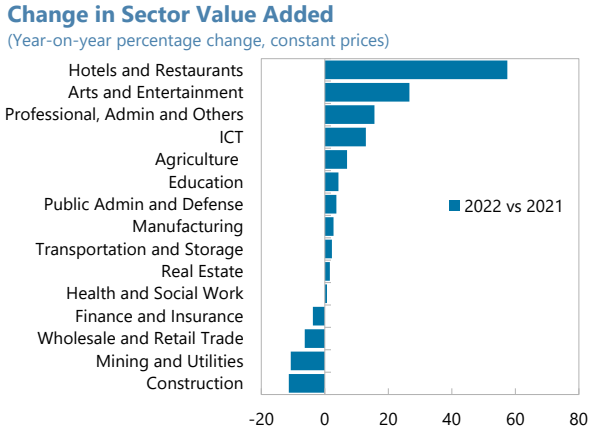


Sources: Haver Analytics; and IMF staff calculations.

- **Skilled labor shortages:** Latvia has a shortage of qualified labor supply, which is linked to an aging population and emigration.[7] These two factors have caused Latvia's active population to shrink more than in the OECD since 1990, even though net migration has fallen to nearly zero in 2021. This calls for accelerating labor market reforms.

RECENT DEVELOPMENTS

3. After strong growth in the first half of 2022, economic activity slowed in the second half and remained weak in Q1 2023. Economic activity held up in H1:2022, displaying robust output growth of 4.7 percent y/y, as households drew down savings accumulated during the pandemic to finance private consumption. On the supply side, the pandemic-hit services sectors (accommodation, food, entertainment, and recreation) recovered somewhat. However, in H2:2022, growth slowed to 1 percent y/y, largely reflecting slowdowns in household consumption and goods exports, as high inflation dented demand, and lower increase in inventories. Rising material costs have also caused construction value-added to decline. Overall, real GDP growth slowed to 2.8 percent in 2022 from 4.3 percent in 2021, falling behind the euro area average (Text Figure 3). Real GDP growth for Q1 2023, while surprising on the upside, was



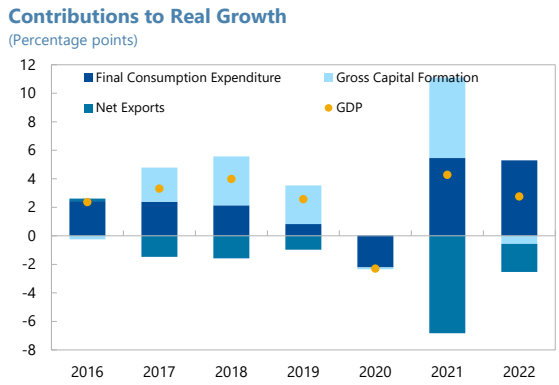
Sources: Haver Analytics; and IMF staff calculations.

[6] See the literature on endogenous growth theory (for instance, P. Aghion and P. Howitt, "Endogenous Growth Theory", The MIT Press, 1997).

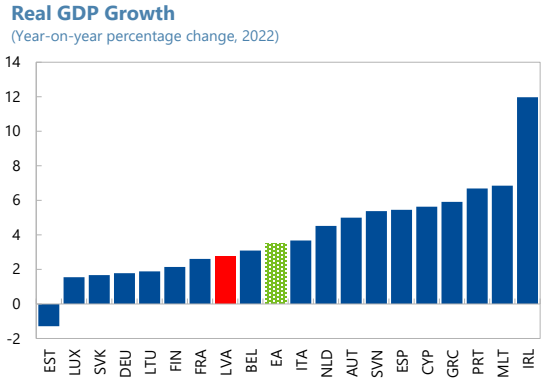
[7] See "Analysis of the RRP of Latvia," European Commission (2021).

only 0.8 percent y/y.

Text Figure 3. Economic Activity



Sources: Authorities and IMF Staff Calculations.



Source: World Economic Outlook, IMF.

4. Inflation surged into double digits, largely driven by high energy and food price increases (Figure 1). After averaging 17.2 percent in 2022, headline inflation remained elevated at 12.3 percent y/y in May—one of the highest in the euro area, despite the energy support measures. Energy and food price increases are the main drivers because of their high share in the consumer price index basket (about 19.1 and 33.2 percent for energy and food, respectively, versus 10.2 and 20 percent for the euro-area average).[8] Meanwhile, core inflation also accelerated to 12.4 percent in May, as the second-round effects of energy prices were broad-based and much stronger than anticipated. Supply chain disruptions have also exacerbated underlying price pressures.

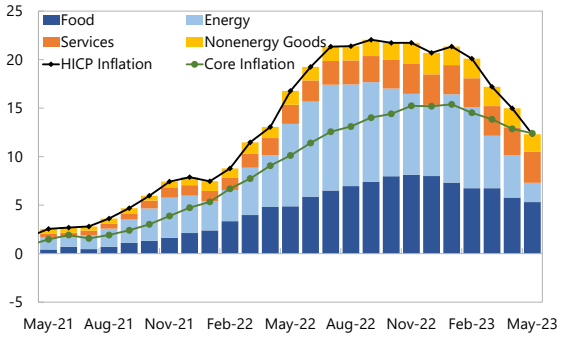
5. The labor market has been resilient so far, despite the slowdown in growth (Figure 2). The unemployment rate declined to 6.9 percent in 2022, as employment and labor force participation rebounded among low-skilled workers in the pandemic-hit service sectors. The Ukrainian refugees seemed to have eased mostly low-skilled labor shortages. Nonetheless, the labor markets in Latvia remain tight, especially for skilled workers. Meanwhile, average nominal wage growth reached 7.5 percent in 2022, mostly reflecting public salary increases. Real wages remained negative, as inflation surged.

6. The current account deficit worsened despite the recovery in services exports. The current account deficit widened from 4.2 percent of GDP in 2021 to 6.4 percent of GDP in 2022, driven by the widening goods trade deficit (Text Figure 4). In contrast, the services trade surplus increased to 5.6 percent of GDP, as demand in transportation and tourism sectors rebounded from its depressed levels during the pandemic. Trade data continue to show that Latvia has been successful in reorienting its trade away from Russia. Overall, Latvia's external position in 2022 is assessed to be weaker than the levels implied by fundamentals and desirable policies (Annex II).

[8] See Annex VI. Global factors (energy and food price increases) are the main drivers of inflation in the Baltic countries.

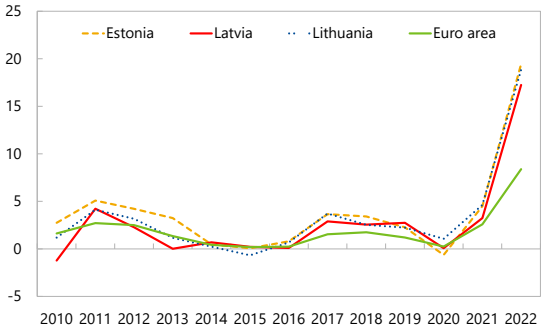
Figure 1. Inflation Developments

Inflation Decomposition
(Percentage points)



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

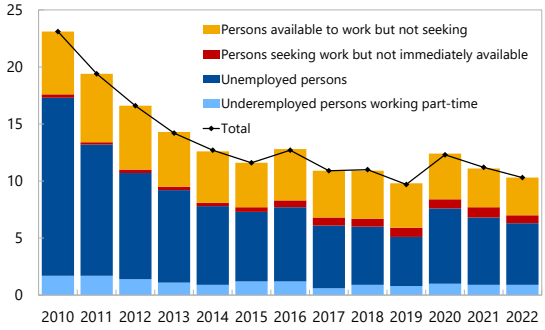
Headline Inflation
(Year-on-year percentage change)



Source: World Economic Outlook, IMF.

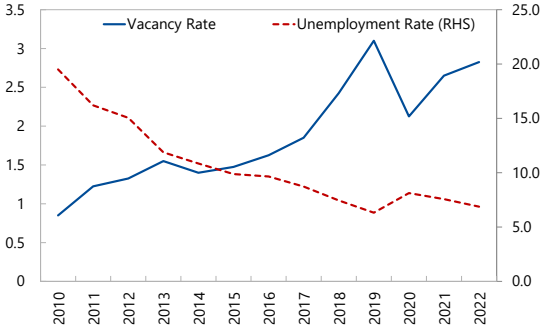
Figure 2. Labor Market Indicators

Labor Market Slack Composition
(Percent of extended labor force aged 15-74 years)



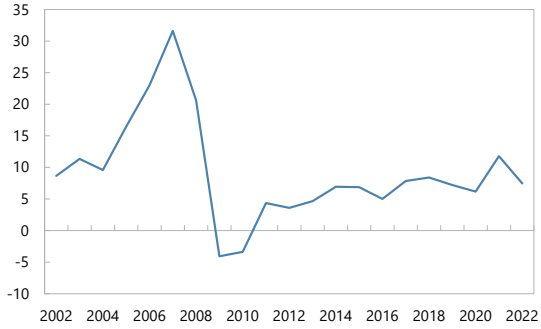
Source: Eurostat.

Job Vacancies and Unemployment
(LHS - in percent of unemployed; RHS - in percent)



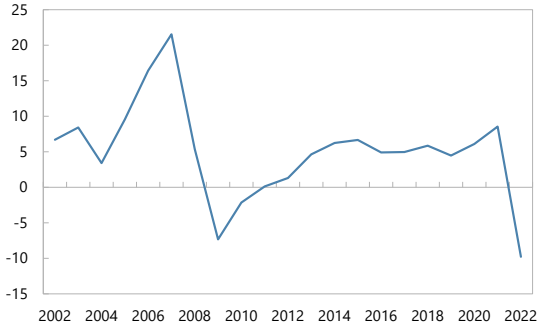
Source: Haver Analytics.

Nominal Wage Growth
(Year-on-year percentage change)



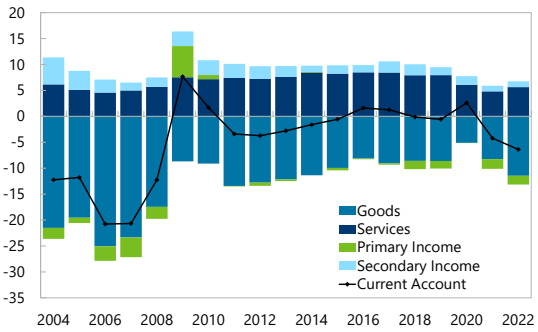
Sources: Statistics Latvia; Haver Analytics; and IMF staff calculations.

Real Wage Growth
(Year-on-year percentage change)

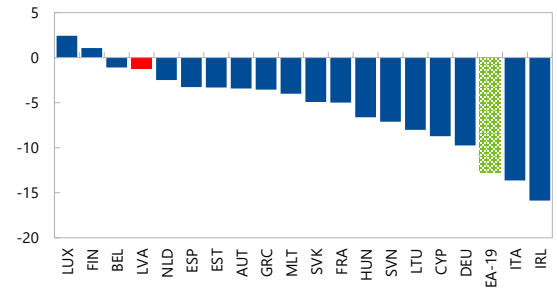


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Text Figure 4. External Sector Developments



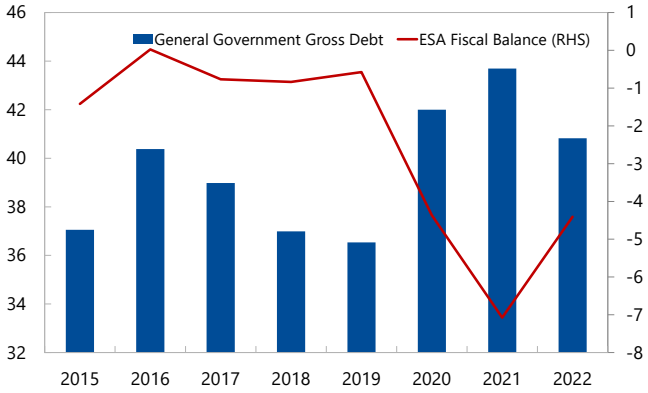
Sources: Haver Analytics; and IMF staff calculations.



Source: Eurostat.
1/ This is based on the trade unit value index comprising of intermediate, capital and consumer goods.

7. The fiscal deficit in 2022 contracted, mostly reflecting the withdrawal of COVID-related spending. The overall deficit declined to 4.4 percent in 2022, from 7.1 percent in 2021, as COVID-related spending was phased out. Meanwhile, higher inflation helped boost tax revenue and reduce the debt-to-GDP ratio (Annex IV).

Fiscal Balance and General Government Debt
(Percent of GDP)

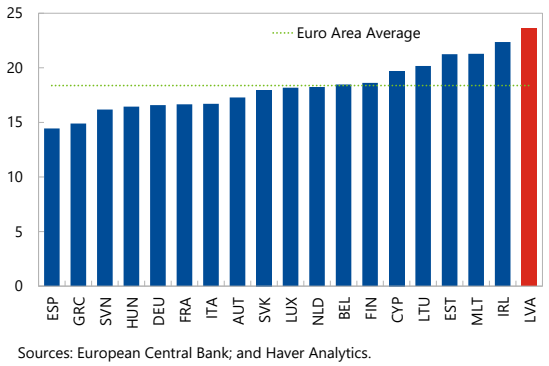


Sources: Authorities; and IMF staff calculations.

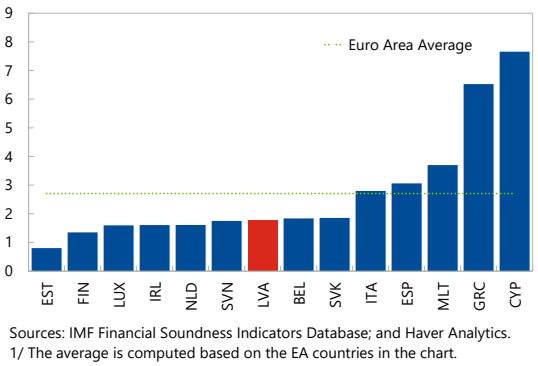
8. The government deployed time-bound energy support. The support measures (1.5 percent of GDP in 2022) included price caps for natural gas, compensation for electricity, natural gas, and heating, additional benefits to vulnerable households, and support for energy intensive businesses. These measures were mostly untargeted.

9. The financial sector has so far been resilient, with improved profitability and comfortable capital buffers. The banking sector remained well capitalized and liquid, with a low NPL ratio at 1.8 percent in 2022 (Text Figure 5). Bank profitability was boosted by the rise in interest rates on loans, while deposits growth continued to accelerate, on the back of resilient household savings. Domestic credit growth accelerated in 2022, mostly reflecting increased working capital loans to non-financial corporations (NFC) to deal with higher energy prices. Meanwhile, the amount of new mortgage loans declined, due to tighter lending standards and higher interest rates.

Text Figure 5. Capital and Non-Performing Loans



Sources: European Central Bank; and Haver Analytics.



Sources: IMF Financial Soundness Indicators Database; and Haver Analytics.
1/ The average is computed based on the EA countries in the chart.

OUTLOOK AND RISKS

10. Growth is projected to slow in 2023 and rebound thereafter (Text Table 1). The baseline assumes that the war will continue without escalation, commodity prices will decline, fiscal policy, as measured by the change in the ESA cyclically adjusted fiscal balance, will remain contractionary to help contain inflation, and financial conditions will continue to tighten. Under the baseline, real GDP growth is projected to slow to 0.9 percent in 2023, as high inflation weighs on consumption and external demand declines. The output gap is forecasted to remain negative at 1.4 percent in 2023 and slowly close by 2028. High energy prices, driven by the war, are expected to have an impact on the level of productivity (EUR REO, April 2023). Growth is projected to average 3.1 percent over 2024–2028, underpinned by reforms, a rebound in consumption, and public investment (averaging 3.4 percent of GDP over the next 5 years).[9] The current account deficit is projected to decline over the medium term, as the terms of trade shock dissipates and external demand recovers.

11. Receding energy prices and weakening demand will help to gradually lower inflation. Headline inflation is projected to decline to 10.4 percent in 2023 and continue to ease in the outer years, reflecting falling energy and food prices and weakening demand. Given the lagged pass-through of energy prices, core inflation is projected to average 11 percent in 2023 before falling to about 2.5 percent in 2026. Average nominal wages are expected to increase by 9.3 percent in 2023, reflecting tight labor market conditions.

[9] If executed efficiently, this high level of public investment should help accelerate the convergence process.

Text Table 1. Latvia: Summary of Medium-Term Macroframework, 2023–28

	2023	2024	2025	2026	2027	2028
Real GDP growth (percent)	0.9	2.7	3.2	3.2	3.2	3.2
Output gap (percent)	-1.4	-1.2	-0.8	-0.4	-0.1	0.0
Headline inflation (average)	10.4	3.4	3.3	2.5	2.4	2.3
Core inflation (average)	11.0	5.0	3.4	2.6	2.5	2.5
Unemployment rate (LFS, percent)	6.7	6.6	6.5	6.4	6.4	6.4
Nominal wage growth (percent)	9.3	8.0	7.0	5.0	5.0	5.0
Current account balance (percent of GDP)	-3.0	-2.2	-2.0	-2.0	-1.9	-1.9
ESA fiscal balance (percent of GDP)	-3.7	-2.5	-2.1	-2.1	-1.2	-1.0

Source: IMF staff projections.

12. Amid high uncertainty, the balance of risks is tilted to the downside (Annex I). The main risks stem from an escalation of the war and associated sanctions, which could result in renewed increases in energy prices, energy supply disruptions in Europe, and weaker external demand. Global financial conditions could further tighten, with spillovers to Latvian banks and domestic credit growth. Domestic risks include not sufficiently tight fiscal policy, tight labor markets and wage pressure, delays in public investments and other reforms, and heightening risks from real-financial feedback loops. On the upside, China's reopening may have a positive impact on demand, the use of large savings accumulated during the pandemic could help cushion private demand, and swift implementation of structural reforms may boost productivity.

Authorities' Views

13. The authorities broadly agreed with staff's economic outlook and risks, though they are somewhat more optimistic than staff. With the continued decline in energy prices and the robust 2023 Q1 outturns, the authorities noted that real GDP growth in 2023 will be marginally higher and headline inflation marginally lower than staff projections. However, like staff, they expect wage pressures and tight labor market conditions to have some second-round effects on core inflation, keeping inflation above 2 percent in the coming years. The authorities believe that the risks will likely be balanced, as risks related to Russia have been reduced by alternative energy supply and limited economy exposure to Russian market, while better-than-expected economic performance in recent quarters will likely further boost confidence.

POLICY DISCUSSIONS

14. The key priorities are to contain inflation in the short term, while addressing long-standing challenges. 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. Financial sector policies should continue heightened monitoring of risks and devise

contingency plans. To further support investment and productivity, structural policies should facilitate the green transition, boost high-skilled labor supply, reduce the regulatory burden in product and services markets, and strengthen the digital transformation.

A. Fiscal Policy: Supporting the Economy while Containing Inflation

15. The ESA cyclically adjusted fiscal deficit is projected to contract, although the budget envisages additional priority spending. To support the new government's priorities, the budget allocates additional resources (about 1.5 percent of GDP) to improve security (including an increase in defense spending)[10], education, healthcare, energy security, and competitiveness. The phasing-out of COVID-19 support measures provides much-needed fiscal space for these spending plans, while energy support measures remain broadly the same (Text Table 2). Capital spending is also projected to increase, supported by the Recovery and Resilience Facility (RRF) and EU funds. Although no tax policy changes were introduced, additional revenue is expected from strengthening revenue administration and dividends from state joint-stock companies. Overall, staff projects that the ESA cyclically adjusted fiscal deficit would narrow to 3.1 percent of potential GDP in 2023, down from 4.3 percent of potential GDP in 2022.

Text Table 2. Latvia: Support Measures for COVID-19 and High Energy Prices, 2020–24
(Percent of GDP)

COVID-19 and High Energy Prices: Support Measures					
	2020	2021	2022	2023	2024
				Proj.	
COVID-19 support measures	3.2	6.3	2.0	0.3	0.0
Delayed tax payments	0.4	0.0	0.0	0.0	0.0
Social benefits	0.4	1.6	0.2	0.0	0.0
Loans and guarantees	0.3	0.3	0.2	0.1	0.0
Sectoral support	2.1	4.3	1.6	0.2	0.0
Support related to EU funds	0.0	0.0	0.0	0.0	0.0
Energy support measures		0.0	1.5	1.4	0.0
Cost-cutting measures for end users		0.0	0.9	1.3	0.0
Social transfers		0.0	0.6	0.2	0.0

Sources: Authorities and IMF staff calculations.

16. Staff welcomes the projected decline in the ESA cyclically adjusted fiscal deficit and advised the authorities to tighten the cash deficit.[11] In contrast to the ESA cyclically adjusted fiscal deficit, the cash deficit is increasing slightly, suggesting that fiscal policy could intensify inflationary

[10] Defense spending is expected to increase by 0.3 percent of GDP over 2023-25.

[11] The difference between these two indicators is mostly explained by the accrued EU funds' revenue in 2023 (0.8 percent of GDP).

pressures. To ensure fiscal policy will indeed contribute to the disinflationary effort, staff recommends keeping the cash deficit below the 2022 level.

17. Better targeting of energy support measures would help reduce the cash deficit, while allowing the full pass-through of international fuel prices to domestic consumers. The untargeted measures should ideally be replaced with more targeted cash transfers to vulnerable households. Support to firms should be consistent with the EU state aid and restricted to energy-intensive viable firms. Measures that suppress energy prices, such as price caps, subsidized or reduced energy prices, and reductions of energy-related fees and taxes (on fuel, gas, or electricity), should be avoided. The current price cap on natural gas could be replaced with block pricing, where energy consumption below a minimum subsistence level[12] would be subsidized at a guaranteed price, while consumption above that level would be based on market prices to spur energy efficiency.

18. Fiscal policy should remain flexible and evolve if risks materialize. Materialization of a negative demand shock simultaneously lowering growth and inflation could call for more limited fiscal adjustment compared to the baseline. In contrast, an adverse supply shock leading to persistently low growth but high inflation (e.g., due to a further escalation of the war) would call for a continuation on the recommended fiscal path while providing targeted support to the most vulnerable to prevent upward price-wage dynamics and damage to competitiveness.

19. Under current policies, staff expects the ESA fiscal deficit to average 1.8 percent of GDP over the medium term (2024–2028), with public debt declining below 40 percent of GDP (Text Table 3). In the absence of new major tax policy changes, the tax-to-GDP ratio is projected to remain broadly stable in the medium term. Reflecting the government's spending priorities, current spending will amount to 36.5 percent of GDP in 2023, before declining gradually to 34 percent of GDP in 2028, as grant-financed spending falls. Supported by the RRF, investment spending is projected to peak in 2024, before averaging 3.4 percent of GDP in 2024–2028. Staff assesses that Latvia has some fiscal space. It should, therefore, be used to increase spending on social sectors and support much-needed public investment over the medium term to build resilience and help remove supply bottlenecks.

Text Table 3. Latvia: Indicators of Fiscal Performance, 2023–28
(Percent of GDP, unless noted otherwise)

	2023	2024	2025	2026	2027	2028
Revenue	36.2	37.4	36.5	36.4	36.3	36.4
Expenditure	40.1	39.3	38.6	38.5	37.5	37.3
o/w: current spending	36.5	35.6	35.1	35.2	34.3	34.0
o/w: capital spending	3.6	3.7	3.4	3.3	3.3	3.3
ESA fiscal balance	-3.7	-2.5	-2.1	-2.1	-1.2	-1.0
ESA cyclically adjusted fiscal balance (percent of potential GDP)	-3.1	-2.0	-1.8	-2.0	-1.2	-1.0
General government debt	40.5	39.7	39.0	38.6	37.7	36.5

Source: IMF staff projections.

[12] This could be a fixed amount, an amount linked to household size, or a fraction of past consumption.

20. The medium-term fiscal path needs to be adjusted to achieve the authorities' stated medium-term deficit objective (MTO). Latvia's fiscal discipline law prescribes a reduction in the structural deficit by 0.5 percent of GDP annually until the MTO of a structural fiscal deficit of 0.5 percent of GDP is reached. The government achieves these deficit-reduction objectives by imposing a nominal ceiling each year on non-essential current spending (e.g., goods and services), before considering additional measures, if needed. However, as the structural fiscal deficit under staff's current policies is still at 1.8 percent of GDP in 2025, above the MTO, an adjustment will be required, although Latvia has some fiscal space given the low levels of public debt over the projection period. For example, this could be achieved by reducing tax exemptions or broadening the bases of corporate income tax (CIT), personal income tax (PIT), and property taxes. Meanwhile, rationalizing spending on goods and services and targeting energy support measures could help to contain spending. In addition, the structural reforms below should help boost growth and prepare Latvia for spending pressures stemming from population ageing, the proposed mandatory health insurance, and defense initiatives (e.g., the reinstatement of military draft).

Potential Fiscal Savings by 2025 (percent of GDP)

	Cumulative
Revenue	**1.0**
Property tax 1/	0.4
Broadening the PIT and CIT bases 2/	0.2
Tax exemptions 3/	0.4
Expenditure	**1.0**
Goods and services	0.2
Energy support measures in 2023 4/	0.8
Total savings	**2.0**

1/ To come closer to the euro area average of 1.4 percent of GDP, we propose an increase in property tax revenue of 0.4 percent of GDP.
2/ Given the high level of the informal sector in Latvia (26.5 percent of GDP in 2022), there is scope to broaden the tax base of PIT and CIT.
3/ Tax exemptions are high in Latvia (7.7 percent of GDP) compared to Estonia (0.9 percent of GDP) and Lithuania (4.2 percent of GDP).
4/ Better targeting of energy support measures.

21. Fiscal reforms should address structural challenges related to low productivity, low investment, and a decline in labor supply. Key reforms should focus on increasing public investment and strengthening public investment management, reforming the pension system, and reducing labor taxes.

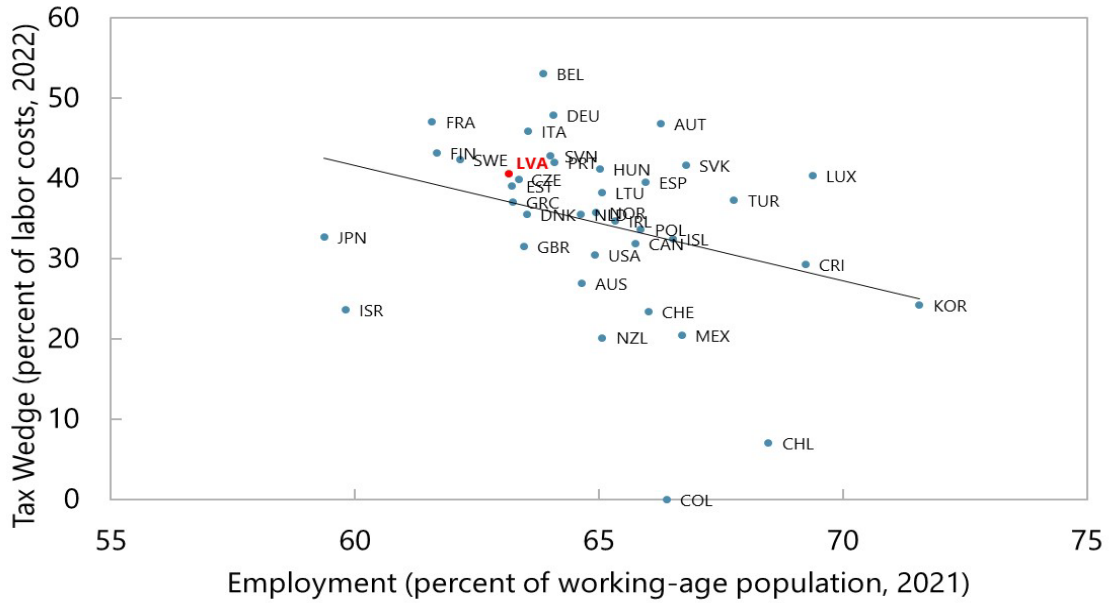
- *If well-implemented, the National Recovery and Resilience Plan (NRRP) will help boost public investment.* Notably significant investments are planned in green and digital transition (see section C), healthcare, education and skills, research and innovation, and affordable housing. Given the scaling up of public investment amid high uncertainty, further improving public investment management would also be critical to increase efficiency.
- *Pension reforms should be prioritized***.** The government's recent White Paper proposes measures that aim at lowering old-age poverty, which is high in Latvia compared to the OECD average[13].

[13] OECD Economic Surveys: Latvia 2022.

Further, the authorities are encouraged to continue to increase the retirement age by three months annually until it reaches 65 years in 2025. Additional reforms could include: (i) linking the official and early retirement ages to future life expectancy gains to encourage longer work lives once the retirement age reaches 65, and (ii) reviewing the minimum contribution period required for a pension.[14]

- *Latvia's labor tax wedge could be reduced to strengthen work incentives and increase high-skilled labor supply*.[15] Latvia has a relatively high tax wedge (Text Figure 6). Lowering the tax wedge could strengthen work incentives and induce a positive labor supply response, particularly for high-skilled workers. Given that Latvia's tax-to-GDP ratio is below the euro area average,[16] the revenue impact of the labor tax reduction could be offset by increasing revenues from property taxation and reducing tax exemptions, which are high in Latvia (Text Figure 7). The government could also consider carbon tax reforms for those emissions which are not already covered by the EU Emissions Trading System (ETS).

Text Figure 6. Tax Wedge and Working Age Population 1/
(Percent)



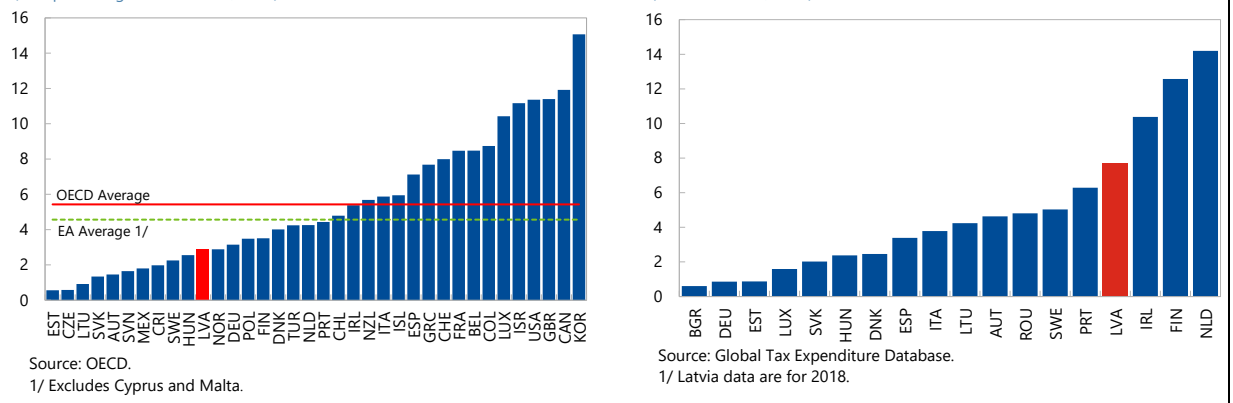
Source: OECD.
1/ Average tax wedge for single person at 100 percent of average earnings.

[14] OECD Reviews of Pension Systems: Latvia (2018).

[15] "Fiscal Policy and Long-term Growth," IMF (2015).

[16] In 2022, Latvia's overall tax-to-GDP ratio was 20.6 percent, compared to the euro area average of 27 percent.

Text Figure 7. Property Tax and Tax Expenditures



Source: OECD.
1/ Excludes Cyprus and Malta.

Source: Global Tax Expenditure Database.
1/ Latvia data are for 2018.

Authorities' Views

22. The authorities broadly agreed with staff's fiscal policy advice, but they see the composition of spending mitigating the impact of the deficit on inflation. They noted that although the cash deficit might be slightly expansionary, the import content of public spending (i.e., import of military equipment and investment goods) would alleviate the impact of the fiscal deficit on inflation. Moreover, with the decline in energy spending, they expect sizeable savings in budgeted energy support measures and aim to use those for decrease of the deficit. They will continue to work to improve the targeting of the support measures by integrating various databases. The national fiscal rule, which aims for a structural fiscal deficit of 0.5 percent of GDP will continue to guide the medium-term fiscal strategy and keep the already low public debt on a downward path. The continued implementation of the NRRP is expected to boost investment and lift growth in the medium term.

23. The authorities reiterated their commitment to pursue structural fiscal reforms. They are contemplating a tax reform this year. While the authorities see merit in staff's advice on pension reforms, they plan to complete and evaluate their current reforms before considering staff's recommendations. A notable measure of the ongoing reform is to increase the minimum contribution period for a pension from 15 years to 20 years by 2025, to safeguard the sustainability of the pension system.

B. Financial Sector Policies: Balancing Risks and Resilience

24. The energy crisis and tighter financial conditions have accentuated risks to the financial sector. The current macro-financial environment has aggravated the financial health of NFCs already affected by the pandemic (e.g., hotels), while constraining implementation of investment projects through labor shortages, supply chain disruptions, and rising material costs. Although rising interest rates could boost banks' net interest income, they put more pressure on the borrowers' ability to service their debt and, therefore, heighten credit risks, especially given the prevalence of variable-

interest-rate loans to both households and NFCs. Liquidity risks and interest-rate risks may also be rising, including among nonbank financial institutions. Higher-for-longer inflation could negatively affect the real investment returns of pension funds, insurance companies, and investment platforms.

25. Consequently, close monitoring and contingency plan preparedness are warranted. A regular, risk-based monitoring of banks' asset quality should continue, supported by tailored stress tests to identify specific vulnerabilities. Intensive supervisory monitoring is necessary to ensure prompt loan reclassification and adequate, forward-looking provisioning. Special attention should be given to banks' and nonbank financial institutions' liquidity and interest rates risks, including spillovers from foreign parent companies to their branches in Latvia. Problems related to variable-rate mortgage loans should be addressed through consumer bankruptcy legislation, including early restructuring and out-of-court settlement. This could be supplemented by the social protection system for the most vulnerable. Households' low indebtedness (at about 20 percent of GDP in 2022, among the lowest in the EU) could mitigate financial stress on households and banks. Continued efforts are needed to counter cyber-attacks and prepare contingency plans to mitigate risks from cyberattacks. In this regard, the mission welcomes Latvia's efforts through the Nordic-Baltic Stability Group to conduct regular crisis preparedness exercises.

26. Staff welcomes the Bank of Latvia's (BoL's) enhanced use of stress testing to assess macro-financial conditions and liquidity risks. The BoL's stress test suggests that the resilience of the significant credit institutions to potential shocks (related to worsening macro-financial conditions) has increased, although vulnerability of small banks has increased. However, it concludes that credit institutions have sufficient liquidity to withstand a potential financing outflow and do not need to draw additional funding from the financial markets. Overall, spillovers from advanced economies' banking sector stress have been muted so far.

27. While the current macroprudential stance is broadly appropriate, consideration could be given to increasing capital-based measures to further build resilience. The macroprudential toolkit was enhanced in mid-2020 with several borrower-based measures (Text Table 4). The current macroprudential stance is broadly appropriate and strikes the right balance between maintaining financial stability and the need to support credit to the economy. However, higher insolvency risks in the commercial real estate market should be watched closely. Although residential real estate prices increased, they appeared to be broadly in line with wage growth and remained less buoyant than in the other Baltic countries (Text Figure 8). 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. Given that these factors could widen the imbalances on the housing markets going forward, consideration could be given to increasing capital-based measures (for instance, a positive neutral countercyclical capital buffer requirement), to further build resilience and avoid a procyclical move later.

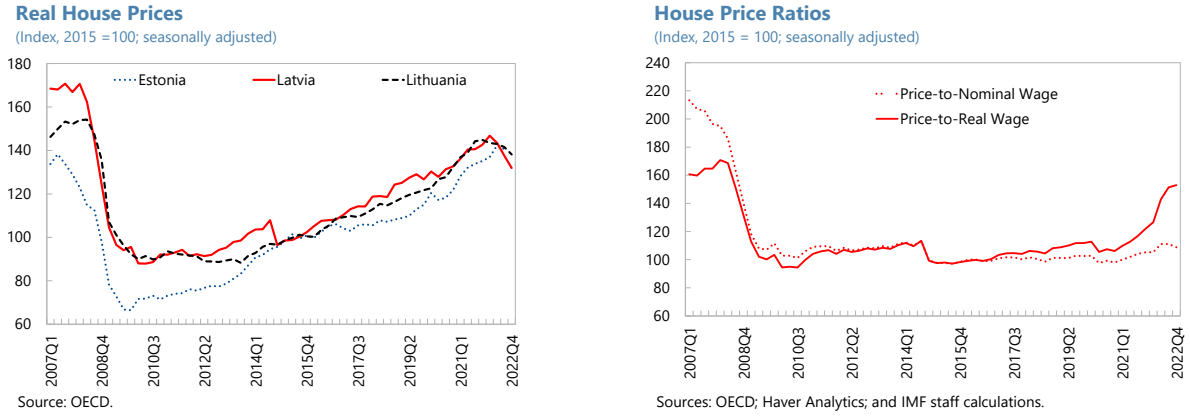
Text Table 4. Latvia: Macroprudential Instruments in Place

Borrower based measures		Capital based measures	
2007 May	**90% LTV** (95% for the State guarantee program participants)	2014 May	CCoB (2.5%)
2020 June	**70% LTV** for buy-to-let mortgages and borrowers whose income is largely generated from real estate	2014 May	CCyB (0%)
	40% DSTI	2017 June	**O-SII buffer (5 banks (0.25% – 2%))**
	6 times DTI		
	Maturity caps - 30 years (mortgages) and 7 years (consumer loans)	2014 January	100% risk-weight for exposures secured by commercial immovable property registered in Latvia under Standardized Approach
2022 January	Applicable also to credit institutions authorized in other EU Member States that are authorized to offer financial services in Latvia		

Note: "LTV" refers to loan-to-value ratio. "DSTI" refers to debt-service-to-income ratio. "DTI" refers to debt-to-income ratio. "CCoB" refers to capital conservation buffer requirement. "CCyB" refers to countercyclical capital buffer requirement. "O-SII" refers to "other systemically important institutions".

Source: Bank of Latvia.

Text Figure 8. House Prices



28. Latvia continues to make significant progress in strengthening its AML/CFT and anti-corruption frameworks.[17] Further progress has been made through the implementation of the amendments to the AML/CFT legal framework introduced in 2021, ongoing risk-assessment of banks and non-financial institutions (including independent providers of legal and accounting services), and continuous training and outreach activities to obliged entities. The authorities are encouraged to continue to further improve the effectiveness of their AML/CFT regime, including the beneficial

[17] See IMF Country Report No. 21/194 (Annex IX) for more details on AML/CFT reforms.

ownership framework and continued focus on emerging risks (e.g., sanctions evasion). Steps to enhance the risk-based supervision of banks and virtual asset service providers are welcome, and the authorities should continue to improve the supervisory ML/TF risk assessment, including through enhanced domestic cooperation between bank supervisors and other relevant competent authorities (including the FIU) involved in AML/CFT activities and more detailed collection of data.[18] Latvia has completed GRECO's Fifth Evaluation Round on preventing corruption and promoting integrity in central governments (top executive functions) and law enforcement agencies. The authorities should continue addressing the few outstanding recommendations and implement the country's Anti-Corruption Plan and National Strategy.

Authorities' Views

29. The authorities agreed with staff's advice, while stressing the resilience of the financial sector. They stressed that stress testing results, ample capital reserves and strong profitability attest to the strong resilience of the financial sector. They agreed to review the capital-based measures and assess the costs and benefits of increasing capital buffers. The authorities stressed that banks' lending policy is too conservative, holding back investment by nonfinancial corporations. They will continue to engage in regular dialogue with the financial sector on this issue. They assessed the liquidity risks for nonbank financial institutions as limited, as they are attenuated by the fact that the majority of the market is formed by such institutions that are owned by banks, which command ample liquidity.

30. The authorities reiterated their unwavering commitment to pursue further AML/CFT framework improvements. They noted that they are currently working on updating the National Risk Assessment (NRA) which will be completed in 2023 and developing risk mitigating measures soon after and are actively managing the risk of sanctions evasion (by creating task forces, dialogue with the market, and public outreach). The recent integration of the FCMC into the BoL will be leveraged to further integrate the AML/CFT risks into a comprehensive risk-based supervision of banks. To foster a sound regulation of crypto assets, a law is expected to be adopted by end-2023, building on the EU's regulation on markets in crypto-assets (MiCA) and the Financial Action Task Force (FATF) Standards.

31. Regarding governance reforms the authorities emphasized their successful implementation of most of the recommendations of the GRECO's evaluation. Following the adoption of the country's Anti-Corruption Plan and National Strategy, they will focus on the introduction of code of ethics for cabinets of senior officials and adapt the law on conflict of interest for civil servants, in consultation with OECD. The authorities have also taken measures to strengthen the transparency of public procurement, including by amending the legal framework to

[18] The ongoing regional IMF Nordic-Baltic Technical Assistance Project that focuses on analysis of cross-border ML/TF threat and related aspects of banking sector supervision, potential financial integrity implications on financial stability, and virtual assets is due to be finalized in 2023.

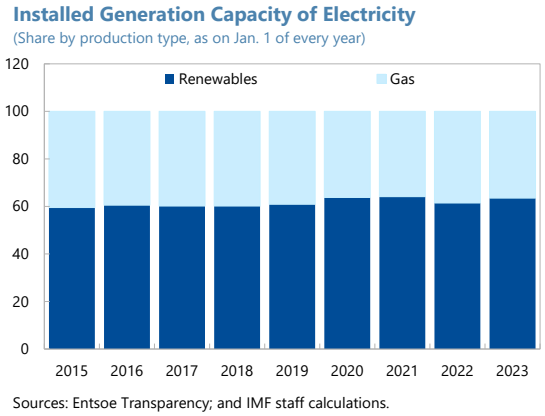
foster the integrity of economic operators in the procurement process, which entered into force on January 1, 2023.

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

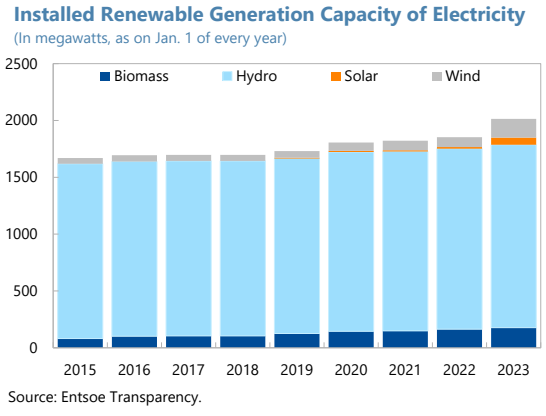
Energy Security and Climate Change Policies

32. The government should continue to build up reserves, while accelerating investment in energy security. A mild winter has helped the government build up sufficient gas reserves, which positions the country well for the 2023/2024 winter season. Latvia has taken concrete steps to increase the supply of wind energy, by approving regulation to facilitate the construction of wind energy turbines and by signing an agreement to start developing an offshore wind farm. The government also expects an increase in the installed capacity of solar energy. The authorities believe that energy security would be significantly enhanced given their continued efforts to expand LNG import capacity and boost investment in clean energy and connections (Text Figure 9).

Text Figure 9. Electricity Capacity and Renewables



Sources: Entsoe Transparency; and IMF staff calculations.



Source: Entsoe Transparency.

33. Swift implementation of planned measures to address climate change is critical. Latvia's National Energy and Climate Plan (NECP) specifies several useful measures to address climate change. These include implementing a tax for combustion installations outside the EU ETS, phasing out fossil fuel subsidies, transitioning to renewable energy, energy efficiency, investing in grid connections and interconnections, and supporting the electrification of transport. In addition, Latvia intends to reduce GHG emissions from land use and build carbon sinks. As part of the NRRP, improving energy efficiency in private and public buildings, and modernizing and greening electricity networks, would also help to support climate mitigation. A large share of greenhouse gases remains without a price or with a price well below the EU ETS price. Therefore, Latvia could extend carbon pricing to emissions not covered by the EU ETS. More vigorous climate policy is urgently needed because Latvia's greenhouse gas emissions have increased since 2000, against the trend in the EU.

34. Adaptation to climate change should be mainstreamed in all government activities. Increasing frequency and intensity of summer heat waves and droughts can cause adverse effects that should be closely monitored. Forward looking land use policies and intervention could help reduce sea-level rise costs. Changes in the intensity and frequency of floods from the Daugava River should also be closely monitored.

Corporate Reforms

35. Accelerating corporate reforms could help reverse Latvia's decade-long pattern of weak investment growth. Key priority reforms include:

- *Corporate recapitalization*: Lessons from the implementation of the existing recapitalization fund of 0.3 percent of GDP for large enterprises should be drawn to pave the way to a new recapitalization fund to support SMEs and micro firms, which form most of the corporate sector. Staff acknowledges the ongoing measures to promote the development of domestic capital market, and a state program to help startups and small and medium enterprises obtain access to finance.

- *Insolvency processes*: Staff welcomes the policy measures taken so far to implement the EU directive on restructuring and insolvency (Directive 2019/1023), including amendments to the insolvency law. However, staff emphasized faster implementation of the EU restructuring directive will simplify debt restructuring through out-of-court and hybrid procedures, as the energy crisis and tighter financial conditions could increase the number of corporate bankruptcies.

Labor Market Reforms

36. Latvia should advance reforms to boost high-skilled labor supply. As part of the NRRP, Latvia plans to address the shortage of high-skilled labor by undertaking reforms in higher education, investing in affordable housing and schools, and modernizing healthcare. Plans to retain skilled workers include scholarships on science, technology, engineering, and mathematics (STEM) subjects. In addition, Latvia should continue to leverage active labor market policies (ALMPs) like job search assistance and counseling for groups most affected by unemployment, vocational training, employment incentives, direct job creation, and support for micro-entrepreneurs and self-employed workers.[19] Finally, reducing employment protection[20] and promoting inward labor migration[21] could mobilize workers not currently available to Latvia's labor market. Also, stimulating the green labor market through stronger environmental policies and providing targeted training would help to facilitate the move to green jobs.

[19] See IMF Country Report No. 22/277.

[20] With an indicator score of 2.5, Latvia is near the top of countries for employment protection. See OECD Employment Outlook 2020: Worker Security and the COVID-19 Crisis, Figure 3.1.

[21] See IMF 18/267.

Product and Service-Market Reforms

37. The regulatory burden in product and services markets could further be reduced to support investment and firm growth. Indicators of Regulatory Policy and Governance (iREG) of the OECD show Latvia to be above OECD average in stakeholder engagement in developing regulations, close to average in regulatory impact assessment (RIA), and below average in ex post evaluation of regulations.[22] According to the BoL's survey of real estate developers[23], it takes a longer time to approve construction documentation in Latvia than in Estonia and Lithuania. Therefore, further streamlining spatial planning and construction regulation could benefit the housing market and investment. Staff also encouraged the authorities to accelerate streamlining the regulations for green transition.

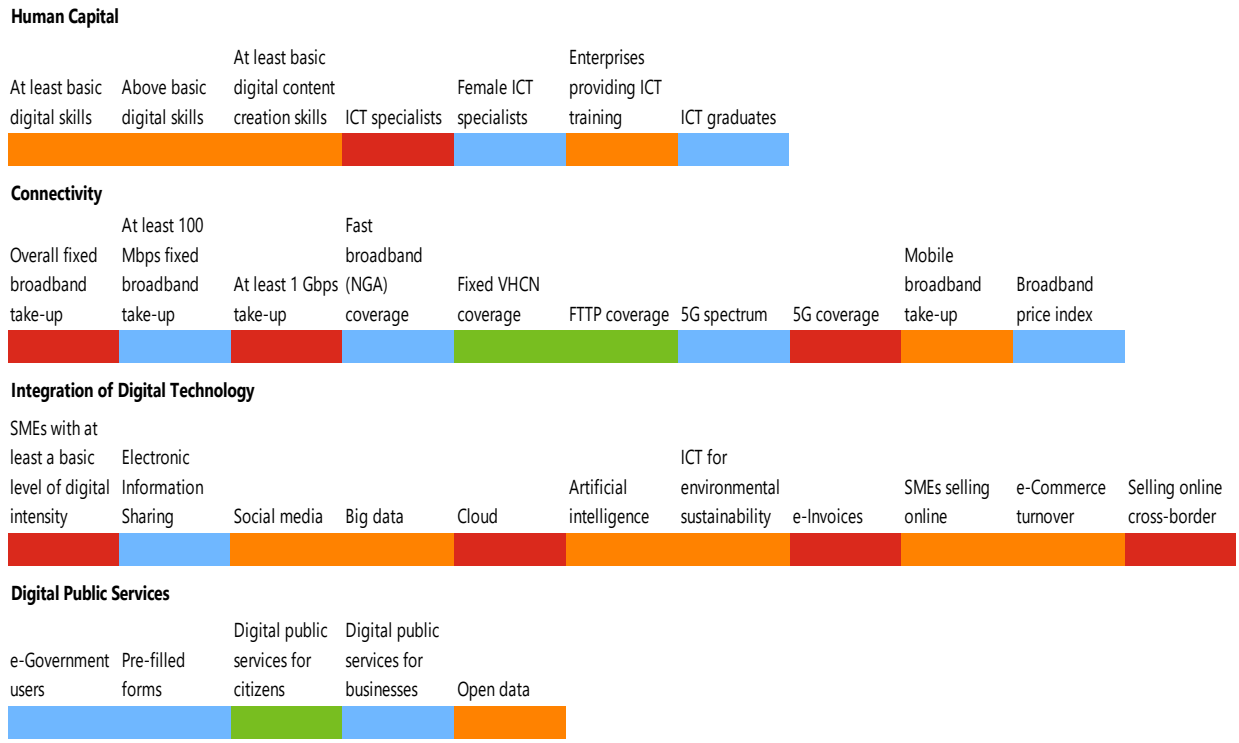
Digitalization

38. Strengthening Latvia's digital transformation could help reduce labor shortages and support productivity. Latvia ranks 17th out of 27 EU Member States in the 2022 edition of the Digital Economy and Society Index and has the slowest growing index value among all EU countries (Text Figure 10). Latvia's digital transformation should focus on enhancing connectivity, increasing adoption and use of digital technologies, unleashing digital innovation, and providing training on digital technologies. The NRRP allocates 21 percent of the financing to support a comprehensive range of measures, including broadband infrastructure development, business digitalization, digital upskilling for citizens and public administration, 5G deployment, and a regulatory framework for remote learning. If implemented well and without delay, the digital agenda would help to boost labor supply and positively contribute to future productivity.

[22] "Better Regulation Practices across the EU," OECD (2022).

[23] Bank of Latvia, Financial Stability Report, 2022.

Text Figure 10. The Digital Economy and Society Index, 2022



Sources: European Commission, the Digital Economy and Society Index (DESI); and IMF staff calculations.

Note: Red, orange, blue and green indicate, respectively, that Latvia's value falls in the 1st (lowest), 2nd, 3rd, and 4th (highest) quartile among the EU members.

Authorities' Views

39. The authorities reiterated their strong commitment to continue pursuing structural reforms to ensure energy security and address climate change. Latvia has taken decisive steps to improve its energy security by replacing natural gas with renewable energy production, developing LNG import capacity, and strengthening integration into the European electricity grid. Substantial investments in wind and solar electricity generation are under way. Latvia recognizes the need for more ambitious climate policy for those GHG emissions not covered by the EU ETS. A draft climate change legislation aims to set sectoral targets and considers setting financial mechanism in case sectoral targets are not met and improve accountability for emissions. Latvia has also adopted a National Adaptation Plan, which will enhance adaptation policies in all government activities.

40. Further progress has been made on corporate and regulatory reforms. In September 2023, amendments to the Insolvency Law, focusing on the implementation of the EU directive on Restructuring and Insolvency (Directive 2019/1023), will go into force. The ongoing plan to develop the capital market will help provide alternative sources of financing for investment, increase transparency, and improve corporate governance. The state-owned joint-stock company (JSC) Development Financial Institution (ALTUM) also has a program to help start-ups and SMEs through credit guarantees and loans. Initiatives are underway to reduce the regulatory burden. A

Green channel project has already streamlined procedures for investments in the green transition. The digitalization of construction permits will also streamline procedures for this sector. The issue of relatively high and sticky share of negative capital companies necessitates a structured approach, which is currently being examined by the authorities.

41. Labor market reforms continue to advance. Latvia has developed targeted measures to enable all groups with above-average unemployment to join the workforce. The most important groups are workers with disability, workers older than 50 years, and workers in rural areas. To help improve health outcomes, an EU-financed initiative has helped incentivize the return of medical professionals from abroad.

42. Latvian authorities are implementing a comprehensive and ambitious action plan on digitalization. Public administration is highly digitalized already, with nearly all services offered online in a convenient one-stop shop. Another priority is innovation, where Latvia has managed to achieve a leading role, for example, on the quantum computing topic within the European Union. The country is also working on providing high-quality training to female students in STEM. The community dedicated to educating and inspiring girls and women about technology, Riga TechGirls, has been very successful. Efforts to ensure cybersecurity continue, as the country withstood heightened security threats from abroad. As a part of the digital transformation, final beneficiaries are generally provided with non-financial support (digital maturity tests, digital development roadmaps, opinions, consultations, European Digital Innovation Hubs (EDIH) services, etc.) and support in the form of grants, training, as well as for the development of new products. From the planned 7,000 supported final beneficiaries under the Recovery and Resilience Mechanism by June 2026, Latvian European digital innovation hubs have currently received 1,500 supported applications.

STAFF APPRAISAL

43. Latvia is facing an inflation shock, slow growth, and geopolitical headwinds. In 2022, headline inflation was elevated, largely driven by high energy and food price increases. At the same time, real GDP growth slowed, mostly reflecting lower increase in inventories and slower fixed investment growth.

44. These short-term concerns are adding to the long-term policy challenge of sustaining the income convergence process. The uncertainty associated with the geopolitical situation and high inflation will likely depress investment and productivity, with potentially serious implications for future prosperity. To secure high long-term growth in a low inflation environment, Latvia needs to lift productivity, increase investment, and overcome skilled labor shortages.

45. Amid high uncertainty, growth is set to slow and the balance of risks is tilted to the downside. Growth is projected to slow in 2023, as high inflation weighs on consumption and external demand declines. Headline inflation is projected to retreat in 2023, reflecting falling energy and food prices and weakening demand. In the medium term, growth is projected to rebound,

underpinned by reforms, strong consumption, and public investment. Key downside risks include an escalation of the war and associated sanctions, which could result in renewed increases in energy prices, energy supply disruptions in Europe, and weaker external demand. Global financial conditions could further tighten, with spillovers to Latvian banks and domestic credit growth. Domestic risks, such as not sufficiently tight fiscal policy, tight labor markets, and wage pressure, could cause core inflation to persist.

46. To lower high inflation, staff recommends a tighter fiscal stance in 2023. To ensure that fiscal policy contributes to the disinflationary effort, the cash deficit should be below the 2022 level. Better targeting of energy support measures would help to reduce the cash deficit, while allowing the full pass-through of international fuel prices to domestic consumers. Fiscal policy should remain flexible, given high uncertainty.

47. Fiscal reforms should focus on public investment, pension, and growth-enhancing tax reform. If implemented well, the NRRP will help boost public investment and productivity. Planned reforms of the pension system should continue, and additional reforms could be considered to encourage longer working lives and review the minimum contribution period. A growth-enhancing tax reform should aim to reduce the labor tax wedge. The revenue impact of the labor tax reduction could be compensated by rationalizing tax exemptions and increasing property taxation. Carbon tax for emissions not covered by the EU-ETS could also be considered to generate revenue.

48. The financial sector has so far been resilient, though tighter financial conditions warrant close monitoring and contingency plans. The banking sector remained well capitalized and liquid, with a low NPL ratio. However, given heightened risks, continued monitoring of financial sector vulnerabilities is important. Notably, regular, risk-based monitoring of banks' asset quality and liquidity should continue, supported by tailored stress tests to identify specific vulnerabilities. Facilitating early debt restructuring and out-of-court settlement for distressed households' loans should be encouraged, backed up by the social protection system for the most vulnerable. Latvia's efforts through the Nordic-Baltic Stability Group should continue to help counter cyberattacks.

49. While the current macroprudential stance is broadly appropriate, consideration could be given to increasing capital-based measures to further build resilience. The current macroprudential stance strikes the right balance between maintaining financial stability and credit support to the economy. However, given the likely persistent imbalances on the housing markets, it is advisable to consider increasing capital-based measures (for instance, a positive neutral countercyclical capital buffer requirement), to avoid a procyclical move later.

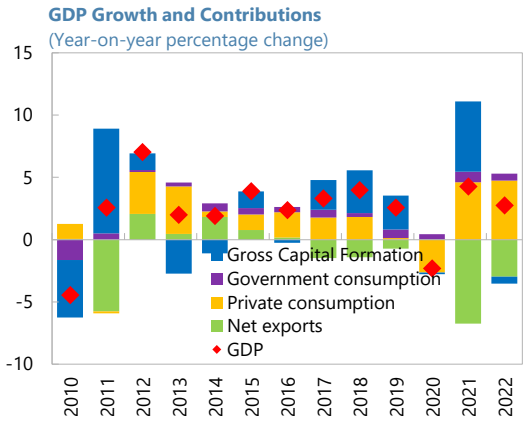
50. Latvia has made significant progress with AML/CFT framework, and the authorities should continue to strengthen it and implement the country's Anti-Corruption Plan and National Strategy. The authorities are encouraged to continue to further improve the effectiveness of their AML/CFT regime, including the beneficial ownership framework and continued focus on emerging risks (e.g., sanctions evasion). Furthermore, implementing the newly adopted Anti-Corruption Plan and National Strategy should be a priority.

51. Structural reforms should be accelerated to build resilience and lift long-term growth. Latvia continues to enhance energy security, boost investment in clean energy and connections, and adapt to climate change. Accelerating corporate recapitalization and improving the insolvency regime could help boost investment. Given the aging population and skill mismatches, Latvia should continue to advance reforms to boost high-skilled labor supply. The use of targeted labor market policies should be combined with the reforms of the business environment. Further streamlining spatial planning and construction regulation could benefit the housing market and investment. Streamlining the regulations for green transition should also be accelerated. Strengthening Latvia's digital transformation could help reduce labor shortages and support productivity. Planned structural reforms in the NRRP should be implemented well and without delay to boost labor supply, investment, and productivity.

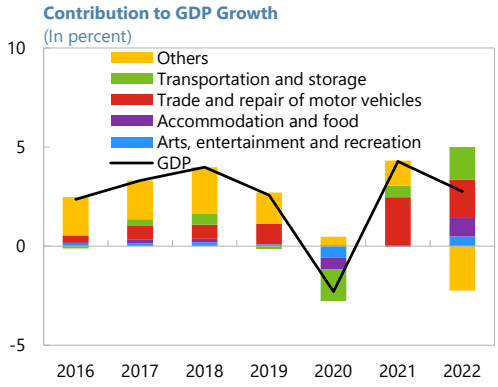
52. It is recommended that the next Article IV consultation take place on the regular 12-month cycle.

Figure 3. Real Sector and Inflation Developments

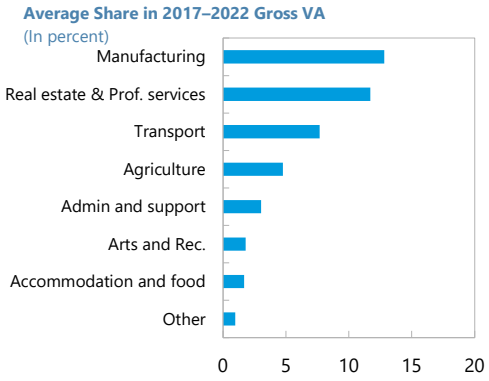
GDP growth declined, driven by lower increase in inventories and slower fixed investment growth.



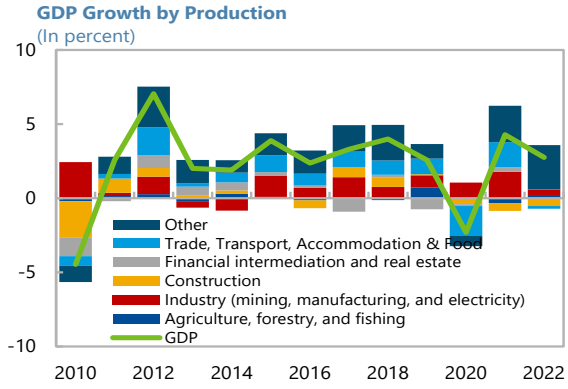
Growth contribution of arts, entertainment, recreation, accommodation, and food rebounded following lifting of pandemic restrictions…



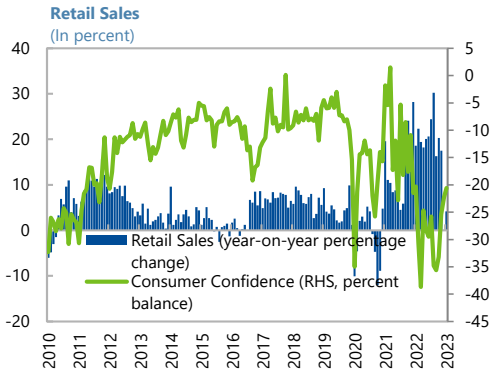
…though their share in gross value added in the economy is not large.



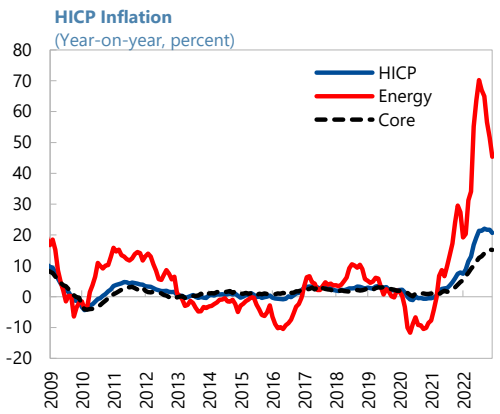
Growth contribution of other services also rebounded somewhat.



Retail sales growth spiked.



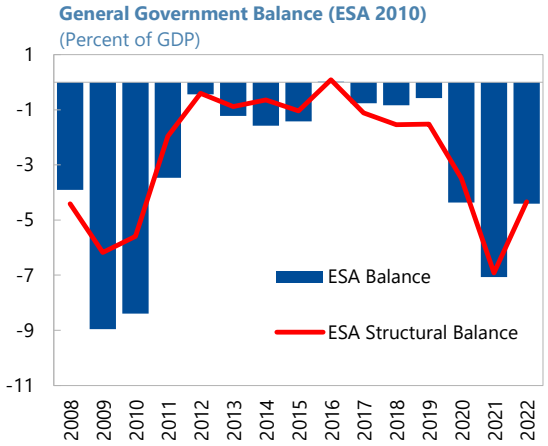
High energy prices caused inflation to spike.



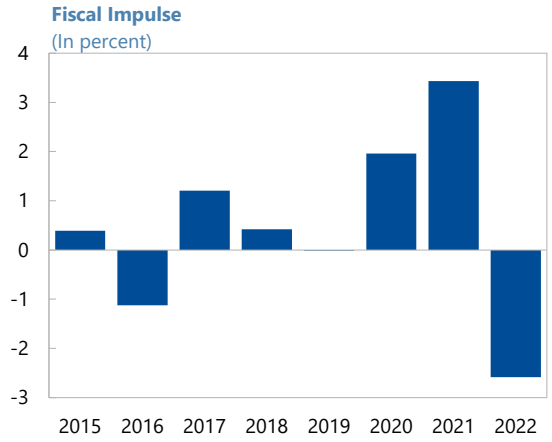
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 4. Fiscal Sector Developments

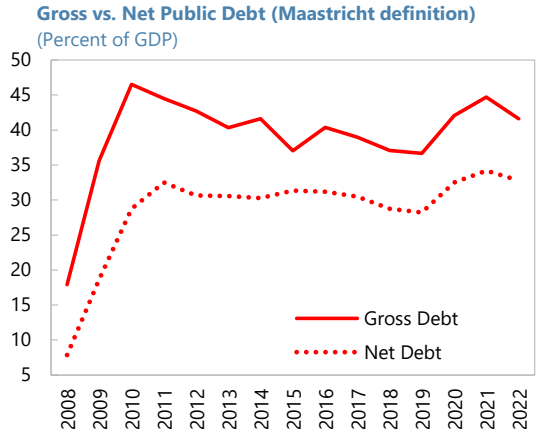
Fiscal balances improved...



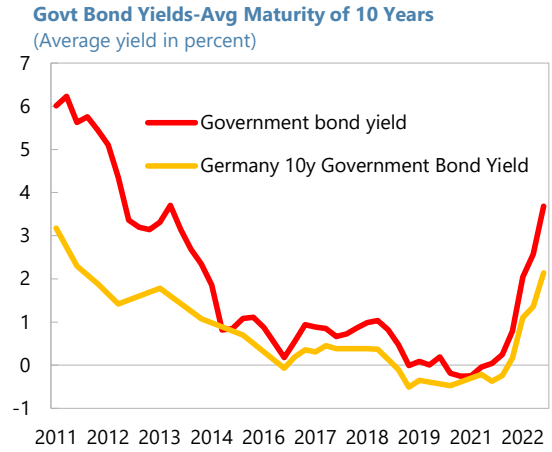
...as significant crisis relief measures were scaled back.



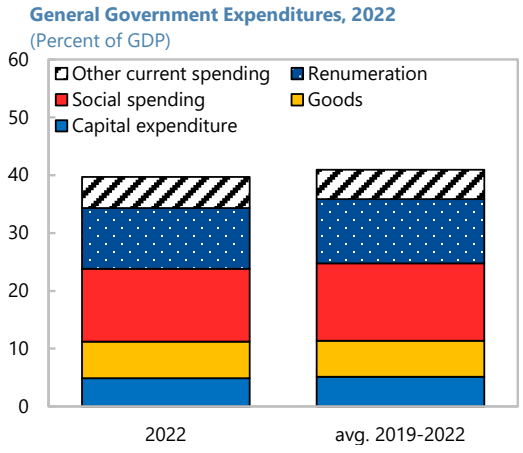
Public debt has decreased.



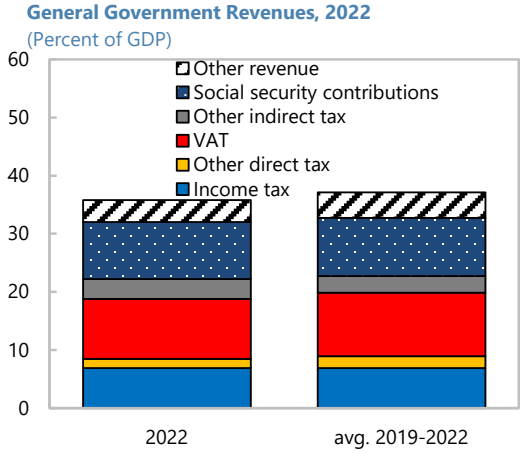
While the tightening of financial conditions caused an increase in bond yields.



Social spending has increased marginally...



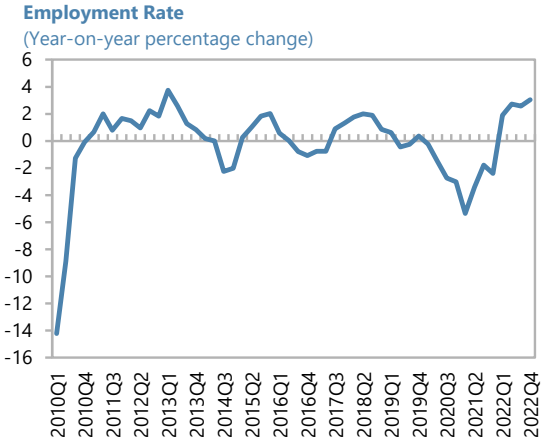
...while revenue sources held up.



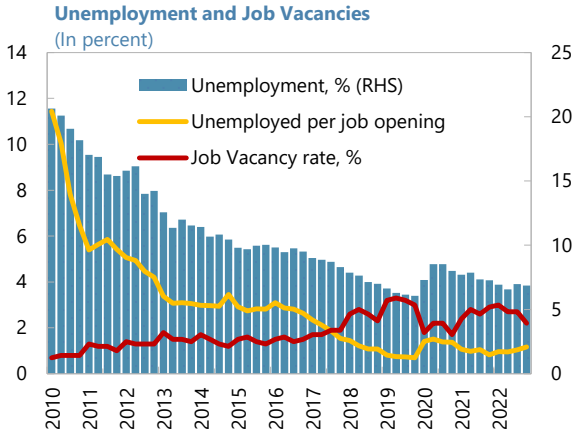
Sources: Latvian authorities; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 5. Labor Market Developments

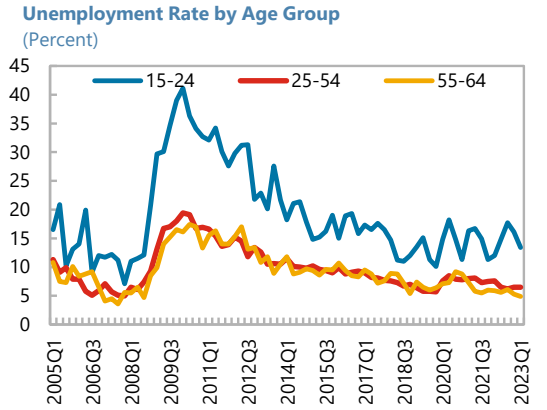
The employment rate increased following the lifting of pandemic restrictions…



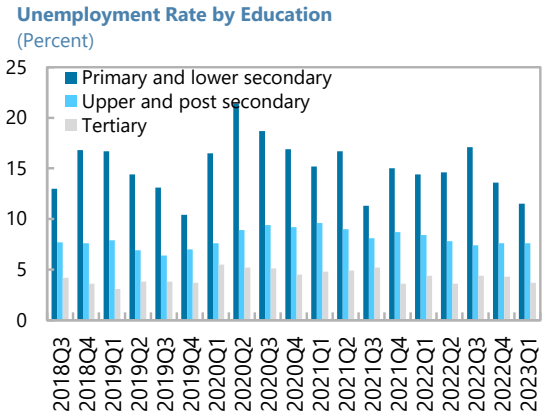
…causing the unemployment rate to decline.



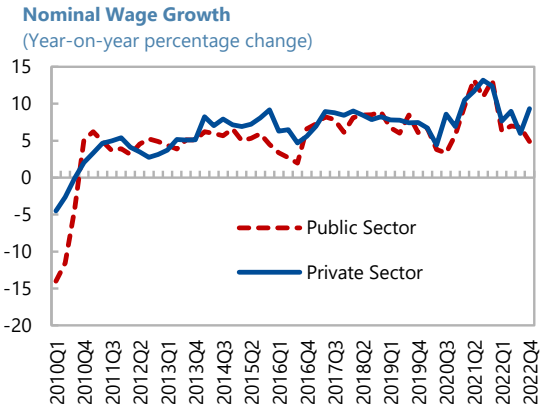
The unemployment rate is higher among the young…



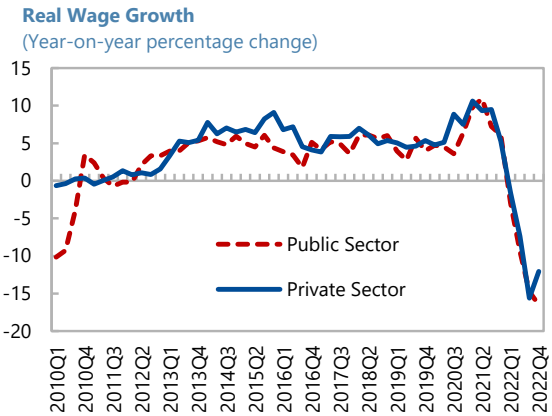
…and those with lower education.



Nominal wage growth declined from the pandemic heights…



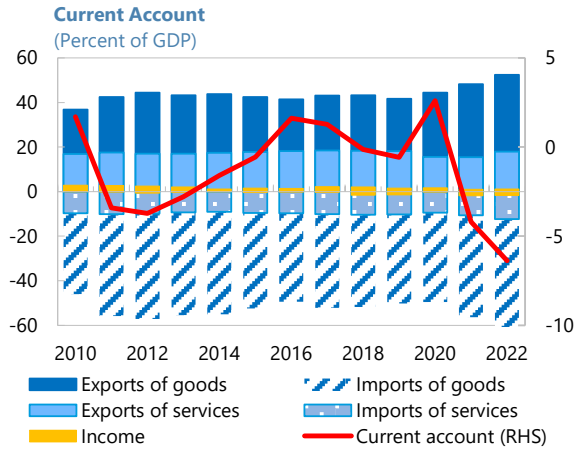
…while real wage growth remained negative.



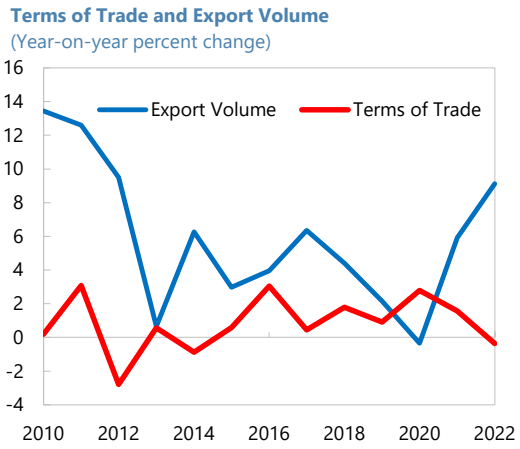
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 6. External Sector Developments

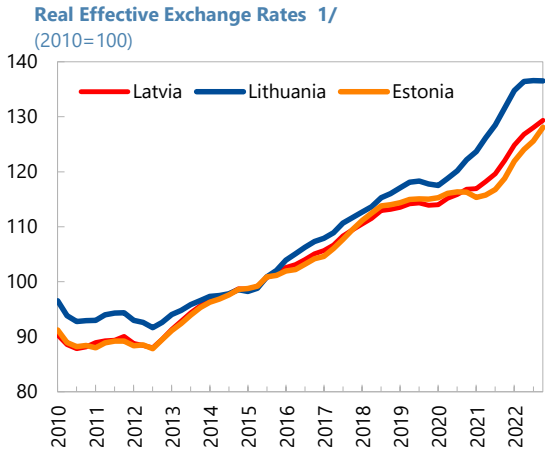
The current account deficit widened in 2022…



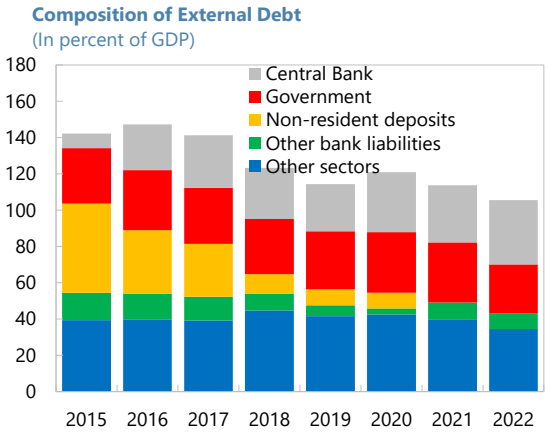
… despite an increase in export volume.



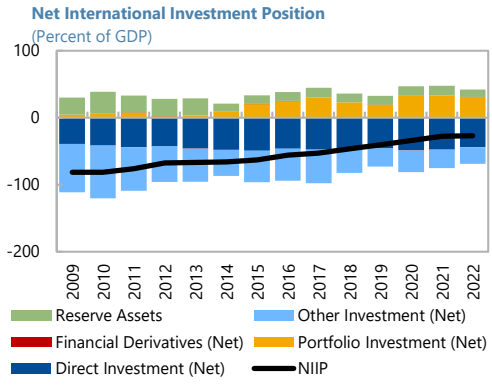
External competitiveness held up in 2022.



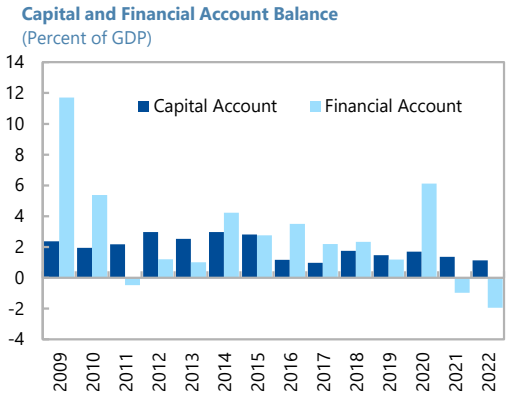
The total external debt burden decreased.



The NIIP remained relatively unchanged…



…and the financial account balance remained negative.

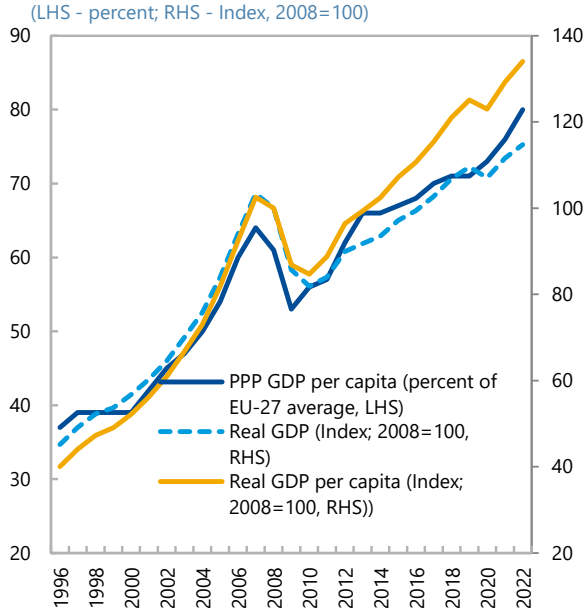


Sources: Bank of Latvia; Statistics Latvia; European Commission; and IMF staff calculations.
1/ Real effective exchange rates are based on IC–37 countries for ULC.

Figure 7. Inequality and Poverty Indicators

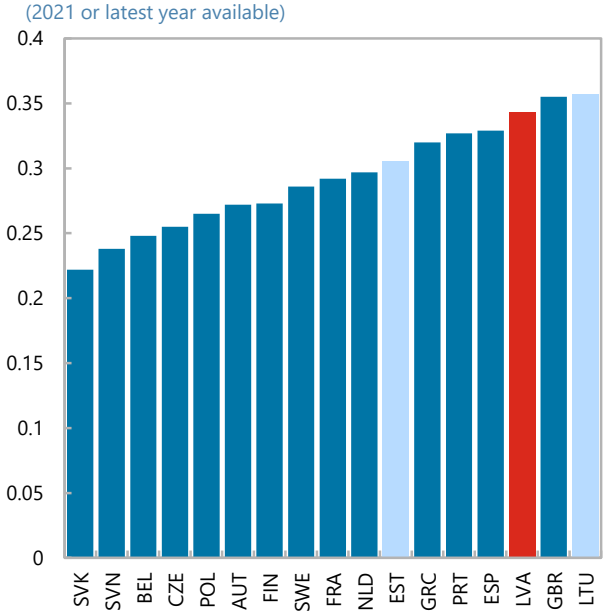
GDP per capita remains below that of Western Europe.

Real GDP
(LHS - percent; RHS - Index, 2008=100)



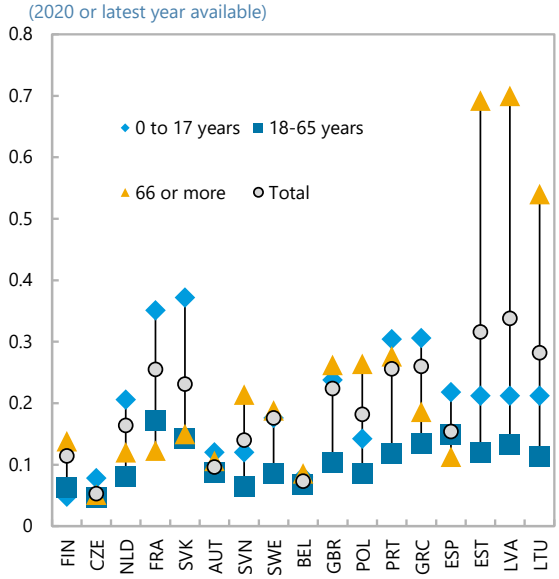
Income inequality is one of the highest in the EU.

Disposable Income Gini Coefficient 1/
(2021 or latest year available)



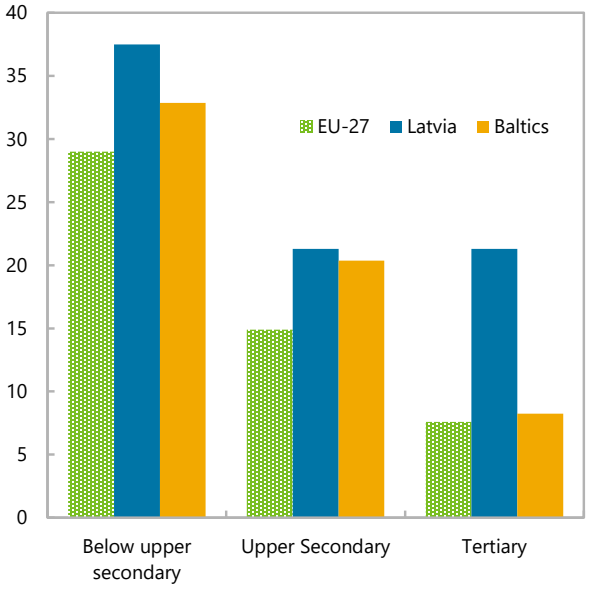
Poverty rates are one of the highest in the EU, especially among the elderly…

Poverty Rate Relative to EU Income Level 2/
(2020 or latest year available)



…. and those with lower education.

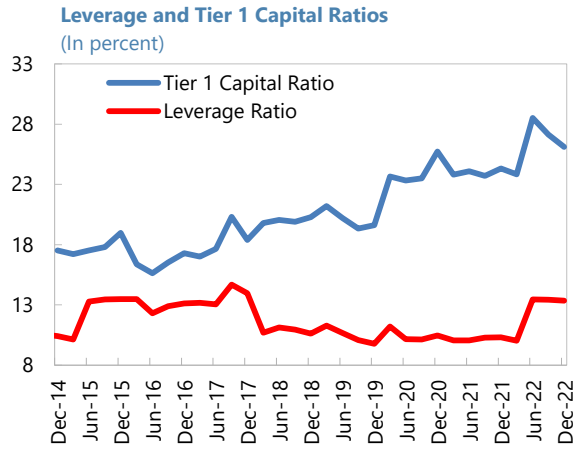
At-Risk-of-Poverty Rate, 2022
(Percent)



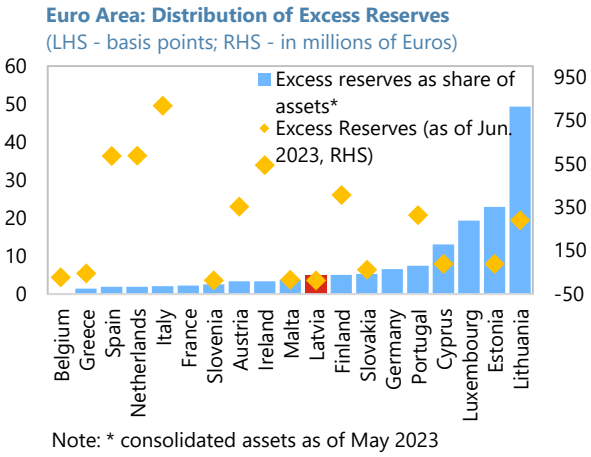
Sources: OECD, Eurostat; and IMF staff calculations.
1/ 2021 data are available for Latvia, Sweden, Finland, and the Netherlands. Data for Latvia and the Netherlands are provisional. Data for France and Slovakia are for 2019.
2/ Data for France and Slovakia are for 2018.

Figure 8. Banking Sector Developments

Banks hold high capital buffers...

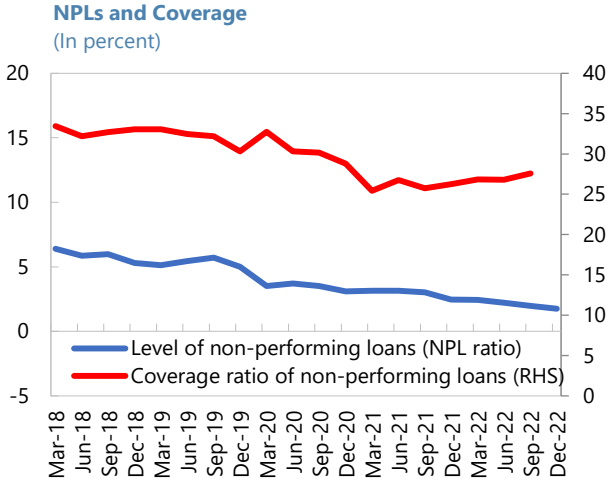


...and excess reserves relative to assets remain relatively high compared to some euro area countries.

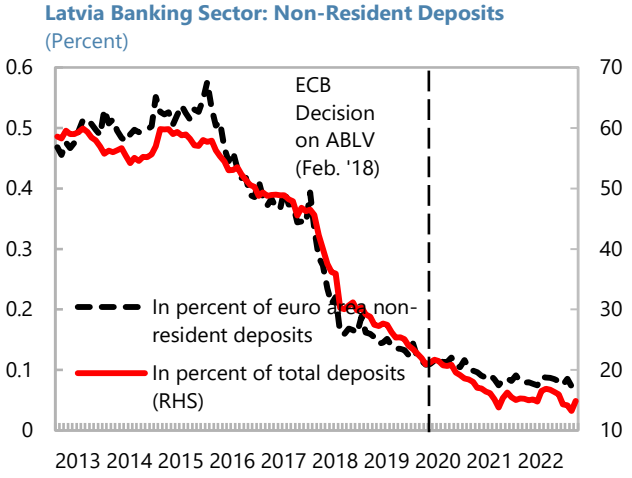


Note: * consolidated assets as of May 2023

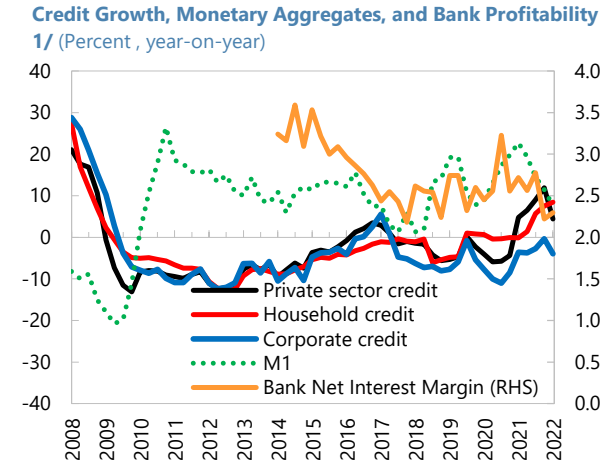
NPLs continue to decline.



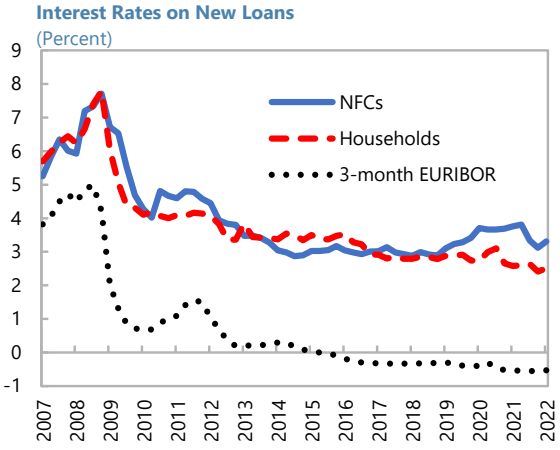
The retrenchment of non-resident deposits reduces the risk of money laundering.



Interest margins are on the rise...



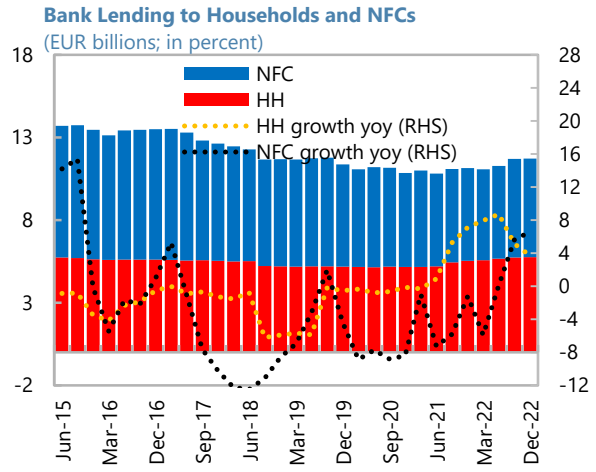
...and lending rates remain well above the cost of funding.



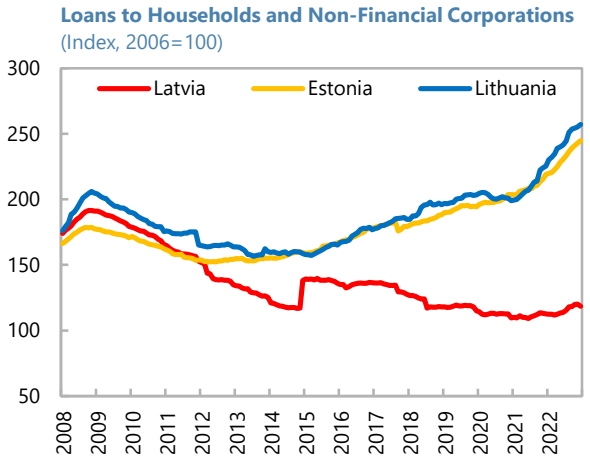
Sources: Bank of Latvia; ECB; FCMC; Haver Analytics; and IMF staff calculations.
1/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

Figure 9. Indicators of Financial System's Credit

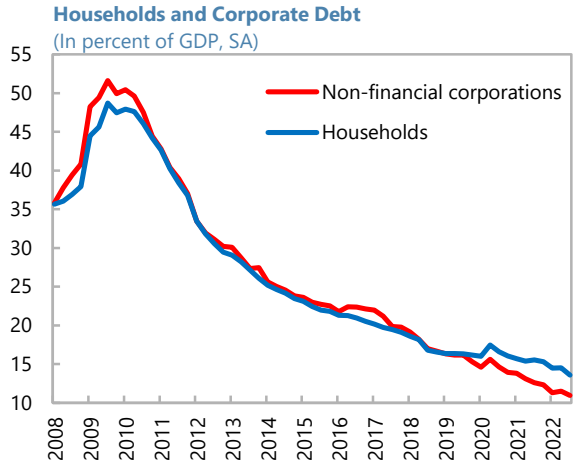
Bank lending remains relatively unchanged in Latvia...



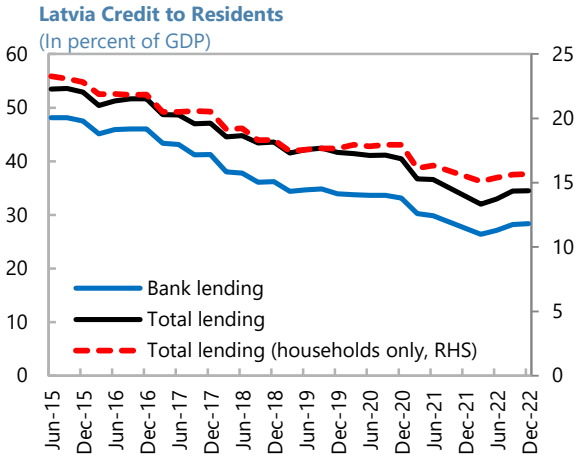
...and still lags Baltic peers.



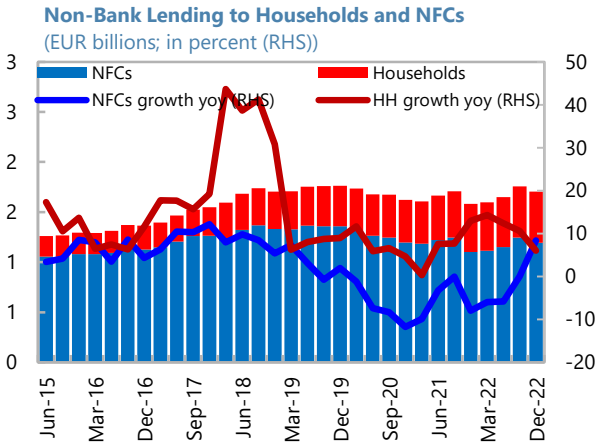
Although household credit appears more resilient than that of non-financial corporates...



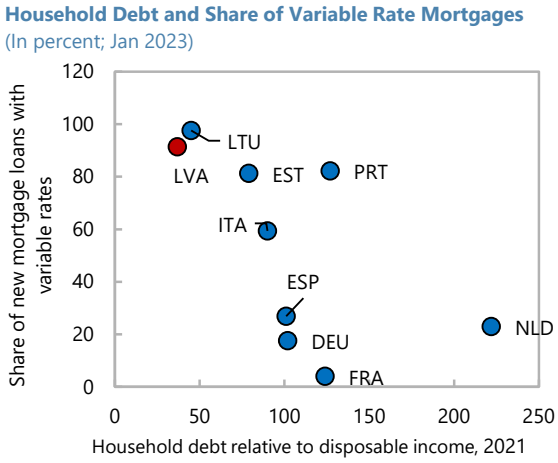
...total lending to residents remained relatively unchanged recently.



Non-bank lending to households increased slightly.



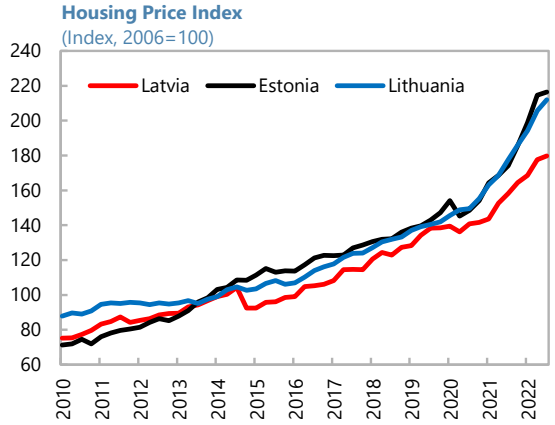
Mortgage credit has a vulnerability due to high share of variable interest rates.



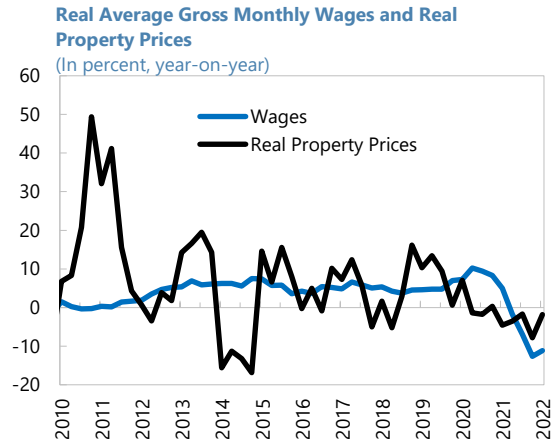
Sources: Bank of Latvia; ECB; FCMC; Haver; OECD; and IMF staff calculations.

Figure 10. Housing Market Indicators

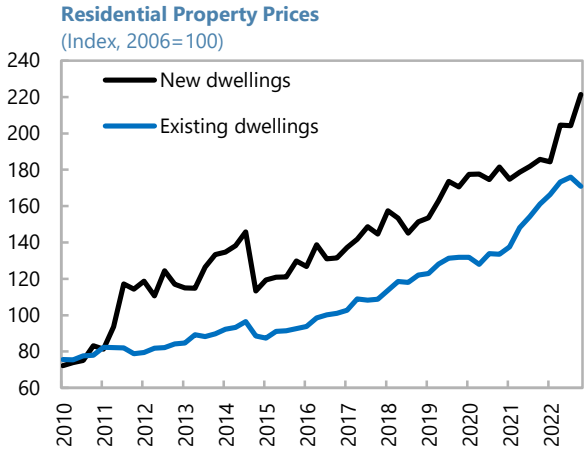
Increases in Latvia's house prices have been in line with those of its Baltic neighbors...



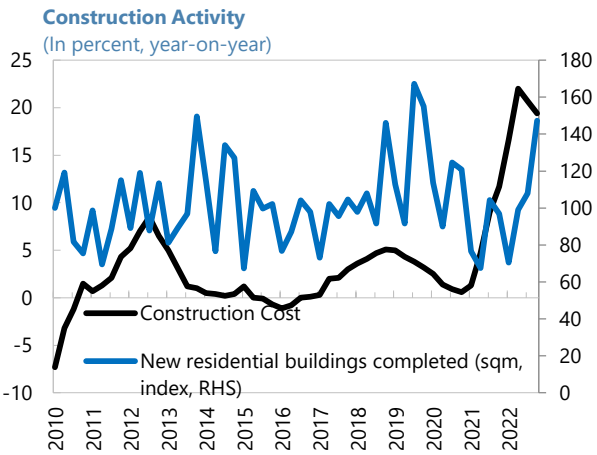
...and on average in line with wage growth.



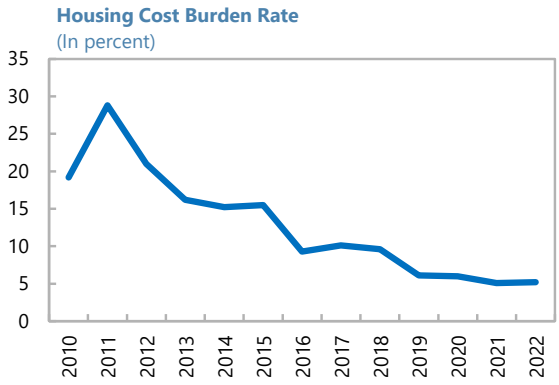
Prices for new dwellings rose rapidly...



...as construction costs increased.

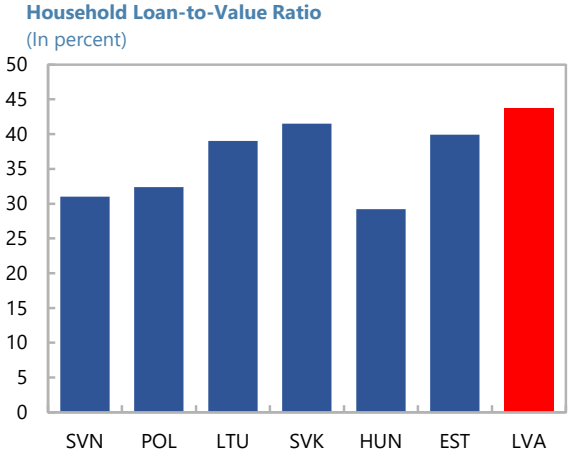


Housing is becoming gradually more affordable...



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 still higher than peers.



Sources: Haver Analytics; Eurostat; ECB; and IMF staff calculations.

Table 1. Latvia: Selected Economic Indicators, 2019–24

	2019	2020	2021	2022	2023	2024
					Proj.	
National Accounts	(Percentage change, unless otherwise indicated)					
Real GDP	2.6	-2.3	4.3	2.8	0.9	2.7
Private consumption	0.2	-4.6	8.1	8.1	2.0	2.8
Public consumption	3.9	2.4	4.4	2.8	1.0	2.7
Gross capital formation	10.1	-0.4	19.2	-1.7	-0.8	2.7
Gross fixed capital formation	6.9	-2.6	2.9	0.7	0.9	3.8
Exports of goods and services	2.1	-0.3	5.9	9.1	-0.2	3.0
Imports of goods and services	3.1	-0.3	15.3	11.7	-0.5	3.0
Nominal GDP (billions of euros)	30.7	30.3	33.6	39.1	43.3	46.3
GDP per capita (thousands of euros)	16.0	15.9	17.8	20.8	23.1	24.8
Savings and Investment						
Gross national saving (percent of GDP)	22.4	24.5	20.9	19.4	21.1	21.4
Gross capital formation (percent of GDP)	23.0	21.9	25.1	25.8	24.1	23.6
Private (percent of GDP)	19.1	17.7	21.4	22.5	20.5	20.0
HICP Inflation						
Headline, period average	2.7	0.1	3.2	17.2	10.4	3.4
Headline, end-period	2.1	-0.5	7.9	20.7	4.4	4.1
Core, period average	2.7	1.1	2.0	11.3	11.0	5.0
Core, end-period	1.9	0.9	4.7	15.2	7.5	4.2
Labor Market						
Unemployment rate (LFS; period average, percent)	6.3	8.1	7.6	6.9	6.7	6.6
Nominal wage growth	7.2	4.2	11.1	7.5	9.3	8.0
Consolidated General Government 1/	(Percent of GDP, unless otherwise indicated)					
Total revenue	37.2	37.5	37.4	36.5	36.2	37.4
Total expenditure	37.6	41.2	42.8	40.3	40.1	39.3
Basic fiscal balance	-0.4	-3.7	-5.4	-3.7	-3.9	-1.9
ESA fiscal balance	-0.6	-4.4	-7.1	-4.4	-3.7	-2.5
General government gross debt	36.5	42.0	43.7	40.8	40.5	39.7
Money and Credit						
Credit to private sector (annual percentage change)	-2.3	-4.4	11.9	7.0	...	...
Broad money (annual percentage change)	8.0	13.1	9.2	5.1	...	...
Balance of Payments						
Current account balance	-0.6	2.6	-4.2	-6.4	-3.0	-2.2
Trade balance	-8.6	-5.1	-8.3	-11.5	-7.1	-6.6
Gross external debt	116.7	121.4	109.6	100.6	99.6	98.3
Net external debt 2/	18.1	13.4	10.2	8.1	8.2	7.4
Exchange Rates						
U.S. dollar per euro (period average)	1.12	1.14	1.18	1.05	...	...
REER (period average; CPI based, 2005=100)	123.0	124.5	125.1	129.7	...	...
Terms of trade (annual percentage change)	0.9	2.8	1.6	-0.4	-0.6	0.8

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, 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Proj					
	(Percentage change, unless otherwise indicated)									
National Accounts										
Real GDP	2.6	-2.3	4.3	2.8	0.9	2.7	3.2	3.2	3.2	3.2
Consumption	1.1	-2.9	7.2	6.8	1.8	2.8	3.0	3.0	3.0	3.0
Private consumption	0.2	-4.6	8.1	8.1	2.0	2.8	3.0	3.0	3.0	3.0
Public consumption	3.9	2.4	4.4	2.8	1.0	2.7	3.0	3.0	3.0	3.0
Gross capital formation	10.1	-0.4	19.2	-1.7	-0.8	2.7	3.3	3.3	3.3	3.3
Gross fixed capital formation	6.9	-2.6	2.9	0.7	0.9	3.8	4.5	4.5	4.5	4.5
Exports of goods and services	2.1	-0.3	5.9	9.1	-0.2	3.0	2.6	2.6	2.6	2.6
Imports of goods and services	3.1	-0.3	15.3	11.7	-0.5	3.0	2.5	2.5	2.5	2.5
Contributions to growth										
Domestic demand	3.5	-2.3	11.1	4.7	1.2	3.1	3.5	3.5	3.5	3.5
Net exports	-0.7	0.0	-6.7	-3.0	0.3	-0.4	-0.3	-0.3	-0.3	-0.3
HICP Inflation										
Headline, period average	2.7	0.1	3.2	17.2	10.4	3.4	3.3	2.5	2.4	2.3
Headline, end-period	2.1	-0.5	7.9	20.7	4.4	4.1	2.6	2.4	2.3	2.3
Core, period average	2.7	1.1	2.0	11.3	11.0	5.0	3.4	2.6	2.5	2.5
Core, end-period	1.9	0.9	4.7	15.2	7.5	4.2	2.7	2.6	2.5	2.5
Labor Market										
Unemployment rate (LFS, percent)	6.3	8.1	7.6	6.9	6.7	6.6	6.5	6.4	6.4	6.4
Employment (period average, percent)	0.1	-1.9	-3.2	2.6	0.2	0.1	0.1	0.1	0.1	0.1
Nominal wage growth	7.2	4.2	11.1	7.5	9.3	8.0	7.0	5.0	5.0	5.0
	(Percent of GDP)									
Consolidated General Government 1/										
Total revenue	37.2	37.5	37.4	36.5	36.2	37.4	36.5	36.4	36.3	36.4
Total expenditure	37.6	41.2	42.8	40.3	40.1	39.3	38.6	38.5	37.5	37.3
ESA fiscal balance	-0.6	-4.4	-7.1	-4.4	-3.7	-2.5	-2.1	-2.1	-1.2	-1.0
ESA structural fiscal balance	-1.5	-3.5	-6.9	-4.3	-3.2	-2.0	-1.8	-2.0	-1.2	-1.0
General government gross debt	36.5	42.0	43.7	40.8	40.5	39.7	39.0	38.6	37.7	36.5
Saving and Investment										
Gross national saving	22.4	24.5	20.9	19.4	21.1	21.4	21.3	21.0	20.9	20.8
Foreign saving	0.6	-2.6	4.2	6.4	3.0	2.2	2.0	2.0	1.9	1.9
Gross capital formation	23.0	21.9	25.1	25.8	24.1	23.6	23.3	23.0	22.8	22.7
External Sector										
Current account balance	-0.6	2.6	-4.2	-6.4	-3.0	-2.2	-2.0	-2.0	-1.9	-1.9
Net IIP	-40.3	-34.2	-27.5	-27.0	-27.4	-26.0	-24.8	-23.9	-23.0	-22.1
Gross external debt	116.7	121.4	109.6	100.6	99.6	98.3	95.7	90.1	87.2	84.1
Net external debt 2/	18.1	13.4	10.2	8.1	8.2	7.4	6.8	6.7	6.4	6.2
Memorandum Items:										
Nominal GDP (billions of euros)	30.7	30.3	33.6	39.1	43.3	46.3	49.6	52.6	55.7	58.9
Output gap (percent of potential GDP)	2.0	-2.3	-0.4	-0.2	-1.4	-1.2	-0.8	-0.4	-0.1	0.0
Potential output growth (percent)	2.4	2.0	2.3	2.5	2.2	2.5	2.8	2.8	3.0	3.1
Terms of trade (annual percentage change)	0.9	2.8	1.6	-0.4	-0.6	0.8	0.5	0.3	0.2	0.1

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, 2019–28 1/

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
	(percent of GDP, unless otherwise indicated)									
Revenue	37.2	37.5	37.4	36.5	36.2	37.4	36.5	36.4	36.3	36.4
Taxes	20.1	20.1	19.5	20.2	20.1	20.0	20.1	20.1	20.0	20.1
Personal Income Tax	6.3	6.0	5.7	5.8	5.7	5.7	5.7	5.7	5.7	5.7
Corporate Income Tax	0.1	0.7	0.8	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Property Tax	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Value-added tax	8.6	8.4	8.2	9.1	9.1	9.1	9.1	9.1	9.1	9.1
Excise tax	3.5	3.5	3.3	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Other taxes	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Social Contributions	9.4	9.6	9.3	9.4	9.4	9.6	9.6	9.6	9.6	9.6
Grants	4.3	4.3	4.1	3.7	3.5	4.8	3.8	3.8	3.7	3.7
Other Revenue	3.4	3.4	4.5	3.3	3.2	3.0	3.0	3.0	3.0	3.0
Expenditure	37.6	41.2	42.8	40.3	40.1	39.3	38.6	38.5	37.5	37.3
Expense	33.6	37.0	39.1	37.0	36.5	35.6	35.1	35.2	34.3	34.0
Compensation of Employees	8.5	9.0	8.7	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Use of goods and services	4.9	4.9	4.6	5.9	4.6	4.5	4.5	4.5	4.5	4.5
Interest	0.9	0.9	0.8	0.5	0.5	0.8	0.9	1.0	0.8	0.7
Subsidies 2/	7.6	9.2	10.8	9.8	10.7	9.6	9.0	9.0	8.3	8.2
Grants	1.1	1.2	1.4	1.2	1.0	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	0.9
International organizations	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social Support	10.6	12.0	12.8	11.6	11.6	11.6	11.6	11.6	11.6	11.6
Pensions	7.2	8.4	7.6	7.3	7.3	7.3	7.3	7.3	7.3	7.3
Other	3.4	3.6	5.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Net Acquisition of Nonfinancial Assets	3.9	4.1	3.8	3.3	3.6	3.7	3.4	3.3	3.3	3.3
Gross Operating Balance	3.6	0.4	-1.7	-0.4	-0.3	1.7	1.4	1.2	2.0	2.3
Net Lending/Borrowing	-0.4	-3.7	-5.4	-3.7	-3.9	-1.9	-2.1	-2.1	-1.2	-1.0
Domestic financing	-3.0	1.5	1.6	-1.0	1.9	0.7	1.5	3.7	1.2	1.0
External financing	3.3	2.2	3.8	4.7	2.0	1.2	0.5	-1.6	0.0	0.0
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items										
ESA fiscal balance 3/, 4/	-0.6	-4.4	-7.1	-4.4	-3.7	-2.5	-2.1	-2.1	-1.2	-1.0
ESA structural fiscal balance (percent of GDP) 4/	-1.5	-3.5	-6.9	-4.3	-3.2	-2.0	-1.8	-2.0	-1.2	-1.0
ESA cyclically adjusted fiscal balance (percent of potential GDP) 4/	-1.4	-3.4	-6.9	-4.3	-3.1	-2.0	-1.8	-2.0	-1.2	-1.0
ESA structural fiscal balance (percent of potential GDP) 4/	-1.6	-3.4	-6.9	-4.3	-3.1	-2.0	-1.8	-2.0	-1.2	-1.0
Cyclically adjusted fiscal balance (percent of potential GDP) 5/	-1.2	-2.8	-5.3	-3.6	-3.3	-1.4	-1.8	-2.0	-1.2	-1.0
General government debt	36.5	42.0	43.7	40.8	40.5	39.7	39.0	38.6	37.7	36.5
Nominal GDP (billions of euros)	30.7	30.3	33.6	39.1	43.3	46.3	49.6	52.6	55.7	58.9

Sources: Latvia authorities and IMF staff estimates.

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

2/ The increase in subsidies in 2023 is mainly driven by higher subsidies and grants to businesses and institutions, which are supported by EU funds.

3/ ESA refers to European System of Accounts.

4/ The decline in the ESA deficit in 2023 is mainly due to the correction of EU funds' revenue in 2023 (equivalent to 0.8 percent of GDP).

5/ Cash basis.

Table 4. Latvia: Medium-Term Balance of Payments, 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
				(Percent of GDP, unless otherwise indicated)						
Current Account	-0.6	2.6	-4.2	-6.4	-3.0	-2.2	-2.0	-2.0	-1.9	-1.9
Goods and services (fob)	-0.7	1.0	-3.4	-5.8	-1.7	-1.0	-0.7	-1.0	-0.9	-1.2
Goods (fob)	-8.6	-5.1	-8.3	-11.5	-7.1	-6.6	-6.3	-6.6	-6.5	-6.6
Exports	41.6	44.4	48.2	52.5	47.0	45.0	42.8	41.2	40.5	39.8
Imports	-50.2	-49.5	-56.4	-63.9	-54.1	-51.5	-49.1	-47.8	-47.0	-46.4
Services	7.9	6.1	4.8	5.6	5.4	5.6	5.7	5.6	5.5	5.4
Credit	18.2	15.6	15.4	17.9	15.7	15.8	15.7	15.7	15.8	15.6
Debit	-10.3	-9.5	-10.6	-12.3	-10.3	-10.2	-10.1	-10.1	-10.3	-10.2
Primary Income	-1.5	0.0	-1.8	-1.7	-2.3	-2.3	-2.3	-2.0	-1.9	-1.7
Compensation of employees	1.6	1.3	1.2	1.0	1.7	1.7	1.6	1.7	1.7	1.7
Investment income	-4.2	-2.6	-4.0	-3.7	-4.2	-4.1	-3.9	-3.8	-3.6	-3.4
Secondary Income	1.5	1.7	1.1	1.1	0.9	1.1	1.0	1.0	1.0	1.0
Capital and Financial Account	0.3	-4.4	2.3	3.1	3.0	2.2	2.0	2.0	1.9	1.9
Capital account	1.5	1.7	1.4	1.1	0.8	1.0	0.7	0.7	0.7	0.7
Financial account	1.2	6.1	-1.0	-1.9	-2.3	-1.2	-1.2	-1.3	-1.2	-1.2
Direct investment	3.0	2.1	2.5	3.3	3.0	2.9	2.7	2.6	2.5	2.3
Portfolio investment and financial derivatives	1.7	-13.1	0.8	-3.6	0.4	-0.1	-0.4	-3.3	-0.9	-0.9
of which: general government net issuance	3.3	-1.1	1.8	2.0	2.3	1.7	1.4	-1.3	0.9	0.8
Other investment	-6.2	6.3	-1.9	1.0	-1.2	-1.5	-1.1	2.0	-0.4	-0.3
Reserve assets	0.3	-1.5	-0.4	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	0.3	1.8	1.9	3.3	0.0	0.0	0.0	0.0	0.0	0.0
				(Percent change, unless otherwise indicated)						
Goods and Services										
Export value (fob)	2.4	-1.1	17.9	28.5	-1.2	3.7	3.1	3.2	4.6	4.2
Import value (fob)	2.4	-3.8	26.3	32.0	-6.3	2.6	2.7	3.7	4.6	4.6
Export volume	2.1	-0.3	5.9	9.1	-0.2	3.0	2.6	2.6	2.6	2.6
Import volume	3.1	-0.3	15.3	11.7	-0.5	3.0	2.5	2.5	2.5	2.5
Gross Reserves (billions of euros)	4.0	4.3	4.8	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Gross External Debt (billions of euros)	35.8	36.8	36.8	39.3	43.1	45.6	47.5	47.4	48.6	49.5
Medium- and long-term (billions of euros)	21.5	20.9	20.6	19.7	21.2	21.7	21.7	21.0	21.7	22.3
Short term (billions of euros)	14.3	15.9	16.2	19.5	21.9	23.9	25.8	26.3	26.9	27.2
Net External Debt (billions of euros) 1/	5.5	4.1	3.4	3.2	3.5	3.4	3.4	3.5	3.6	3.7
Gross External Debt (percent of GDP)	116.7	121.4	109.6	100.6	99.6	98.3	95.7	90.1	87.2	84.1
Medium and long term (percent of GDP)	70.2	69.0	61.4	50.6	49.0	46.8	43.8	40.0	39.0	37.9
Short term (percent of GDP)	46.5	52.4	48.1	50.0	50.5	51.5	51.9	50.1	48.3	46.1
Net External Debt (percent of GDP) 1/	18.1	13.4	10.2	8.1	8.2	7.4	6.8	6.7	6.4	6.2
Memo Items										
Nominal GDP (billions of euros)	30.7	30.3	33.6	39.1	43.3	46.3	49.6	52.6	55.7	58.9
U.S. dollar per euro (period average)	1.12	1.14	1.18	1.05	...	...	...	...	...	...

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, 2016–22

(In percent, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022
Core FSIs							
Regulatory capital to risk-weighted assets	20.4	20.8	22.3	21.7	26.8	25.3	22.4
Tier 1 capital to risk-weighted assets	17.7	18.8	20.6	20.6	26.0	24.6	21.6
Nonperforming loans net of provisions to capital	27.3	23.2	23.2	26.8	15.7	12.5	7.4
Capital to assets (leverage ratio)	8.5	9.7	11.1	8.5	9.3	9.0	7.9
Nonperforming loans to total gross loans	6.3	5.5	5.3	5.0	3.1	2.5	1.8
Provisions to nonperforming loans	45.4	43.3	39.7	44.4	40.3	45.1	59.9
Return on assets	1.6	1.0	1.1	0.6	0.8	1.3	1.3
Return on equity	14.5	6.7	9.0	4.9	7.5	12.3	12.8
Interest margin to gross income	41.4	45.0	46.4	48.2	51.4	50.3	57.2
Noninterest expenses to gross income	54.9	66.1	67.9	69.8	70.2	64.7	59.0
Liquid assets to total assets	57.2	67.1	58.2	50.9	56.0	59.3	47.7
Liquid assets to short-term liabilities	80.8	86.2	75.1	84.0	87.3	100.9	68.4
Net open position in foreign exchange to capital	3.5	2.1	1.0	5.2	1.3	0.5	1.2
Additional FSIs							
Large exposures to capital	204.6	113.8	102.8	83.8	78.5	71.7	80.1
Gross asset position in financial derivatives to capital	6.7	1.7	2.8	4.7	2.1	4.8	5.2
Gross liability position in financial derivatives to capital	6.2	1.9	2.7	4.6	2.5	4.3	4.4
Trading income to total income	18.8	9.6	5.4	9.5	5.4	6.6	5.0
Personnel expenses to noninterest expenses	40.8	39.7	40.3	40.3	41.5	41.8	41.5
Customer deposits to total (noninterbank) loans	106.5	96.3	86.0	88.1	94.2	89.8	98.2
Residential real estate loans to total gross loans	20.3	20.4	22.6	23.2	23.4	23.0	21.6
Commercial real estate loans to total gross loans	17.2	15.6	18.4	19.7	19.8	18.6	17.0

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) **Intensification of regional conflict(s).** Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, refugee flows, FDI and financial flows, and payment systems.	**High** Trade with Russia has diminished significantly since the Annexation of Crimea. Nonetheless, the sanctions against Russia and Belarus could lead to disruptions in Latvia's trade and finance. The war could further increase risks to economic and investor confidence, reduce foreign direct investment, and make the inflow of refugees disorderly. Almost 44,000 refugees have arrived in the country already. It is not clear how many more refugees will follow or will stay in Latvia.	Deploy additional discretionary fiscal support. Prioritize such support in key security-related areas and the integration of refugees. Address structural issues to encourage investment. Further enhance the anti-corruption and AML/CFT frameworks to protect the financial sector.
High (short to medium term) **Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and markets fragmentation. • **Europe:** Intensifying fallout from the war in Ukraine, worsening energy crisis and supply disruptions, and monetary tightening exacerbate economic downturns and housing market corrections.	**High** The spillovers from the war have impacted Latvia. Growth slowed as external demand waned and higher prices hurt consumption. An escalation of the war could result in energy supply disruptions in Europe and weaker external demand.	Deploy targeted fiscal support to mitigate the impact of the war on the economy. Provide fiscal support to protect low income and possibly middle-income households against high energy prices. Use macroprudential tools should overheating emerge in the housing market.
Medium (short term) **Commodity price volatility.** A succession of supply disruptions (e.g., due to conflicts and export restrictions) and demand fluctuations (e.g., reflecting China reopening) causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	**Medium** Much of the increase in inflation in Latvia has been driven by high international energy and food prices (because of their high share in the consumer price index basket). An escalation of the war could result in renewed increases in energy prices.	Participate in European policy responses. Diversify energy supply and implement measures to ensure energy security. Provide incentives to boost domestic food production and diversify the supply of food.

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

Source of Risks, Likelihood, and Time Horizon	Impact on Latvia	Recommended Policy Response
Medium (short to medium term) **Systemic financial instability.** Sharp swings in real interest rates, risk premia, and assets repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing markets dislocations and adverse cross-border spillovers.	**Medium** Banks are well capitalized and liquid and appear resilient. However, given the large share of variable interest rate loans, a sharp increase in interest rates could have implications for borrowers. A sudden correction in house prices could affect banks' profits.	Banks could restructure loans if sharp changes to interest rates affect borrowers' ability to repay loans. Intensify monitoring of banks' capital positions and risk management practices to contain systemic risk.
High (short to medium term) **Deepening geo-economic fragmentation.** Broader and deeper conflict(s) and weakened international cooperation lead to a more rapid reconfiguration of trade and FDI, supply disruptions, technological and payments systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth.	**High** Latvia will continue to face geopolitical challenges in the Baltic region. A prolonged war in Ukraine would weigh on activity in trading partners causing external demand to fall or fluctuate around a lower level, keep inflation elevated, worsen supply chain disruptions, and weaken confidence.	Provide discretionary fiscal support. Reduce energy dependence. Seek alternative markets and products for exports.
Medium (short to medium term) **Cyberthreats**. Cyberattacks on critical domestic and/or international physical or digital infrastructure (including digital currency and crypto ecosystems) trigger financial and economic instability.	**Medium** Latvia is susceptible to cyber-attacks from the Russian invasion of Ukraine 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. External Sector Assessment

Overall Assessment: *The external position of Latvia in 2022 was weaker than the level implied by fundamentals and desirable policies. The current account (CA) balance deteriorated, following a greater increase in imports than that in exports of goods and services.*

Potential Policy Responses: *In the short term, fiscal policy should continue to play a key role to help mitigate the impact of external shocks resulting from the war in Ukraine. Macroprudential policy should remain flexible given high macro-financial uncertainty. Structural reforms to boost productivity growth, including measures to address skilled labor shortage, reduce regulatory burden in product and services markets, and facilitate the digital transformation, should be prioritized. Efforts to foster green and digital transformation and ensure energy security should help address other important challenges.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Gross assets decreased from 138 to 125 percent of GDP, and gross liabilities fell from 166 to 152 percent of GDP. The declines in asset and liability were mainly driven by lower portfolio and direct investment. The NIIP remained unchanged at -27 percent of GDP in 2022. Gross external debt declined from 109.6 percent of GDP in 2021 to 100.6 percent of GDP at end-2022, thereby remaining below 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 is projected to improve in the medium-term.

2022 (% GDP)	NIIP: -27	Gross Assets: 125	Debt Assets: 97	Gross Liab.: 152	Debt Liab.: 101

Current Account

Background.

The current account deficit widened from -4.2 percent of GDP in 2021 to -6.4 percent in 2022. Imports of goods grew significantly by 32 percent in nominal terms. Exports of goods increased by 27 percent in 2022. The goods trade balance deteriorated from -8.3 percent of GDP in 2021 to -11.5 percent in 2022.

Exports of services grew by 35 percent in 2022 while imports of services increased by 34 percent. The service trade surplus improved from 4.8 percent of GDP in 2021 to 5.6 percent in 2022.

Primary income account registered a deficit of -1.7 percent of GDP in 2022, a slight improvement from -1.8 in 2021. Secondary income balance was broadly unchanged from its 2021 level, at 1.1 percent of GDP.

Latvia: EBA-lite Model Results, 2022

	CA model 1/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**-6.4**	
Cyclical contributions (from model) (-)	0.1	
COVID-19 adjustors (-) 2/	-0.1	
Additional temporary/statistical factors (-	0.0	
Natural disasters and conflicts (-)	-0.5	
Adjusted CA	**-5.8**	
CA Norm (from model) 3/	**-2.4**	
Adjustments to the norm (-)	0.0	
Adjusted CA Norm	**-2.4**	
CA Gap	**-3.4**	**-3.9**
o/w Relative policy gap	3.5	
Elasticity	-0.4	
REER Gap (in percent)	**7.7**	**8.9**

1/ Based on the EBA-lite 3.0 methodology.
2/ Additional cyclical adjustment to account for the temporary impact of the tourism (0.1 percent of GDP).
3/ Cyclically adjusted, including multilateral consistency adjustments.

Assessment. Overall, the current account position is assessed to be weaker than the levels implied by fundamentals and desirable policies. The EBA-lite CA model results suggest a CA gap of -3.4 percent of GDP in 2022, and the gap attributed to policies amounts to 3.5 percent of GDP. The COVID-19 adjustor of -0.1 percent

of GDP reflects the temporary decline in tourism activity. The current account balance is projected to remain in a deficit position over the medium term.

Real Exchange Rate

Background. The REER appreciated by 3.6 percent in 2022. From 2016 to 2022, the REER appreciated by 9 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 2022 to 7.5 percent in nominal terms, reflecting a rise in public servants' wages in some sectors, and progressively tight labor market.

Assessment. The preferred EBA-lite CA model suggests an overvaluation of about 7.7 percent. The EBA-lite REER Index model finds a larger overvaluation of 8.9 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 1.1 percent of GDP in 2022, mainly reflecting the transfer of funds from the EU. The level is lower than the average over the past few years. The financial account (BPM6 methodology) balance widened from -1 percent of GDP in 2021 to -1.9 in 2022. Direct and portfolio investment inflows were the main drivers of this change, being partially offset by financial derivatives outflows.

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 (10.7 percent of GDP for Latvia as of end-2022).

Assessment. Reserve level is assessed to be adequate.

Annex III. External Debt Sustainability Assessment

1. Latvia's gross external debt declined as a share of GDP from 109.6 percent to 100.6 percent. General government gross external debt decreased by EUR 607 million. Monetary and financial institutions' foreign deposits, excluding the Bank of Latvia (BoL), increased by about EUR 138 million from 2021 to 2022, while the BoL's foreign deposits increased by EUR 3.3 billion. Financial sector's external debt fell by EUR 230 million. External debt of non-financial corporations and households declined by EUR 8 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 100.6 percent in 2022 to 84.1 percent of GDP in 2028. The current account balance excluding interest payments is projected to be 0.7 percent of GDP in 2028, above the debt stabilizing level (-6.1 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 2022 level over the projection horizon until 2028.

Annex III. Table 1. External Debt Sustainability Framework (2018–28)

(Percent of GDP, unless otherwise indicated)

	Actual						Projections							
	2018	2019	2020	2021			2022	2023	2024	2025	2026	2027	2028	Debt-stabilizing non-interest current account 6/
Baseline: External debt	123.3	116.7	121.4	109.6			**100.6**	**99.6**	**98.3**	**95.7**	**90.1**	**87.2**	**84.1**	**-6.1**
Change in external debt	-18.1	-6.6	4.7	-11.9			-9.0	-1.0	-1.3	-2.6	-5.7	-2.9	-3.2	
Identified external debt-creating flows (4+8+9)	-13.1	-8.1	-3.4	-10.8			0.3	-0.8	-3.2	-3.7	-3.5	-3.3	-3.1	
Current account deficit, excluding interest payments	-1.7	-1.4	-4.4	3.0			4.8	1.7	0.8	0.7	0.7	0.7	0.7	
Deficit in balance of goods and services	0.7	0.7	-1.0	3.4			5.8	1.7	1.0	0.7	1.0	0.9	1.2	
Exports	61.5	59.8	60.0	63.6			70.4	62.7	60.8	58.5	57.0	56.3	55.5	
Imports	62.1	60.5	59.0	67.1			76.2	64.4	61.7	59.2	57.9	57.3	56.6	
Net non-debt creating capital inflows (negative)	-2.2	-3.1	-2.2	-2.6			-3.2	-3.0	-2.9	-2.7	-2.6	-2.5	-2.3	
Automatic debt dynamics 1/	-9.2	-3.6	3.2	-11.2			-1.4	0.5	-1.2	-1.6	-1.6	-1.5	-1.5	
Contribution from nominal interest rate	1.8	2.0	1.8	1.2			1.5	1.3	1.4	1.3	1.3	1.2	1.2	
Contribution from real GDP growth	-5.0	-3.2	2.7	-4.5			-2.9	-0.8	-2.5	-3.0	-2.9	-2.7	-2.7	
Contribution from price and exchange rate changes 2/	-6.0	-2.4	-1.3	-7.9			...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-5.0	1.5	8.1	-1.0			-9.3	-0.2	2.0	1.1	-2.2	0.4	-0.1	
External debt-to-exports ratio (in percent)	200.6	195.1	202.5	172.2			142.9	158.8	161.8	163.6	158.1	154.9	151.6	
Gross external financing need (in billions of US dollars) 4/	25.1	19.8	17.2	23.3			21.6	23.9	26.6	28.7	31.4	30.3	31.0	
in percent of GDP	73.0	57.5	49.8	58.6	10-Year	10-Year	52.5	51.0	53.4	53.7	55.3	50.5	48.7	
Scenario with key variables at their historical averages 5/							**100.6**	**107.0**	**107.2**	**106.5**	**101.1**	**98.5**	**95.2**	**-4.1**
Key Macroeconomic Assumptions Underlying Baseline					Historical Average	Standard Deviation								
Real GDP growth (in percent)	4.0	2.6	-2.3	4.3	2.9	2.4	2.8	0.9	2.7	3.2	3.2	3.2	3.2	
GDP deflator in US dollars (change in percent)	8.7	-2.8	2.9	10.5	1.1	7.7	0.7	12.8	3.7	3.7	2.8	2.7	2.5	
Nominal external interest rate (in percent)	1.4	1.6	1.5	1.2	1.9	0.6	1.5	1.5	1.4	1.5	1.5	1.4	1.4	
Growth of exports (US dollar terms, in percent)	12.8	-3.0	0.8	22.2	4.7	9.9	14.5	1.4	3.2	3.1	3.3	4.8	4.3	
Growth of imports (US dollar terms, in percent)	12.9	-2.9	-1.9	30.9	4.5	12.5	17.6	-3.8	2.1	2.7	3.9	4.7	4.7	
Current account balance, excluding interest payments	1.7	1.4	4.4	-3.0	1.7	2.1	-4.8	-1.7	-0.8	-0.7	-0.7	-0.7	-0.7	
Net non-debt creating capital inflows	2.2	3.1	2.2	2.6	2.1	0.9	3.2	3.0	2.9	2.7	2.6	2.5	2.3	

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

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

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

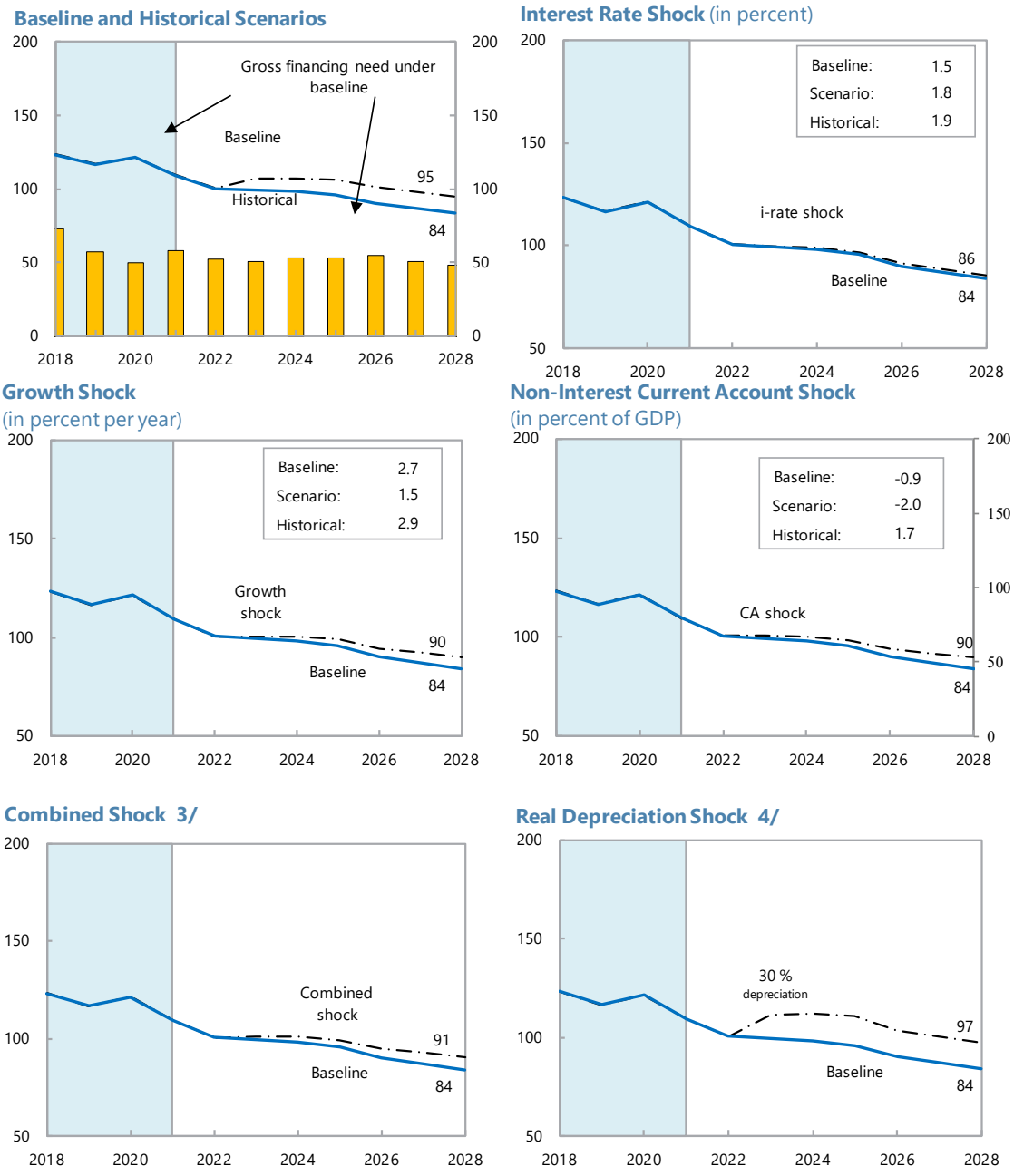
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Annex III. 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 IV. Sovereign Risk and Debt Sustainability Analysis

Annex IV. Figure 1. Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Low	The overall risk of sovereign stres is low, reflecting a relatively low level of vulnerability in the near-term and low levels of vulnerability in the medium and long-term horizons.
Near-term 1/			
Medium-term	Low	Low	Medium-term risks are assessed as low against a mechanical low signal.
Fanchart	Moderate	...	
GFN	Low	...	
Stress test	...	...	
Long-term	...	Low	Long-term risks are low as expenditure in the long term is on a declining path.
Sustainability assessment 2/	...	...	Not required for surveillance countries.
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: Latvia is at a low overall risk of sovereign stress and debt is sustainable. Most indicators have started to normalize as the recovery from the COVID-19 shock has proceeded well and support measures in response to the cost of living crisis are projected to expire in 2023. Over the medium and longer term, Latvia should continue with reforms to address long-standing issues to boost productivity growth.

Source: Fund staff.
Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.
1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.
2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Annex IV. Figure 2. Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	

2. Subsectors included in the chosen coverage in (1) above:

		Subsectors captured in the baseline	Inclusion
CPS / NFPS / GG: expected / CG	1	Budgetary central government	Yes
	2	Extra budgetary funds (EBFs)	Yes
	3	Social security funds (SSFs)	Yes
	4	State governments	Yes
	5	Local governments	Yes
	6	Public nonfinancial corporations	No
	7	Central bank	No
	8	Other public financial corporations	No

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

4. Accounting principles:	Basis of recording		Valuation of debt stock		
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

5. Debt consolidation across sectors:	Consolidated	Non-consolidated

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on Intra-Government Debt Holdings

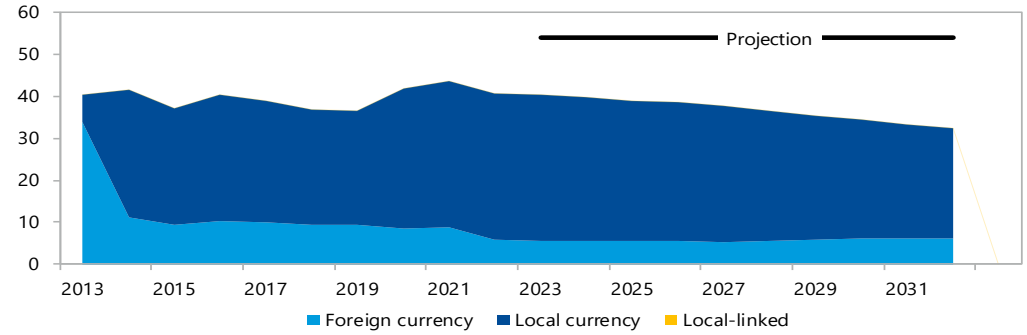
		Issuer \ Holder	Budget. central govt	Extra-budget. funds (EBFs)	Social security funds (SSFs)	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1	Budget. central govt									0
	2	Extra-budget. funds									0
	3	Social security funds									0
	4	State govt.									0
	5	Local govt.									0
	6	Nonfin pub. corp.									0
	7	Central bank									0
	8	Oth. pub. fin. corp									0
		Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: The coverage in this SRDSA is for the general government.

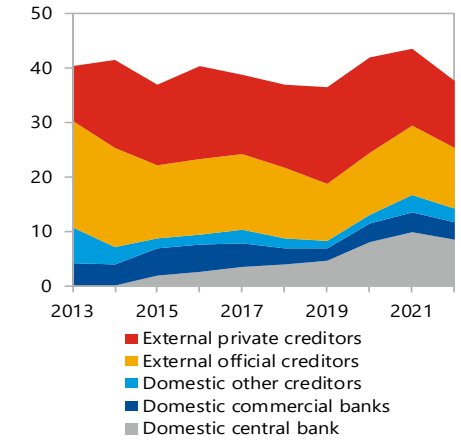
Annex IV. Figure 3. Public Debt Structure Indicators

Debt by Currency (percent of GDP)



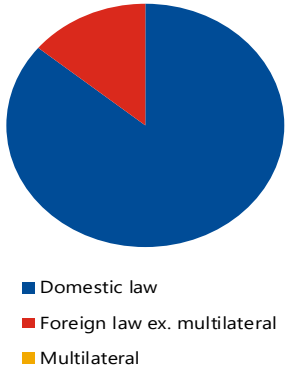
Note: The perimeter shown is general government.

Public Debt by Holder (percent of GDP)



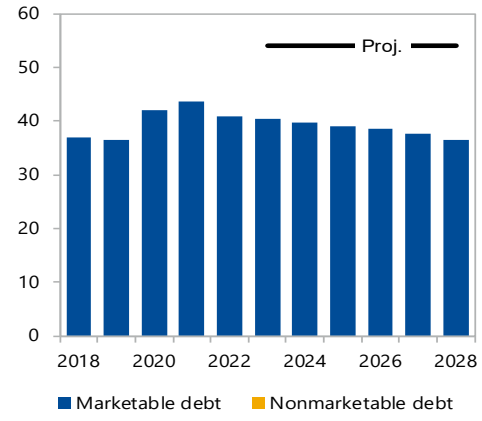
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2022 (percent)



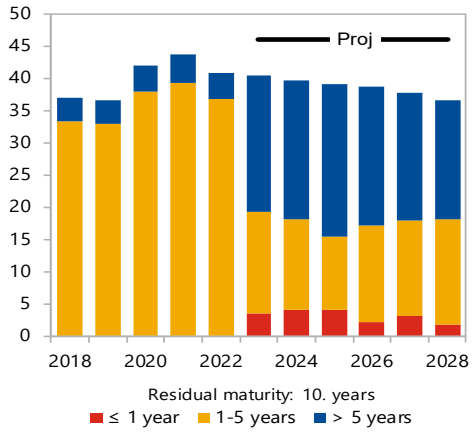
Note: The perimeter shown is general government.

Debt by Instruments (percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (percent of GDP)



Note: The perimeter shown is general government.

Commentary: The improvement in the primary balance contributes to low debt. Currency risks are also minimal for Latvia as it is part of the euro area.

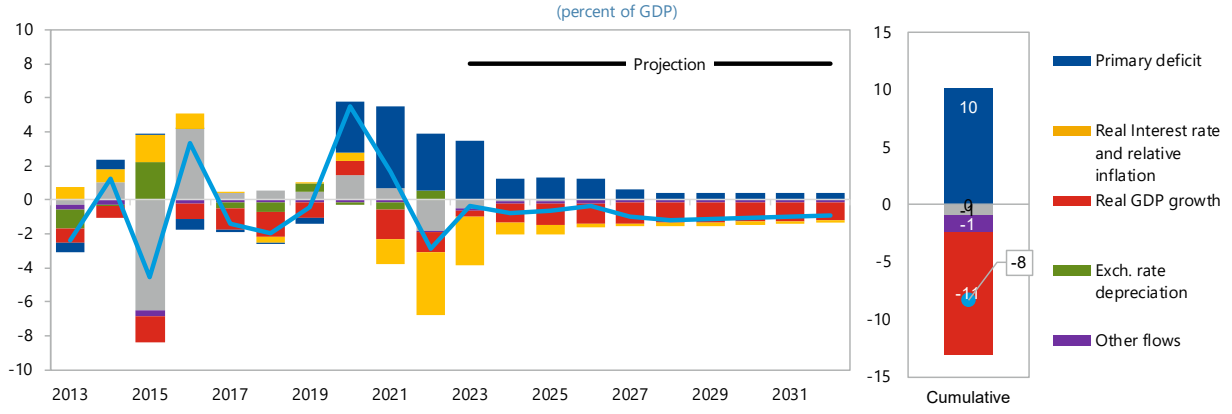
Annex IV. Figure 4. Baseline Scenario

(percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	40.8	40.5	39.7	39.0	38.6	37.7	36.5	35.4	34.4	33.4	32.5
Change in public debt	-2.9	-0.4	-0.8	-0.7	-0.4	-1.0	-1.2	-1.1	-1.0	-1.0	-0.9
Contribution of identified flows	-1.1	0.1	-0.7	-0.6	-0.3	-0.9	-1.1	-1.1	-1.0	-0.9	-0.9
Primary deficit	3.4	3.5	1.3	1.3	1.3	0.6	0.4	0.4	0.4	0.4	0.4
Noninterest revenues	36.4	36.1	37.2	36.3	36.3	36.1	36.2	36.2	36.2	36.2	36.2
Noninterest expenditures	39.8	39.6	38.5	37.7	37.5	36.8	36.6	36.6	36.6	36.6	36.6
Automatic debt dynamics	-4.3	-3.2	-1.8	-1.8	-1.4	-1.4	-1.4	-1.4	-1.3	-1.2	-1.2
Real interest rate and relative inflation	-3.7	-2.9	-0.8	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1
Real interest rate	-4.4	-3.2	-0.9	-0.6	-0.3	-0.2	-0.2	-0.3	-0.2	-0.2	-0.1
Relative inflation	0.8	0.4	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-1.2	-0.4	-1.1	-1.2	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1	-1.0
Real exchange rate	0.5	...	...	...	...	...	...	...	...	...	...
Other identified flows	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Contribution of residual	-1.8	-0.5	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	5.5	8.4	5.2	6.7	7.2	5.7	7.3	6.5	6.6	8.3	6.3
of which: debt service	2.3	5.1	4.1	5.5	6.1	5.2	7.1	6.2	6.4	8.0	6.1
Local currency	2.0	5.1	4.1	5.4	5.9	5.0	6.8	5.9	5.9	7.5	5.5
Foreign currency	0.3	0.0	0.0	0.1	0.2	0.2	0.3	0.3	0.4	0.5	0.6
Memo:											
Real GDP growth (percent)	2.8	0.9	2.7	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Inflation (GDP deflator; percent)	13.1	9.8	4.2	3.7	2.7	2.5	2.5	2.4	2.4	2.4	2.4
Nominal GDP growth (percent)	16.2	10.8	7.1	7.0	6.0	5.9	5.8	5.7	5.7	5.7	5.7
Effective interest rate (percent)	1.3	1.1	2.0	2.0	2.0	2.0	1.8	1.7	1.8	1.9	2.0

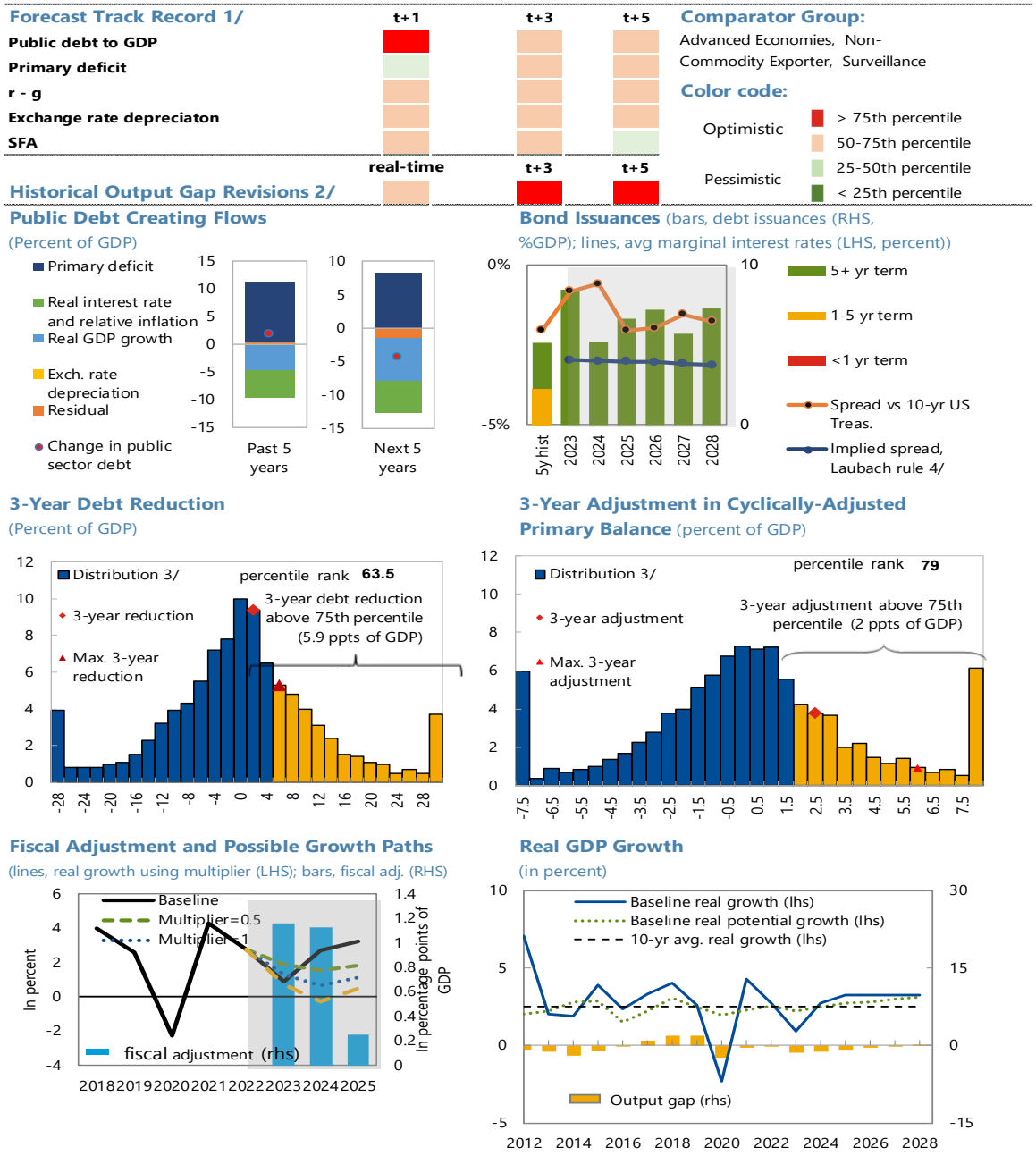
Contribution to Change in Public Debt

(percent of GDP)



Staff commentary: Public debt will decline, reflecting improvement in the primary balance and stable economic conditions.

Annex IV. Figure 5. Realism of Baseline Assumptions



Commentary: The adjustment in debt reduction reflects the fact that the economy is recovering from COVID-19. Previously, some forecast track record was in the top quartile.

Source : IMF Staff.

1/ Projections made in the October and April WEO vintage.

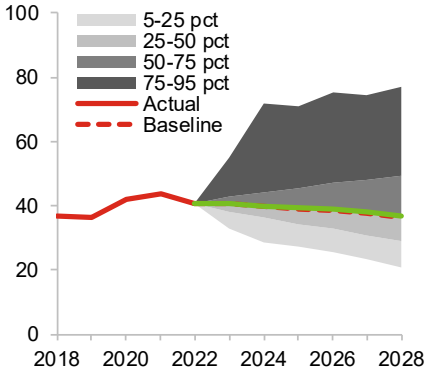
2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates and final estimates in the latest October WEO) in the total distribution of revisions across the data sample.

3/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

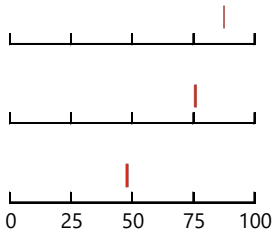
Annex IV. Figure 6. Medium-Term Risk Assessment

Final Fanchart (pct of GDP)

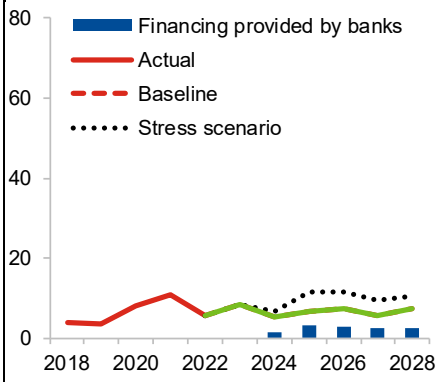


Debt Fanchart Module

	Value	Contrib [1/]	Percentile in peer group [2/]
Fanchart width *(percent of GDP)*	56.0	0.8	
Probability of debt non-stabilizaiton *(percent)*	26.2	0.2	
Terminal debt-to-GDP x institutions index	11.6	0.3	
Debt fanchart index (DFI)		1.3	
Risk signal: [3/]		Moderate	

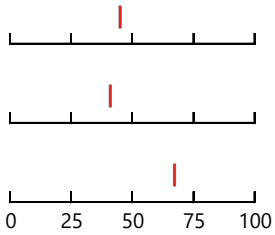


Gross Financing Needs (pct of GDP)

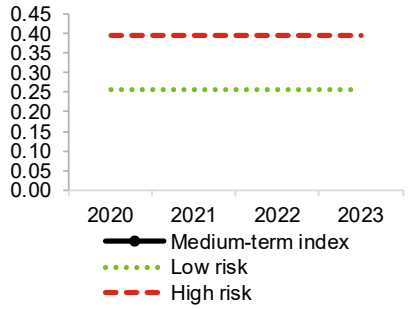


Gross Financing Needs (GFN) module

	Value	Contrib [1/]	Percentile in peer group [2/]
Average baseline GFN *(percent of GDP)*	6.7	2.3	
Banks' claims on the gen. govt *(pct bank assets)*	4.2	1.4	
Chg. In banks' claims in stress *(pct banks' assets)*	6.3	2.1	
GFN Financeability Index (GFI)		5.8	
Risk signal: [4/]		Low	



Medium-term Index (index number)



Medium-term Risk Analysis

	Value	Weight	Contribution
Debt fanchart index (normalized)	0.29	0.50	0.14
GFN finaceability index (normalized)	0.11	0.50	0.06
Medium-term index	0.20		
Risk signal: 5/	Low		
Final assessment:	Low		

Prob. of missed crisis, 2023-2028, if stress not predicted: 9.1 pct.
Prob. of false alarms, 2023-2028, if stress predicted: 55.7 pct.

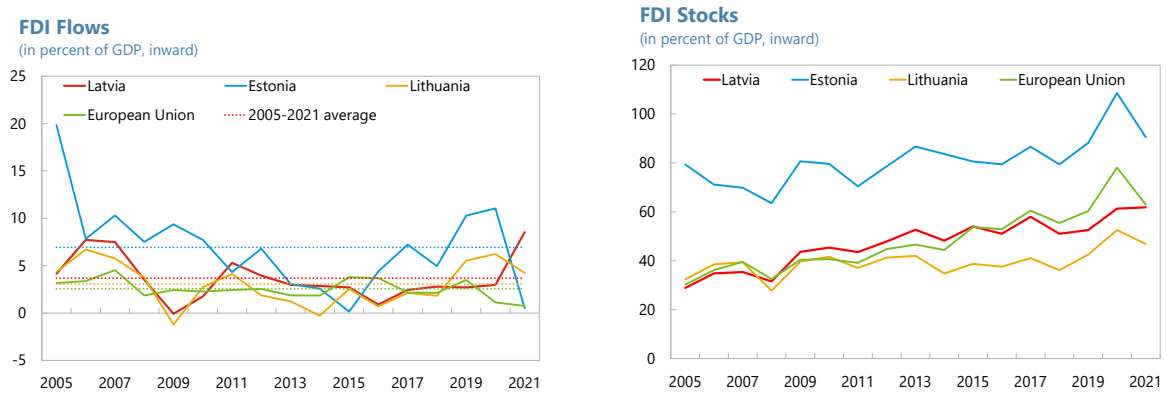
Commentary: While the fanchart width is high, debt-to-GDP is low; so the fanchart risk score is moderate. Gross financing needs are not large and banks do not hold high levels of debt. Banks are well capitalized and highly liquid. Given strong banks and low gross financing needs, the overall risk of gross financing needs is low.

Source: IMF staff estimates and projections.
1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
2/ The comparison group is advanced economies, non-commodity exporter, surveillance.
3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, if it is moderate risk.
4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, if it is moderate risk.
5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, if it is moderate risk.

Annex V. Foreign Direct Investment: Trends and Policy Options in Latvia

1. Inward FDI flows have increased from 2016 to 2021 and stocks are comparable to average EU values. Average foreign direct investment (FDI) inflows in percent of GDP are higher in Latvia than in the EU and in Lithuania (Text Figure 1). Estonia, by contrast, is at a much higher level for receiving FDI due to large investments from Finland and Sweden. The large uptick in inward FDI flows to Latvia in 2021 is due to 3.8 billion USD investments from Sweden, a tenfold increase compared to previous years (OECD, 2023). FDI to "Professional, scientific and technical activities", a subsector of services, has increased from less than 150 million USD to 4.7 billion USD in 2021. FDI stocks are trending steadily upwards since 2005 and Latvia is close to the EU average (Text Figure 1). The 2021 Swedish increase in FDI means that Sweden now holds the largest stock of FDI in Latvia.

Annex V. Text Figure 1. FDI Trends in Latvia



Source: International Direct Investment Statistics, OECD.

2. The sectoral composition in Latvia is similar to its Baltic neighbors, but manufacturing FDI is mainly directed at low-technology sub-sectors. Text Table 1 shows that the composition of inward FDI into Latvia has a similar composition than that of Estonia and Lithuania. Latvia receives less investment into services than Estonia but is a bit more diversified among the sectors that receive lower amounts of FDI. Manufacturing receives about 11 percent of inward FDI, but this is directed to sectors with relatively low technology (OECD, 2022). The largest FDI position within manufacturing is in the sector "Textiles, wood and paper products; printing" (OECD, 2023). However, between 2013 and 2019, the higher technology sectors, including biomedicine and information technology, have grown rapidly and more quickly than the lower technology sectors. The OECD recommends improving skills and the business environment to reinforce this trend.

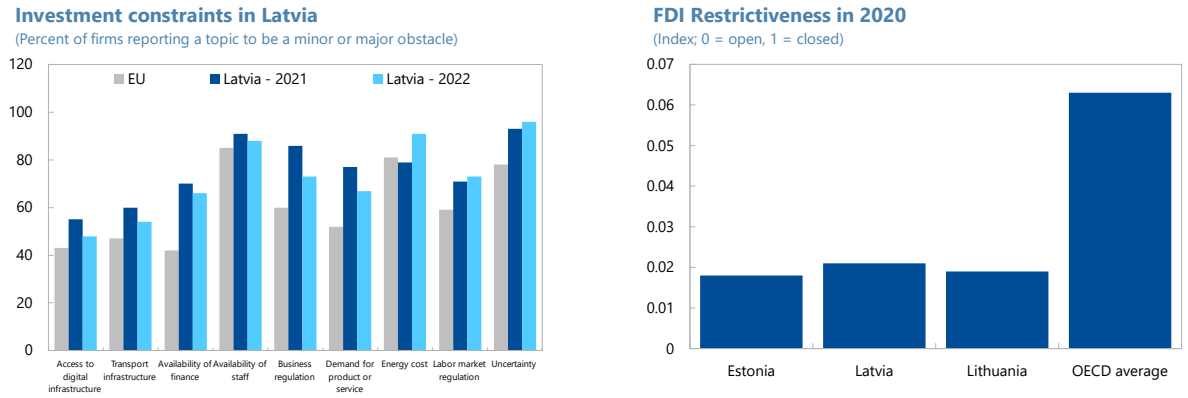
Annex V. Text Table 1. Inward FDI Stocks by Industry, 2021
(Percent of total)

	Estonia	Latvia	Lithuania
Manufacturing	10.8	10.9	14.5
Agriculture, forestry, fishing	2.0	3.8	1.6
Mining and quarrying	0.3	0.8	0.2
Electricity, gas etc.	0.6	3.2	1.7
Water supply and waste management	0.2	0.1	0.1
Construction	0.8	1.8	1.9
Services	83.3	75.1	75.6
Other	2.1	4.4	4.3
Total	100	100	100

Source: International Direct Investment Survey, OECD.

3. According to an investor survey by the European Investment Bank, the key bottlenecks for investors are energy cost and availability of staff. Text Figure 2 shows that the top three concerns for investors in Latvia are general uncertainty, energy cost, and availability of staff. Based on these results, this annex takes a closer look at energy cost and labor market mismatches. Energy cost has jumped up in importance by 12 percentage points between 2021 and 2022, thus reflecting the energy crisis following the import stop for natural gas from Russia. At the same time, the values for demand and business regulation have declined markedly in 2022, reflecting a successful recovery from the effects of the COVID-19 pandemic. Compared to the EU average, Latvia has a higher share of constraints mentioned for each category. The largest differences are in the availability of finance (23 pp), uncertainty (18 pp), and demand (15 pp). This could indicate that Latvia can learn from best practices in these categories from other EU countries. FDI restrictiveness, as measured by the OECD, is much lower in Latvia than in the OECD average and at a similar level as the other Baltic countries (Text Figure 2).

Annex V. Text Figure 2. Investment Conditions in Latvia



Sources: EIB Investment Survey; and OECD.

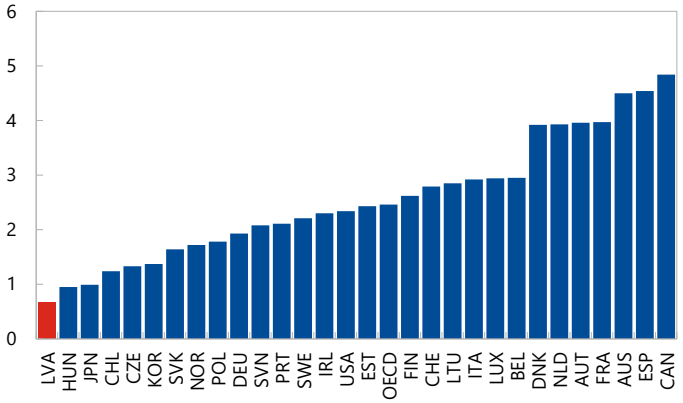
A. Labor Supply

4. While demographic trends are difficult to influence by policy, there are also challenges of skill mismatch, which are more accessible by policy. As the recovery from the COVID-19 pandemic is still ongoing, unemployment is still above the long-term average. In addition, Ukrainian refugees are supplying labor. Overall labor supply is not a pressing issue at the moment, but the skill mismatch remains a concern. Some of the underlying reasons, like an aging population and emigration are difficult to affect with policy, but there are other areas which can be affected by policy in the short to medium term. Possibly the most important bottleneck for increasing the supply of qualified labor is a strong fragmentation and underfunding of higher education institutions. Further, a lack of affordable housing impedes labor mobility. In addition, lifelong learning is low, and the labor tax wedge is larger than in most EU countries.

5. Measures decided in the Recovery and Resilience Plan (RRP) are promising. As part of its RRP, Latvia has decided on a series of measures to address the shortage of high-skilled labor. These include a higher education reform, investments into affordable housing and schools, as well as modernizing healthcare. The European Commission notes that measures to develop educational institutions and employment service are progressing satisfactorily (European Commission, 2022).

6. Additional labor market policies can further reduce the skill mismatch. Implementing the measures of the RRP can be expected to improve the supply of qualified labor and to reduce the skill mismatch. The IMF also recommends a series of policy measures including a reform of vocational training, facilitating labor market mobility, reducing employment protection, and promoting inward labor migration (IMF, 2018). This could help to reduce labor costs to employers and increase employment and net wages. The IMF has also developed policy advice for labor markets after the pandemic (Ando et al., 2022). As energy prices stabilize, countries can normalize the generosity of short-term work schemes. To adjust to changes in employment demand across sectors, facilitating job-to-job transitions is an important option. Latvia is at the bottom of the OECD in using active labor market policies (ALMP) like career counseling and job placement, a pattern that was already visible before the COVID-19 and energy crisis.

Public Expenditure on ALMP, 2020
(Percent of GDP)



Source: OECD.

7. In addition to these measures focused directly on the labor market, the IMF also provides recommendations to take advantage of the transition to net zero emissions. Recent IMF work notes that the green labor market can be stimulated through stronger environmental policies (IMF, 2022). This means that a market for clean good is created, which might then even develop into a comparative advantage and boost exports. The environmental policy can be

complemented with targeted training, as higher skills facilitate the move to green jobs. One example for an environmental policy, as noted in Latvia's 2020 National Energy and Climate Plan (NECP), is to introduce a carbon price for emissions not covered by the EU ETS. The revenue from carbon pricing can be used to lower labor taxes as recommended by the IMF (IMF, 2019). Creating green jobs can thus be combined with a reduction in the labor tax wedge.

B. Energy Supply

8. The overriding question is how Latvia can address the cost of energy, which is seen as an impediment to FDI, given the green transition. In the short term, Latvia will continue to rely on gas. In the medium to long term, Latvia will shift towards renewable energy and use natural gas capacity increasingly as a capacity reserve.

9. In the short term, the government has taken the necessary measures to ensure energy security. The government of Latvia has taken comprehensive measures to store natural gas, reduce natural gas demand, and improve the supply of natural gas. Given that gas storage is currently exceeding the average of previous years, this policy approach is largely successful. Following the import stop for natural gas from Russia, this policy change was very urgent and necessary. In the medium-term, energy security in Latvia would strongly benefit from a transition away from using natural gas in electricity generation towards using renewable energy.

10. Expanding electricity capacity with wind and solar power is the lowest-cost option. According to data from the International Renewable Energy Agency (IRENA), wind and solar power now have the lowest levelized cost of electricity (LCOE) of all technologies for generating electricity. Expanding wind and solar capacity is thus more efficient than building additional capacity for natural gas or other fossils fuels. According to a research study on electricity generation in the Baltic region, wind power seems the most efficient form of electricity generation until 2025, after which capacity addition would switch increasingly to solar energy (Child et al., 2018). In addition to LCOE, however, countries need to consider the cost of system integration for variable renewable energy (VRE) like wind and solar power. Since VRE is not always available, the electricity system needs to have alternative options. Electricity storage in batteries is one option to access electricity when VRE is not producing sufficient amounts, but Latvia can also use hydropower.

11. The availability of hydropower, as well as integration in the European electricity grid, supports an increase in the use of solar and wind energy in Latvia. Latvia so far is generating electricity almost completely with natural gas and hydropower. This is a fortunate situation for Latvia because hydropower is a complement to VRE. Hydropower can be activated in a flexible manner and thus temporarily serve as energy storage. In addition, integration into the European electricity grid facilitates pooling of renewable energy from a large geographical area. Latvia could extend its capacity in wind and solar energy. Over time, Latvia could even phase out the use of natural gas. The system could then rely on VRE and export electricity when renewable energy conditions are favorable and increase the use of hydropower and electricity imports when VRE production is low.

12. Wind and solar could increase affordable electricity supply, reduce import dependence, and facilitate the electrification of other sectors. Larger supply of wind and solar energy would reduce electricity cost and make Latvia more attractive to investors. At the same time, Latvia could reduce its emissions from the current use of natural gas to generate electricity. The switch to VRE would also reduce the need to import fossil fuels. This increases energy security but can also improve Latvia's trade balance. Finally, an increase in cheap, clean electricity will facilitate the electrification of other sectors, notably transportation. The large supply of hydropower can thus be turned into a competitive advantage for Latvia.

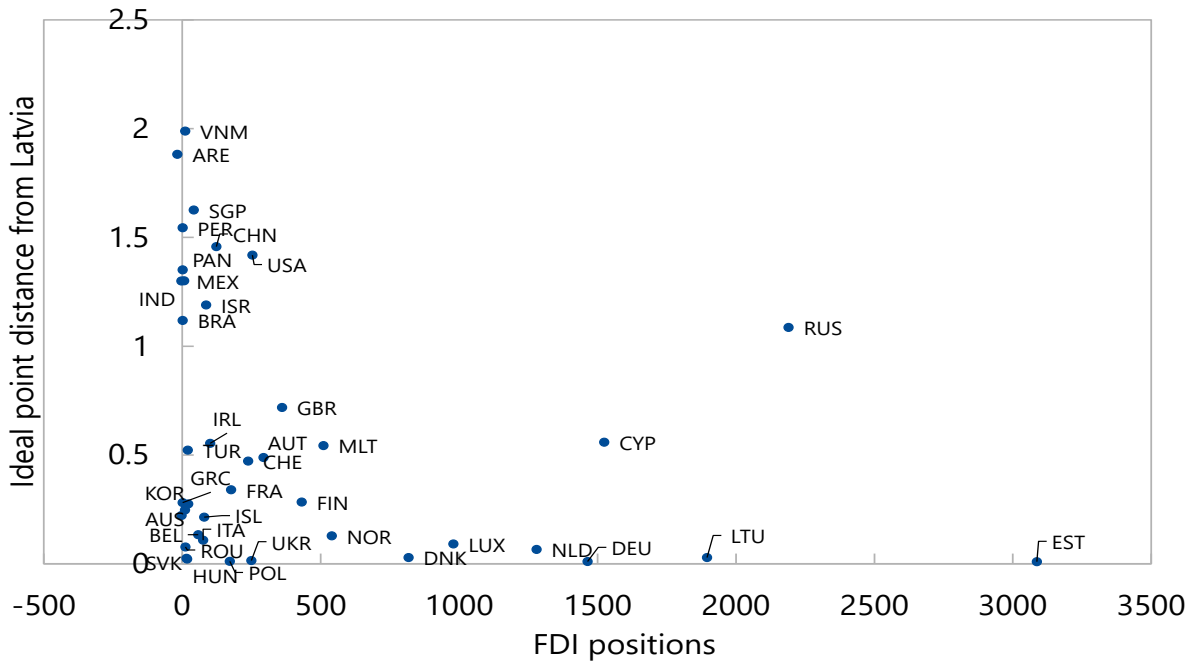
C. Geoeconomic Fragmentation

13. Global FDI flows are affected by geoeconomic fragmentation. An IMF analysis identified that there are already signs that FDI is reallocated from geoeconomic rivals to allies (IMF 2023, Ch. 4). The degree of vulnerability to FDI relocation can be determined by three factors. First, the geopolitical distance between source and host countries determines whether countries can be considered rivals or allies. Geopolitical distance can be measured, for example, through the similarity of voting patterns at the United Nations General Assembly. This approach has been proposed by Bailey et al., (2017). Second, countries with market power in the sector receiving the FDI investment are better able to maintain the FDI inflow. The source countries have fewer options for avoiding the country. Finally, FDI going to strategic sectors is more vulnerable to a withdrawal. The source government might deter their firms from investing in geoeconomic rivals for national security reasons.

14. Except for Russia, the top 10 FDI investors in Latvia are close political allies. Figure 1 compares FDI positions in Latvia to political distance. Among the top 10 countries in terms of FDI position in Latia, eight are EU members. By order of investment amount, they are Sweden, Estonia, Lithuania, Cyprus, Germany, the Netherlands, Luxembourg, and Denmark. The remaining two are Norway and Russia. Russia is the third largest FDI investor in Latvia with 2.2 billion US dollars in 2021. While this investment might be at risk from geoeconomic fragmentation, this risk is likely already realized as a result of Russia's invasion of Ukraine. Note that the political distance, as measured here, is lower between Latvia and Russia, than between Latvia and the U.S. This has historical reasons. In the early 1990s, Latvia and Russia had an extremely small political distance. Since then, the distance between Latvia and Russia has increased, while the distance between Latvia and the U.S. has decreased. Until 2021, however, Russia was still closer.

15. Against the backdrop of global FDI reallocation, countries can position themselves better through private sector development. The IMF analysis on the effect of geoeconomic fragmentation on FDI notes that stronger regulatory quality is associated with lower vulnerability to the relocation of FDI. While this link is not proven to be causal, there might be a double benefit from improving regulatory quality. The first benefit is the general increase in attractiveness for FDI and the second is a potential reduction in geoeconomic vulnerability. To improve the regulatory quality, the IMF recommends structural reforms, investment promotion agencies to facilitate investments, and improving infrastructure. Given how closely Latvia is allied with its investors, the need for protective measures is less in Latvia, compared to other countries.

Annex V. Figure 1. Political Distance of FDI Investors in Latvia



Sources: Bailey, Strezhnev, and Voeten (2017); and OECD.

Note: The vertical axis shows the "ideal point distance" as defined by (Bailey et al., 2017). The horizontal axis shows the FDI position of countries in Latvia in million U.S. dollars (OECD, 2023).

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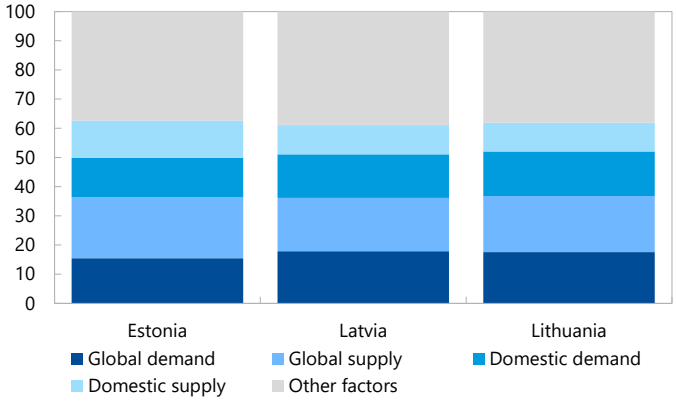
Annex VI. High Inflation in the Baltics: Inflation Dynamics and Its Impact on Competitiveness and Firm Performance[1]

A. Inflation Dynamics and the Role of Policies

1. After a period of low and stable inflation, the Baltics have experienced a surge in inflation, which remains twice as high as in the rest of the eurozone. The period after the global financial crisis (GFC), when the three countries joined the euro, and before the pandemic was characterized by low and stable inflation with a differential vis-a-vis the euro area broadly consistent with the ongoing convergence process. More recently, prior to Russia's invasion of Ukraine, the robust post-pandemic recovery resulted in demand-driven inflationary pressures compounded by supply bottlenecks. The war in Ukraine has generated further supply-side pressures and contributed to second-round effects—intensified by tight labor markets—due to higher wages and production costs. These factors pushed inflation above 20 percent in 2022 and are projected to keep it at an elevated level relative to the euro area for the foreseeable future.

2. Inflation in the Baltics is mainly driven by global factors, but domestic demand matters as well, suggesting that fiscal policy can play a role in containing inflation. Furthermore, while global supply factors do not seem to have an immediate significant impact on wage growth in the Baltics, demand shocks (domestic and global) have a positive and significant impact. Using sign restrictions in a structural vector autoregression model to identify supply and demand factors, we find that about 37 percent of the variance of inflation is explained by global factors (demand and supply). A 5 percentage point increase in oil prices increases inflation in the Baltics by around 0.3–0.4 percentage points (0.1 percentage points in the euro area) and leads to a 0.7–0.8 percentage point contraction in output (0.5 percentage points in the euro area as a whole). Notably, the impact on wage growth is not statistically significant in Estonia and Latvia. However, the oil price shock leads to a 1 percentage point decline in wage growth in Lithuania after the third quarter. While domestic factors (demand and supply) only explain about 25 percent of the variance of inflation, these shocks have a significant impact on inflation. A one standard deviation shock to domestic real GDP—around 0.7–0.8 percentage points of growth in the Baltics and 0.6 percentage points in the euro area—, increases inflation by around 0.3–0.4 percentage points in the Baltics, well above the 0.1 percentage point impact in the euro area. Thus, through its

Variance Decomposition for Inflation
(Shares)



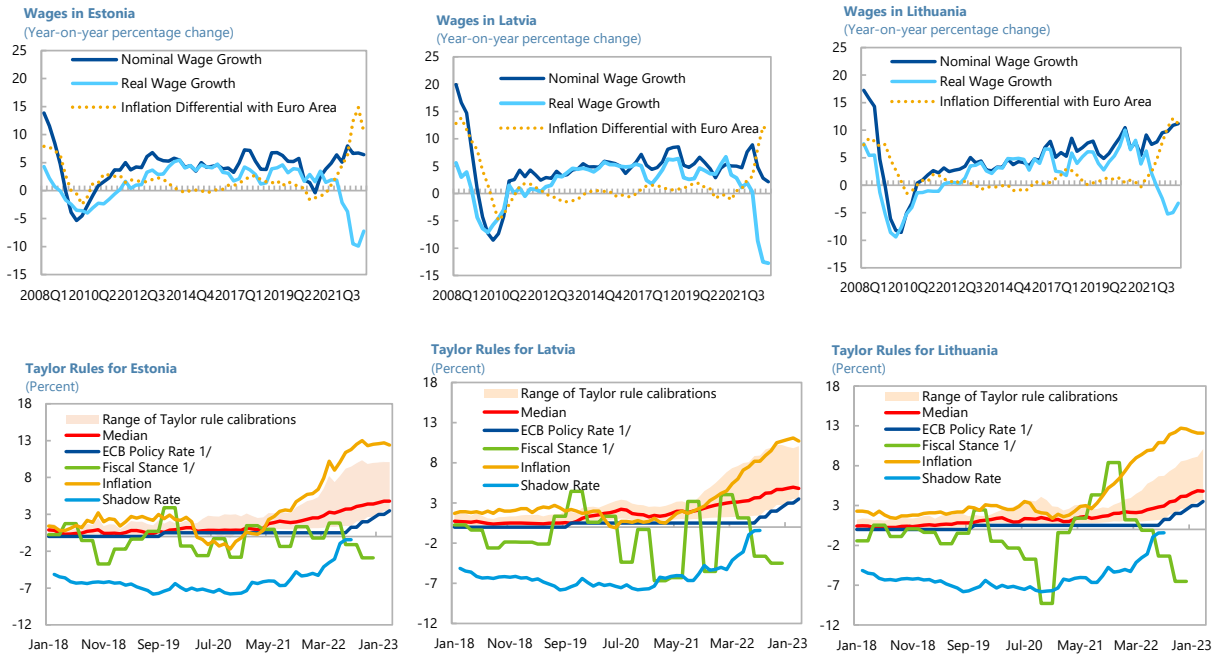
Source: IMF staff calculations.

[1] Cevik, S., A. Fan, B. Hu, S. Naik, N. Noumon, and K. Primus (*forthcoming*). "High Inflation in the Baltics: Disentangling Inflation Dynamics and Its Impact on Competitiveness and Firm Performance," IMF Working Paper No. 23/x.

impact on domestic demand, fiscal policy can affect inflation. A domestic demand shock has an impact on wage growth in Estonia (1 percentage point) and the euro area (0.4 percentage points). Similarly, global demand shocks have a significant positive impact on wage growth in the Baltics (1 percentage point) and euro area (0.5 percentage points).

3. Monetary conditions have tightened recently in response to rising inflation, but fiscal policy—the only macroeconomic stabilization tool available in the Baltics—has not done enough. Given the small share of the Baltic economies in euro area GDP, ECB monetary policy cannot fully respond to specific conditions in these small open economies. As a consequence, over the last few years, monetary tightening came late from the perspective of the Baltic region—starting more than a year after inflation began to pick up—leaving the monetary policy stance too loose relative to domestic economic conditions. Thus, the onus to contain inflationary pressures partly lies with fiscal policy. While the fiscal stance was largely countercyclical before and throughout the pandemic, more recently it has not done enough to contain inflation, particularly in Estonia and Lithuania where the fiscal stance is expected to loosen this year.

Annex VI. Text Figure 1. Monetary and Fiscal Policy Stance



Sources: European Central Bank; Haver Analytics; and IMF staff calculations.
1/ ECB policy rate is the main refinancing operation rate and fiscal stance is calculated as the year-on-year difference in cyclically adjusted primary balance in percent of potential GDP.
Note: The range of Taylor rates includes calibrated interest rates obtained from an adjusted Taylor rule of the type i = r*+π* + a(π–π*) + b(y-y*) with different values for the parameters a and b, and intertial rules with smoothing, where the calibrated rate in the current period depends on the policy rate in the previous period, i.e.: i = c*i(-1)+(1-c)*[r*+π* + a(π–π*) + b(y-y*)]. Core HICP inflation is used in all calibrations while economic slack is measured using detrended unemployment (the unemployment gap).

4. Fiscal policy plays a relevant role in containing inflation through its impact on domestic demand. Using an augmented Phillips curve with fiscal variables, we find that an increase of

one percentage point of (potential) GDP in the cyclically adjusted primary balance is associated with an increase in inflation of around 0.3–0.4 percentage points in the Baltics.[2] A VAR framework delivers consistent results—a 0.3–0.75 percentage points increase in inflation—although, in this case, the result is not statistically significant for Lithuania. These findings are consistent with Chapter 2 of the IMF Fiscal Monitor, April 2023, where, using a Bayesian panel VAR of 17 advanced economies between 1985–2019, the authors found that a one percent of GDP increase in fiscal spending leads to a 0.5 percentage point increase in inflation, with the effect dissipating over 3 to 4 years. While this result is larger than our finding using a Phillips curve framework, their sample includes bigger and less open economies than the Baltics that, therefore, suffer smaller leakage effects of fiscal policy.

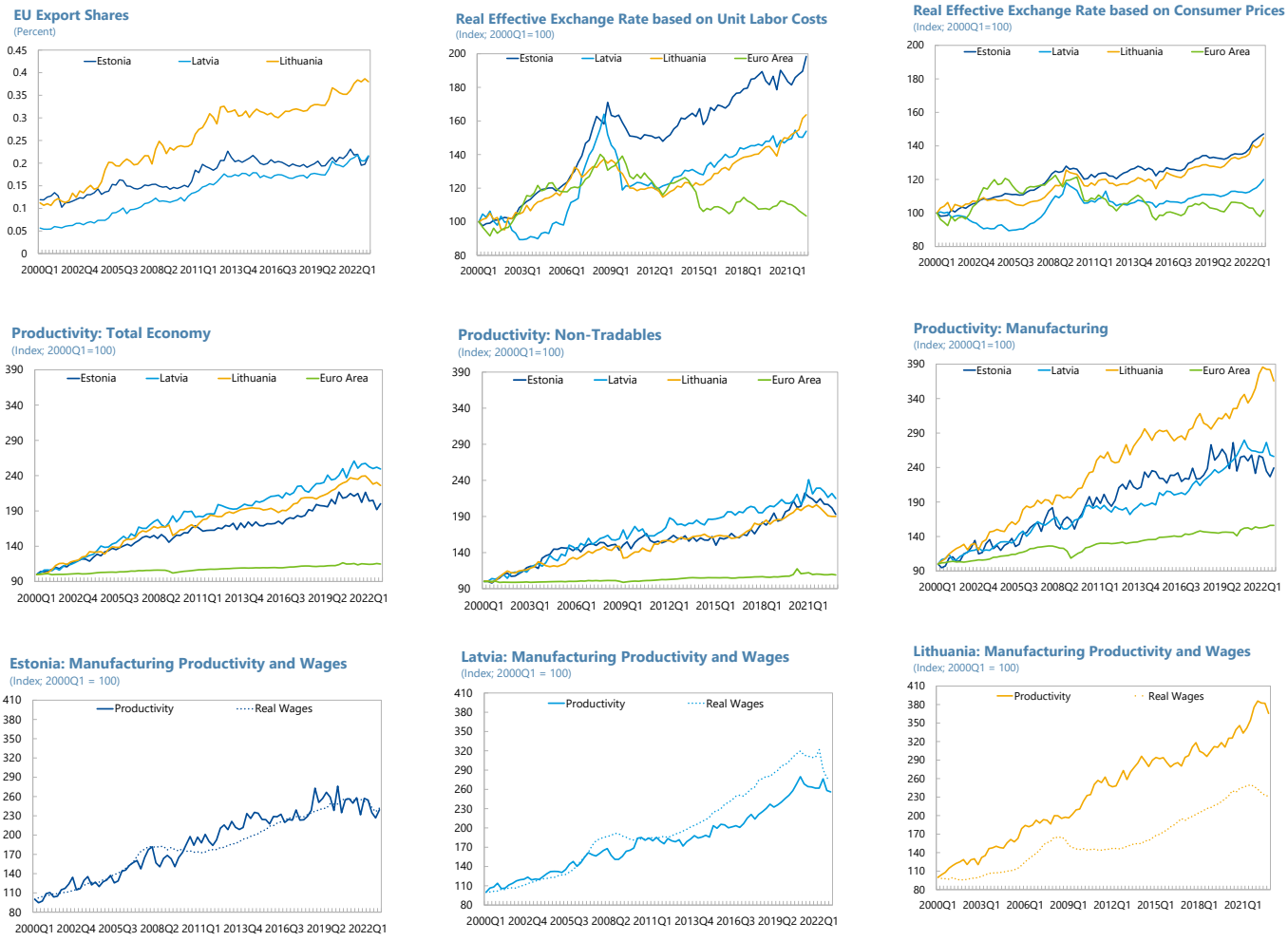
B. Inflation, Wages, and Competitiveness

5. Persistently high inflation and wage growth in the Baltics could put competitiveness and income convergence with the euro area at risk. The strong policy response to the large pre-GFC imbalances through fiscal consolidation and nominal wage reductions boosted competitiveness in the Baltics and set the stage for an export boom. Although real wages have increased significantly since 2013, large productivity gains supported the competitiveness of the tradeable sector. Thus, while the real effective exchange rate has steadily appreciated since the GFC, current accounts have remained strong over the same period. However, going forward, persistently higher inflation than in the euro area above what would be justified by productivity gains, could make inflation expectations adjust upwards, perpetuating large increases in price and wages. This would erode competitiveness and slow income convergence. A loose policy mix, particularly in Estonia and Lithuania, and tight labor markets have exacerbated these risks.

6. The close relationship between wages and productivity in the Baltics and the apparent lack of a self-correcting mechanism in Latvia can be explained by differences in labor markets. Estonia has the most flexible labor market in the Baltics as proxied by employment protection legislations (EPL) underpinned by early reforms (2009–2010). Lithuania follows closely, having made improvements with an important reform of the labor code in 2017–18. Latvia has the least flexible market, with EPLs among the most stringent in Europe and no recent reform efforts. Flexible labor markets result in wages largely determined at the firm-level rather than the industry-level. This is supported by the small share of workers covered by collective bargaining in the region. Flexibility to adjust to the economic cycle is also evident in employers' perceived labor market shortages, which tend to be lower than the EU average during downturn and higher during expansions.

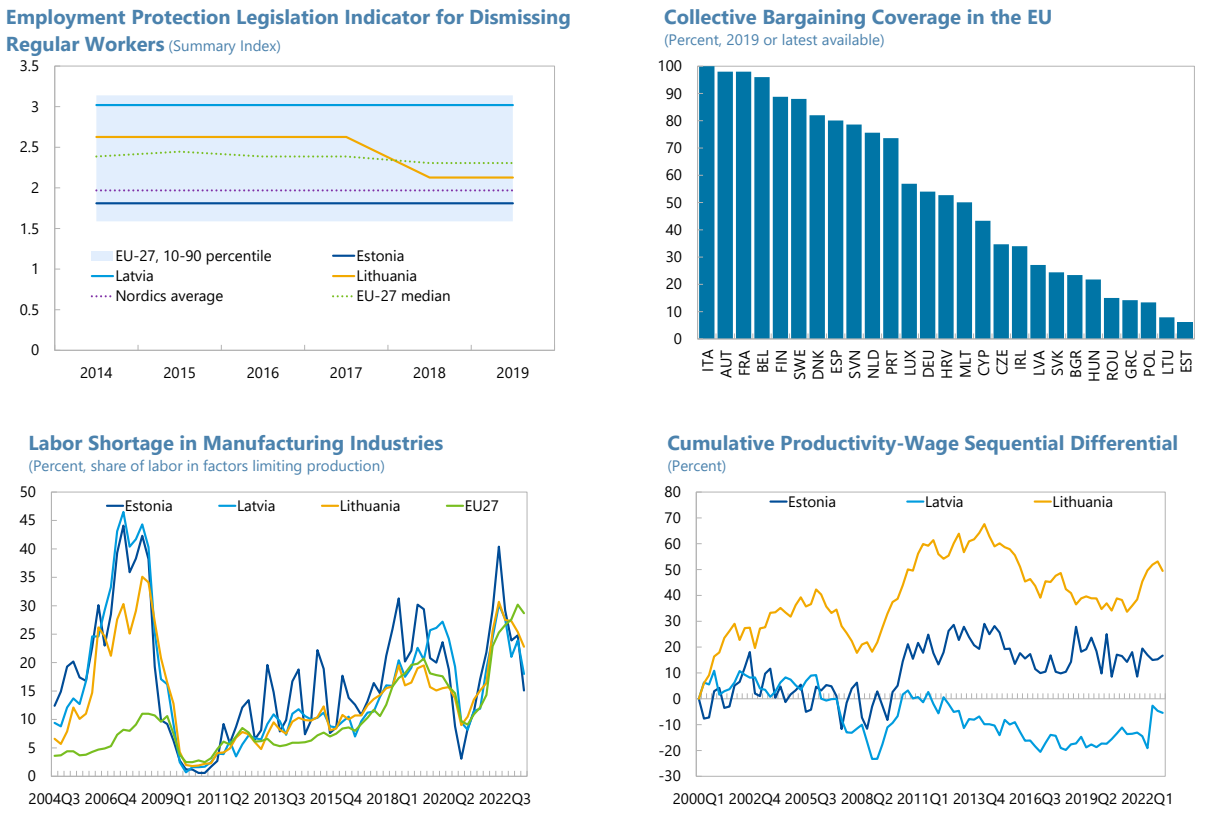
[2] Adding fiscal policy variables in this context raises concerns of endogeneity. However, the use of quarterly data should, as argued by Blanchard and Perotti (2002), largely mitigate this concern given the lags, realistically beyond three months, between approving discretionary fiscal policy measures and their actual implementation. Similarly, collinearity between the output gap and the CAPB could reduce the significance of the estimated coefficients as they explain some of the same variance. However, given the relatively low correlation between the two—around -0.3—and that all estimates of the CAPB are statistically significant, this issue should not be a big concern.

Annex VI. Figure 1. Exports Share, Competitiveness, and Labor Productivity Wage-Productivity Nexus



Sources: Eurostat; IFS; Haver Analytics; and IMF staff calculations.

Annex VI. Text Figure 2. The Role of the Labor Market



Sources: OECD; European Commission; Eurostat; Haver Analytics; and IMF staff calculations.

C. Inflation and Nonfinancial Firm Performance

7. In the past, firm level data suggest that temporary inflation shocks—likely linked to increases in demand—have had a small, transitory positive impact on profitability and investment. Given the negative impact of inflation surprises on real wages, firms' profitability increases in the short-term supporting higher investment that is followed by higher productivity going forward. These are the findings of an analysis based on an unbalanced panel of more than one hundred thousand firms from the Baltics. These results seem to be driven by firms in the tradable sector, with non-tradable firms' responses being statistically insignificant.

8. However, depending on the circumstances, persistent bouts of inflation could have negative effects on investment and productivity. The results suggest, that during expansionary periods, the impact on profitability is positive but transitory with a longer-lasting increase in investment. On the other hand, during contractionary periods, an inflation shock decreases profitability which, over time, has a negative impact on investment. Moreover, the sample period, 1997–2021, is one of low and stable inflation (particularly since the GFC).[3] This suggests that the inflation shocks

[3] One standard deviation inflation shock was equal to 2.5 percent during the sample period, compared to as much as 25 percent recorded in 2022.

analyzed here are moderate demand shocks unlike those in high and volatile inflation cases that have been found to have significant detrimental effects on firms' performance in the literature.[4]

D. Some Policy Considerations

9. High and persistent inflation is the biggest risk facing the Baltic economies and fiscal policy can proactively reduce this risk. Supply shocks present a difficult tradeoff to policy makers that are called to opt between containing inflation or supporting activity. Given the balance of risks and the impact of fiscal policy on inflation through its effect on domestic demand, a tighter fiscal stance would actively contribute to lower inflation in the current context.

10. Structural policies such as setting moderate minimum and public sector wages can also help mitigate the risk of higher wage growth. This is the case given their important role as a reference in private sector wage negotiations. It also makes inflation expectations less backwards looking.

11. Short-term deviations of wages from productivity can be absorbed in Estonia and Lithuania provided they are temporary but not in Latvia where risks are higher. With wage growth in tradables below productivity growth in equilibrium and with short-term deviations self-correcting over time, the long-term impact of deviations of wages from productivity in the current high inflationary environment should be limited for Estonia and Lithuania. With wage growth already above productivity growth in equilibrium and no significant self-correcting mechanism to rectify short-term deviations for Latvia, the long-term impact of the current environment can be long-lasting, especially if further inflation risks materialized. This reinforces the role of fiscal policy in containing inflationary risks.

12. The lack of macroeconomic imbalances, flexible labor markets and the strong external position provide some comfort that these economies will be able to absorb the current shock. This is in sharp contrast to the situation in 2008 when large imbalances triggered increasingly unsustainable macro dynamics. On the other hand, the lower labor market flexibility in Latvia may have an impact on the economy's competitiveness and its capacity to absorb shocks compared to the other Baltic economies.

[4] See, for example, Banerjee, Cockerell, and Russell (2001), Mishkin (2007), and Bhattacharjee and others (2008).

Annex VII. Past IMF Policy Recommendations

IMF 2022 Article IV Recommendations	Implementation
Fiscal Policy	
Targeted, temporary, and timely support should be provided to the most vulnerable individuals and viable firms to support the recovery.	The targeting of support measures has not improved. The authorities plan to make future energy support packages more targeted.
Planned investment under the Recovery and Resilience Plan (RRP) should be accelerated to boost growth and productivity.	The government envisages an increase in public investment in the short-to-medium term, supported by EU funds.
The pension system should be reviewed as demographic pressures from the ageing and declining population would cause gross social contributions to fall. Safety nets should also be strengthened to reduce old-age poverty.	The government prepared a White Paper on improvements needed in the pension system. The proposed reforms are expected to balance adequacy and sustainability, and help to lower old-age poverty, which is high in Latvia.
Increase healthcare spending to address critical needs in the health sector.	The government has allocated additional funding to the health sector, under its priority of "Quality of life, human and public health".
Address GRECO's recommendations to strengthen Latvia's anticorruption framework.	Latvia made progress in addressing GRECO's recommendations for the Fifth Evaluation Round on preventing corruption and promoting integrity in central governments and law enforcement agencies.
Financial Sector Policies	
Closely monitor spillovers from the war, supported by risk assessments and tailored stress tests.	The Bank of Latvia enhanced use of stress testing to assess macro-financial conditions and liquidity risks.
Continue to strengthen the AML/CFT framework.	Latvia made significant progress in strengthening its AML/CFT framework through the implementation of the amendments to the AML/CFT legal framework, ongoing risk-assessment, and continuous training and outreach activities to obliged entities.
Structural Reforms	
Labor market policies should aim to reduce skill mismatches and facilitate job creation and reallocation.	As part of its RRP, Latvia is investing in education, affordable housing, and employment service.
Reforms in digital transformation should be advanced to boost productivity and growth.	The government's digital agenda focuses on enhancing digital skills. The NRRP allocates 21 percent of the financing to support a comprehensive range of measures.
Increase investment in energy security and green technologies.	Latvia has taken concrete steps to ensure natural gas supply, integrate energy infrastructure with European partners, and increase production of wind energy.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 13, 2023

Prepared by The European Department

CONTENTS

FUND RELATIONS

(As of May 31, 2023)

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)	310.24	93.36
Reserve Tranche Position	22.39	6.74

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	439.32	100.00
Holdings	439.59	100.06

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		
	2024	2025	2026
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 19 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 multiple currency practices and restrictions on the making of payments and transfers for current international transactions, with the exception of restrictions notified to the Fund in accordance with decision No.144 (52/51) resulting from UN Security Council Resolutions and EU Council Regulations.

Previous Article IV Consultation:

Latvia is on the 12-month consultation cycle. The last Article IV consultation was concluded on August 23, 2022 (IMF Country Report No. 22/277). The Executive Board assessment is available https://www.imf.org/en/Publications/CR/Issues/2022/08/23/Republic-of-Latvia-2022-Article-IV-Consultation-Press-Release-and-Staff-Report-522545

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 Finance
MCM	Deposit Insurance	Mission	Sept. 2009	FCMC
MCM	Liquidity Management	Mission	November 2009	Bank of Latvia
LEG	Bank Resolution Legal Framework	Mission	January 2010	FCMC
FAD	Tax Policy	Mission	February 2010	Ministry of Finance
LEG	Bank Resolution Legal Framework	Mission	February 2010	FCMC
LEG	Corporate and Personal Insolvency Law	Mission	March 2010	Ministry of Justice
FAD	Public Financial Management	Mission	April 2010	Ministry of Finance
LEG	Corporate and Personal Insolvency Law	Mission	April 2010	Ministry of Justice
MCM	Stress Testing	Mission	June 2010	Bank of Latvia
FAD	Expenditure Policy	Mission	August 2010	Ministry of Finance
FAD	Revenue Administration	Mission	Sept. 2010	Ministry of Finance
LEG	Legal Framework for Foreclosure Procedures	Mission	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 international reserves, and quarterly data on IIP 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.

Table 1. Latvia: Table of Common Indicators Required for Surveillance
(As of June 30, 2023)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the MonetaryAuthorities[1]	April 2023	May 2023	M	M	M
Reserve/Base Money	April 2023	May 2023	M	M	M
Broad Money	April 2023	May 2023	M	M	M
Central Bank Balance Sheet	April 2023	May 2023	M	M	M
Consolidated Balance Sheet of the Banking System	April 2023	May 2023	M	M	M
Interest Rates[2]	April 2023	May 2023	M	M	M
Consumer Price Index	May 2023	June 2023	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	December 2022	April 2023	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	December 2022	April 2023	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 2022	April 2023	Q	Q	Q
External Current Account Balance	April 2023	May 2023	M	M	M
Exports and Imports of Goods and Services	April 2023	May 2023	M	M	M
GDP/GNP	March 2023	May 2023	Q	Q	Q
Gross External Debt	December 2022	March 2023	Q	Q	Q
International Investment Position[6]	December 2022	March 2023	Q	Q	Q

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

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

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

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

[5] Including currency and maturity composition.

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

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

Statement by Mr. Vitas Vasiliauskas, Executive Director for the Republic of Latvia
September 11, 2023

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

Outlook

Due to high uncertainty and subdued foreign demand, economic growth is expected to be sluggish in 2023. Easing cost and price pressures allow the economy to recover in 2024 – a resilient labor market and restored households' purchasing power are expected to support private consumption, while public investment will be supported by EU-financed capital inflows. While inflows of refugees from Ukraine due to Russia's unjustified war have been significant, some of them have returned home or emigrated to other countries and the impact on labor market has been relatively limited (about 1 percent of employment). Latvian trade with Russia has fallen markedly since the invasion and annexation of Crimea in 2014, successfully reorienting flows and overcoming main supply chain vulnerabilities.

While price developments remain largely globally driven, tight labor market conditions and wage pressures are expected to have some second-round effects on core inflation, keeping inflation above 2 percent in coming years. Inflation momentum has declined though, and the difference between the euro area's and Latvia's annual inflation rates has decreased (5.3 percent and 5.6 percent in August, respectively). Containing inflation remains a policy priority in the short term.

Fiscal policy

Fiscal policy is gradually being tightened – as Covid-19 and energy price shock support measures are being phased out, the authorities are planning to use these savings for decreasing deficit. They are also committed to improving the support measures by better targeting. At the same time, additional resources are being allocated to improve national security (including defense spending and energy security), education, competitiveness, and healthcare. In 2023, the enforcement of the EU fiscal rules is still suspended. Yet, in line with the EU Stability and Growth Pact, and according to the updated assessment of August 2023, the general government deficit is projected to be below threshold already in 2023 (2.7 percent in 2023) and decrease further to 2.6 percent in 2024 and 2.3 percent in 2025 (based on the structural balance targets).

The national fiscal rule, which aims for a structural fiscal deficit of 0.5 percent of GDP will continue to guide the medium-term fiscal strategy and keep the public debt below 40 percent in the coming years. The planned structural balance is in compliance with Latvia's Fiscal discipline law, and the authorities do not see a need for adjustment in the fiscal path. The national methodology treats one-off measures differently from that of staff and excludes from the structural deficit the following expenditures: compensation for the extraordinary increase in energy prices, support for Ukraine and its refugees, and certain defense and internal security

expenditures due to war. At the same time, the authorities welcome the discussion and suggestions made by the IMF on adjustment measures.

Financial sector

The financial sector remains resilient – voluntary capital buffers of credit institutions are rather high, and profitability has increased as floating loan interest rates grew faster than deposit rates. Borrowers' balance sheets have been supported by sizable savings made during the pandemic and the substantial state support measures outlined above. Total private sector indebtedness remains low, and the debt servicing burden is rather small. The main bank credit risk indicators have not deteriorated, but credit risk may materialize with a lag. Sticky inflation and tight financial conditions may negatively affect asset quality, and for a rather small share of households the debt burden can become excessive. While smaller banks have somewhat more vulnerable exposures, their resilience is also strong according to the credit risk sensitivity analysis of the Bank of Latvia. The authorities are closely monitoring the financial sector to ensure that problems are recognized in due time. The Bank of Latvia has enhanced and broadened its stress tests to assess macro-financial, credit and liquidity risks, as well as physical and transition climate risks. The authorities also continue their efforts in mitigating risks of cyber-attacks, monitoring risk controls and impact, and evaluating contingency plans.

In July 2023, the Latvian Macroprudential Council[1] advised to introduce the positive neutral countercyclical capital buffer (CCyB), using the present favorable financial conditions to build additional resilience in a timely manner. A gradual implementation of the positive neutral CCyB approach will be initiated in December 2023 – the CCyB rate of 0.5 percent will then take effect in December 2024 and the rate of 1.0 percent in June 2025. The current financial situation of Latvian credit institutions allows fully maintaining this buffer without raising additional capital.

There has been significant progress in strengthening the AML/CFT framework in recent years, and the authorities reiterate their unwavering commitment to pursue further improvements. The work is underway on updating the National Risk Assessment, which will be completed in 2023, and developing risk mitigating measures soon after. The integration of the Financial and Capital Market Commission (FCMC) into the Bank of Latvia, as of January 1, 2023, will help to further integrate the AML/CFT risks into a comprehensive risk-based supervision of banks. The National cybersecurity law is expected to be adopted by end-2023, building on the EU regulation on markets in crypto-assets (MiCA) and the Financial Action Task Force (FATF) standards.

Structural challenges

Anemic lending due to both supply and demand factors remains a pressing and systemically important issue, holding back investment. The authorities will continue to engage in regular dialogue with the financial sector on its lending policy and to implement measures promoting the domestic capital market to help provide alternative sources of financing for investment, increasing transparency, and improving corporate governance. An approach addressing the issue of the persistently high share of companies with negative equity is currently being

[1] A cooperation forum of the Latvijas Banka and the Ministry of Finance - a collegial permanent consultative body for mutual cooperation with the aim to promote the stability of Latvia's financial system.

examined by the authorities. Amendments to the Insolvency Law, focusing on the implementation of the EU directive on Restructuring and Insolvency (Directive 2019/1023), will take effect in September 2023.

Boosting investments and strengthening digital transformation would enhance productivity growth and help sustain the convergence process. The authorities acknowledge that the implementation of the National Recovery and Resilience Plan (NRRP) should be accelerated, and, as public investment is being scaled up, further improvement of public investment management is important. The authorities also continue to work on targeted labor market measures and education reforms to boost high-skill labor supply and encourage digitalization and innovations.

Further progress has been made with structural reforms to ensure energy security and facilitate the green transition. Energy supplies have been reorganized following the halt of natural gas imports from Russia, access to LNG supplies has been improved, and reserves are ensured at the natural gas storage facility. Investments into improving energy efficiency of public and private buildings are anticipated to increase, in line with NRRP. Substantial public and private investments in wind and solar electricity generation are also underway, and full integration with the synchronous electricity grid of Continental Europe is planned by 2025 at the latest. It should be noted that the share of renewable energy in the gross final energy consumption in 2021 was already third highest in the EU. To facilitate the green transition a new draft climate change legislation aims to set sectoral targets for greenhouse gas emissions and considers setting financial mechanism in case sectoral targets are not met and improving accountability for emissions.