Republic of Latvia: 2024 Article IV Consultation-Press Release; and Staff Report

INTERNATIONAL MONETARY FUND

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IMF Country Report No. 24/284

REPUBLIC OF LATVIA

2024 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

September 2024

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 2024 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on June 17, 2024, 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 August 2, 2024.
- An **Informational Annex** prepared by the IMF staff.

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

Selected Issues

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

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PRESS RELEASE

PR 24/319

IMF Executive Board Concludes 2024 Article IV Consultation with the Republic of Latvia

FOR IMMEDIATE RELEASE

Washington, DC –September 5, 2024: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia and endorsed the staff appraisal on a lapse-of-time basis without a meeting.

The Latvian economy contracted with significant disinflation. After the post-pandemic recovery, growth contracted by 0.3 percent in 2023, due to tighter financial conditions and weak external demand. Headline inflation declined to 0.0 percent y/y in May 2024. However, core inflation still stood at 3.1 percent in April 2024. The financial sector has so far been resilient although risks are elevated. Fiscal performance in 2023 was stronger than expected, reflecting revenue buoyancy linked to inflation and expenditure under-execution. The current account deficit narrowed to 4 percent of GDP in 2023 from 4.8 percent in 2022, due to import contraction and lower energy prices. Russia's war in Ukraine and the related geoeconomic fragmentation are adding to structural challenges amid multiple transitions, notably, climate change and energy, and aging and labor shortages. The economic consequences of Russia's war in Ukraine continue to depress private investment and productivity, thus compromising further Latvia's lagging income convergence.

Amid high uncertainty, the outlook is for higher growth and the balance of risks is tilted to the downside. Real GDP growth is projected to increase to 1.7 and 2.4 percent in 2024 and 2025, respectively, underpinned by a recovery in private consumption, higher public investment, and stronger external demand. Growth in the medium-term is projected to continue at an average of around 2.5 percent, supported by public investment and reforms. Inflation is expected to continue to moderate. Headline inflation (annual average) is projected to decline to 2.0 percent in 2024. Meanwhile, core inflation (annual average) is projected to slow to 3.3 percent in 2024, reflecting persistent services inflation. Downside risks dominate, including risk to competitiveness associated with recent high wage growth, rising geopolitical tensions and deeper geoeconomic fragmentation, and weaker external demand.

Executive Board Assessment[2]

Latvia's economy has encountered severe headwinds. The Latvian economy contracted with significant disinflation against the backdrop of geopolitical headwinds. Notably, Russia's war in Ukraine and the related geoeconomic fragmentation are adding to long-standing

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

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

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challenges to productivity, investment, and labor supply, amid multiple transitions around climate change and energy, aging and labor shortages, and rising defense costs.

Amid high uncertainty, growth is projected to rebound, but risks are tilted to the downside. Real GDP growth is projected to increase in 2024 and 2025, largely driven by a rebound in private consumption, higher public investment, and stronger external demand. The main risks stem from rising geopolitical tensions and deeper geoeconomic fragmentation, credit risks related to variable-rate loans, and weaker-than-expected external demand. Risks to competitiveness can also arise given recent high wage growth. Over the medium-term, delays in public investment and structural reforms could weigh on potential growth.

Considering the improving outlook, staff recommends a less expansionary, neutral fiscal stance for 2024 and a tighter fiscal stance in 2025. Proactively identifying spending efficiency and better targeting social support, while protecting the most vulnerable, would help. Staff commends the authorities for the targeting of energy support measures. In 2025, the fiscal stance should be tighter to build buffers for future spending needs. Policy options to achieve this include reducing tax exemptions, raising revenue from property taxation, strengthening tax enforcement, and improving investment spending efficiency. Fiscal policy should remain flexible and evolve if risks materialize.

Although Latvia has some fiscal space, structural fiscal measures are needed to provide buffers for medium to long term spending pressures. Over the medium term, options for fiscal consolidation include (i) broadening the bases of corporate income tax (CIT) and personal income tax (PIT), including by reducing the shadow economy; (ii) broadening the base of property taxes; (iii) reducing tax exemptions and fossil fuel subsidies, and (iv) rationalizing spending on goods and services. Given this scaling-up of public investment amid high uncertainty and cost overrun, enhanced public investment management is warranted to mitigate fiscal risks. The mission welcomes the healthcare reform aimed to generate efficiency gains, while mitigating risks and supporting solidarity. Staff also welcomes the government's pension reform efforts and recommends linking the retirement age to life expectancy. Latvia should swiftly implement the NRRP.

Although the financial sector has so far been resilient, continued monitoring of macrofinancial vulnerabilities and spillovers is warranted. 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. Any households' financial distress related to variable-interest-rate mortgage loans should be addressed through the consumer bankruptcy framework, supplemented by the social protection system for the most vulnerable. The new untargeted interest subsidy scheme for variable-interest-rate mortgages should not be renewed at its expiration in 2024. The authorities should refrain from further initiatives to increase taxation on bank profits given their adverse impact on bank capital and financial stability. Staff welcomes the continued efforts to mitigate cybersecurity risk.

While the current macroprudential policy stance is broadly appropriate, the recent adjustment to the borrower-based measures for energy-efficient housing loans should be reconsidered. The overall policy stance strikes the right balance between maintaining financial stability and the need to extend credit to the economy. However, borrower-based macroprudential measures should be relaxed only when their presence is overly stringent from the financial stability perspective.

Latvia has made significant progress in strengthening its AML/CFT frameworks and governance reforms. Staff commends the authorities' effort to pursue AML/CFT reforms and supports the authorities' priorities to prepare for the 6th round of MONEYVAL evaluation. Staff welcomes the authorities' reforms to digitalize the procurement system and the continued implementation of Latvia's anti-corruption plan and national strategy.

Structural reforms should be accelerated to enhance productivity and resilience. Accelerating corporate reforms could boost investment and productivity by improving capital allocation and access to finance. Given the aging population and skill mismatch, Latvia should continue to address reforms to boost high-skilled labor supply which will enhance investment in productivity. Efforts should focus on promoting training and internal labor mobility toward priority sectors (green and transition, digitalization, health). Further streamlining product and service markets regulations could boost competition, innovation, and productivity. Staff welcomes the ongoing overhaul of the administrative procedures and their digitalization. Implementing measures to promote digital transformation of the economy could help reduce labor shortages and support productivity. Regarding the green and energy transition, more vigorous climate policy is needed. Staff encourages the authorities to expedite the adoption of the climate law and the National Energy and Climate Plan (NECP). The authorities should aim to achieve a robust balance between fiscal support, carbon pricing or taxation, and norms while addressing distributional concerns. Staff welcomes the ongoing work on climate adaptation. Latvia should continue to enhance energy security, and boost investment in clean energy and connection.

Table 1. Latvia: Selected Economic Indicators, 2019–25

	2019	2020	2021	2022	2023	2024	2025
						Proj.	
National Accounts	(Percentage change, unless otherwise indicated)						
Real GDP	0.6	-3.5	6.7	3.0	-0.3	1.7	2.4
Private consumption	0.0	-4.3	7.3	7.2	-1.3	2.4	2.3
Public consumption	5.6	2.1	3.5	2.8	7.0	2.3	2.2
Gross capital formation	0.7	-10.0	24.9	-3.6	5.1	2.6	2.7
Gross fixed capital formation	1.5	-2.2	7.2	0.6	8.2	3.1	3.1
Exports of goods and services	1.3	0.4	9.0	10.3	-5.9	3.0	2.6
Imports of goods and services	2.2	-1.1	15.1	11.1	-2.8	3.0	2.5
Nominal GDP (billions of euros)	30.6	30.1	33.3	38.4	40.3	42.4	44.8
GDP per capita (thousands of euros)	15.9	15.8	17.6	20.5	21.4	22.5	23.9
Savings and Investment							
Gross national saving (percent of GDP)	22.2	24.3	21.1	20.3	19.0	19.1	18.9
Gross capital formation (percent of GDP)	22.8	21.4	25.0	25.0	23.0	22.8	22.5
Private (percent of GDP)	18.9	17.2	21.2	21.7	19.4	18.7	18.6
HICP Inflation							
Headline, period average	2.7	0.1	3.2	17.2	9.1	2.0	2.4
Headline, end-period	2.1	-0.5	7.9	20.7	0.9	3.9	1.6
Core, period average	2.7	1.1	2.0	11.3	9.8	3.3	3.1
Core, end-period	1.9	0.9	4.7	15.2	4.0	3.7	2.8
Labor Market							
Unemployment rate (LFS; period average, percent)	6.3	8.1	7.6	6.9	6.5	6.5	6.5
Nominal wage growth	7.2	6.2	11.7	7.5	11.9	8.5	7.0
Consolidated General Government 1/	(Percent of GDP, unless otherwise indicated)						
Total revenue	37.3	37.7	37.6	37.2	38.5	38.6	38.7
Total expenditure	37.7	41.4	43.2	40.9	42.0	42.0	41.4
Basic fiscal balance	-0.4	-3.7	-5.5	-3.7	-3.5	-3.4	-2.7
ESA fiscal balance	-0.5	-4.4	-7.2	-4.6	-2.2	-2.9	-2.7
General government gross debt	36.7	42.7	44.4	41.8	43.6	44.7	44.8
Money and Credit							
Credit to private sector (annual percentage change)	-2.3	-4.4	11.9	7.1	5.1	…	…
Broad money (annual percentage change)	8.0	13.1	9.2	5.1	2.7	…	…
Balance of Payments							
Current account balance	-0.6	2.9	-3.9	-4.8	-4.0	-3.7	-3.5
Trade balance (goods)	-8.6	-5.1	-8.3	-10.7	-9.3	-8.8	-8.8
Gross external debt	117.1	122.1	110.5	102.3	98.5	94.9	86.6
Net external debt 2/	18.1	13.6	10.3	8.1	7.5	10.7	13.5
Exchange Rates							
U.S. dollar per euro (period average)	1.12	1.14	1.18	1.05	1.08	…	…
REER (period average; CPI based, 2005=100)	123.0	124.5	125.0	129.7	136.8	…	…
Terms of trade (annual percentage change)	0.9	1.8	-1.6	-0.6	3.6	-0.1	0.9

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 2024 ARTICLE IV CONSULTATION

August 2, 2024

KEY ISSUES

Context. The Latvian economy contracted with significant disinflation against the backdrop of geopolitical headwinds. Persistent services inflation, driven by strong nominal wage growth amid tight labor markets, keeps core inflation elevated. Productivity growth has failed to match real wage increases, weighing on competitiveness. The economic consequences of Russia's war in Ukraine continue to depress private investment and productivity, thus compromising further Latvia's lagging income convergence. The government needs to address long-term spending pressures related to its priorities and multiple transitions around climate change and energy, aging and skilled labor shortages, and rising defense costs. The coalition's priorities include managing the fallout from the war in Ukraine, ensuring energy independence, addressing social issues, and pursuing tax reform.

Outlook and Risks. Short-term growth is projected to rebound in 2024 and 2025, underpinned by a recovery in private consumption, higher public investment, and stronger external demand. The expansionary fiscal stance in 2024 will boost growth with upside risks to inflation. Medium-term growth has been revised down, reflecting the longer-term consequences of Russia's war in Ukraine and geoeconomic fragmentation, including the changed energy mix. Downside risks dominate, including risk to competitiveness associated with recent high wage growth, rising geopolitical tensions and deeper geoeconomic fragmentation, and weaker external demand.

Key Policy Recommendations

Fiscal Policy. For 2024, a less expansionary, neutral fiscal stance is warranted given the improving outlook and upside risks from inflationary pressures; adjustment measures should be identified. For 2025, the fiscal stance should be tighter to build buffers to address future spending needs. Structural fiscal measures should address rising pressures from long-term fiscal challenges and create the needed room for higher public investment on infrastructure and on research and development.

Financial Sector Policies. Continued monitoring of financial sector vulnerabilities and macrofinancial spillovers is warranted. The current macroprudential stance is broadly appropriate but the recent adjustment for energy-efficient housing loans should be reconsidered. Building upon the significant progress made thus far, the authorities should continue to pursue vigorously their AML/CFT reforms.

Structural Policies. The overriding priority is to boost investment and productivity and meet the new structural challenges from Russia's war in Ukraine and the multiple transitions already in train while ensuring social support and policy predictability. To enhance investment and productivity, policymakers should facilitate the green and energy transition, structural transformation of the labor market, implement corporate reforms, streamline product and service market regulation, and bolster the digital transformation.

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

Discussions were held in Riga during June 4–17, 2024. The team comprised Bernardin Akitoby (head), Nina Budina, Bingjie Hu, and Keyra Primus (all EUR). Carlos Acosta (LEG) participated virtually in meetings. Inese Allika (OED) also joined the discussions.
Kelly MacKinnon and Can Ugur (all EUR) supported the mission. The mission met with Bank of Latvia Governor Kazāks, Minister of Finance Ašeradens, officials from the ministry of energy and climate, other senior officials, and private sector representatives.

CONTENTS

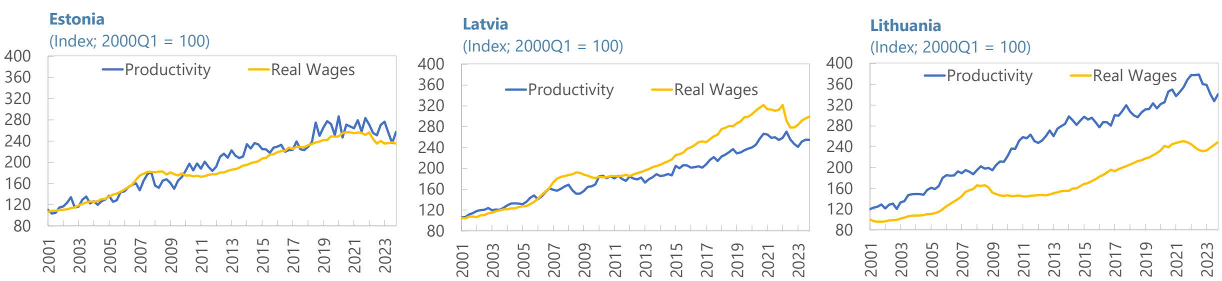
ANNEXES

CONTEXT

1. **Latvia's economy has encountered severe headwinds.** After the post-pandemic recovery, growth contracted in 2023, reflecting tighter financial conditions and weak external demand. The energy shock also called into question the viability of energy-intensive activities. Although headline inflation is declining, persistent service inflation, driven by robust nominal wage growth amid tight labor markets, is keeping core inflation elevated.

2. **Productivity growth has not kept up with wage growth.**[1] In contrast to Lithuania and Estonia, wage growth outpaced productivity growth as investment growth weakened following the Great Financial Crisis (GFC), thereby depressing competitiveness of the manufacturing sector (Text Figure 1).[2] Boosting productivity would help support higher wage income while reducing inflationary pressure.

Text Figure 1. Baltics: Manufacturing Productivity and Real Wages[1]



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

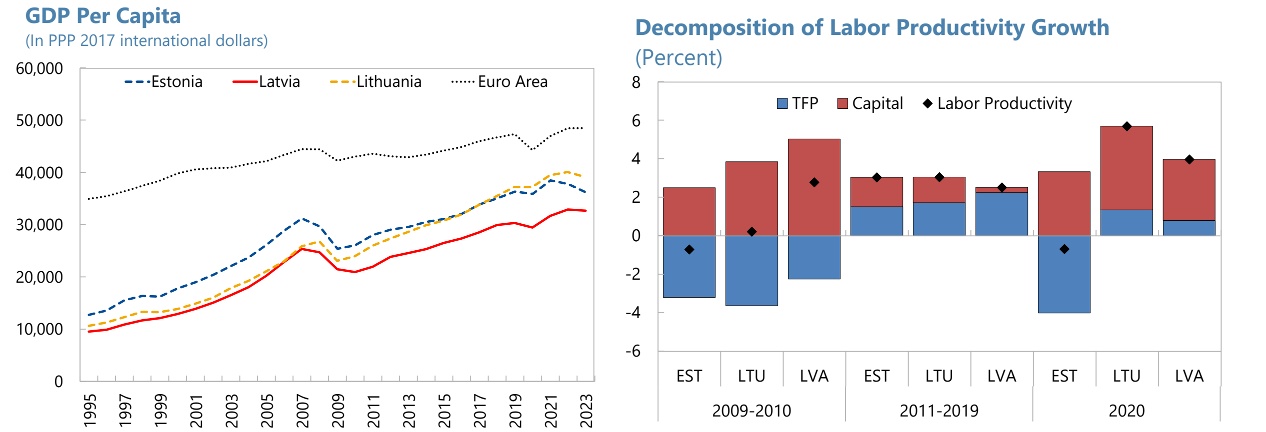
[1] Manufacturing productivity is defined as real gross value added (million chained 2010 euros) per hour worked. Real wages are defined as hourly wages and salaries (seasonally and working day adjusted) in manufacturing deflated by total economy harmonized index of consumer prices (seasonally adjusted).

3. **Russia's war in Ukraine and the related geoeconomic fragmentation are adding to structural challenges amid multiple transitions.** Labor productivity growth has turned negative since the start of the war, compromising further Latvia's lagging income convergence (Text Figure 2). Higher investment and reforms are needed to lift and sustain growth going forward. Moreover, the green and energy transitions could further weigh on productivity by affecting the profitability of energy-intensive activities. Meanwhile, aging and emigration have tightened the labor market. While labor market reforms and immigration could help increase labor supply, the sustained gains in growth will likely come from investment and productivity growth.

[1] Latvia's manufacturing real wages rose by 4.9 percent, outgrowing Estonia (3.8 percent) and Lithuania (4.1 percent) during 2000–2023. A 28 percent population drop since 1990 (EBRD, 2024) likely exacerbated skill shortages, pushing wages above those in other Baltic states.

[2] See forthcoming Selected Issues Paper on Recent Developments in Latvia's Competitiveness and Productivity in the context of Baltic Economies. Latvia's post-GFC total factor productivity growth outperformed the other Baltic countries' (Annex IV, Figure 3), but weaker investment held back labor productivity overall.

Text Figure 2. Baltics: Convergence and Decomposition of Productivity



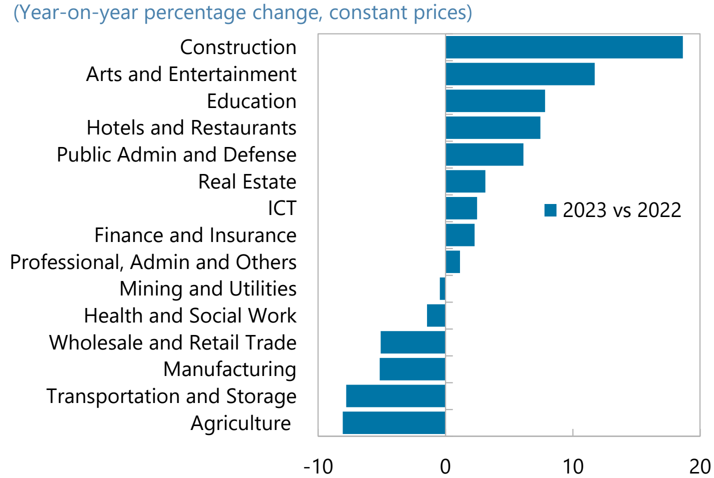
Sources: World Economic Outlook, IMF; EUKLEMS; Annex IV and IMF staff calculations.

4. Latvia's government needs to address long-term spending pressures related to its priorities and multiple transitions. The coalition's priorities include dealing with the spillovers in the Baltic region from the war in Ukraine, ensuring energy independence, addressing social issues, and pursuing tax reform. In this context, the government will have to address long-term spending pressures from defense, health, pension, and climate change, estimated to increase by around 2.6 percent of GDP over 2024 to 2050, which is lower than in advanced European economies (around 5.5 percent of GDP).[3]

RECENT DEVELOPMENTS

5. The economy contracted in 2023, reflecting tighter financial conditions and weak external demand (Text Figure 3). Latvia registered negative q/q growth in the first half of 2023, as tight financial conditions and high inflation caused private consumption to decline. Exports remained sluggish, reflecting weak external demand. However, growth picked up in the second half of 2023, mainly driven by an increase in public investment and private consumption, supported by robust wage growth and improving household purchasing power. Overall, the economy

Change in Sector Value Added
(Year-on-year percentage change, constant prices)



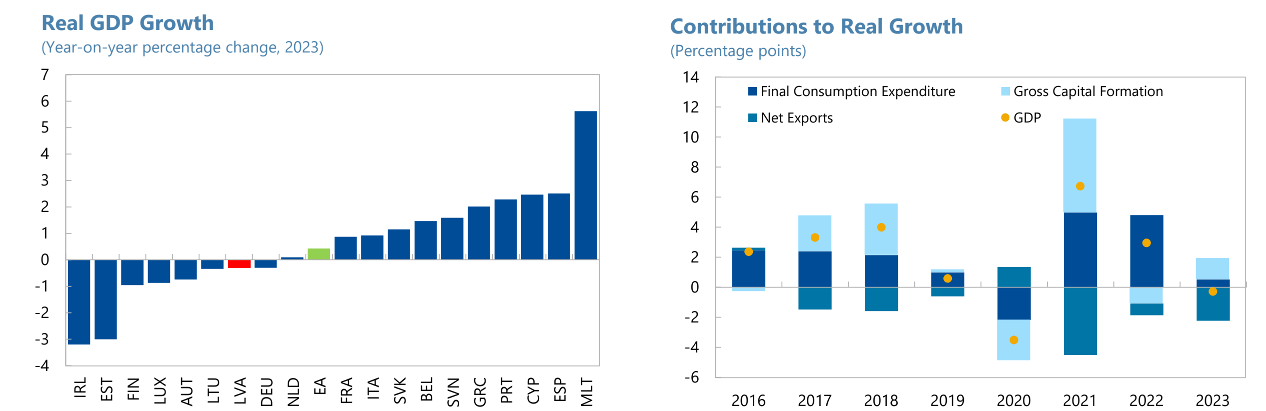
Sources: Haver Analytics; and IMF staff calculations.

[3] See Policy Discussions, Section A and Regional Economic Outlook for Europe, April 2024.

contracted by 0.3 percent in 2023, down from a 3 percent expansion in 2022 and falling behind the euro area average (Text Figure 3). Real GDP growth for Q1 2024, surprised on the upside at 0.9 percent q-on-q, driven by private and public consumption and improving external demand.

Text Figure 3. Latvia: Economic Activity

Real GDP growth contracted in 2023… *….reflecting a decline in consumption and net exports.*



Source: World Economic Outlook, IMF.

Sources: Authorities and IMF Staff Calculations.

6. **Headline inflation declined markedly, while core inflation remains elevated.** (Text Figure 4). Headline inflation declined to 0.0 percent y/y in May 2024, from its peak of 22.1 percent y/y in September 2022, driven by a decline in energy and food prices[4]. Core inflation fell from its peak of 15.4 percent in January 2023, but at 3.1 percent in April 2024 it remains high, reflecting persistent services inflation, partly sustained by robust nominal wage growth.

7. **The labor market has been resilient so far, despite the contraction in growth** (Text Figure 5). At 6.5 percent in 2023, unemployment rate is historically low for Latvia and in line with other Baltic countries. The robust wage increases (11.9 percent in 2023), mostly driven by public wage increases and tight labor markets, have helped return real wages to pre-inflationary period levels. While this is expected to mitigate further upward wage pressures from catch-up growth, unit labor costs have outpaced the EA average (Text Figure 5).

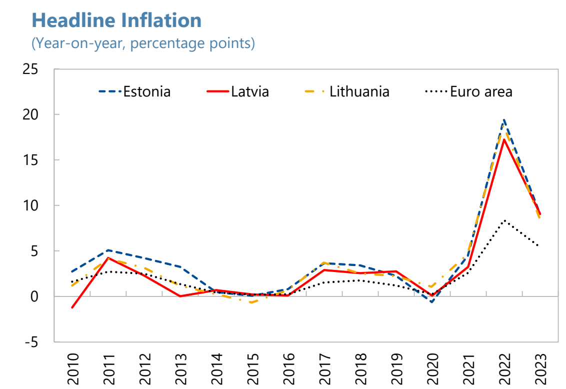
8. **The external position was weaker than implied by fundamentals and desirable policy settings in 2023** (Annex II). The real effective exchange rate appreciated by 5.4 percent in 2023, stemming from rapid wage growth, weakening Latvia's price competitiveness. The current account remained in deficit at 4 percent of GDP in 2023 (Text Figure 6). The narrowing from 4.8 percent in 2022 reflected a slight reduction in the trade deficit due to import compression and lower energy prices. In contrast to a contraction in exports of goods, services exports remained stable, especially in transport and tourism sectors. Latvia has continued to transition its trade away from Russia, as other euro area economies and China became more important sources of imports.

[4] Energy and food represent about 19.1 and 33.2 percent in the consumer price index, respectively, versus 10.2 and 20 percent for the euro-area average.

Exports to Lithuania, Sweden, UK, and the Netherlands have taken an increasing share of total Latvian exports, as trade with Russia declined.

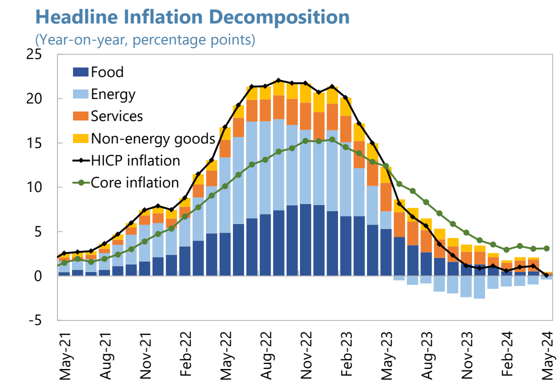
Text Figure 4. Latvia: Inflation Developments

Headline inflation declined markedly…



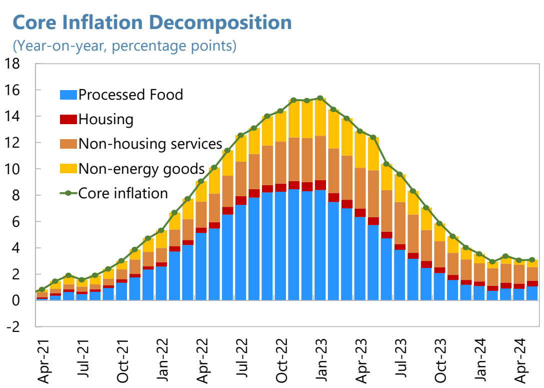
Source: World Economic Outlook, IMF.

…driven by lower food and energy prices.



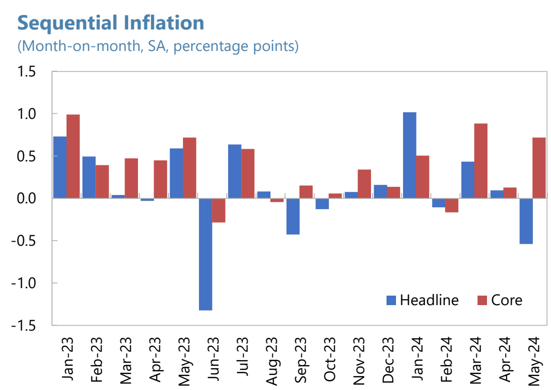
Sources: Eurostat; Haver Analytics; and IMF Staff Calculations.

Core inflation is elevated, driven by persistent non-housing services.



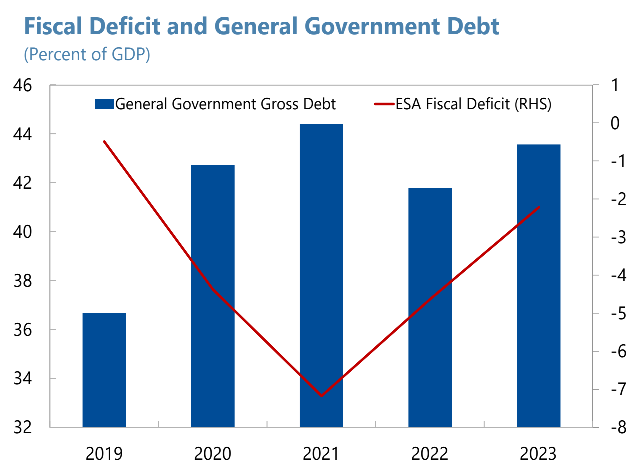
Sources: Eurostat; Haver Analytics; and IMF staff calculations.

In recent months, there has been a decline in headline inflation.



Sources: Haver Analytics and IMF staff calculations.

9. **Fiscal performance in 2023 was stronger than expected, reflecting revenue buoyancy linked to inflation and expenditure under-execution.** The headline ESA fiscal deficit declined to 2.2 percent in 2023 from 4.6 percent of GDP in 2022. As energy prices declined, spending on energy support measures was 0.5 percent of GDP below the target. Meanwhile, higher inflation helped boost tax revenue. The debt-to-GDP ratio increased to 43.6 percent of GDP in 2023 from 41.8 percent of GDP in 2022, but debt remains sustainable (Annex III).



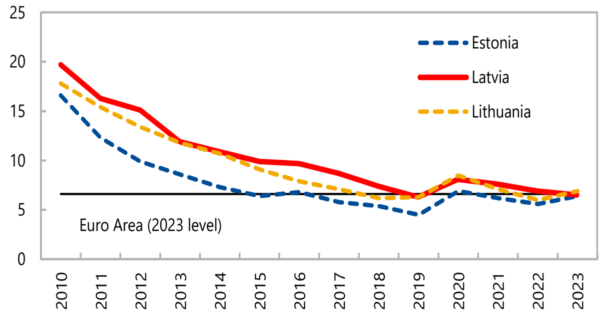
Sources: Authorities; and IMF staff calculations.

Text Figure 5. Latvia: Labor Market and Wages

Unemployment rate is historically low, in line with that of the other Baltics and the euro area.

Unemployment Rate

(Percent, ages 15-74)

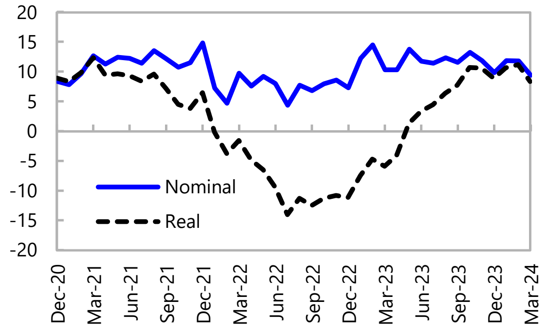


Source: Eurostat.

Real wages have caught up to pre-inflationary levels, thanks to double-digit nominal wage increases.

Average Gross Monthly Wages and Salaries /1

(Year-on-year growth, percent, not seasonally adjusted)

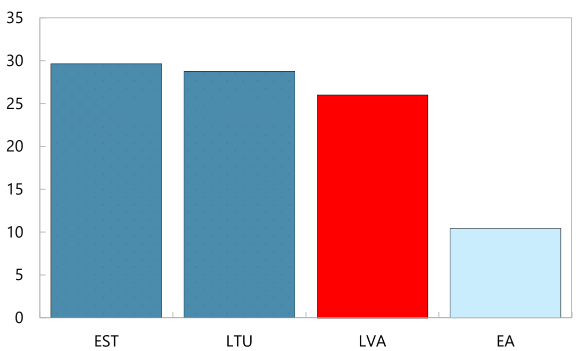


Sources: Haver Analytics and IMF staff calculations.
/1 Real series are deflated by HICP.

Although unit labor cost growth is below that of the other Baltics, it has outpaced that of the euro area.

Real Unit Labor Cost Growth

(In percent, change in real ULC during 2021-2023)

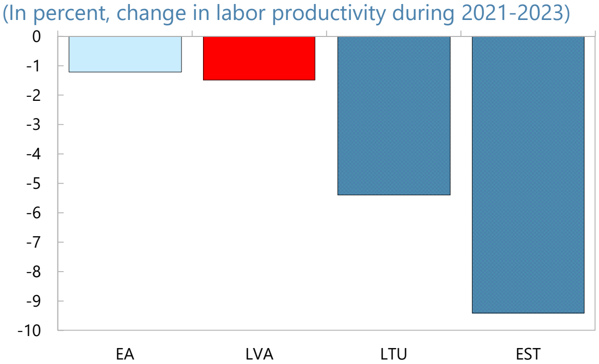


Sources: Haver Analytics and IMF staff calculations.

Labor productivity growth fell less than in the other Baltics, as post-pandemic employment recovery was much weaker in Latvia.

Labor Productivity Growth 1/

(In percent, change in labor productivity during 2021-2023)



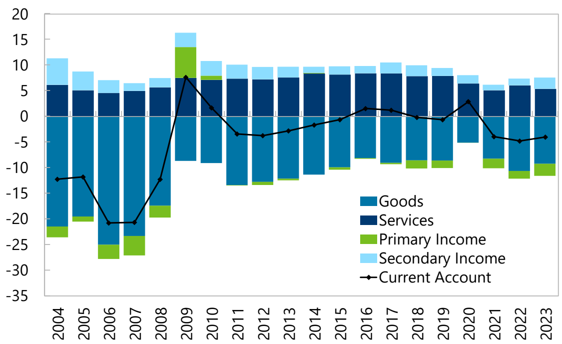
Sources: Haver Analytics and IMF staff calculations.
1/ Labor productivity defined as real GDP per hour worked.

10. **The financial sector has so far been resilient although risks are elevated.** The banking sector remained well capitalized and liquid, with a low NPL ratio at 2.4 percent in 2023 (Figure 7). Bank profitability was boosted by the rise in interest rates on loans. Despite the higher interest rates on term deposits, the share of term deposits remained low, thus attenuating the increase in banks' funding costs. Domestic credit growth moderated in 2023, reflecting the slowdown in growth and higher borrowing costs. Lending to non-financial corporations declined by 1.6 percent (y/y) in 2023, while mortgage loan growth decelerated from 4.6 percent (y/y) in 2022 to 1.6 percent in 2023, mostly due to tighter lending standard and higher interest rates (Figure 8). However, high frequency data suggest that growth in loans to NFCs picked up from 0.2 to 1 percent (y/y) in March-April 2024 and that mortgage loan growth accelerated slightly from 2.3 to 2.8 percent (y/y) during the same period. The main vulnerabilities relate to corporate and household credit risks (see Annex I, financial sector risks) given the prevalent share of variable-interest-rate loans to both

households and non-financial corporations (87 and 94 percent of outstanding loans respectively). Housing prices are still high by historical standards in Latvia, though housing price-to-wage ratios suggest a slight improvement in affordability in 2023 (Text Figure 7).

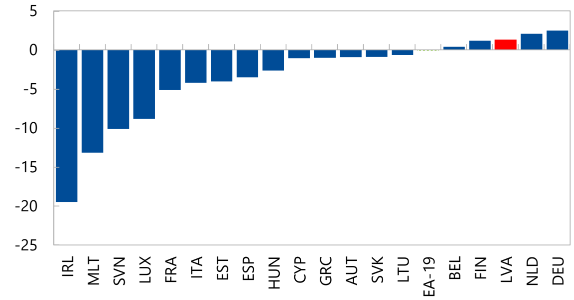
Text Figure 6. Latvia: External Sector Developments

Current Account
(Percent of GDP)



Sources: Haver Analytics; and IMF staff calculations.

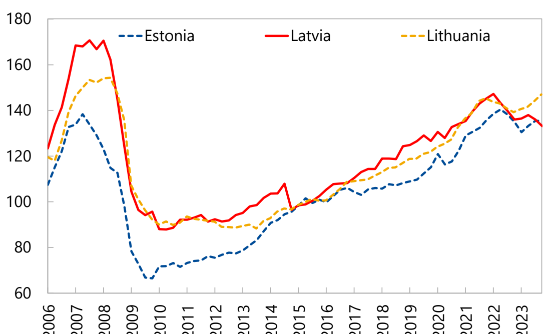
Terms of Trade: Goods 1/
(Percentage change between February 2024 and January 2021)



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

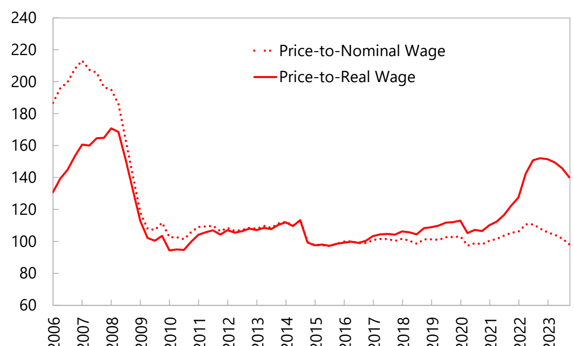
Text Figure 7. Latvia: House Prices

Real House Prices
(Index, 2015 =100; seasonally adjusted)



Source: OECD.

House Price Ratios
(Index, 2015 = 100; seasonally adjusted)



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

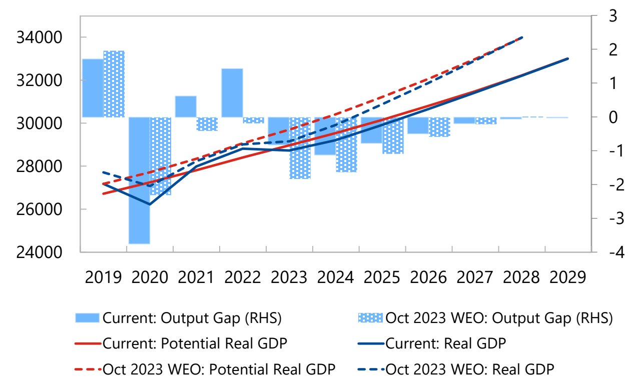
OUTLOOK AND RISKS

11. Short-term growth is projected to rebound (Text Table 1). Real GDP growth is projected to increase from -0.3 in 2023 to 1.7 and 2.4 percent in 2024 and 2025, respectively, largely driven by a rebound in private consumption, higher public investment, and stronger external demand. Fiscal policy will provide additional support to growth this year, reflecting the increase in the deficit. The output gap is forecasted to remain negative at 1.1 percent in 2024 before slowly closing over time.

12. Inflation is expected to continue to moderate. Headline inflation is projected to decline from 9.1 percent in 2023 to 2 percent in 2024 (annual averages), reflecting falling energy and food prices, while base effects and an increase in energy prices in 2025 (in the absence of energy support measures) will cause average headline inflation to increase slightly to 2.4 percent. Core inflation is expected to moderate from its 2023 level (9.8 percent) to 3.3 percent in 2024 but remain elevated, reflecting the lagged pass-through of energy prices and persistent services inflation, which is partly sustained by nominal wage growth. Both headline and core inflation are expected to approach the ECB's 2 percent target after 2026. Average nominal wages are expected to increase by 8.5 percent in 2024 (11 percent y/y in Q1), reflecting tight labor market conditions.

13. The recent shocks are expected to have scarring effects. Despite the temporary fiscal impulse to mitigate the effects of the Covid-19 pandemic and the war in Ukraine, a sustained impact is expected on economic output. Although energy prices have declined recently, the change in energy supply to Liquified Natural Gas from relatively lower-cost natural gas delivered by pipeline will keep energy prices above their pre-war levels. Therefore, permanently higher level of energy prices and production costs, along with lower TFP and labor productivity growth will result in scarring effects under the baseline. As a result, potential output growth is projected to slow to 2.1–2.5 percent in the medium-term (down from around 2.7–3 percent). Medium-term growth is projected at about 2.5 percent underpinned by reforms and public investment.

Real and Potential GDP
(LHS - Million Euros, RHS - Percent of potential GDP)



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

14. The current account deficit is projected to narrow gradually, driven by the recovery of external demand and some improvement in price competitiveness. Given the expected growth rebound in the euro area, Latvia's exports of goods and services are expected to grow at 3 percent in 2024 and around 2.5 percent during 2025–2029. Staff also expects some recovery in the price competitiveness of Latvian exports in the medium-term, as inflation and wage growth moderate, which may lead to a depreciation of real effective exchange rate. As a result, the current account deficit is expected to gradually narrow over the medium-term from 4 percent of GDP in 2023 to 3.7 in 2024, reaching 3.3 percent in 2029.

15. Amid high uncertainty, downside risks dominate (Annex I). The main risks stem from rising geopolitical tensions and deeper geoeconomic fragmentation, which could dampen confidence and result in renewed increases in energy prices and further monetary tightening. Credit risks related to the prevalence of variable rate loans and rising interest costs may weaken consumption and investment growth. Weaker-than-expected external demand would adversely affect the Latvian economy. Risks to competitiveness can also arise given recent high wage growth. Vulnerability to climate change also constitutes a risk. Over the medium-term, delays in public investment to boost productivity and structural reforms to address labor supply shortages could weigh on potential growth and delay the green transition. On the upside, swift implementation of reforms planned in the National Recovery and Resilience Plan (NRRP) could boost productivity.

Text Table 1. Latvia: Macroeconomic Projections, 2022–29

	2022	2023	2024	2025	2026	2027	2028	2029
Real GDP growth (percent)	3.0	-0.3	1.7	2.4	2.5	2.5	2.5	2.5
Output gap (percent)	1.4	-0.8	-1.1	-0.8	-0.5	-0.2	-0.1	0.0
Potential output growth (percent)	2.1	2.0	2.0	2.1	2.2	2.2	2.3	2.5
Headline inflation (average)	17.2	9.1	2.0	2.4	2.2	2.2	2.2	2.2
Core inflation (average)	11.3	9.8	3.3	3.1	2.5	2.2	2.2	2.2
Unemployment rate (LFS, percent)	6.9	6.5	6.5	6.5	6.4	6.4	6.3	6.3
Nominal wage growth (percent)	7.5	11.9	8.5	7.0	6.0	6.0	6.0	6.0
Current account balance (percent of GDP)	-4.8	-4.0	-3.7	-3.5	-3.5	-3.4	-3.4	-3.3
ESA fiscal balance (percent of GDP)	-4.6	-2.2	-2.9	-2.7	-2.6	-2.7	-2.7	-2.8
ESA structural fiscal balance (percent of potential GDP)	-5.3	-1.9	-2.4	-2.4	-2.4	-2.6	-2.7	-2.8
ESA structural fiscal primary balance (percent of GDP)	-4.7	-1.3	-1.5	-1.2	-1.1	-1.2	-1.3	-1.4
General government debt (percent of GDP)	41.8	43.6	44.7	44.8	45.2	45.7	46.1	46.6

Sources: Authorities and IMF staff projections.

Authorities' Views

16. **The authorities broadly agreed with staff's economic outlook and risks, though they are somewhat more optimistic than staff.** The Bank of Latvia expects higher growth in 2025, at 3.3 percent versus 2.4 percent under staff's projections, reflecting a more optimistic assumption about investment execution and stronger consumption recovery. However, like staff, they expect wage pressures and tight labor market conditions to have some second-round effects on core inflation, keeping core inflation above 3 percent in 2024 and 2025. The authorities believe that the risks are tilted to the downside as the geopolitical tension and geoeconomic fragmentation continue to weigh on confidence.

POLICY DISCUSSIONS

Near-term fiscal policy should balance upside risks to inflation and wage growth, and headwinds to growth, while the medium-term fiscal strategy should focus on creating the fiscal space to support public investment and address rising pressures from longer-term fiscal challenges. Although the financial sector continues to be resilient, continued monitoring of financial vulnerabilities and macrofinancial spillovers is warranted. Structural policies should focus on boosting investment and productivity, meeting new challenges from Russia's war in Ukraine and ongoing multiple transitions, while ensuring social support and policy predictability.

A. Fiscal Policy: Balancing Risks While Creating Fiscal Space

17. The 2024 budget is expansionary despite the expected improvement in domestic demand. The ESA cyclically adjusted fiscal deficit is projected to increase by 0.5 percentage points to 2.4 percent of potential GDP in 2024, mostly reflecting higher spending on the government's priorities (e.g., security, health, and education). Capital spending is also projected to increase, supported by the Recovery and Resilience Facility (RRF) and other EU structural funds. While the energy package continues to be phased out, the authorities amended the law on energy support to improve targeting. Discretionary revenue measures include an increase in VAT registration, an annual corporate income tax (CIT) surcharge of 20 percent for credit institutions and consumer lending service providers, and an increase in excise duty for tobacco products and alcoholic beverages.

18. Staff recommends a less expansionary, neutral fiscal stance in 2024. Given the improving outlook and upside risks from inflationary pressures, a risk-balancing approach that would call for a neutral near-term fiscal stance is warranted. Keeping the 2024 cyclically adjusted deficit broadly unchanged relative to the 2023 outcome would require an adjustment of about 0.5 percentage points of GDP. While underspending and revenue overperformance may deliver the desired stance in the end, proactively identifying and implementing deficit-reducing measures would send a stronger signal. A good way to achieve this is through improving spending efficiency and better targeting social support, while protecting the most vulnerable. Staff commends the authorities for the amended law on energy support, which improves the targeting of energy support measures.

19. The fiscal stance should be tighter in 2025 to build buffers to address future spending needs. Staff projects the ESA cyclically adjusted fiscal deficit to remain unchanged at 2.4 percent of potential GDP in 2025. Meanwhile, staff's baseline projects the headline ESA fiscal deficit at 2.7 percent of GDP in 2025.[5] Staff suggests that the 2025 budget considers revenue and spending adjustments to reduce the headline deficit further. Consistent with the medium-term strategy, fiscal consolidation reforms should include reducing tax exemptions, raising revenue from property taxation by updating cadaster values with market prices, broadening the tax base for direct taxes, and improving the efficiency of investment spending. These measures combined could deliver up to 0.5 percent in deficit reduction in 2025, which would be used to rebuild buffers for future spending needs. In addition, reforms should be initiated to reduce fossil fuel subsidies to yield savings in the medium-term.

20. Fiscal policy should remain flexible and evolve if risks materialize. Materialization of a sizable 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 notably higher inflation (e.g., energy price increases due to geopolitical tensions) would call for a tighter fiscal path while providing targeted support to the most vulnerable to prevent upward

[5] The government's stability program projects a headline ESA fiscal deficit of 2.7 percent of GDP in 2025, in line with staff's baseline.

price-wage dynamics and damage to competitiveness.

21. Under staff's baseline, the fiscal deficit is projected to improve temporarily in the medium-term (Text Table 2). The headline ESA fiscal deficit is expected to average 2.7 percent of GDP over the medium-term (2025-2029), while public debt is projected to average 45.7 percent of GDP. In the absence of new major tax policy changes, the tax-to-GDP ratio is projected to remain broadly stable in the medium-term, while spending is forecasted to remain relatively unchanged. Additional spending pressures are expected to arise from defense, aging, and climate change. These spending increases are manageable for Latvia in the medium-term but will accumulate in the long-term (Figure 1).

Text Table 2. Latvia: Indicators of Fiscal Performance Under Current Policies, 2024–29

(Percent of GDP, unless noted otherwise)

	2024	2025	2026	2027	2028	2029
Current policies						
Revenue	38.6	38.7	38.7	38.6	38.8	38.8
Expenditure	42.0	41.4	41.3	41.4	41.5	41.6
o/w: current spending	37.9	37.5	37.4	37.4	37.5	37.6
o/w: capital spending	4.1	3.9	3.9	4.0	4.0	4.0
ESA fiscal balance	-2.9	-2.7	-2.6	-2.7	-2.7	-2.8
ESA structural fiscal balance (percent of GDP)	-2.5	-2.4	-2.4	-2.6	-2.7	-2.8
ESA structural fiscal primary balance (percent of GDP)	-1.5	-1.2	-1.1	-1.2	-1.3	-1.4
ESA cyclically adjusted fiscal balance (percent of potential GDP)	-2.4	-2.4	-2.4	-2.6	-2.7	-2.8
General government debt	44.7	44.8	45.2	45.7	46.1	46.6

Source: IMF staff projections.

22. Although Latvia has some fiscal space, reforms are needed to provide buffers to address future spending challenges. Staff recommends reducing the deficit by about 0.5 percent of GDP annually over 2025-2029 to achieve the medium-term deficit objective (MTO) of a structural fiscal deficit of 1.0 percent of GDP by 2028 (Text Table 3).[6] This adjustment will also provide room for an increase in capital spending by about 0.4 percent of GDP over 2027-2029. This increase should boost infrastructure spending to: (i) reduce regional disparities and housing shortages, (ii) increase childcare facilities to raise labor market participation rates for women[7], and (iii) enhance research and development (R&D).[8]

[6] Effective 2025 the MTO will increase from 0.5 percent to 1 percent of GDP.

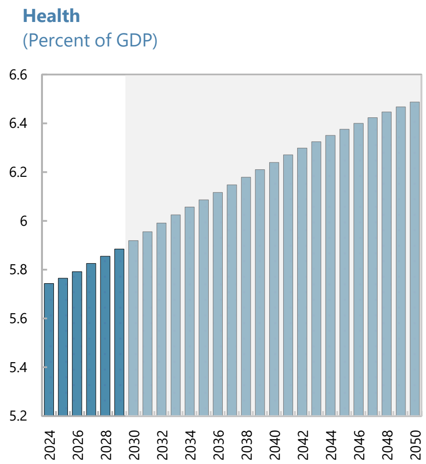
[7] The gender wage gap is particularly high for workers between 25 and 44 years (about 25 percent for Latvia compared to the OECD average of about 12 percent), which is during the period when women are performing child caring activities. Labor market participation rates for women in this age group are significantly lower than for men due to child caring activities (OECD Economic Surveys: 2024 Latvia).

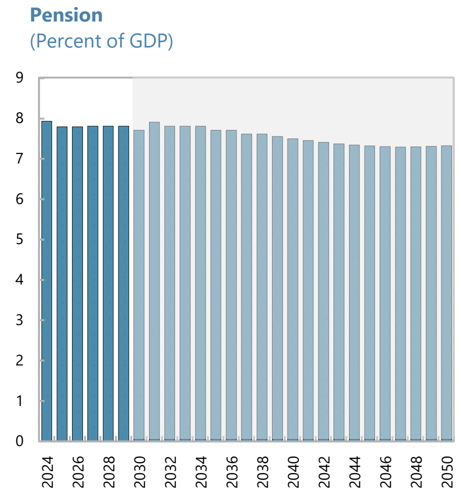
[8] In 2020, expenditure on R&D was 0.7 percent of GDP, below the OECD average of 2.9 percent of GDP (OECD Economic Surveys: Latvia 2024).

Figure 1. Long-Term Fiscal Pressures[1]

Aging pressures are expected to increase health spending from 5.7 percent of GDP in 2024 to 6.5 percent of GDP in 2050.

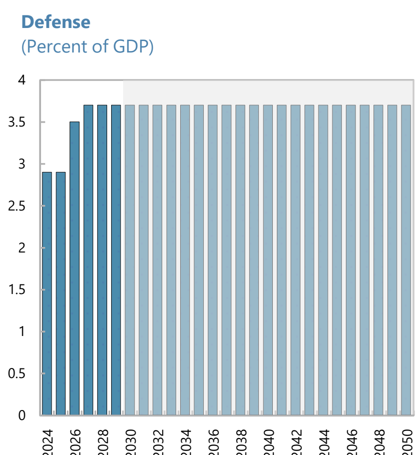
The authorities' projections in the EC 2024 Aging Report assume that a declining replacement rate and benefit ratio will reduce pension spending from 7.9 percent of GDP in 2024 to 7.3 percent of GDP in 2050 but appear optimistic from a pension adequacy perspective (See Note iii).

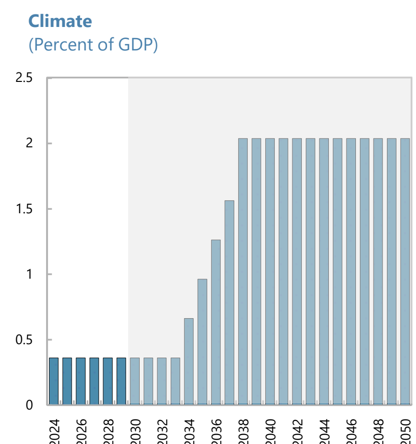




Due to geopolitical risks, defense spending is projected to increase from 2.9 percent of GDP in 2024 to 3.7 percent of GDP from 2027 onwards, beyond NATO's 2 percent of GDP target.

Climate spending needs, which are uncertain, are estimated at about 2 percent of GDP annually. The authorities are expected to delay climate spending until the mid-2030s, given other spending priorities.





[1] (i) Additional spending pressures for Latvia are estimated at around 2.6 percent of GDP by 2050, compared to 2024, lower than in advanced European economies (around 5.5 of GDP, see EUR REO, April 2024). (ii) Long-term spending needs for health and defense are similar to those in other Baltic countries. For instance, health spending is projected to increase from 5.6 to 6.4 percent of GDP in 2050 for Estonia, and 5.3 to 6.5 percent of GDP for Lithuania. Defense spending is estimated at 3.2 percent of GDP in Estonia from 2027 and 3 percent of GDP in Lithuania from 2030. (iii) The decline in the replacement rate and the benefit ratio is due to switching part of the public old-age scheme into privately funded schemes. However, this may not be sustainable given possible concerns about the adequacy of pension income for persons relying on public pension. Staff's projections for long-term pension spending are based on the EC 2024 Aging Report, and account for service and working-accident pension spending.

Source: IMF staff estimates.

Text Table 3. Latvia: Indicators of Fiscal Performance in Recommended Scenario, 2024–29
(Percent of GDP, unless noted otherwise)

	2024	2025	2026	2027	2028	2029
Recommended scenario						
Revenue	38.6	39.2	39.6	40.1	40.7	41.2
Expenditure	42.0	41.4	41.2	41.6	41.7	41.8
o/w: current spending	37.9	37.5	37.3	37.3	37.4	37.4
o/w: capital spending	4.1	3.9	3.9	4.4	4.4	4.4
ESA fiscal balance	-2.9	-2.1	-1.5	-1.5	-1.0	-0.6
ESA structural fiscal balance (percent of GDP)	-2.5	-1.9	-1.3	-1.4	-1.0	-0.6
ESA structural fiscal primary balance (percent of GDP)	-1.5	-0.7	-0.1	0.0	0.4	0.8
ESA cyclically adjusted fiscal balance (percent of potential GDP)	-2.4	-1.8	-1.3	-1.4	-1.0	-0.6
General government debt	44.7	44.3	43.6	43.1	41.9	40.4

Source: IMF staff projections.

23. In the medium-term, options to support fiscal consolidation can be explored on both the revenue and spending side. For instance, measures include (i) broadening the bases of corporate income tax (CIT) and personal income tax (PIT); including by reducing the shadow economy; (ii) broadening the base of property taxes; (iii) reducing tax exemptions and fossil fuel subsidies; and (iv) rationalizing spending on goods and services.

Potential Measures to Support Fiscal Consolidation

Measures	Estimated Impact (by 2029, percent of GDP)
Revenue	**2.4**
Property tax 1/	0.4
Broadening the PIT and CIT bases 2/	0.2
Tax exemptions (incl. fossil fuel subsidies) 3/	1.8
Expenditure	**0.2**
Goods and services	0.2
Total savings	**2.6**

Source: IMF staff calculations.
1/ To come closer to the euro area average of 1.4 percent of GDP, we propose an increase in property tax revenue of 0.6 percent of GDP.
2/ Given the high level of the informal sector in Latvia (22.9 percent of GDP in 2023), 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).

24. Additional reforms are needed to accommodate long-term spending pressures. Beyond 2029, the savings from the structural revenue and expenditure measures (approximately 1.7 percent of GDP) and the reduction in capital spending would help to provide fiscal buffers to address long-term spending challenges.[9] Additional measures could include:

- *Public investment management.* Significant investments are planned in green and digital transitions, healthcare, education, and affordable housing[10]. Given this scaling up of public investment amid high uncertainty and the large cost overrun in Rail Baltica (originally

[9] Beyond 2029, additional spending pressures are estimated at 1.7 percent of GDP, which will be offset by savings from structural revenue measures which is equivalent to 1.7 percent of GDP (i.e., the remaining structural revenues after 0.9 percent of GDP is used to address spending pressures by 2029).

[10] See the government's housing affordability strategy.

estimated at 4.6 percent and now at about 22.6 percent of 2024 GDP, see Annex VIII), urgent improvement in public investment management is warranted to mitigate fiscal risks.[11]

- *Healthcare*. Given Latvia's aging population, public health spending will increase on the back of higher elderly care. Improving the health and well-being of older workers could help to boost the quality and quantity of labor supply and raise productivity growth.[12] Staff welcomes the public health strategy, which aims to generate efficiency gains by consolidating the hospital network, promoting primary health care, and digitalizing health care management. This reform is expected to improve health care outcomes (e.g., life expectancy), while mitigating risks and supporting solidarity.
- *Pension*. Recent reforms raised the minimum contribution required for a pension from 15 years to 20 years effective January 2025. The mission welcomes the government's pension reform efforts to increase the retirement age by three months annually until it reaches 65 years in 2025 and recommends linking both the official and early retirement ages to future life expectancy gains to encourage longer work lives once the retirement age reaches 65.[13] Linking further increases in the statutory retirement age to improvements in life spans would help slow the inflow of new retirees and encourage older workers to remain in the labor force thereby boosting productivity. Staff stresses that the assumed decline in the replacement rate and the benefit ratio embedded in the authorities' long-term pension spending forecast (EC 2024 Aging Report[14]) may raise questions about the adequacy of the pension income for persons relying on public pension, generating upside risks for public spending needs.
- *Climate.* On climate, Latvia should use the investments planned under the NRRP to facilitate the green transition. An orderly shift towards a greener economy is important to ensure that industries and firms have sufficient time and resources to invest in sustainable practices and technologies and could yield long-term productivity benefits.[15] Also, tilting the balance away from fossil fuels towards pricing/carbon taxes could help achieve climate goals efficiently, while supporting fiscal sustainability (see Section C).

Authorities' Views

25. The authorities broadly agreed with staff's fiscal policy advice but saw benefits in a less ambitious adjustment in the short-term. They noted that fiscal policy will be expansionary in 2024 mainly because of an increase in security spending to strengthen border security and saw staff's recommended reduction of the cyclically adjusted deficit by 0.5 percentage points of potential GDP in 2025 as too ambitious. They noted that the recommend 2025 adjustment would be significantly higher than required by the new EU fiscal rules, and in a period of negative output

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[11] See IMF Country report No. 23/330.

[12] See IMF 2019, The Macroeconomics of Aging and Policy Implications.

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

[14] See EC 2024 Aging Report and Latvia - Country Fiche.

[15] The Impact of Climate Change and Policies on Productivity, ECB Occasional Paper Series, No. 340.

gap and fragile recovery a less restrictive fiscal stance would be more appropriate. They broadly agreed on the long-term spending pressures related to climate change, health, and defense, but expect a reduction in pension spending in line with the declining replacement rate. While the authorities agreed with staff's concern regarding the declining replacement rate from a socio-economic and pension-adequacy perspectives, they emphasized that they would secure the revenue to finance any additional long-term spending if needed. Therefore, they expect a decline in the structural primary balance as a share of GDP, which is the key indicator they use to gauge the medium- to long-term fiscal strategy. The authorities also plan to raise the structural fiscal deficit target from 0.5 to 1 percent of GDP to provide room for additional spending.

26. The authorities are committed to pursuing structural fiscal reforms. They are contemplating a tax reform this year, which will include lowering the tax burden for smaller income earners and reducing the labor tax burden to help decrease inequality. Given the lapse in the management of Rail Baltica, the authorities plan to strengthen project coordination by merging the various units in charge of project management with the help of OECD. Based on ongoing reforms, the retirement age will be increased to 65 next year.

B. Financial Sector Policies: Balancing Risks and Resilience

27. Given heightened risks, continued monitoring of financial sector vulnerabilities and macrofinancial spillovers is warranted.

- A regular risk-based monitoring of banks' asset quality supported by tailored stress testing should continue. Intensive supervisory monitoring is necessary to ensure prompt loan reclassification and adequate, forward-looking provisioning.

- Any households' financial distress related to variable-interest-rate mortgage loans should be addressed via the consumer bankruptcy framework, including early debt restructuring and out-of-court settlement, which could be supplemented by the social protection system. Although the new fiscal measure to subsidize interest expenses of variable-rate mortgage loan borrowers is budget-neutral as the subsidy is financed by revenues from the mortgage borrower protection fee (MBPF) on credit institutions, staff stressed that the subsidy is untargeted[16] and may hamper the transmission of monetary policy, and that the MBPF may affect banks' profitability and capital adequacy. Such discretionary fiscal measures should not be renewed at the expiration of the current law in 2024.

- Continued efforts in strengthening the financial infrastructure are necessary to contain risks related to cyberattacks. The mission welcomes the continued efforts to mitigate cybersecurity risk, including participation in ECB 2024 cyber resilience stress tests, education of market participants, and regular crisis preparedness exercises.

[16] It covers almost 99 percent of loans.

28. The current macroprudential policy stance is broadly appropriate but the recent adjustment for energy-efficient housing loans should be reconsidered. The overall policy stance strikes the right balance between maintaining financial stability and the need to support credit to the economy. The deviation of the loan-to-GDP ratio from the long-term trend remains negative, but the credit gap is narrowing.[17] Staff welcomes the authorities' recent decision to gradually raise the countercyclical capital buffer requirement from zero to a positive neutral rate of 0.5 percent in December 2024, and 1 percent in June 2025 (Text Table 4), to further build resilience, consistent with staff's advice. However, the recent adjustment to borrower-based macroprudential measures (BBM)[18] to promote energy efficiency of housing should be revisited. The authorities could consider other options to increase the energy efficiency of Latvia's housing stock. Macroprudential measures should be relaxed only in cases where their presence is overly restrictive from the financial stability perspective. It is appropriate for borrower-based measures (BBMs) to differ across loan segments only when the risk profiles differ significantly across such segments.

Text Table 4. Latvia: Macroprudential Measures

Borrower Based Measures		Capital Based Measures	
2007 May	**90% LTV** (95% for the State guarantee program participants)	2023 December	**O-SII buffer (0.25% – 2%)** (5 banks)
2020 June	**70% LTV** for buy-to-let mortgages* **40% DSTI*** **6 times DTI*** Maturity caps - **30 years*** (mortgages) and 7 years* (consumer loans)	2024 June	**80%** risk weight on commercial real estate exposures for banks with standardized approach
		2024 December	**CCyB (0.5%)**
2024 January	**45% DSTI*** for energy-efficient housing loans **8 times DTI*** for energy-efficient housing loans	2025 June	**CCyB (1%)**

*10 percent of institutions' total newly issued loans to households in a quarter may exceed relevant limits
Source: Bank of Latvia.

29. Staff welcomes the Bank of Latvia's (BoL's) enhanced climate risk oversight. The BoL's climate risk supervision identifies the flood risk as the most significant of physical climate change risks in Latvia. Its stress tests suggest that, even under a rather pessimistic risk scenario, the effect of flood risk on banks' assets is small—only 0.2 percent of banks' total domestic loan portfolio and 0.1 percent of banks' total assets would be affected.

[17] Financial Stability Report, Bank of Latvia, 2023.

[18] As of January 2024, the debt-service-to-income ratio limit was raised from 40 to 45 percent for energy-efficient housing loans; the debt-to-income ratio limit was raised from 6 to 8 times for such loans.

30. The authorities should refrain from further initiatives to increase taxes on bank profits[19]. They implemented a 20 percent corporate income tax advance payment for credit institutions, based on last year's earnings instead of distributed profits. While this measure is likely to have limited effect on bank profits and capital adequacy given the temporary profit boost from rising interest rates, further tax increases may undermine banks' capacity to extend credit to the economy, reduce their capital headroom, and weaken financial stability.

31. Latvia has made further progress in strengthening its AML/CFT and Governance and anticorruption frameworks. Staff positively note the authorities' effort to pursue AML/CFT reforms, including steps to amend the AML/CFT law in order to cover the revised requirements of Financial Action Task Force's Recommendation 4, steps to adopt the EU crypto assets regulation, and based on recent technical assistance provided by staff, updates in the banking sector ML/FT risk assessment model to account for geographical risks via analysis of cross-border financial flows. The authorities have recently created a centralized mechanism for sanctions implementation in Latvia (where the Financial Intelligence Unit is the authority in charge) and developed a machine-learning tool to detect cross-border payment anomalies. Staff supports the authorities' priorities to prepare for the 6th round of MONEYVAL AML/CFT evaluation. Staff welcomes the authorities' reforms to digitalize the procurement system and the continued implementation of Latvia's anti-corruption plan and national strategy.

Authorities' Views

32. The authorities broadly agreed with staff's advice, with some reservation on borrower-based macroprudential measures. They view the initiatives as a signal of support for sustainability and strategic autonomy and part of a broader mix of policies supporting the green transition. The recent slight and targeted relaxation will not influence credit risk, since the share of green housing is small and the degree of relaxation is conservatively calibrated to be cash flow neutral from a borrower's perspective considering that savings on energy improve capacity to service more debt on such energy efficient housing. The revised BBM framework remains prudent not only in Baltic but also EU perspective. They will continue to monitor closely the situation and stand ready to update the macroprudential measures if necessary. Regarding the housing market, the authorities do not assess any price overvaluation and see further room for prices to catch up with those in neighboring countries, which will incentivize builders to increase supply.

33. The authorities emphasized their strong commitment to pursuing further AML/CFT and governance reforms. Building on the progress made, the authorities have focused their efforts on the sixth round of MONEYVAL evaluation of ML and FT risks. They are confident that the upcoming evaluation will recognize the effectiveness of the AML/CFT framework. Regarding governance reforms, the authorities emphasized their successful implementation of most of the recommendations of the GRECO's evaluation.

[19] See IMF Regional Economic Outlook for Europe, April 2024.

C. Structural Policies to Enhance Productivity and Resilience

The overriding priority is to boost investment and productivity and meet new challenges from Russia's war in Ukraine and ongoing multiple transitions, while ensuring social support and policy predictability. Efforts should prioritize boosting investment through corporate reforms and enhancing productivity by facilitating structural transformation of the labor market, streamlining product and service market regulation, advancing digital transformation, and facilitating green and energy transition.

Boosting Investment by Corporate Reforms

34. Corporate reforms could improve allocation of capital and boost access to finance, thereby enhancing investment and productivity. By facilitating the exit of non-viable firms, insolvency reforms reallocate resources towards more viable ones, improving productivity. Staff welcomes the authorities' efforts in the transposition of the EU Directive 2019/1023 on restructuring and insolvency. Key areas of reform include (i) enhancing the restructuring procedure in the initial phase, which introduces the rights to revoke the moratorium and to request a longer duration thereof and (ii) streamlining the insolvency procedure for small businesses (e.g., individual merchants, farms, and fisheries). Staff looks forward to the initial assessment of the latest reforms. Regarding access to finance, the share of firms considering availability of finance as a major obstacle to investment is among the highest in the EU.[20] Given the large share of small firms and the high corporate equity gap, *corporate recapitalization*, including measures to promote domestic capital market development could improve SMEs' access to finance and help reverse Latvia's decade-long pattern of weak investment growth.[21] The listing of SOEs could also help improve their corporate governance and productivity.

Boosting Productivity by Labor and Product Market Reforms

35. Skilled labor shortages are a major impediment to firm growth, investment, and productivity.[22] Latvia faces skilled labor shortages due to an aging population and emigration, although the net migration was positive in 2023.[23] This limits productivity growth, underscoring the need to implement 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 and vocational training, 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, to help alleviate labor market shortages, the authorities have been relying on active labor market policies (ALMPs), including training and subsidy for mobility to regions with high unemployment rates and migration. Selected measures of EU member countries to address labor shortages are summarized in Annex V.

[20] Yashiro and others, 2019, "Policies for stronger productivity growth in Latvia", OECD WP No. 1671.
[21] See Latvia 2022 and 2023 Staff Reports.
[22] OECD (2017), OECD Economic Surveys: Latvia 2017, OECD Publishing, Paris.
[23] 2023 Latvia Staff report, "Analysis of the RRP of Latvia," European Commission (2021).

36. In this context, staff advises:

- *Promoting training and labor mobility towards priority sectors (green transition, digitalization, health)*. Efforts should focus on: (i) adjusting active labor market policies by reorienting training towards addressing skill shortages in priority sectors; and (ii) continuing to enhance and target lifelong learning programs to improve productivity.

- *Considering measures to adopt technology (including through AI) and* strengthening *migration processes.* Technology, including robotics and automation, may help reduce vacancies. For migrants, existing processes should be strengthened to avoid leakages through the posting of migrants in a third country.

- *Reducing employment protection.* Compared to the other Baltic countries, Latvia has stricter regulation for dismissals of regular workers.[24] Lowering employment protection while providing targeted social support, could facilitate structural transformation by improving labor mobility towards the most productive sectors and activities.[25]

- *Improving labor force participation for women* between 25 and 44 years to further reduce gender inequality. Increasing investments in childcare facilities and addressing labor shortages through expanding training and flexible work arrangements is key for securing a sufficient supply of high-quality childcare services and improving labor market outcomes for women.[26]

37. Product and service-market reforms could enhance competition, innovation, and productivity. The burden of government regulation is perceived to be higher in Latvia than in other Baltic countries.[27] According to the 2023 Product market regulation indicators, Latvia still ranks below the OECD average in the competition assessment of regulation, while at the same time market entry barriers in service sectors with high presence of SOEs are still among the highest in OECD.[28] According to the BoL's survey of real estate developers, it takes longer to approve construction documentation in Latvia than in Estonia and Lithuania.[29] Therefore, further streamlining spatial planning and construction regulation could benefit the housing market and investment, including in the green sectors. Staff urged the authorities to expedite and disseminate to investors the Green Channel Law, which aims to reduce regulatory burden and accelerate green investments and foreign direct investments[30] in high-value-added sectors. The mission welcomes

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[24] OECD Employment Outlook 2020: Worker Security and the COVID-19 Crisis.
[25] See Martin, J. and S. Scarpetta, "Setting it Right: Employment protection, Labor reallocation and productivity. paper-flex-martin-2.pdf (cpb.nl).
[26] OECD Economic Surveys: 2024 Latvia.

[27] See World Economic Forum (https://single-market-scoreboard.ec.europa.eu/business-framework-conditions/administration_rules_en).

[28] 2024 OECD Economic Survey for Latvia, pp. 51.

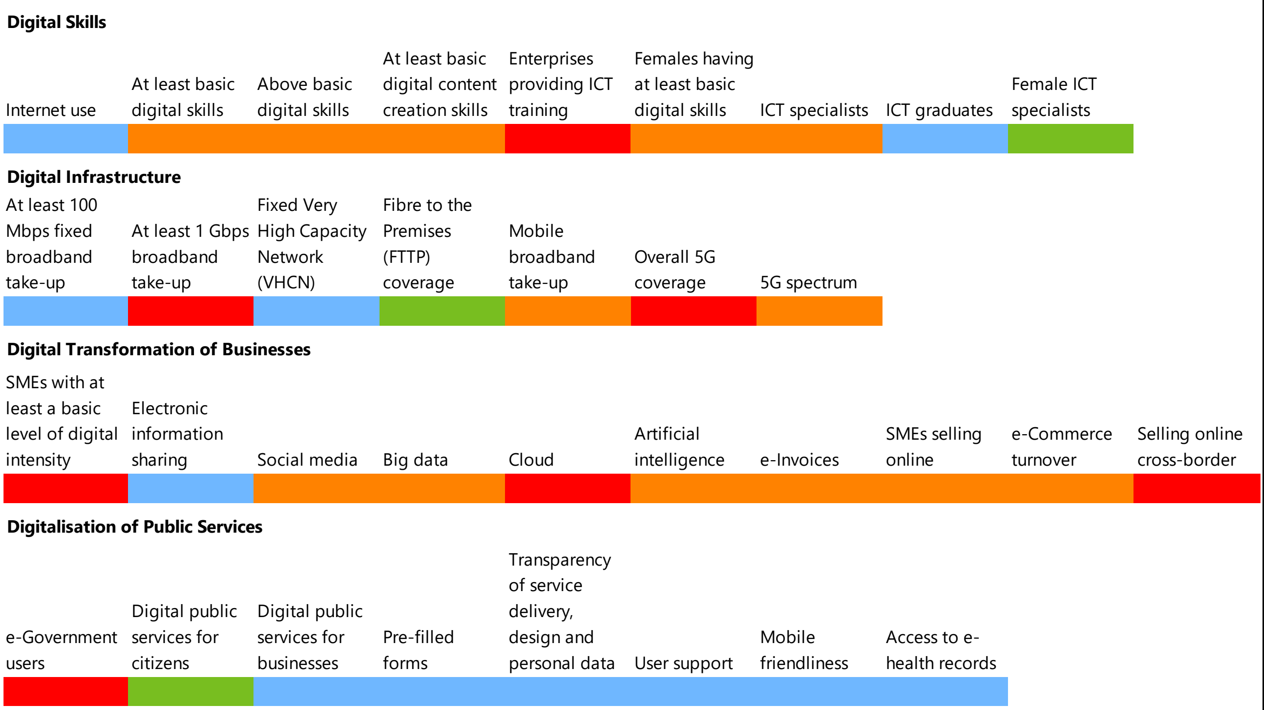
[29] See Bank of Latvia, 2022, Financial Stability Report.

[30] See Annex V, IMF Staff Report for the 2023 Republic of Latvia Article IV Consultation.

the ongoing overhaul of the administrative procedures and the digitalization of administrative procedures related to the construction sector.

38. Staff encouraged the authorities to implement measures to promote digitalization, focusing on (i) enhancing connectivity, adoption and use of digital technologies, digital innovation, and providing training on digital technologies; and (ii) implementation of NRRP measures focusing on digitalization (2022 Latvia Staff Report). Strengthening Latvia's digital transformation could help reduce labor shortages and support productivity (OECD, 2019, and 2023 Latvia Staff report).

Text Figure 8. Latvia: The Digital Economy and Society Index, 2023



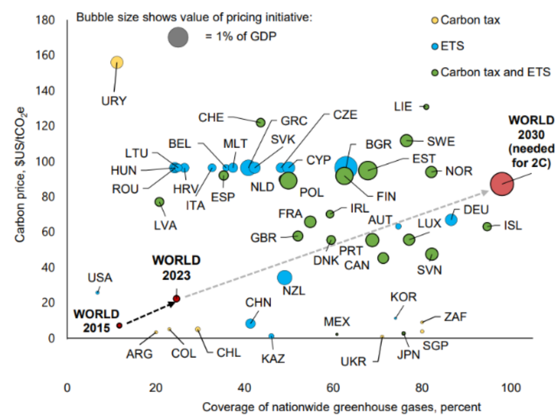
Sources: European Commission, the Digital Economy and Society Index (DESI); and IMF staff calculations.

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.

Climate Change Policy and Energy Security

39. Climate risks are expected to dampen productivity. For instance, a rise in temperatures is expected to reduce productivity through its impact on labor, capital, and total factor productivity. Climate change risks could also entail financial stability risks with negative implication on credit to the economy and NFC profitability.

Explicit Carbon Pricing Schemes, 2023



Source: S. Black, I. Parry and K. Zhunussova, IMF Staff Climate Note 2023/002.

40. However, the green transition's impact on productivity is less clear-cut. The green transition will be accompanied by a significant reallocation of capital and labor, which could lower conventional measures of productivity.[31] Carbon pricing or new environmental regulations could also incentivize innovation, thereby improving productivity. For example, there is evidence that in the medium to long run an orderly[32] green transition is associated with a markedly higher labor productivity.[33]

41. More vigorous climate policy is urgently needed because Latvia's greenhouse gas emissions have increased since 2000, against the trend in the EU. The climate law and the National Energy and Climate Plan (NECP) are expected to be adopted by the end of the year to ensure policy predictability and certainty. Latvia's 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, increasing investments and transitioning to renewable energy (mainly wind 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. The NRRP also aims to enhance energy efficiency in private and public buildings and modernize and green electricity networks.

42. A critical issue is to achieve a robust balance among subsidies/fiscal support, carbon pricing or similar fiscal instruments, and norms, while addressing distributional concerns:

- *Pricing/carbon taxation.* At 20 percent, the share of Latvia's emissions covered by the European Union's ETS is the lowest in EU. Efforts should focus on designing measures to extend carbon

[31] See October 2020 World Economic Outlook, Chapter 3.

[32] An orderly transition assume that climate policies are introduced relatively early and become gradually more stringent over time.

[33] October 2020 World Economic Outlook, Chapter 3 and European Central Bank (2024): The Impact of climate change and policies on productivity, Occasional Paper Series, No. 340.

pricing to emissions not covered by the EU ETS and enhance effectiveness of carbon taxation on sectors with the largest non-ETS emissions, such as transport and agriculture.

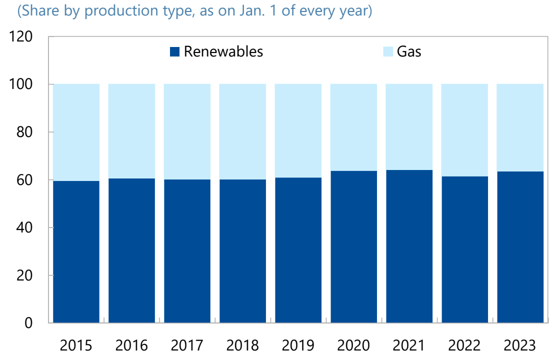
- *Implicit fossil fuel subsidies.* Removing implicit subsidies (estimated at 3.1 percent of GDP in 2022), particularly the favorable tax treatment of diesel for vehicle use would help equalize abatement costs across activities, promoting efficient decarbonization.[34]

43. Given the damages from recent extreme climate events in Latvia (extreme heat waves, floods, and hail), staff welcomes the ongoing work on climate adaptation focusing on: (i) integrating adaptation into long-term planning frameworks of the government; (ii) adaptation with large positive externalities (e.g., climate risk research, updating building codes, strengthening infrastructure, early warning systems), and (iii) addressing distributional concerns.[35] Work on updating the adaptation strategy is also ongoing in close coordination with municipalities.

44. Latvia should continue to enhance energy security in line with staff advice, including by increasing renewable energy in the mix (Text Figure 9) and boosting investment in clean energy and connections.[36] As recommended by the European Commission, this entails setting a more ambitious target for renewable energy share of at least 61 percent of gross final energy consumption by 2030 (currently 57 percent), and specifying measures to achieve this binding target.[37]

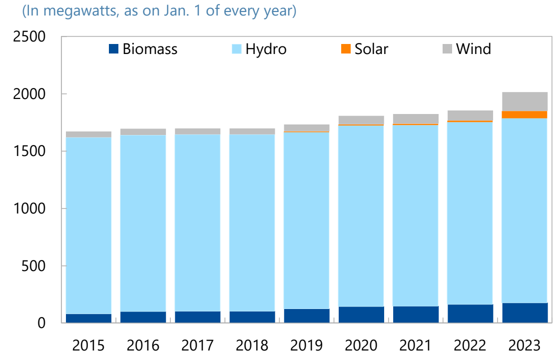
Text Figure 9. Latvia: Electricity Capacity and Renewables

Installed Generation Capacity of Electricity
(Share by production type, as on Jan. 1 of every year)



Sources: Entsoe Transparency; and IMF staff calculations.

Installed Renewable Generation Capacity of Electricity
(In megawatts, as on Jan. 1 of every year)



Source: Entsoe Transparency.

[34] See Parry and others, 2023 IMF Working paper, "IMF Fossil Fuel Subsidies Data: 2023 Update."

(https://www.imf.org/en/Publications/WP/Issues/2023/08/22/IMF-Fossil-Fuel-Subsidies-Data-2023-Update-537281) and the related database (https://www.imf.org/-/media/Files/Topics/energy-subsidies/EXTERNALfuelsubsidiestemplate2023new.ashx).

[35] See Latvia 2023 Article IV Staff Report.

[36] See Latvia 2022 Article IV Staff Report.

[37] See EC's recommendation 2024/1035 on Latvia's NECP.

Authorities' Views

45. The authorities agreed with staff's policy advice on climate change and energy security. They stressed that work is under way to design carbon taxation to make faster progress towards emissions goals. The upcoming climate law will be an important tool to enforce climate policies going forward. Together with the upcoming law, the NECP is key to ensuring policy predictability and certainty. The authorities emphasized that the creation of a new ministry dealing with climate, energy, and environmental policies is a clear signal for the government's commitment to the green transition.

46. Further progress has been made on corporate and regulatory reforms. Following the transposition of the EU Directive 2019/1023 on restructuring and insolvency, the authorities look forward to the initial assessment of the latest reforms. The authorities continue their efforts to develop capital markets, while the Development Financial Institution (ALTUM) has been implementing a program to help start-ups and SMEs through credit guarantees and loans. The authorities are working on initiatives, such as cumulative assessment of the overall impact of multiple regulations and streamlining processes including those in the real estate development, to reduce the regulatory burden.

47. The authorities agreed with staff's labor market advice. On the employment protection, they plan to amend the labor law by removing an old provision for authorization by third party (trade unions) of the dismissal of unionized workers. This change is expected to bring the labor protection regulation in line with that in neighboring Baltic countries. Regarding migration, they are planning to take targeted measures to increase migration for the ICT sector where they have considerable skilled labor shortages.

48. The Latvian authorities continue to implement a comprehensive and ambitious action plan on digitalization. A key priority is innovation, where Latvia has managed to achieve a leading role, for example, in quantum computing within the European Union. Building on the successful program, Riga TechGirls, the authorities have made renewed efforts in training IT specialists, including providing high-quality training to female students in STEM. Although cybersecurity threats have abated, the cybersecurity infrastructure has been strengthened to withstand increased cybersecurity threats from abroad. Implementation of the digitalization component of the Recovery and Resilience Mechanism continues with uneven success.

STAFF APPRAISAL

49. Latvia's economy has encountered severe headwinds. The Latvian economy contracted with significant disinflation against the backdrop of geopolitical headwinds. Notably, Russia's war in Ukraine and the related geoeconomic fragmentation are adding to long-standing challenges to productivity, investment, and labor supply, amid multiple transitions around climate change and energy, aging and labor shortages, and rising defense costs.

50. Amid high uncertainty, growth is projected to rebound, but risks are tilted to the downside. Real GDP growth is projected to increase in 2024 and 2025, largely driven by a rebound in private consumption, higher public investment, and stronger external demand. The main risks stem from rising geopolitical tensions and deeper geoeconomic fragmentation, credit risks related to variable-rate loans, and weaker-than-expected external demand. Risks to competitiveness can also arise given recent high wage growth. Over the medium-term, delays in public investment and structural reforms could weigh on potential growth.

51. Considering the improving outlook, staff recommends a less expansionary, neutral fiscal stance for 2024 and a tighter fiscal stance in 2025. Proactively identifying spending efficiency and better targeting social support, while protecting the most vulnerable, would help. Staff commends the authorities for the targeting of energy support measures. In 2025, the fiscal stance should be tighter to build buffers for future spending needs. Policy options to achieve this include reducing tax exemptions, raising revenue from property taxation, strengthening tax enforcement, and improving investment spending efficiency. Fiscal policy should remain flexible and evolve if risks materialize.

52. Although Latvia has some fiscal space, structural fiscal measures are needed to provide buffers for medium to long term spending pressures. Over the medium term, options for fiscal consolidation include (i) broadening the bases of corporate income tax (CIT) and personal income tax (PIT), including by reducing the shadow economy; (ii) broadening the base of property taxes; (iii) reducing tax exemptions and fossil fuel subsidies, and (iv) rationalizing spending on goods and services. Given this scaling-up of public investment amid high uncertainty and cost overrun, enhanced public investment management is warranted to mitigate fiscal risks. The mission welcomes the healthcare reform aimed to generate efficiency gains, while mitigating risks and supporting solidarity. Staff also welcomes the government's pension reform efforts and recommends linking the retirement age to life expectancy. Latvia should swiftly implement the NRRP.

53. Although the financial sector has so far been resilient, continued monitoring of macrofinancial vulnerabilities and spillovers is warranted. 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. Any households' financial distress related to variable-interest-rate mortgage loans should be addressed through the consumer bankruptcy framework, supplemented by the social protection system for the most vulnerable. The new untargeted interest subsidy scheme for variable-interest-rate mortgages should not be renewed at its expiration in 2024. The authorities should refrain from further initiatives to increase taxation on bank profits given their adverse impact on bank capital and financial stability. Staff welcomes the continued efforts to mitigate cybersecurity risk.

54. While the current macroprudential policy stance is broadly appropriate, the recent adjustment to the borrower-based measures for energy-efficient housing loans should be reconsidered. The overall policy stance strikes the right balance between maintaining financial stability and the need to extend credit to the economy. However, borrower-based macroprudential measures should be relaxed only when their presence is overly stringent from the financial stability perspective.

55. Latvia has made significant progress in strengthening its AML/CFT frameworks and governance reforms. Staff commends the authorities' effort to pursue AML/CFT reforms and supports the authorities' priorities to prepare for the 6th round of MONEYVAL evaluation. Staff welcomes the authorities' reforms to digitalize the procurement system and the continued implementation of Latvia's anti-corruption plan and national strategy.

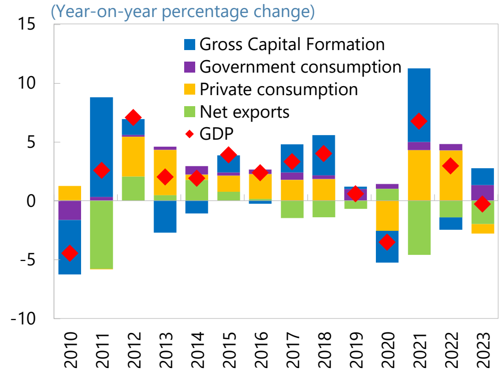
56. Structural reforms should be accelerated to enhance productivity and resilience. Accelerating corporate reforms could boost investment and productivity by improving capital allocation and access to finance. Given the aging population and skill mismatch, Latvia should continue to address reforms to boost high-skilled labor supply which will enhance investment in productivity. Efforts should focus on promoting training and internal labor mobility toward priority sectors (green and transition, digitalization, health). Further streamlining product and service markets regulations could boost competition, innovation, and productivity. Staff welcomes the ongoing overhaul of the administrative procedures and their digitalization. Implementing measures to promote digital transformation of the economy could help reduce labor shortages and support productivity. Regarding the green and energy transition, more vigorous climate policy is needed. Staff encourages the authorities to expedite the adoption of the climate law and the National Energy and Climate Plan (NECP). The authorities should aim to achieve a robust balance between fiscal support, carbon pricing or taxation, and norms while addressing distributional concerns. Staff welcomes the ongoing work on climate adaptation. Latvia should continue to enhance energy security, and boost investment in clean energy and connection.

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

Figure 2. Real Sector and Inflation Developments

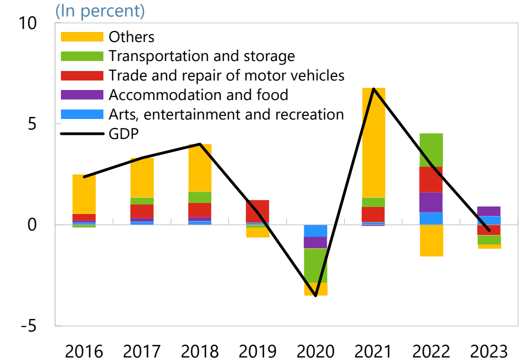
GDP growth declined, driven by a decline in consumption and net exports.

GDP Growth and Contributions
(Year-on-year percentage change)



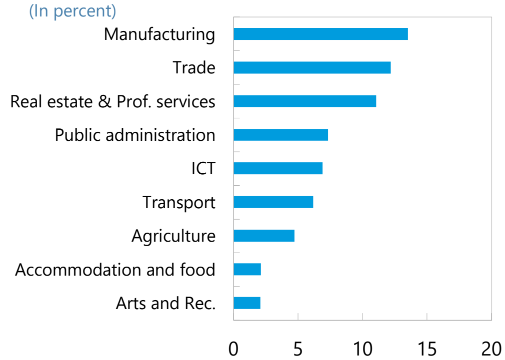
Growth contribution of arts, entertainment, recreation, accommodation, and food remained positive...

Contribution to GDP Growth
(In percent)



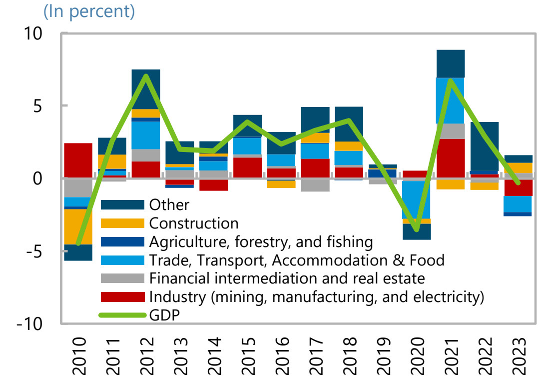
...though their share in gross value added in the economy is not large.

Share in Gross VA, 2023
(In percent)



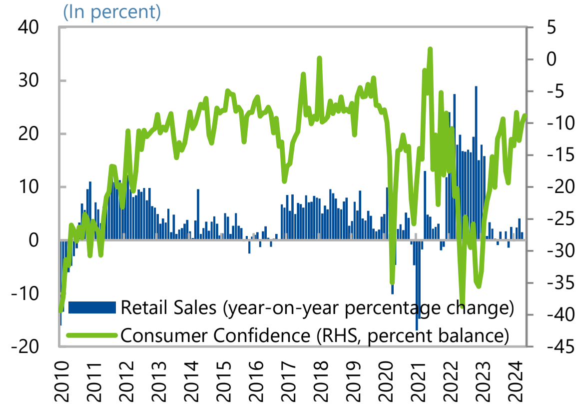
Growth contribution of construction rebounded.

GDP Growth by Production
(In percent)



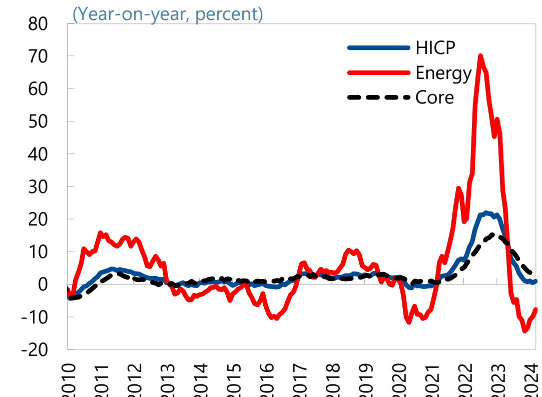
Retail sales growth declined from previous highs.

Retail Sales
(In percent)



A decline in energy prices caused inflation to decelerate.

HICP Inflation
(Year-on-year, percent)

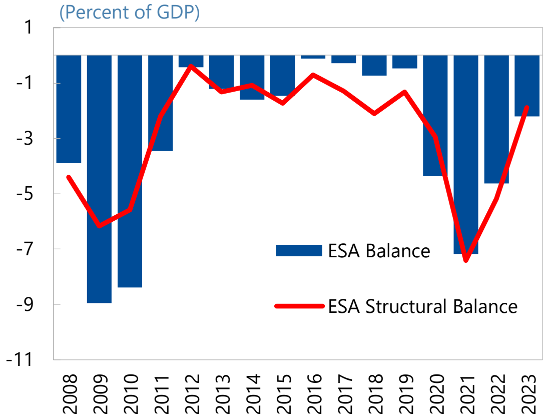


Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 3. Fiscal Sector Developments

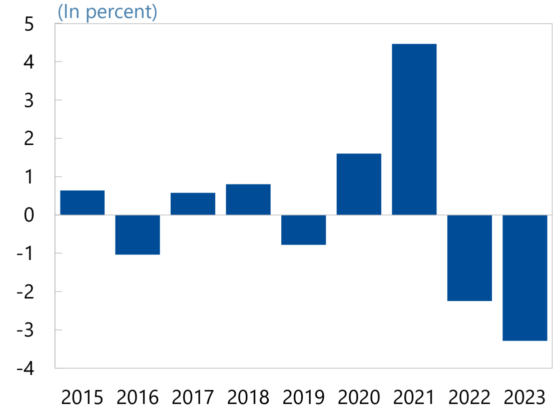
Fiscal balances improved…

General Government Balance (ESA 2010)
(Percent of GDP)



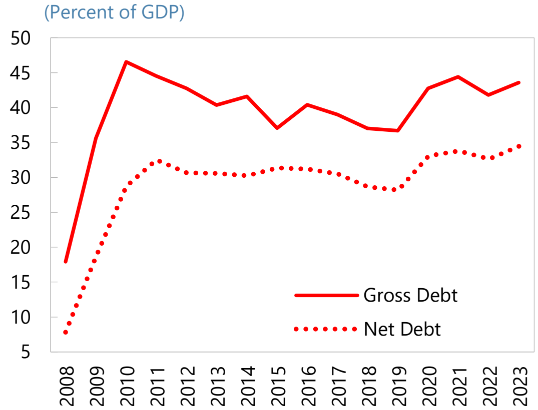
…as significant crisis relief measures were scaled back.

Fiscal Impulse
(In percent)



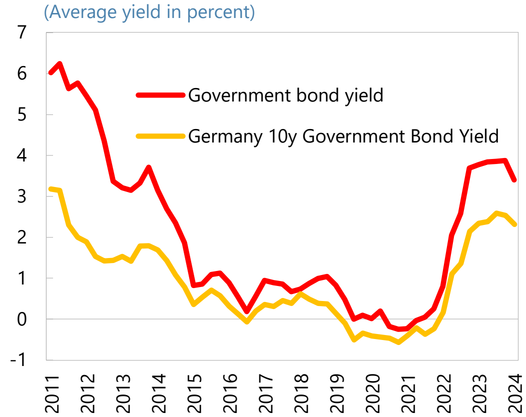
Public debt has inched up.

Gross vs. Net Public Debt (Maastricht definition)
(Percent of GDP)



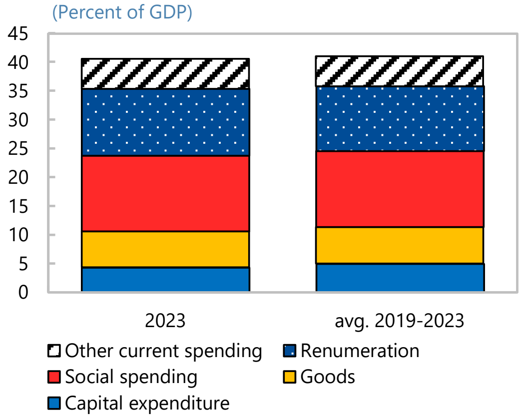
While the tightening of financial conditions caused an increase in bond yields.

Govt Bond Yields-Avg Maturity of 10 Years
(Average yield in percent)



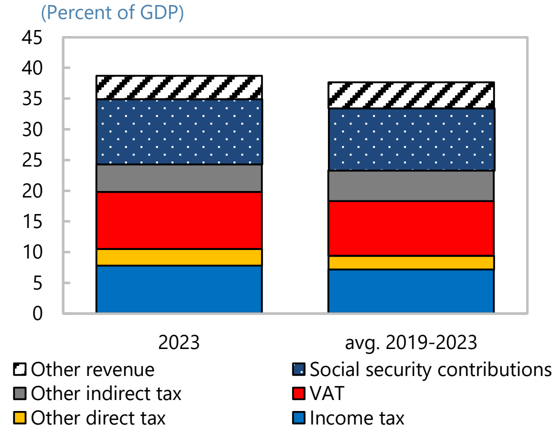
Social spending remained relatively unchanged…

General Government Expenditures, 2023
(Percent of GDP)



…while revenue sources held up.

General Government Revenues, 2023
(Percent of GDP)

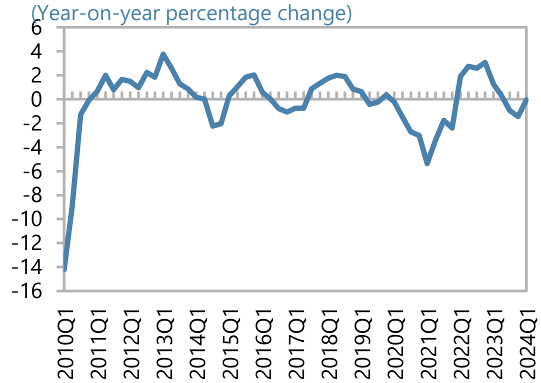


Sources: Latvian authorities; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Labor Market Developments

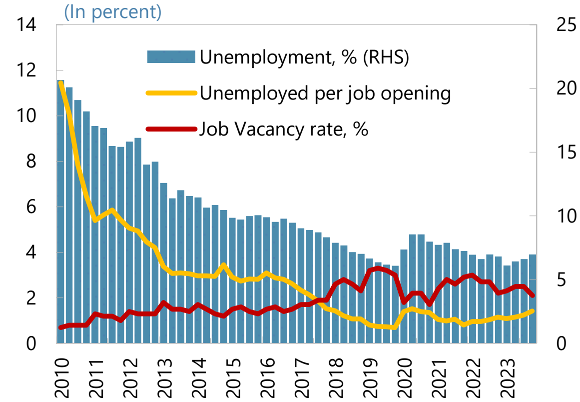
Employment growth increased recently.

Employment Growth
(Year-on-year percentage change)



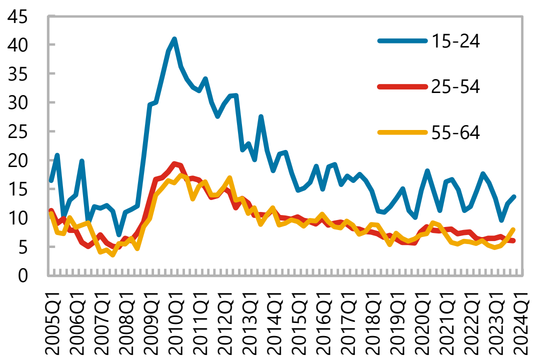
Overall the unemployment rate declined in 2023.

Unemployment and Job Vacancies
(In percent)



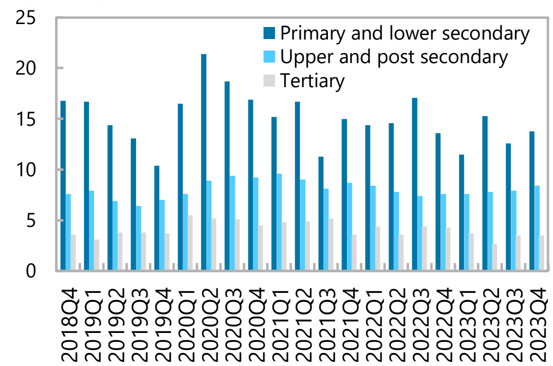
The unemployment rate is higher among the young…

Unemployment Rate by Age Group
(Percent)



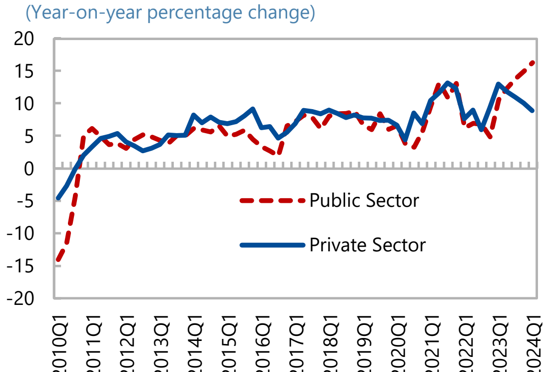
…and those with lower education.

Unemployment Rate by Education
(Percent)



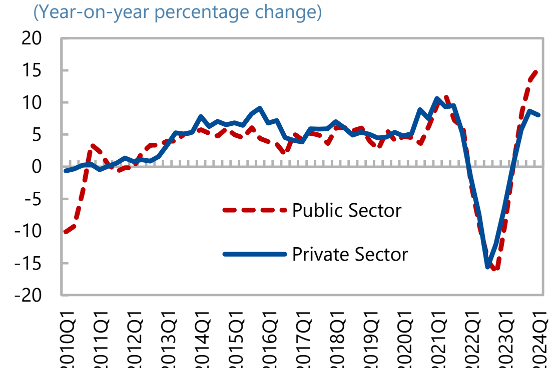
Nominal wage growth increased, mainly in the public sector…

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



…causing real wage growth to turn positive.

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

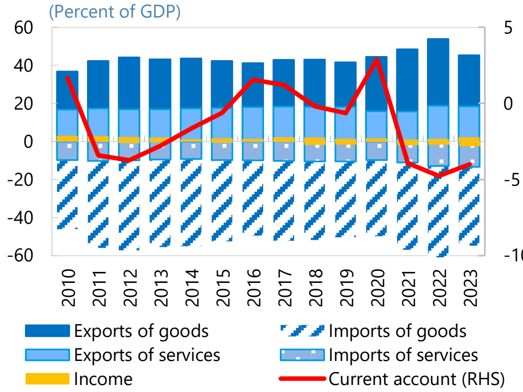


Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

Figure 5. External Sector Developments

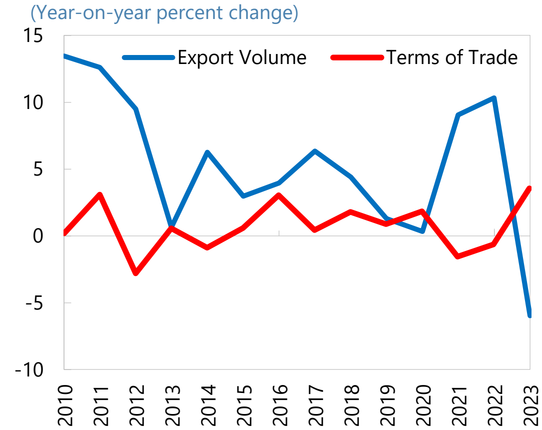
The current account deficit narrowed in 2023...

Current Account
(Percent of GDP)



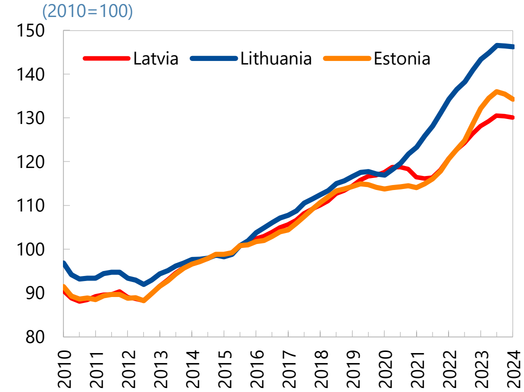
... despite a decline in export volume.

Terms of Trade and Export Volume
(Year-on-year percent change)



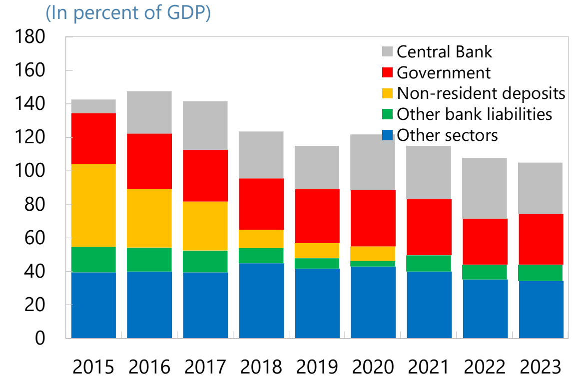
REER appreciation led to erosion of price competitiveness in 2023.

Real Effective Exchange Rates 1/
(2010=100)



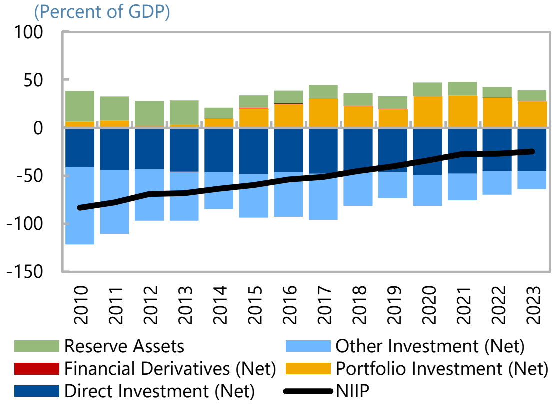
The total external debt burden decreased.

Composition of External Debt
(In percent of GDP)



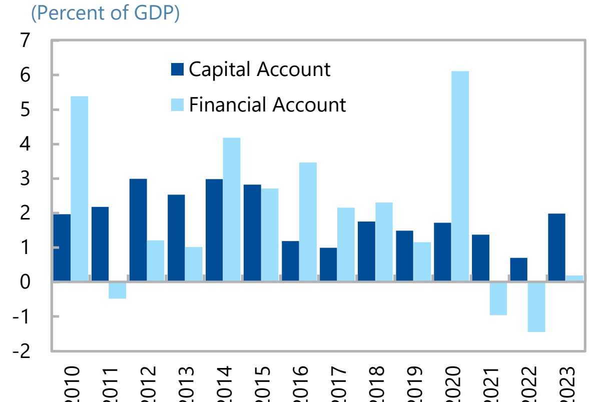
The NIIP remained relatively unchanged...

Net International Investment Position
(Percent of GDP)



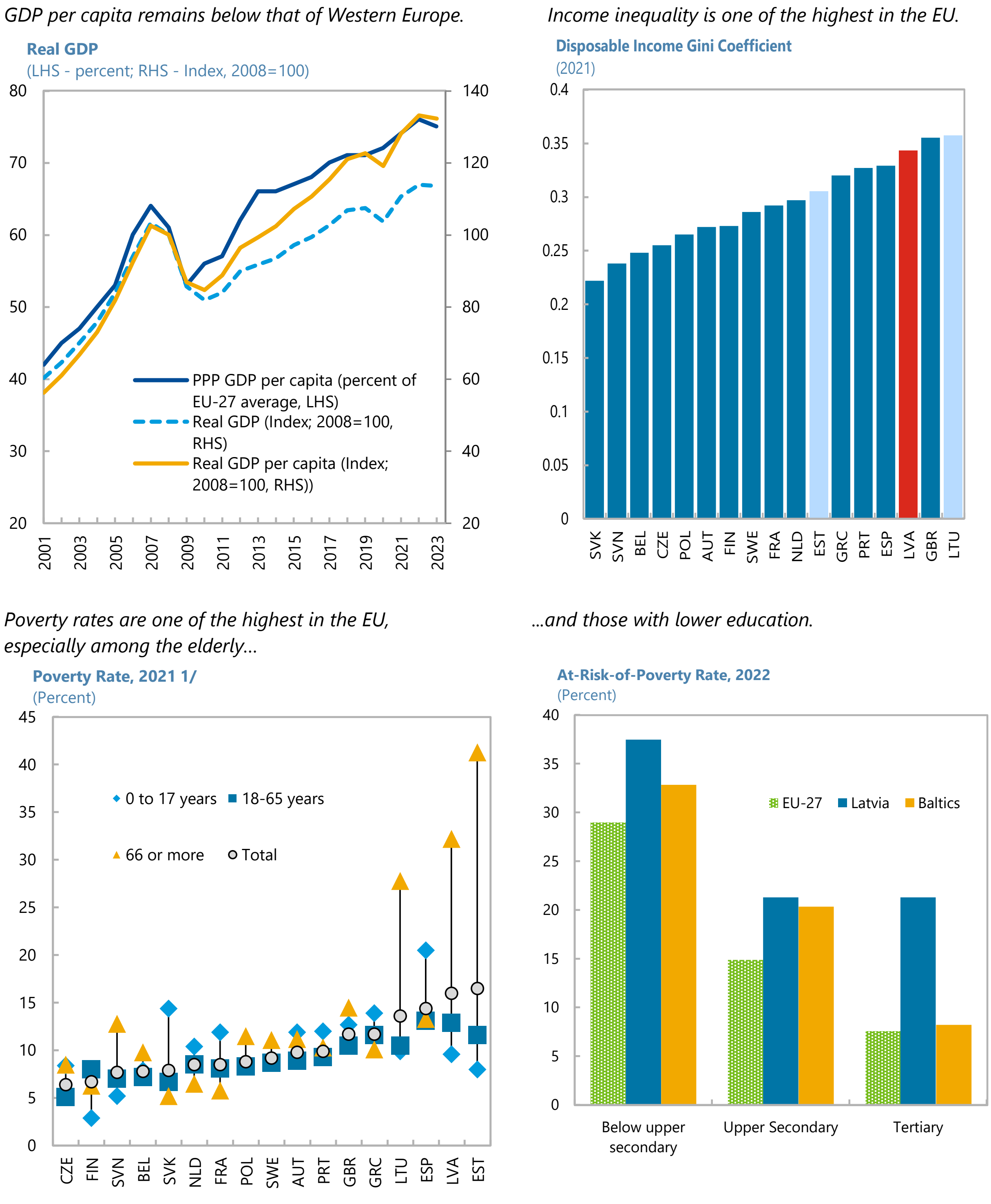
...and the financial account balance turned positive.

Capital and Financial Account Balance
(Percent of GDP)



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

Figure 6. Inequality and Poverty Indicators

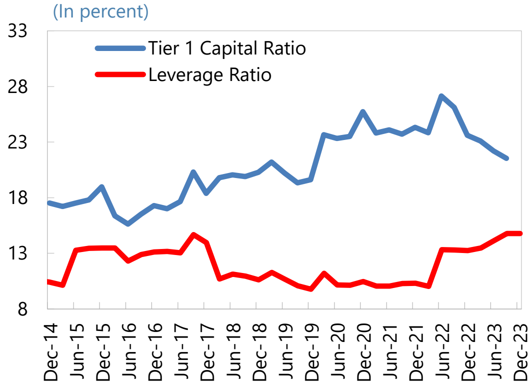


Sources: OECD, Eurostat; and IMF staff calculations.
1/ Poverty rate based on 50% of the national median disposable income.

Figure 7. Banking Sector Developments

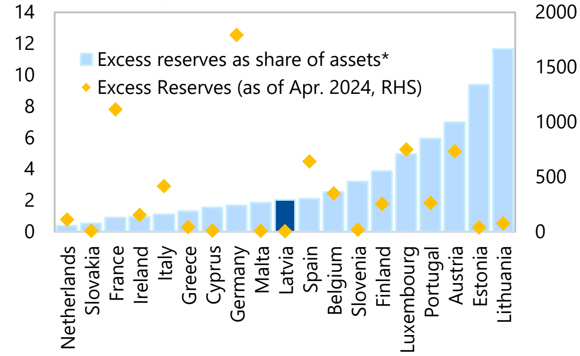
Banks hold adequate capital buffers…

Leverage and Tier 1 Capital Ratios
(In percent)



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

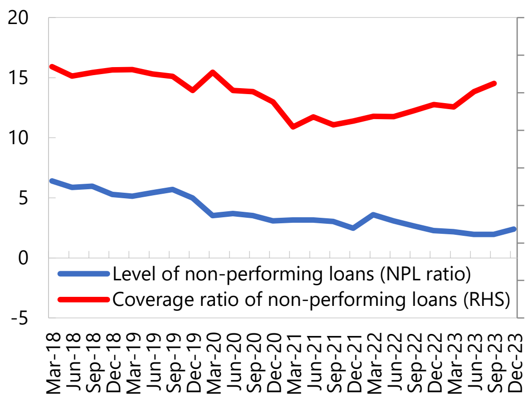
Euro Area: Distribution of Excess Reserves
(LHS - basis points; RHS - in millions of Euros)



Note: * consolidated assets as of April 2024.

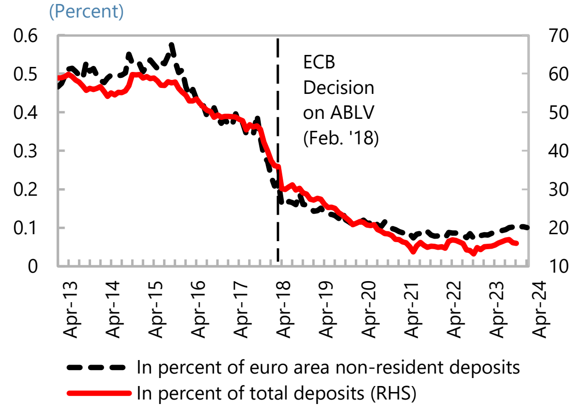
NPL ratio remained low.

NPLs and Coverage
(In percent)



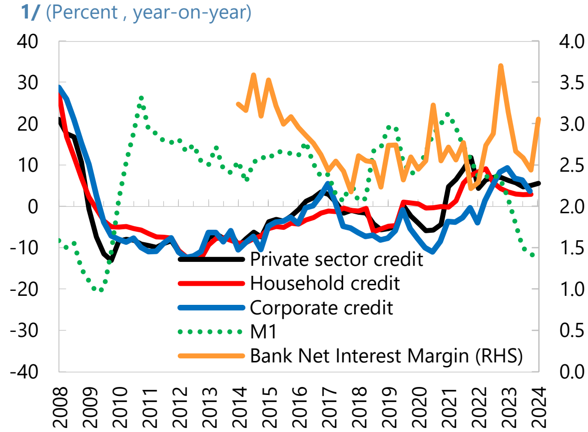
The retrenchment of non-resident deposits reduces the risk of money laundering.

Latvia Banking Sector: Non-Resident Deposits
(Percent)



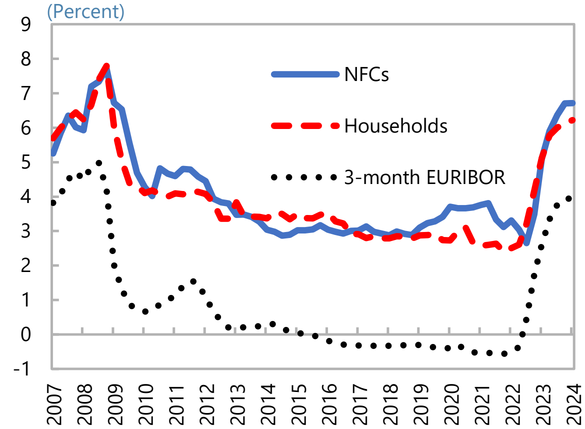
Interest margins are on the rise…

Credit Growth, Monetary Aggregates, and Bank Profitability 1/ (Percent , year-on-year)



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

Interest Rates on New Loans
(Percent)

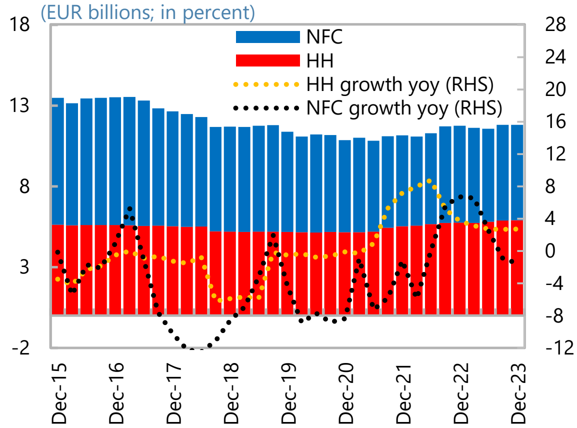


Sources: Bank of Latvia; ECB; Haver Analytics; and IMF staff calculations.
1/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

Figure 8. Indicators of Financial System's Credit

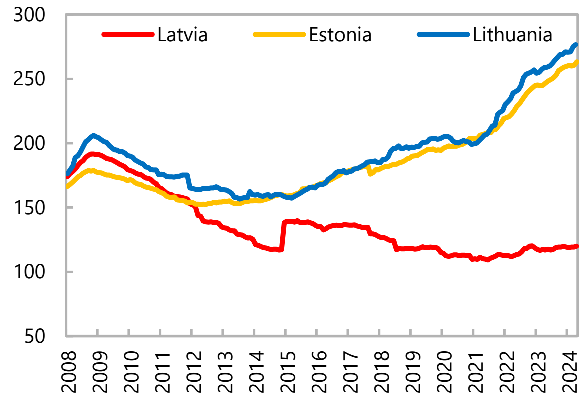
Bank lending remains relatively unchanged in Latvia...

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



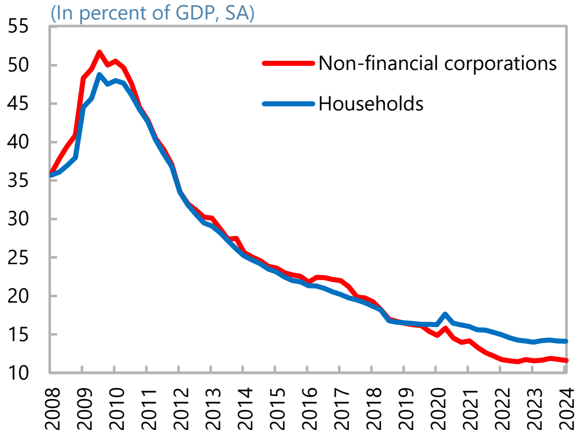
...and still lags that of Baltic peers.

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



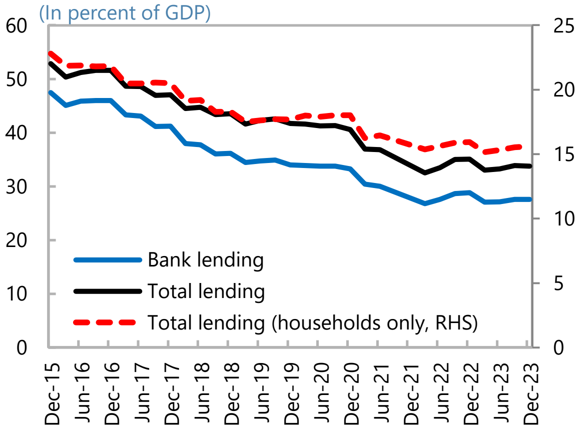
Household credit appears more resilient than that of non-financial corporates...

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



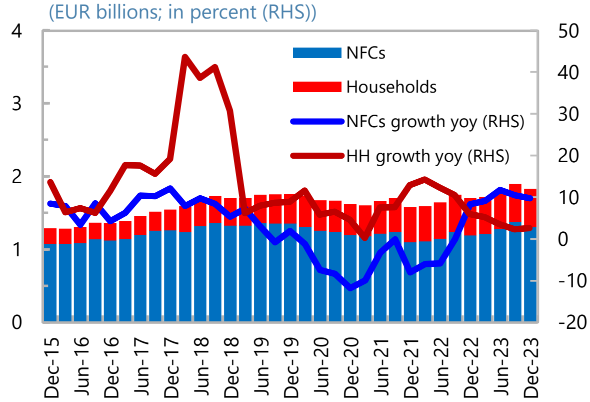
...but overall total lending to residents declined in line with higher interest rates.

Latvia Credit to Residents
(In percent of GDP)



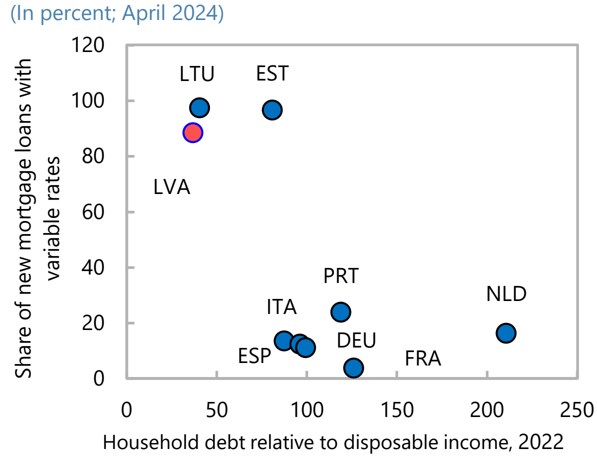
Non-bank lending to households and NFCs increased.

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



Credit risks are elevated due to high share of variable interest rate loans.

Household Debt and Share of Variable Rate Mortgages
(In percent; April 2024)

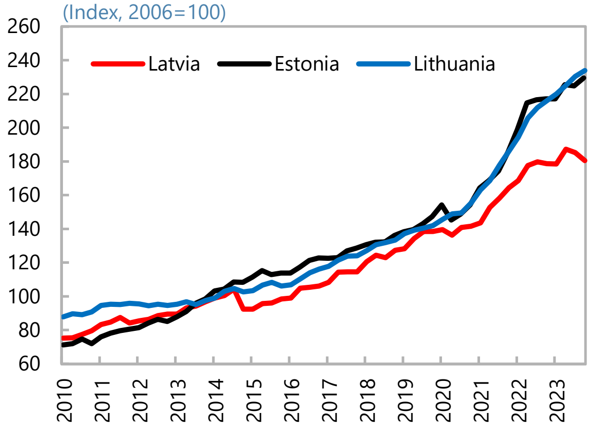


Sources: Bank of Latvia; ECB; FCMC; Haver; OECD; and IMF staff calculations.

Figure 9. Housing Market Indicators

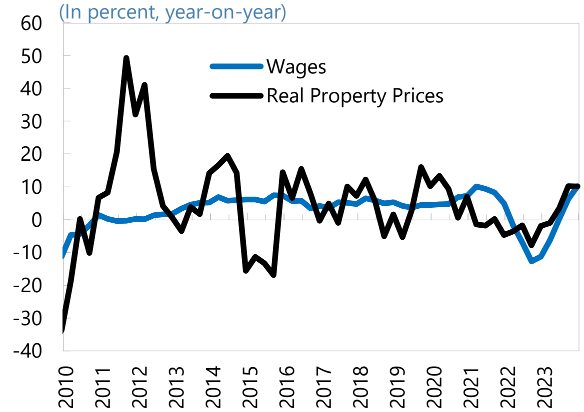
Increases in Latvia's house prices have been slower than those for its Baltic neighbors...

Housing Price Index
(Index, 2006=100)



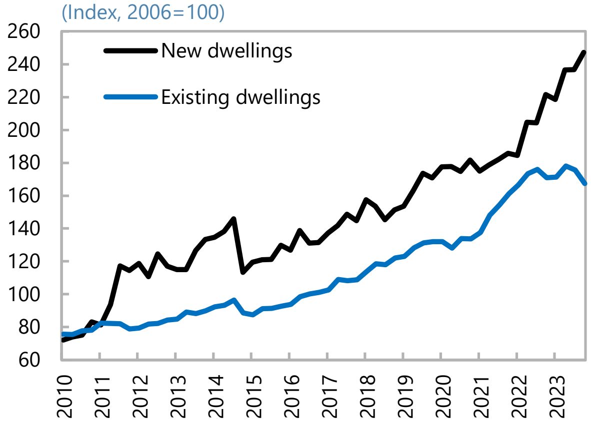
...and on average in line with wage growth.

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



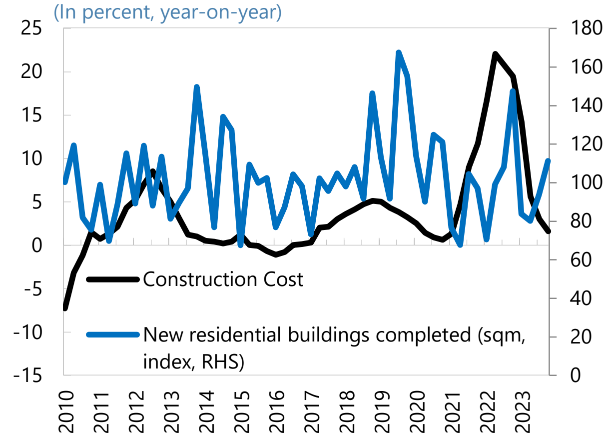
Prices for new dwellings rose rapidly...

Residential Property Prices
(Index, 2006=100)



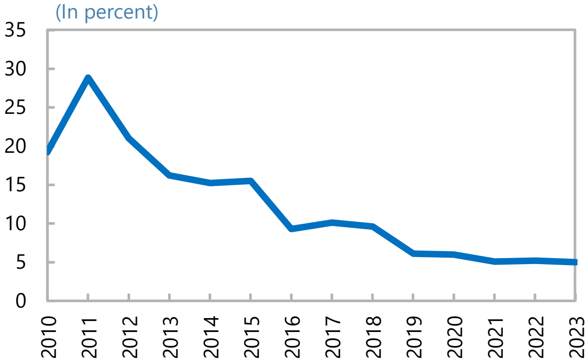
...despite the recent decline in construction costs.

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



Housing is gradually becoming more affordable...

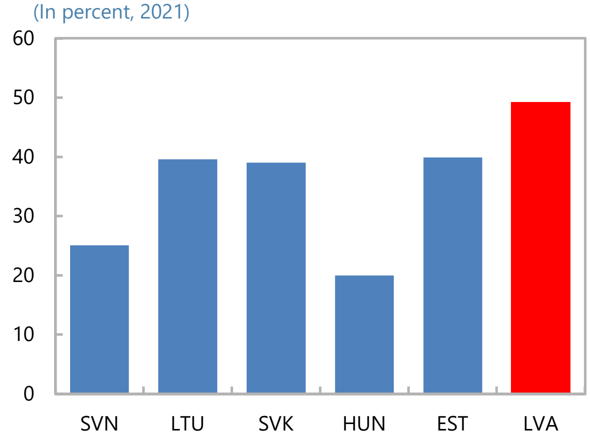
Housing Cost Burden Rate
(In percent)



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

...but the loan to value ratio is still higher than that for peers.

Household Loan-to-Value Ratio
(In percent, 2021)



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

Table 1. Latvia: Selected Economic Indicators, 2019–25

	2019	2020	2021	2022	2023	2024	2025
						Proj.	
National Accounts	(Percentage change, unless otherwise indicated)						
Real GDP	0.6	-3.5	6.7	3.0	-0.3	1.7	2.4
Private consumption	0.0	-4.3	7.3	7.2	-1.3	2.4	2.3
Public consumption	5.6	2.1	3.5	2.8	7.0	2.3	2.2
Gross capital formation	0.7	-10.0	24.9	-3.6	5.1	2.6	2.7
Gross fixed capital formation	1.5	-2.2	7.2	0.6	8.2	3.1	3.1
Exports of goods and services	1.3	0.4	9.0	10.3	-5.9	3.0	2.6
Imports of goods and services	2.2	-1.1	15.1	11.1	-2.8	3.0	2.5
Nominal GDP (billions of euros)	30.6	30.1	33.3	38.4	40.3	42.4	44.8
GDP per capita (thousands of euros)	15.9	15.8	17.6	20.5	21.4	22.5	23.9
Savings and Investment							
Gross national saving (percent of GDP)	22.2	24.3	21.1	20.3	19.0	19.1	18.9
Gross capital formation (percent of GDP)	22.8	21.4	25.0	25.0	23.0	22.8	22.5
Private (percent of GDP)	18.9	17.2	21.2	21.7	19.4	18.7	18.6
HICP Inflation							
Headline, period average	2.7	0.1	3.2	17.2	9.1	2.0	2.4
Headline, end-period	2.1	-0.5	7.9	20.7	0.9	3.9	1.6
Core, period average	2.7	1.1	2.0	11.3	9.8	3.3	3.1
Core, end-period	1.9	0.9	4.7	15.2	4.0	3.7	2.8
Labor Market							
Unemployment rate (LFS; period average, percent)	6.3	8.1	7.6	6.9	6.5	6.5	6.5
Nominal wage growth	7.2	6.2	11.7	7.5	11.9	8.5	7.0
Consolidated General Government 1/	(Percent of GDP, unless otherwise indicated)						
Total revenue	37.3	37.7	37.6	37.2	38.5	38.6	38.7
Total expenditure	37.7	41.4	43.2	40.9	42.0	42.0	41.4
Basic fiscal balance	-0.4	-3.7	-5.5	-3.7	-3.5	-3.4	-2.7
ESA fiscal balance	-0.5	-4.4	-7.2	-4.6	-2.2	-2.9	-2.7
General government gross debt	36.7	42.7	44.4	41.8	43.6	44.7	44.8
Money and Credit							
Credit to private sector (annual percentage change)	-2.3	-4.4	11.9	7.1	5.1	...	...
Broad money (annual percentage change)	8.0	13.1	9.2	5.1	2.7	...	...
Balance of Payments							
Current account balance	-0.6	2.9	-3.9	-4.8	-4.0	-3.7	-3.5
Trade balance (goods)	-8.6	-5.1	-8.3	-10.7	-9.3	-8.8	-8.8
Gross external debt	117.1	122.1	110.5	102.3	98.5	94.9	86.6
Net external debt 2/	18.1	13.6	10.3	8.1	7.5	10.7	13.5
Exchange Rates							
U.S. dollar per euro (period average)	1.12	1.14	1.18	1.05	1.08	...	...
REER (period average; CPI based, 2005=100)	123.0	124.5	125.0	129.7	136.8	...	...
Terms of trade (annual percentage change)	0.9	1.8	-1.6	-0.6	3.6	-0.1	0.9

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, 2019–29

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change, unless otherwise indicated)										
National Accounts											
Real GDP	0.6	-3.5	6.7	3.0	-0.3	1.7	2.4	2.5	2.5	2.5	2.5
Consumption	1.3	-2.8	6.3	6.1	0.7	2.4	2.3	2.4	2.4	2.4	2.4
Private consumption	0.0	-4.3	7.3	7.2	-1.3	2.4	2.3	2.5	2.5	2.5	2.5
Public consumption	5.6	2.1	3.5	2.8	7.0	2.3	2.2	2.2	2.2	2.2	2.2
Gross capital formation	0.7	-10.0	24.9	-3.6	5.1	2.6	2.7	2.4	2.4	2.4	2.4
Gross fixed capital formation	1.5	-2.2	7.2	0.6	8.2	3.1	3.1	2.8	2.8	2.8	2.8
Exports of goods and services	1.3	0.4	9.0	10.3	-5.9	3.0	2.6	2.6	2.6	2.6	2.6
Imports of goods and services	2.2	-1.1	15.1	11.1	-2.8	3.0	2.5	2.5	2.5	2.5	2.5
Contributions to growth											
Domestic demand	1.2	-4.9	11.2	3.7	1.9	2.7	2.6	2.7	2.7	2.7	2.7
Net exports	-0.7	1.0	-4.6	-1.4	-2.0	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2
HICP Inflation											
Headline, period average	2.7	0.1	3.2	17.2	9.1	2.0	2.4	2.2	2.2	2.2	2.2
Headline, end-period	2.1	-0.5	7.9	20.7	0.9	3.9	1.6	2.7	1.7	2.6	1.9
Core, period average	2.7	1.1	2.0	11.3	9.8	3.3	3.1	2.5	2.2	2.2	2.2
Core, end-period	1.9	0.9	4.7	15.2	4.0	3.7	2.8	2.3	2.1	2.3	2.1
Labor Market											
Unemployment rate (LFS, percent)	6.3	8.1	7.6	6.9	6.5	6.5	6.5	6.4	6.4	6.3	6.3
Employment (period average, percent)	0.1	-1.9	-3.2	2.6	-0.2	0.2	0.1	0.1	0.1	0.1	0.1
Nominal wage growth	7.2	6.2	11.7	7.5	11.9	8.5	7.0	6.0	6.0	6.0	6.0
	(Percent of GDP)										
Consolidated General Government 1/											
Total revenue	37.3	37.7	37.6	37.2	38.5	38.6	38.7	38.7	38.6	38.8	38.8
Total expenditure	37.7	41.4	43.2	40.9	42.0	42.0	41.4	41.3	41.4	41.5	41.6
ESA fiscal balance	-0.5	-4.4	-7.2	-4.6	-2.2	-2.9	-2.7	-2.6	-2.7	-2.7	-2.8
ESA structural fiscal balance	-1.3	-2.9	-7.4	-5.2	-1.9	-2.5	-2.4	-2.4	-2.6	-2.7	-2.8
General government gross debt	36.7	42.7	44.4	41.8	43.6	44.7	44.8	45.2	45.7	46.1	46.6
Saving and Investment											
Gross national saving	22.2	24.3	21.1	20.3	19.0	19.1	18.9	18.7	18.5	18.3	18.2
Foreign saving	0.6	-2.9	3.9	4.8	4.0	3.7	3.5	3.5	3.4	3.4	3.3
Gross capital formation	22.8	21.4	25.0	25.0	23.0	22.8	22.5	22.2	21.9	21.7	21.5
External Sector											
Current account balance	-0.6	2.9	-3.9	-4.8	-4.0	-3.7	-3.5	-3.5	-3.4	-3.4	-3.3
Net IIP	-40.1	-34.0	-27.3	-26.8	-24.6	-28.3	-30.0	-31.7	-33.2	-34.7	-36.0
Gross external debt	117.1	122.1	110.5	102.3	98.5	94.9	86.6	82.4	80.9	78.7	77.1
Net external debt 2/	18.1	13.6	10.3	8.1	7.5	10.7	13.5	16.3	18.9	21.6	24.2
Memorandum Items:											
Nominal GDP (billions of euros)	30.6	30.1	33.3	38.4	40.3	42.4	44.8	47.2	49.6	52.2	54.9
Output gap (percent of potential GDP)	1.7	-3.8	0.6	1.4	-0.8	-1.1	-0.8	-0.5	-0.2	-0.1	0.0
Potential output growth (percent)	2.4	2.0	2.1	2.1	2.0	2.0	2.1	2.2	2.2	2.3	2.5
Terms of trade (annual percentage change)	0.9	1.8	-1.6	-0.6	3.6	-0.1	0.9	0.3	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, 2019–29 1/

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(percent of GDP, unless otherwise indicated)										
Revenue	37.3	37.7	37.6	37.2	38.5	38.6	38.7	38.7	38.6	38.8	38.8
Taxes	20.2	20.2	19.7	20.5	21.4	20.9	20.9	20.9	20.9	21.1	21.0
Personal Income Tax	6.3	6.0	5.8	5.9	6.2	6.0	6.0	6.0	6.0	6.0	6.0
Corporate Income Tax	0.1	0.7	0.8	1.0	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Property Tax	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Value-added tax	8.7	8.5	8.3	9.3	9.6	9.4	9.4	9.4	9.4	9.4	9.4
Excise tax	3.5	3.5	3.3	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Other taxes	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Social Contributions	9.5	9.7	9.4	9.6	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Grants	4.3	4.4	4.1	3.8	3.4	4.1	4.2	4.2	4.2	4.2	4.2
Other Revenue	3.4	3.4	4.5	3.4	3.8	3.6	3.6	3.6	3.6	3.6	3.6
Expenditure	37.7	41.4	43.2	40.9	42.0	42.0	41.4	41.3	41.4	41.5	41.6
Expense	33.7	37.2	39.4	37.6	38.4	37.9	37.5	37.4	37.4	37.5	37.6
Compensation of Employees	8.5	9.0	8.8	8.1	8.9	8.8	8.8	8.8	8.8	8.9	9.0
Use of goods and services	4.9	4.9	4.7	6.0	5.7	5.2	5.2	5.2	5.3	5.4	5.4
Interest	0.9	0.9	0.8	0.5	0.6	1.0	1.2	1.3	1.4	1.4	1.4
Subsidies 2/	7.6	9.2	10.9	10.0	10.0	9.9	9.5	9.2	9.0	9.0	9.0
Grants	1.1	1.2	1.4	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Payments to EU budget	1.0	1.1	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
International organizations	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social Support	10.7	12.0	12.9	11.8	12.0	11.8	11.7	11.7	11.7	11.7	11.7
Pensions	7.2	8.4	7.6	7.4	8.0	7.9	7.8	7.8	7.8	7.8	7.8
Other	3.4	3.6	5.3	4.4	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Net Acquisition of Nonfinancial Assets	4.0	4.2	3.8	3.3	3.6	4.1	3.9	3.9	4.0	4.0	4.0
Gross Operating Balance	3.6	0.4	-1.7	-0.4	0.1	0.7	1.2	1.3	1.3	1.3	1.1
Net Lending/Borrowing	-0.4	-3.7	-5.5	-3.7	-3.5	-3.4	-2.7	-2.6	-2.7	-2.7	-2.8
Domestic financing	-3.0	1.5	1.7	-1.1	1.4	2.0	2.1	4.4	1.9	1.9	2.0
External financing	3.3	2.2	3.8	4.8	2.1	1.4	0.6	-1.8	0.8	0.8	0.8
Errors and omissions	0.0	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/	-0.5	-4.4	-7.2	-4.6	-2.2	-2.9	-2.7	-2.6	-2.7	-2.7	-2.8
ESA structural fiscal balance (percent of GDP) 4/	-1.3	-2.9	-7.4	-5.2	-1.9	-2.5	-2.4	-2.4	-2.6	-2.7	-2.8
ESA cyclically adjusted fiscal balance (percent of potential GDP) 4/	-1.2	-2.8	-7.5	-5.3	-1.9	-2.4	-2.4	-2.4	-2.6	-2.7	-2.8
ESA structural fiscal balance (percent of potential GDP) 4/	-1.4	-2.8	-7.5	-5.3	-1.9	-2.4	-2.4	-2.4	-2.6	-2.7	-2.8
ESA structural fiscal primary balance (percent of GDP) 4/	-0.5	-2.1	-6.7	-4.7	-1.3	-1.5	-1.2	-1.1	-1.2	-1.3	-1.4
Cyclically adjusted fiscal balance (percent of potential GDP) 5/	-1.1	-2.2	-5.8	-4.3	-3.2	-2.9	-2.4	-2.4	-2.6	-2.7	-2.8
General government debt	36.7	42.7	44.4	41.8	43.6	44.7	44.8	45.2	45.7	46.1	46.6
Nominal GDP (billions of euros)	30.6	30.1	33.3	38.4	40.3	42.4	44.8	47.2	49.6	52.2	54.9

Sources: Latvia authorities and IMF staff estimates.

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

2/ Changes in subsidies are 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, 2019–29

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percent of GDP, unless otherwise indicated)										
Current Account	-0.6	2.9	-3.9	-4.8	-4.0	-3.7	-3.5	-3.5	-3.4	-3.4	-3.3
Goods and services (fob)	-0.7	1.3	-3.2	-4.6	-3.9	-3.4	-3.2	-3.0	-3.0	-3.2	-3.2
Goods (fob)	-8.6	-5.1	-8.3	-10.7	-9.3	-8.8	-8.8	-8.7	-8.6	-8.7	-8.7
Exports	41.7	44.7	48.6	54.0	45.4	47.1	45.5	44.4	43.9	43.2	42.7
Imports	-50.4	-49.8	-56.9	-64.7	-54.7	-55.9	-54.3	-53.1	-52.4	-51.9	-51.4
Services	7.9	6.4	5.1	6.1	5.4	5.5	5.6	5.7	5.6	5.5	5.4
Credit	18.3	16.1	16.0	18.9	18.6	16.5	16.7	17.0	17.1	16.9	16.7
Debit	-10.3	-9.6	-10.9	-12.8	-13.2	-11.0	-11.1	-11.3	-11.4	-11.4	-11.3
Primary Income	-1.5	0.0	-1.9	-1.5	-2.3	-2.2	-2.2	-2.2	-2.2	-2.0	-1.9
Compensation of employees	2.2	1.8	1.8	1.8	1.9	1.6	1.5	1.4	1.3	1.3	1.3
Investment income	-4.3	-2.6	-4.0	-3.4	-3.9	-3.3	-3.1	-3.0	-2.9	-2.7	-2.6
Secondary Income	1.5	1.6	1.1	1.3	2.2	1.8	1.9	1.7	1.7	1.8	1.8
Capital and Financial Account	0.3	-4.4	2.3	2.1	1.8	3.7	3.5	3.5	3.4	3.4	3.3
Capital account	1.5	1.7	1.4	0.7	2.0	0.8	0.8	0.8	0.8	0.8	0.8
Financial account	1.2	6.1	-1.0	-1.5	0.2	-2.9	-2.7	-2.7	-2.6	-2.6	-2.5
Direct investment	3.0	2.2	2.5	3.2	1.4	1.3	1.0	0.9	0.7	0.6	0.5
Portfolio investment and financial derivatives	1.8	-13.1	0.8	-3.6	4.3	0.6	0.3	-2.9	-0.2	-0.4	-0.4
of which: general government net issuance	3.3	-1.1	1.8	2.0	4.7	1.9	1.5	-1.5	1.0	1.0	0.9
Other investment	-6.2	6.3	-1.9	0.7	-5.4	1.0	1.5	4.7	2.1	2.4	2.5
Reserve assets	0.3	-1.5	-0.4	1.1	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	0.3	1.5	1.6	2.6	2.2	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	-0.3	17.8	29.9	-7.6	4.3	3.4	3.8	4.4	3.8	4.0
Import value (fob)	2.4	-3.6	26.2	31.7	-7.9	3.5	3.4	3.5	4.4	4.2	4.2
Export volume	1.3	0.4	9.0	10.3	-5.9	3.0	2.6	2.6	2.6	2.6	2.6
Import volume	2.2	-1.1	15.1	11.1	-2.8	3.0	2.5	2.5	2.5	2.5	2.5
Gross Reserves (billions of euros)	4.0	4.3	4.8	4.2	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Gross External Debt (billions of euros)	35.8	36.8	36.9	39.3	39.7	40.2	38.8	38.8	40.2	41.1	42.3
Medium- and long-term (billions of euros)	21.5	20.9	20.7	19.7	21.9	23.5	23.9	23.5	24.5	25.4	26.5
Short term (billions of euros)	14.3	15.9	16.2	19.5	17.8	16.7	14.9	15.3	15.6	15.6	15.8
Net External Debt (billions of euros) 1/	5.5	4.1	3.4	3.1	3.0	4.5	6.0	7.7	9.4	11.3	13.3
Gross External Debt (percent of GDP)	117.1	122.1	110.5	102.3	98.5	94.9	86.6	82.4	80.9	78.7	77.1
Medium and long term (percent of GDP)	70.5	69.4	62.0	51.4	54.3	55.6	53.3	49.9	49.5	48.7	48.4
Short term (percent of GDP)	46.6	52.7	48.5	50.9	44.2	39.3	33.3	32.5	31.5	30.0	28.8
Net External Debt (percent of GDP) 1/	18.1	13.6	10.3	8.1	7.5	10.7	13.5	16.3	18.9	21.6	24.2
Memo Items											
Nominal GDP (billions of euros)	30.6	30.1	33.3	38.4	40.3	42.4	44.8	47.2	49.6	52.2	54.9
U.S. dollar per euro (period average)	1.12	1.14	1.18	1.05	1.08	...	...	...	...	...	...

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, 2016–23

(In percent, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023
Core FSIs								
Regulatory capital to risk-weighted assets	20.4	20.8	22.3	21.7	26.8	25.3	23.0	20.8
Tier 1 capital to risk-weighted assets	17.7	18.8	20.6	20.6	26.0	24.6	22.1	20.2
Nonperforming loans net of provisions to capital	27.3	23.2	23.2	26.8	15.7	12.5	7.3	7.2
Capital to assets (leverage ratio)	8.5	9.7	11.1	8.5	9.3	9.0	9.4	9.5
Nonperforming loans to total gross loans	6.3	5.5	5.3	5.0	3.1	2.5	2.3	2.4
Provisions to nonperforming loans	45.4	43.3	39.7	44.4	40.3	45.1	59.8	60.3
Return on assets	1.6	1.0	1.1	0.6	0.8	1.3	1.2	2.8
Return on equity	14.5	6.7	9.0	4.9	7.5	12.3	12.3	21.3
Interest margin to gross income	41.4	45.0	46.4	48.2	51.4	50.3	56.4	73.5
Noninterest expenses to gross income	54.9	66.1	67.9	69.8	70.2	64.7	61.1	44.3
Liquid assets to total assets	57.2	67.1	58.2	50.9	56.0	59.3	24.0	27.9
Liquid assets to short-term liabilities	80.8	86.2	75.1	84.0	87.3	100.9	35.0	42.2
Net open position in foreign exchange to capital	3.5	2.1	1.0	5.2	1.3	0.5	0.9	0.2
Additional FSIs								
Large exposures to capital	204.6	113.8	102.8	83.8	78.5	71.7	88.2	93.5
Gross asset position in financial derivatives to capital	6.7	1.7	2.8	4.7	2.1	4.8	5.1	1.5
Gross liability position in financial derivatives to capital	6.2	1.9	2.7	4.6	2.5	4.3	4.3	1.3
Trading income to total income	18.8	9.6	5.4	9.5	5.4	6.6	5.0	2.3
Personnel expenses to noninterest expenses	40.8	39.7	40.3	40.3	41.5	41.8	39.5	38.3
Customer deposits to total (noninterbank) loans	106.5	96.3	86.0	88.1	94.2	89.8	125.5	126.5
Residential real estate loans to total gross loans	20.3	20.4	22.6	23.2	23.4	23.0	28.1	28.7
Commercial real estate loans to total gross loans	17.2	15.6	18.4	19.7	19.8	18.6	22.1	23.1

Source: IMF Financial Soundness Indicators.

Annex I. Risk Assessment Matrix[1]

Risks	Likelihood	Impact on Latvia	Recommended Policy Response
Conjunctural Risks			
Intensification of regional conflict(s). Escalation or spread of the conflict in Gaza and Israel, Russia's war in Ukraine, and/or other regional conflicts or terrorism disrupt trade (e.g., energy, food, tourism, supply chains), remittances, FDI and financial flows, payment systems, and increase refugee flows.	High	**High** Trade with Russia has diminished significantly since the Annexation of Crimea. Nonetheless, the sanctions against Russia and Belarus could lead to some 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. The war would also affect the economy via indirect spillovers and rekindled inflation from higher commodity prices.	Automatic stabilizers should be allowed to operate. More active support, if necessary to cushion the impact on the most vulnerable groups, should be well-targeted, also prioritizing key security-related areas and the integration of refugees. Address structural issues to encourage investment. Energy support, if any, should preserve price signals to foster savings.
Commodity price volatility. A series of supply shocks (e.g., due to conflicts, export restrictions, and OPEC+ decisions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, cross-border spillovers, and social and economic instability.	High	**High** 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.	Keep participating in European policy responses. Diversify energy supply and implement measures to ensure energy security. Provide incentives to boost domestic food production. Energy support, if any, should preserve price signals to foster savings, be limited in scope to preserve fiscal buffers and be offset by adjustment in other areas to avoid rekindling inflation.
Abrupt global slowdown or recession. Global and idiosyncratic risk factors cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation.	Medium	**Medium** As a small open economy, Latvia would be affected through its trading partners. However, limited complex production processes and industrial clusters reduce the likelihood of large supply chain disruptions.	Participate in global and European policy initiatives. Manage risk through supply diversification, contingency plans, and investment in energy efficiency.
Monetary policy miscalibration. Amid high economic uncertainty, major central banks loosen policy stance prematurely, hindering disinflation, or keep it tight for longer than warranted, causing abrupt adjustments in financial markets and weakening the credibility of central banks.	Medium	**Medium** A looser ECB monetary policy would exacerbate inflationary pressures on Latvia. This could further increase scarring including related to competitiveness erosion and increase the risk-of-poverty.	Adjust fiscal spending to be better targeted and efficient, while allowing automatic stabilizers. Reduce vulnerabilities of households and corporates including using macroprudential policy tools.

[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 scenarios 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.

Risks	Likelihood	Impact on Latvia	Recommended Policy Response
Systemic financial instability. High interest rates and risk premia and asset repricing amid economic slowdowns and political uncertainty (e.g., from elections) trigger market dislocations, with cross-border spillovers and an adverse macrofinancial feedback loop affecting weak banks and NBFIs.	Medium	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.
Structural Risks			
Deepening geo-economic fragmentation. Broader conflicts, inward-oriented policies, and weakened international cooperation result in a less efficient configuration of trade and FDI, supply disruptions, protectionism, policy uncertainty, technological and payments systems fragmentation, rising shipping and input costs, financial instability, a fracturing of international monetary system, and lower growth.	High	High Geopolitical tensions are high due to Latvia's border with Russia. 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.	Ensure that support and spending in security-related areas are adequate. Reduce energy dependence. Seek alternative markets and products for exports.
Cyberthreats. Cyberattacks on physical or digital infrastructure and service providers (including digital currency and crypto assets) or misuse of AI technologies trigger financial and economic instability.	Medium	Medium Possible disruptions in economic activity, as Latvia is susceptible to cyber-attacks from Russia's war in Ukraine and this risk could rise given the planned increases in reliance on ICT processes and innovation. Weaker confidence may also lead to capital outflows.	Continue to enhance preparedness for cyberattacks through extensive risk monitoring in cooperation with private and public sector stakeholders. Participate in global and European defenses against cyber-attacks.
Extreme climate events. Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.	Medium	Medium Latvia's National Energy and Climate Plan identifies agriculture and forestry as the sectors most affected by climate change and the extreme variability of weather conditions, such as the replacement of long-lasting rainfall or floods with long-lasting droughts and heat.	Swiftly adopt the climate law and the revised National Energy and Climate Plan to facilitate the green transition.
Domestic Risks			
Financial sector risks are accentuated by multiple transitions. These include transitions related to climate change and energy.	Medium	Medium The main risks stem from corporates' and households' weakening capacity to repay their debt due to higher energy prices and interest costs; imbalances in the residential and commercial real estate markets; and liquidity and interest rate risks in the non-bank financial sector. However, the authorities assess these risks to be moderate.	Any measures for vulnerable households which are financial distressed should be targeted. Corporate reforms to facilitate resource allocation should be accelerated to promote productivity growth. To resolve imbalances in the real estate market, measures to increase supply of new housing units and renovate energy-inefficient properties should be implemented. Non-bank financial institutions should be monitored closely.

Risks	Likelihood	Impact on Latvia	Recommended Policy Response
Skilled labor shortages.	**Medium**	**Medium** Ambitious investment and reform agenda to address multiple transitions (security, climate, aging, digitalization) can be compromised in the absence of skilled labor.	Implement policies to reduce labor market shortages and facilitate structural transformation of labor markets towards new sectors. Target training and skills-building in areas of expected labor pressures (digitalization, green transition).
Inefficient execution of the increase in EU-financed public investment.	**Medium**	**Medium** Inefficient execution of the increase in EU-financed public investment could delay climate and energy transition, and digitalization, weighing on potential output and denting Latvia's economic competitiveness.	Improve the efficiency of EU financed investment. Ensure all EU funds are utilized by the required time frame.

Annex II. External Sector Assessment

Overall Assessment: *The external position of Latvia in 2023 was weaker than the level implied by fundamentals and desirable policies. The current account (CA) remained in deficit at 4 percent of GDP due to weak external demand and real exchange rate appreciation. As in recent years, a large goods trade deficit was partly offset by a surplus of the services balance, along with the primary income balance in deficit. Over the medium-term, the current account deficit is expected to remain wider than the norm, reflecting concerns over external competitiveness. Both the current account and real effective exchange rate (REER) models indicate an overvaluation of REER.*

Potential Policy Responses: *Russia's war in Ukraine has triggered supply-side disruptions and a rise in inflation in the Baltic region. Cost levels have increased compared to the rest of the euro area, hurting competitiveness. Given improving growth outlook and upside risks for inflation, fiscal policy stance should be neutral in the near-term. It should be tighter in the medium-term to build buffers and address future spending needs. Macroprudential policies should mitigate financial vulnerabilities. Structural reforms to boost productivity growth, including measures to address skilled labor shortage, reduce regulatory burden in product and service markets, and facilitate the green and digital transformation, should be prioritized.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Gross assets slightly increased from 127 to 128 percent of GDP, and gross liabilities went down from 154 to 153 percent of GDP. The asset increase was mainly driven by the expansion in other investment, while the liability decrease was driven by financial derivatives and other investment. The NIIP improved to -25 percent of GDP in 2023, from -27 percent of GDP in 2022. Gross external debt decreased from 102.3 percent of GDP in 2022 to 98.6 percent of GDP at end-2023, 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 stabilize at -35 percent of GDP in the medium-term.

2023 (% GDP)	NIIP: -25	Gross Assets: 128	Debt Assets: 45	Gross Liab.: 153	Debt Liab.: 99

Current Account

Background. The current account deficit narrowed from 4.8 percent of GDP in 2022 to 4 percent in 2023. Imports of goods declined by 11.1 percent in nominal terms in 2023. Exports of goods declined by 11.6 percent. The goods trade balance narrowed from -10.7 percent of GDP in 2022 to -9.3 percent in 2023.

Exports of services grew by 3.8 percent in 2023 while imports of services increased by 8.6 percent. The service trade surplus narrowed from 6.1 percent of GDP in 2022 to 5.4 percent in 2023.

Primary income account registered a deficit of 2.4 percent of GDP in 2023, moderately widening from 1.5 in 2022. Secondary income surplus increased from 1.3 to 2.2 percent of GDP.

Latvia: EBA-lite Model Results, 2023

	CA model 1/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**-4.0**	
Cyclical contributions (from model) (-)	0.0	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	**-4.0**	
CA Norm (from model) 2/	**-1.1**	
Adjusted CA Norm	**-1.1**	
CA Gap	**-2.9**	**-2.4**
o/w Relative policy gap	2.0	
Elasticity	-0.5	
REER Gap (in percent)	**6.4**	**5.3**

1/ Based on the EBA-lite 3.0 methodology

2/ 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 -2.9 percent of GDP in 2023, and the gap attributed to policies amounts to 2 percent of GDP. This mainly reflects Latvia's lower public

health expenditure and smaller fiscal policy gap compared to the world. The temporary adjustor of -0.1 percent of GDP reflects the temporary decline in tourism activity due to the war. The current account balance is projected to remain in a deficit position over the medium-term.
Real Exchange Rate
Background. The REER appreciated by 5.4 percent in 2023. From 2016 to 2023, the REER appreciated by 15.1 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 from 7.5 percent in 2022 to 11.9 percent in 2023 in nominal terms, reflecting a rise in public servants' wages in some sectors, and tight labor market. **Assessment.** The preferred EBA-lite CA model suggests an overvaluation of about 6.4 percent. The EBA-lite REER Index model finds an undervaluation of 5.3 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 2 percent of GDP in 2023, mainly reflecting the transfer of funds from the EU. The level is higher than the average over the past five years (1.4). The financial account (BPM6 methodology) balance switched from an inflow of 1.5 percent of GDP in 2022 to an outflow of 0.2 percent in 2023. The outflow is mainly driven by other investment abroad (5.4 percent of GDP). **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 (11 percent of GDP for Latvia as of end-2023). **Assessment.** Reserve level is assessed to be adequate.

Annex III. Sovereign Risk and Debt Sustainability Analysis

Annex III. Figure 1. Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Low	The overall risk of sovereign stress is low, reflecting a relatively low level of vulnerability in the near-and medium-term horizons, and a moderate vulnerability in the long-term horizon.
Near term 1/			
Medium term	Moderate	Low	Medium-term risks are assessed as low against a mechanical low signal.
Fanchart	Moderate	...	
GFN	Low	...	
Stress test	Comm. Prices Nat. Diast.	...	
Long term	...	Moderate	Long-term risks are moderate as spending pressures from challenges such as aging, defense, and climate change feed into debt dynamics.
Sustainability assessment 2/	...	...	Not required for surveillance countries.
Debt stabilization in the baseline			No

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 were phased out in 2023. Over the medium and longer term, Latvia should undertake reforms to tackle fiscal pressures (from aging, defense, and climate change) and 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 III. 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?					0	
2. Subsectors included in the chosen coverage in (1) above:						

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

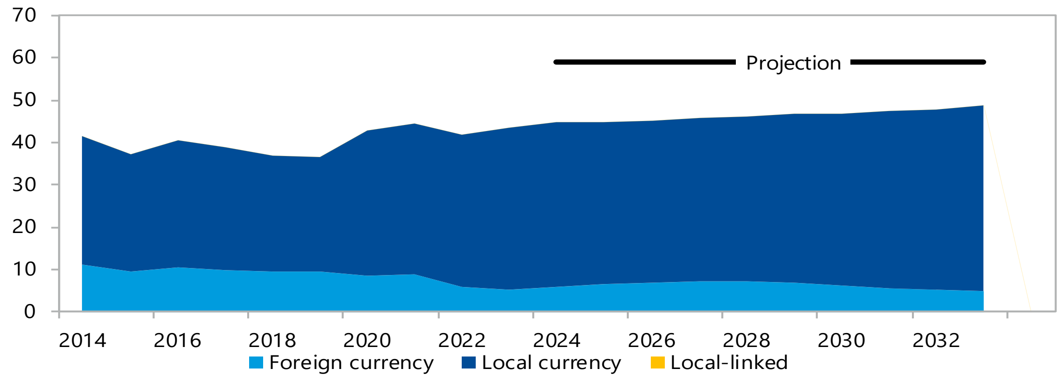
Coverage		Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1	Budget. central govt									0
CPS / NFPS / GG: expected / CG	2	Extra-budget. funds									0
CPS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

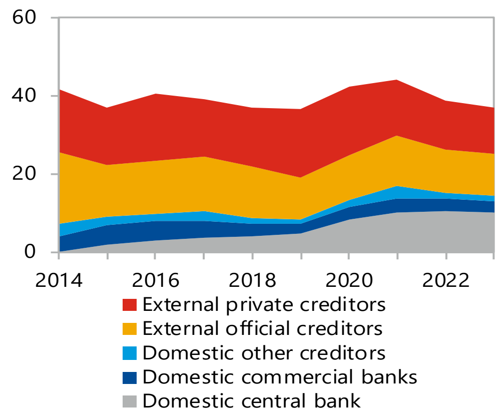
Annex III. Figure 3. Public Debt Structure Indicators

Debt by Currency (Percent of GDP)



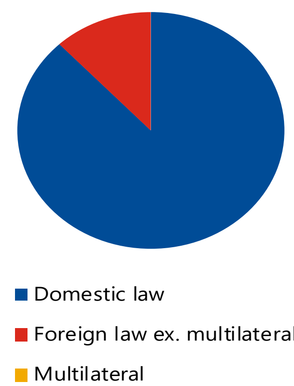
Note: The perimeter shown is central government.

Public Debt by Holder (Percent of GDP)



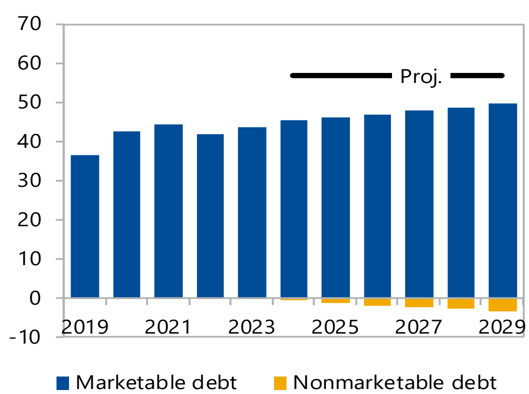
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2023 (Percent)



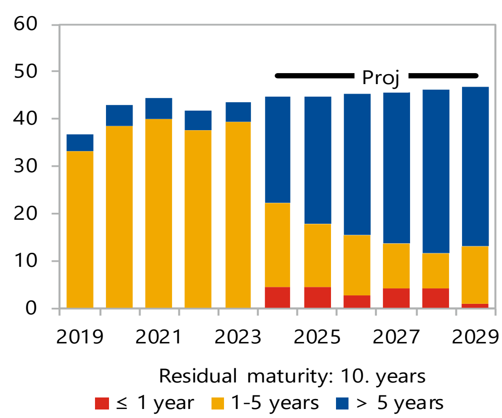
Note: The perimeter shown is general government.

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: Public debt is entirely marketable; and most debt is in domestic currency. Currency risks are also minimal for Latvia as it is part of the euro area.

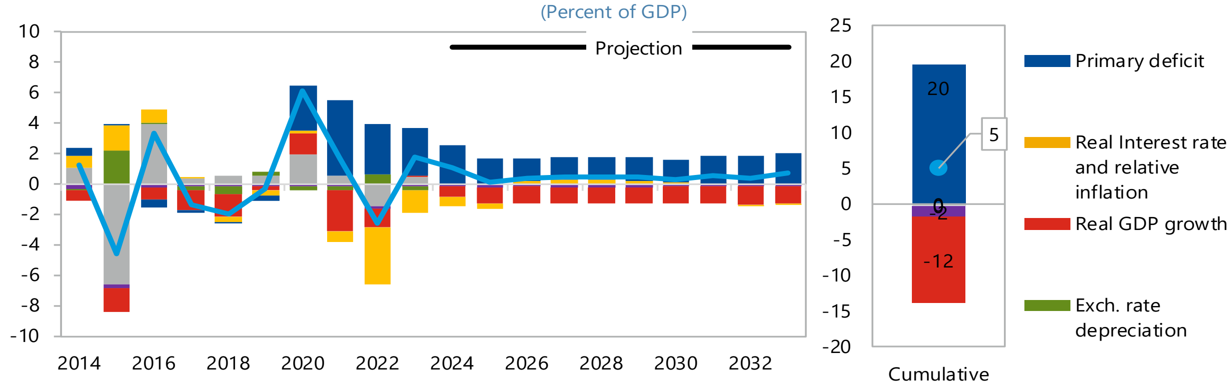
Annex III. Figure 4. Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Public debt	43.6	44.7	44.8	45.2	45.7	46.1	46.6	46.9	47.4	47.8	48.6
Change in public debt	1.8	1.1	0.1	0.4	0.5	0.4	0.5	0.3	0.6	0.4	0.7
Contribution of identified flows	1.4	1.1	0.2	0.4	0.5	0.5	0.5	0.3	0.6	0.4	0.7
Primary deficit	3.1	2.6	1.7	1.5	1.5	1.4	1.6	1.5	1.9	1.8	2.1
Noninterest revenues	38.4	38.4	38.5	38.5	38.5	38.7	38.6	38.6	38.6	38.6	38.6
Noninterest expenditures	41.5	41.0	40.3	40.0	40.0	40.1	40.2	40.1	40.5	40.4	40.7
Automatic debt dynamics	-1.6	-1.3	-1.4	-0.9	-0.8	-0.8	-0.9	-1.0	-1.1	-1.3	-1.2
Real interest rate and relative inflation	-1.5	-0.6	-0.4	0.2	0.3	0.3	0.2	0.1	0.0	-0.1	0.0
Real interest rate	-1.6	-0.7	-0.4	0.1	0.3	0.3	0.2	0.1	0.0	-0.1	0.0
Relative inflation	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Real growth rate	0.1	-0.7	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.2
Real exchange rate	-0.2	…	…	…	…	…	…	…	…	…	…
Other identified flows	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Other transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contribution of residual	0.4	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	9.6	7.1	6.9	7.7	6.6	8.9	9.4	7.4	10.2	8.6	11.3
of which: debt service	6.6	4.7	5.3	6.3	5.3	7.6	7.9	6.1	8.5	6.9	9.3
Local currency	5.9	4.7	5.3	6.1	4.9	7.1	7.3	5.4	7.8	6.3	8.8
Foreign currency	0.7	0.0	0.0	0.2	0.4	0.5	0.6	0.7	0.7	0.6	0.5
Memo:											
Real GDP growth (percent)	-0.3	1.7	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Inflation (GDP deflator; percent)	5.4	3.3	3.3	2.6	2.6	2.6	2.6	2.5	2.5	2.4	2.0
Nominal GDP growth (percent)	5.1	5.0	5.8	5.2	5.2	5.2	5.1	5.0	5.0	5.0	4.5
Effective interest rate (percent)	1.4	1.7	2.3	2.9	3.2	3.2	3.0	2.7	2.4	2.2	1.9

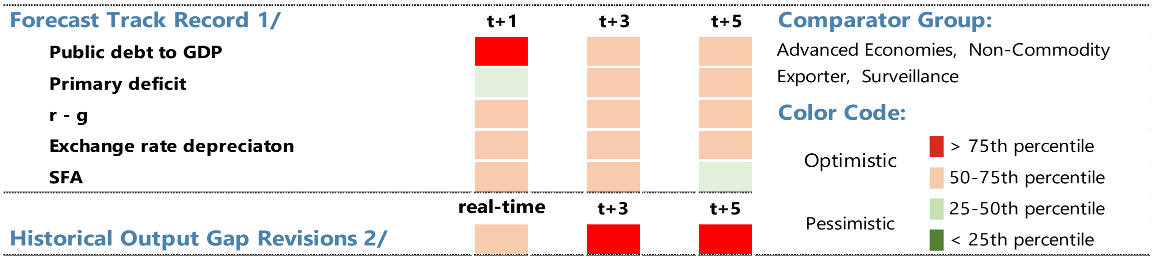
Contribution to Change in Public Debt

(Percent of GDP)

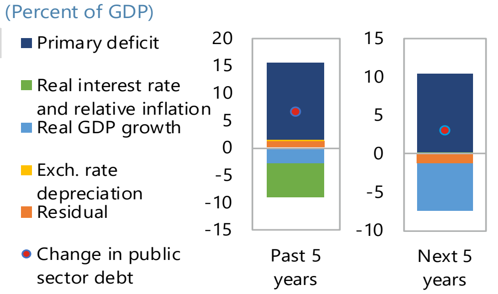


Staff commentary: Public debt will increase due to higher financing needs, long-term spending pressures (aging, climate, defense), and higher interest rates.

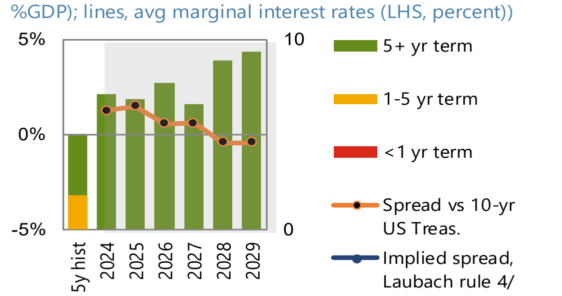
Annex III. Figure 5. Realism of Baseline Assumptions



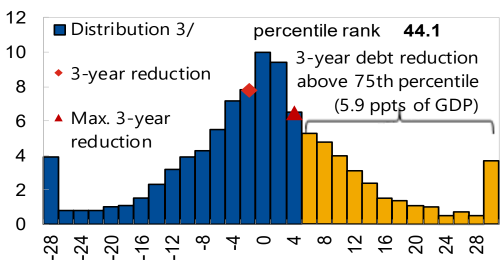
Public Debt Creating Flows
(Percent of GDP)



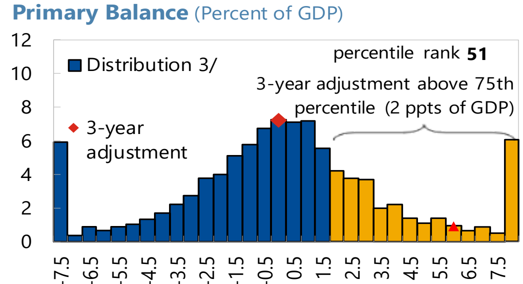
Bond Issuances (Bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))



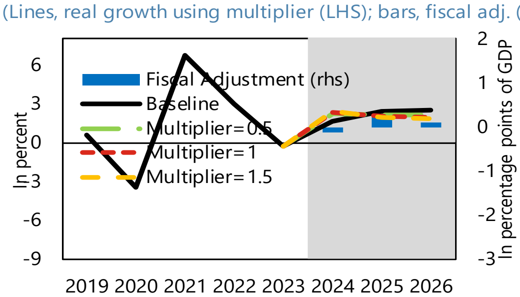
3-Year Debt Reduction
(Percent of GDP)



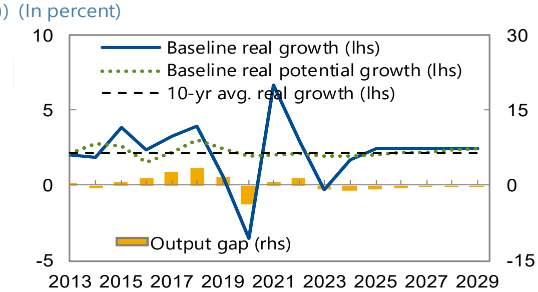
3-Year Adjustment in Cyclically-Adjusted Primary Balance (Percent of GDP)



Fiscal Adjustment and Possible Growth Paths
(Lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS))



Real GDP Growth
(In percent)



Commentary: The 3-year adjustment in the cyclically-adjusted primary balance is within the highest 75-percentile. Previously, some forecast track record was in the top quartile.

Source : IMF Staff.

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

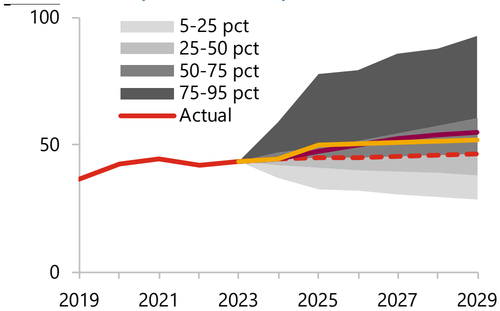
2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates

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

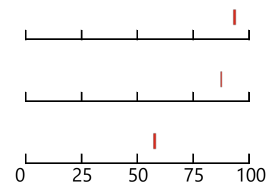
4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Annex III. Figure 6. Medium-Term Risk Assessment

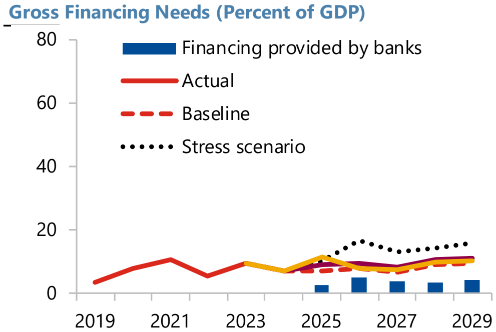
Final Fanchart (Percent of GDP)



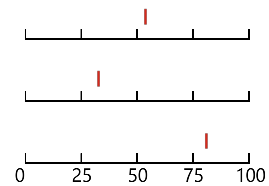
	Value	Contrib 1/	Percentile in peer group 2/
Debt fanchart module			
Fanchart width *(percent of GDP)*	64.4	0.9	
Probability of debt non-stabilizaiton *(percent)*	65.4	0.5	
Terminal debt-to-GDP x institutions index	14.8	0.3	
Debt fanchart index (DFI)		1.8	
Risk signal: 3/		Moderate	



Gross Financing Needs (Percent of GDP)



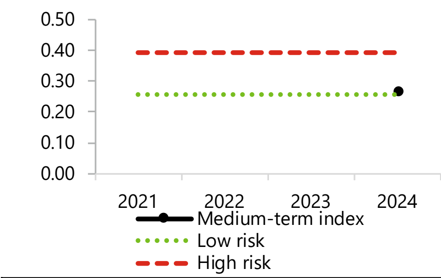
	Value	Contrib 1/	Percentile in peer group 2/
Gross financing needs (GFN) module			
Average baseline GFN *(percent of GDP)*	7.7	2.6	
Initial Banks' claims on the gen. govt *(pct bank assets)*	3.4	1.1	
Chg. In banks' claims in stress *(pct banks' assets)*	10.2	3.4	
GFN financeability index (GFI)		7.2	
Risk signal: 4/		Low	



Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-Term Index (Index Number)



Medium-term risk analysis

	Value	(normalized)	Weight	Contribution
Debt fanchart index	1.8	0.4	0.5	0.2
GFN finaceability index	7.2	0.1	0.5	0.1
Medium-term index		0.3		
Risk signal: 5/		Moderate		
Final assessment:		Low		

Prob. of missed crisis, 2024-2029, if stress not predicted: 18.2 pct.
Prob. of false alarms, 2024-2029, if stress predicted: 38.6 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, 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, 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, it is moderate risk.

Annex III. Figure 7. Long-Term Risk Assessment: Large Amortization

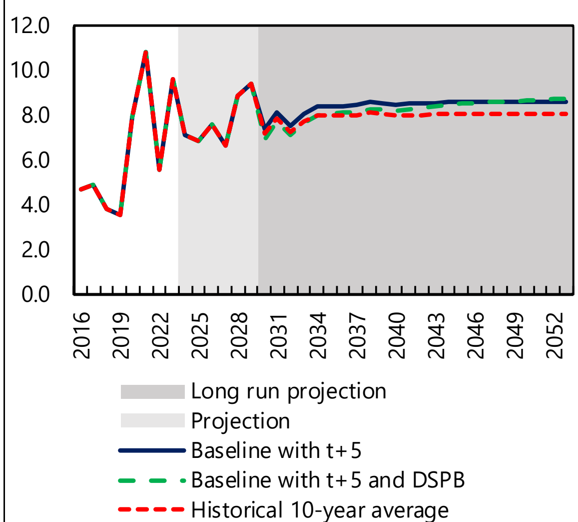
Latvia: Triggered Modules

Large amortizations	Pensions	Climate change: Adaptation	Natural Resources
	Health	Climate change: Mitigation	

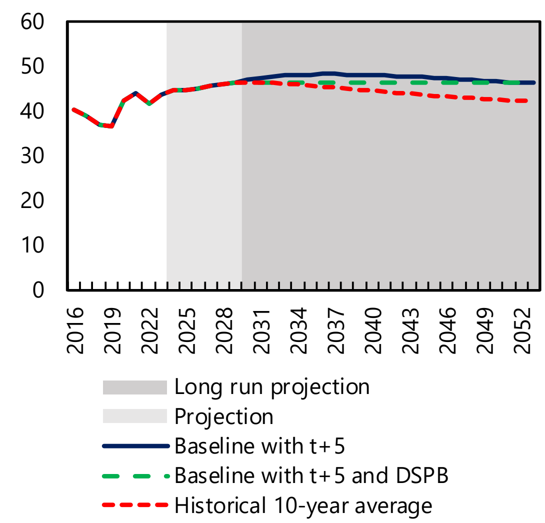
Latvia: Long-Term Risk Assessment: Large Amortization

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Historical average assumptions	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Overall Risk Indication		

GFN-to-GDP Ratio



Total Public Debt-to-GDP Ratio



Commentary: Overall risk from large amortization remains low. Under the baseline, the risks are related to the fact that there may be fiscal pressures from aging, defense, and climate change in the long term. Nonetheless, the long run modules for demographics (pensions, health) and climate were not triggered for Latvia.

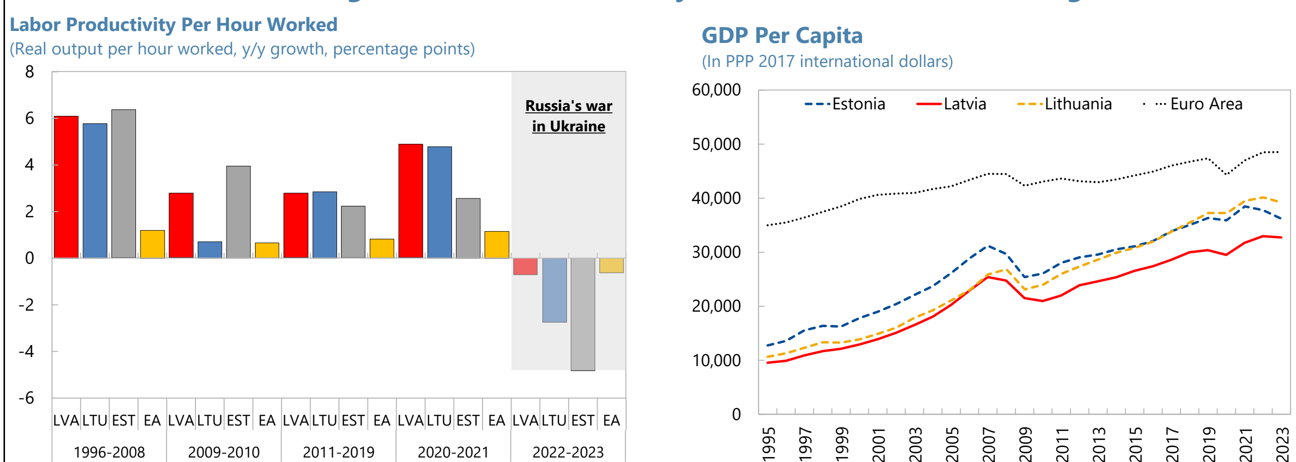
Annex IV. Productivity in the Baltic Context[1]

This Annex discusses Latvia's historical productivity developments in comparative context, noting that while Latvia lags other Baltics in the convergence process and capital deepening, its labor productivity growth was similar to that of other Baltics, powered by relatively stronger TFP growth. The analysis shows that the TFP growth boost experienced after the global financial crisis (GFC) is unlikely to last without sustained structural reforms and efforts to increase capital investment.[2]

A. Background

1. **Latvia's labor productivity growth declined markedly after the global financial crisis (GFC) and turned negative amidst geopolitical tensions** (Annex IV. Figure 1). The decline in productivity partly stemmed from weak investment after the Global Financial Crisis (GFC).[3] Compared to peers, sectoral labor's productivity in the manufacturing sector is relatively low, reflecting inefficient resource allocation, with the highest share of less productive and less innovative small firms relative to peers (Yashiro and others, 2019). Spatial productivity differences are high between Riga and the regions.

Annex IV. Figure 1. Labor Productivity Growth, and Income Convergence



Sources: Haver Analytics and IMF staff calculations.

2. **Latvia's income convergence lags other Baltics, despite comparable labor productivity growth.**[4] Evaluating the drivers of labor productivity growth could help shed some light of this apparent puzzle. The next section investigates the drivers of labor productivity growth in Latvia in a

[1] Prepared by Nina Budina and Can Ugur (EUR).

[2] See forthcoming Selected Issues Paper and Working Paper on competitiveness and productivity in the Baltics.

[3] Latvia's decade long investment weakness stems from pre-GFC excesses (Yashiro and others, 2019, pp. 7).

[4] The divergence in income convergence may also be explained by differences in employment growth changes.

comparable perspective, decomposing the changes in labor productivity into two main factors: capital deepening and total factor productivity (TFP) growth.

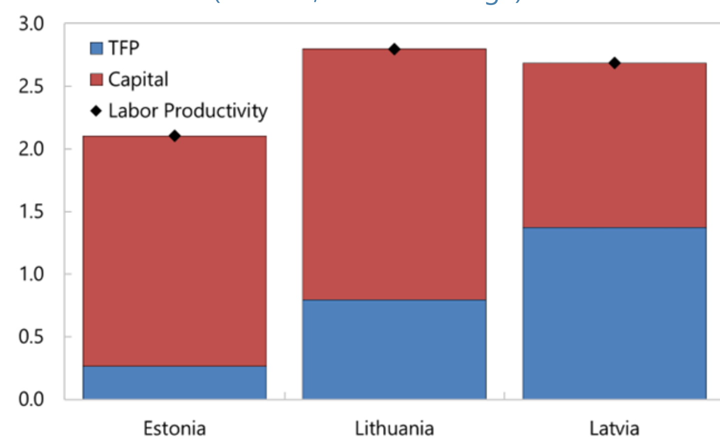
B. Latvia's Productivity Growth compared to other Baltic States

3. **This section evaluates the main drivers of Latvia's labor productivity growth in a comparative perspective.** First, the contributions to labor productivity growth from capital deepening and TFP growth are assessed for the entire historical period (2009-2020). Then the drivers of labor productivity growth are assessed over three distinct sub-periods: (i) the global financial crisis (2009-2010), (ii) post-GFC recovery (2011-2019), and (iii) COVID-19 pandemic (2020).[5] The decompositions are also supplemented with some tentative explanations for key drivers of labor productivity, drawing from literature.

4. **Latvia's total factor productivity (TFP) growth outperformed other Baltic states, contributing the most to overall labor productivity growth over the entire period** (Annex IV. Figure 2). Labor productivity growth was nearly 3 percent in both Latvia and Lithuania, and lower (around 2 percent) in Estonia during this period. Decomposing labor productivity growth into capital deepening and (TFP) growth shows TFP growth contributed over half of Latvia's labor productivity growth, surpassing Lithuania, and Estonia, where TFP growth accounted for only 20 and 10 percent, respectively.

Annex IV. Figure 2. 2009-2020: Decomposition of Labor Productivity Growth

(Percent; annual average)



Sources: EUKLEMS.

5. **Decomposing labor productivity growth across three distinct episodes reveals Latvia's stronger TFP-driven growth was limited to the post-GFC recovery period** (Annex IV. Figure 3).

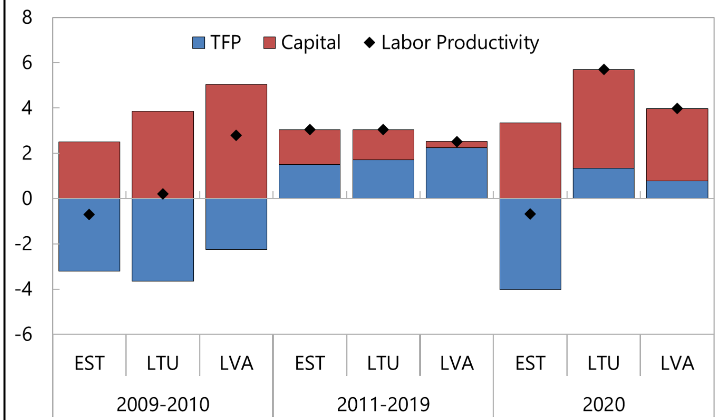
- *During the GFC (2009-2010),* Latvia experienced negative TFP growth, aligning with other Baltic states, while positive labor productivity growth persisted due to significant capital deepening.

[5] Data limitation does not allow decomposing the pre-GFC labor productivity growth since EUKLEMS data and decompositions are only available for 2008-2020. Similarly, since we have only one data point in 2020, we cannot draw any conclusions regarding the post-pandemic period.

- *During the post-GFC recovery (2011-2019)*, labor productivity growth was similar across all Baltic states, but Latvia's TFP growth surpassed that of other Baltic states, becoming the primary driver of its labor productivity growth.

- *During COVID-19 pandemic*, TFP growth in Latvia slowed significantly, falling below Lithuania's level.[6]

Annex IV. Figure 3. Decomposition of Labor Productivity Growth (Percent)



Source: EUKLEMS.

Hence, despite Latvia's TFP growth only slightly surpassing that of other Baltic states during the post-GFC period, it still drove labor productivity growth, compensating for the reduced contribution of capital deepening after the GFC.

6. Explanations for the apparent TFP growth spurt during the post-GFC recovery episode include:

- *Measurement errors.* As TFP is derived as a residual in the production function after considering measured inputs, it is subject to limitations like unobserved factor utilization and potential measurement errors. Notably, the large post-GFC drop in gross fixed capital formation and capital stock in Latvia, compared to Lithuania and Estonia, underscores the difficulty in accurately measuring capital inputs.[7]

- *Reforms.* The intensity and sequencing of economic reforms across the Baltic states varied. For example, Latvia implemented strong reforms during the IMF fund-supported reform program 2009-10 to address the devastating impact of the crisis. These reforms likely contributed significantly to Latvia's post-GFC TFP boost. However, nuanced differences exist among Baltic states' reform paths, with Estonia's early adoption of a digital economy contrasting Latvia's post-crisis reform-driven approach.

- *Differences in economic structure* may explain some of Latvia's unique TFP growth pattern (Annex IV. Figure 4). Latvia has lower share of capital-intensive industries (around 20 percent of total value added in 2019), compared to other Baltic States (close to 30 percent). Less-capital-intensive sectors experienced stronger post-GFC labor productivity growth than capital-intensive sectors in Latvia, likely benefiting from other factors such as technological advancements rather

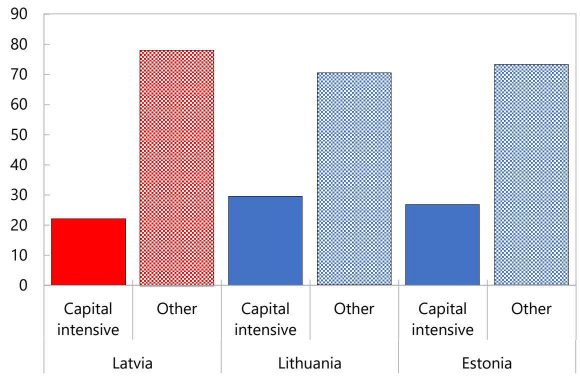
[6] Note that drawing a robust inference about TFP growth is difficult as the EUKLEMS data end at 2020.

[7] See Staehr, 2015, highlighting the diverging dynamics in the capital-output ratio of the three Baltic States, with Latvia's capital output ratio declining to 1.1, Lithuania's – constant at 1.9, while that of Estonia – increasing to 2.9.

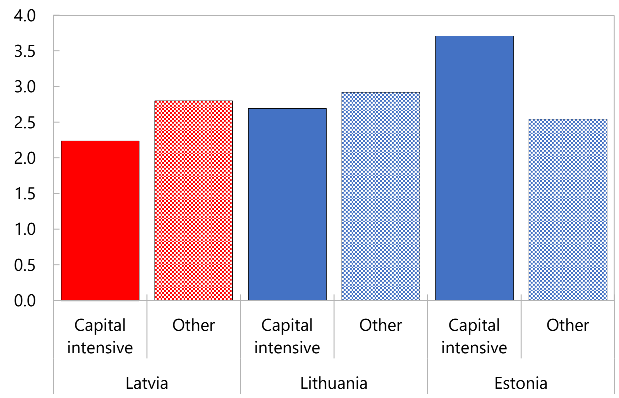
than capital deepening. Consequently, these differences in economic structure explain why the primary driver of aggregate labor productivity growth in Latvia is likely to be stronger TFP growth, rather than capital deepening. This contrasts with other Baltic states, where a higher share of capital-intensive industries implies a greater reliance on capital deepening for productivity improvements.

Annex IV. Figure 4. Baltics: Sectoral Value Added and Productivity Growth

Sectoral Value Added Shares, 2019 /1
(Percentage of total value added, based on chain linked volumes (2015))



Growth in Labor Productivity Per Hour, 2011-2019 1/ 2/
(Percent, annual average)



Source: EUKLEMS and IMF staff calculations.
1/ Capital intensive industries include mining, manufacturing, electricity, water supply, and construction.
2/ Labor productivity calculated as value added (chain linked volumes, 2015) divided by hours worked.

C. Conclusions

7. Latvia's TFP growth boost post-GFC is unlikely to be sustained in the future. The literature, including studies by Eichengreen et al. (2012, 2013), Cai (2012), and Aiyar et al. (2013) suggests that countries often struggle with moving from middle-income to high-income status. When "easy" productivity gains have been exhausted, TFP growth often slows down, because further improvements require more challenging and complex reforms and higher public and private investment.[8] There is a risk, therefore, that Lavia could be caught in a middle-income trap with low growth and slow convergence to euro area income level. This risk stems from:

- *Decade-long weak investment*, with significant implications for both capital deepening and TFP growth. The financial crisis made access to credit harder, particularly for SMEs, hampering private investment and capital development, while inefficiencies in insolvency frameworks hinder capital reallocation, further weighing on private investment post-GFC. Despite a comparable

[8] See the literature on endogenous growth theory (for instance, P. Aghion and P. Howitt, "Endogenous Growth Theory", The MIT Press, 1997), where technological progress is endogenously determined, influenced by economic activities and policies with positive spillovers.

investment/GDP ratio to mature economies, Latvia requires significantly higher investment for sustained convergence (2023 Latvia Staff Report).

- *Large infrastructure gaps*, particularly in transport exacerbate large regional disparities, with some regions experiencing severe high skilled labor shortages, while others – high long-term unemployment rates. This creates allocative inefficiencies of labor across regions, dragging down productivity (Yashiro and others, 2019).

- *Aging and emigration.* A rapid increase in the old-age dependence rate may curtail dynamism and increase the risk of a middle-income trap, exerting negative effect on productivity (Staehr, 2015).

- *Insufficient accumulation in skills weighs on productivity and competitiveness.* The take up of life-long learning programs is low and spending on active labor market policy is also among the lowest in OECD (Ibid, pp.35). Exports mainly concentrated on products produced in medium-skilled sectors, and the share of high-tech products exports is still relatively small.

8. **Boosting productivity is also needed to meet challenges presented from Russia's war in Ukraine and the ongoing transitions to sustain income convergence.** Even though the war in Ukraine has led to a smaller decline in Latvia's trade with Russia than in other Baltic countries, it resulted in major disruptions in energy supply and prices, which could alter viability of all energy-intensive activities:

- Geoeconomic fragmentation could adversely affect foreign direct investment and impact the profitability and competitiveness of firms. Staying price competitive will require strong productivity growth.

- The green and energy transition will call into question viability of energy intensive activities, which would require strong productivity growth to stay in business.

- The low-interest rate to high-interest rate environment will further depress private investment, which has already been on a sustained declining path. While the average investment to GDP ratio is at par with the more matured advanced economies, Latvia needs much higher investment to sustain the convergence. Raising public and private investment would support higher productivity and income.

- The environment of tight labor markets is linked to an aging population and emigration. While labor market reforms and immigration could help increase labor supply, the sustained gains in growth will likely come from investment and productivity growth.

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Annex V. Selected Measures to Address Labor Shortages

Annex V. Table 1. Latvia: Selected Measures to Address Labor Shortages by the EU Member States

Group	Measure	Description	Examples of countries using approach
Attract labor			
	Enhance the appeal of certain sectors	Enhancing the attractiveness of training for certain (vocational) sectors\occupations.	Austria, Germany, Hungary, Luxembourg, Romania
		Improving pay and working conditions in specific sectors (e.g., health and care), incl. regular review of minimum wage.	Belgium, Bulgaria, Croatia, Estonia, Finland, Germany, Hungary, Lithuania, Luxembourg, the Netherlands, Slovakia, Slovenia, Sweden
		Awareness raising of sectors	Austria, Belgium, Finland, Estonia, Malta, the Netherlands, Portugal, Sweden
	Enhance the attractiveness of living and working conditions in a country/region	Attracting specific groups of workers, such as high-level professionals, to countries/regions and assisting in their integration and that of their families.	Austria, Finland, Germany, Latvia
	Active migration policies	Setting up specific migration policy projects based on access requirements for high-, medium-, and low-skilled staff in specific sectors (incl. points-based immigration system, creation of catalogues of shortage occupations, easing of salary criteria and quota system, and easing of admin. requirements). Setting up agreements with specific countries and prolonging the stays of third-country nationals.	Austria, Belgium, Cyprus, Czech Republic, Estonia, Finland, France, Germany, Hungary, Ireland, Latvia, Lithuania, Malta, the Netherlands, Poland, Portugal, Slovenia, Spain
		Setting up specific schemes to support the rights of seasonal workers.	Croatia
		Offering vocational training with integrated language training for migrants.	Sweden
		Encouraging the return migration of diaspora.	Lithuania, Portugal, Slovenia
	Improving recruitment strategies at company level	Providing company-level examples of enhanced recruitment practices	Austria, Malta, Poland
Activate underutilized resources and retain labor			
	Addressing geographical barriers	Support for mobility	Austria, Croatia, Latvia, Lithuania, Sweden
	Addressing work-life balance	Providing support for childcare	Malta
		Enhancing work-life balance policies, including the encouragement of a better balance in caring responsibilities between men and women.	Estonia, The Netherlands, Slovenia, Spain
	Active labor market policies and other measures to support the integration of specific groups	Overcoming non-skills-related barriers to integration for vulnerable groups in the labor market, including long-term unemployed, workers with disabilities, and migrants and refugees	Belgium, Bulgaria, Czech Republic, Denmark, Germany
		Improving rehabilitation services to allow workers to return from long-term sick leave, unemployment or inactivity	Austria, Estonia, Romania

Annex V. Table 1. Latvia: Selected Measures to Address Labor Shortages by the EU Member States (concluded)

Group	Measure	Description	Examples of countries using approach
Enhance the use of existing labor and retain labor			
	Improved matching between supply and demand	Using skills forecasting to adapt vocational and ongoing training systems to identify future shortages	Croatia, Estonia, Greece, Latvia, Lithuania, Malta
		Integrating broader government development strategies with training and job creation (taking account of digital transformation and artificial intelligence).	Ireland
		Improving the match between the education system at all levels and labor market needs through regular updating, including with the involvement of social partners.	Bulgaria, Germany, Latvia, Lithuania, The Netherlands (technology sector), Poland, Spain
	Addressing skills mismatches	Introducing and developing dual education pathways.	Slovakia
		Enhancing the relevance of transferable skills in vocational training systems, including digital and soft skills.	Finland, Ireland
	Improved matching systems	Improving career guidance and counselling.	Greece
		Better validation and certification of existing skills and non-formal and informal education.	Croatia, Cyprus, Sweden
		Implementing active labor market policies (training) to provide a better match between bottleneck occupations and jobseekers	Austria, Belgium, Bulgaria, Croatia, Cyprus, Estonia, Finland, Germany, Latvia, Romania
		Delivering workplace-tailored training (e.g., by public employment service).	Austria, Belgium, Cyprus
		Greater emphasis in active labor market policies on in-work training.	Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Greece, Ireland, Italy, Latvia, Slovenia
	Enhancing the preparation of employees for labor market change	Providing support for the delivery of lifelong learning, including digital skills.	Austria, Belgium, Latvia, Luxembourg, Sweden
		Ongoing assessments of vocational requirements (including mid-career assessments).	Croatia, Germany
	Enhancing the use of existing labor through employee sharing	Addressing labor shortages through employee sharing.	Czech Republic, the Netherlands
	Preventing early exit from the labor market	Providing support for active age management strategies and promoting the retention of the work ability of older workers.	Lithuania, Romania, Slovenia
		Pension reform and other (non-skills-focused) measures to retain older workers.	Croatia, Estonia, Slovakia, Slovenia

Source: Kingdom of the Netherlands – The Netherlands, 2024 Selected issues paper prepared by A. Myrvoda, and Eurofound (2021), Tackling labour shortages in EU Member States, Publications Office of the European Union, Luxembourg.

Annex VI. Data Issues

Annex VI. Table 1. Latvia: Data Adequacy Assessment for Surveillance

Data Adequacy Assessment Rating 1/							
A							
Questionnaire Results 2/							
Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	A	A	A	A	A	A	A
Detailed Questionnaire Results							
Data Quality Characteristics							
Coverage	B	A	A	A	A		
Granularity 3/	A		A	A	A		
			A		A		
Consistency			A	B		A	
Frequency and Timeliness	A	A	A	A	A		

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.
2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF *Review of the Framework for Data Adequacy Assessment for Surveillance*, January 2024, Appendix I).
3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.

A	The data provided to the Fund is adequate for surveillance.
B	The data provided to the Fund has some shortcomings but is broadly adequate for surveillance.
C	The data provided to the Fund has some shortcomings that somewhat hamper surveillance.
D	The data provided to the Fund has serious shortcomings that significantly hamper surveillance.

Rationale for staff assessment. Data provided to the Fund are adequate for surveillance. (1) 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 (which is a common practice). (2) There are statistical discrepancies between GDP and the sum of expenditure components. (3) The external sector accounts have large errors and omissions, greater than 1 percent of GDP in recent years.

Changes since the last Article IV consultation. No changes.

Corrective actions and capacity development priorities. Staff recommends to address the issues raised above to improve national accounts and external sector statistics. Staff will also liaise with STA to improve BoP compilation.

Use of data and/or estimates different from official statistics in the Article IV consultation. Staff also uses data from Eurostat, most importantly for price data – Eurostat produces harmonized price indices that allow for within EU comparisons. Data were also used from EU KLEMS (for productivity), OECD (for structural topics), and the ECB (for financial topics). These sources have data for multiple countries and allow for regional comparative analyses.

Other data gaps. No macro-critical data gaps. There are some data limitations of the EU KLEMS, for instance, for TFP-related data.

Annex VI. Table 2. Latvia: Data Standards Initiative

Latvia adheres to the Special Data Dissemination Standard (SDDS) Plus since August 2018 and publishes the data on its National Summary Data Page. The latest SDDS Plus Annual Observance Report is available on the Dissemination Standards Bulletin Board (https://dsbb.imf.org/).

Annex VI. Table 3. Latvia: Common Indicators Required for Surveillance

As of May 16, 2024

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Expected Frequency[6,7]	Latvia[8]	Expected Timeliness[6,7]	Latvia[8]
Exchange Rates	16-May-24	16-May-24	D	D	D	...	...	...
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr-24	May-24	M	M	M	30	1W	21
Reserve/Base Money	Apr-24	May-24	M	M	M	30	2W	14
Broad Money	Apr-24	May-24	M	M	M	30	1M	20
Central Bank Balance Sheet	Apr-24	May-24	M	M	M	30	2W	14
Consolidated Balance Sheet of the Banking System	Apr-24	May-24	M	M	M	30	1M	20
Interest Rates[2]	16-May-24	16-May-24	D	D	D	...	...	...
Consumer Price Index	May-24	Jun-24	M	M	M	30	1M	6
Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4]	Dec-23	Apr-24	Q	Q	A/Q	...	2Q/12M	...
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	Dec-23	Apr-24	Q	Q	M	30	1M	21
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec-23	Apr-24	Q	Q	Q	30	1Q	21
External Current Account Balance	Mar-24	Apr-24	Q	Q	Q	30	1Q	30
Exports and Imports of Goods and Services	Mar-24	Apr-24	Q	Q	M	30	8W	56
GDP/GNP	Dec-23	Apr-24	Q	Q	Q	90	1Q	70
Gross External Debt	Dec-23	Mar-24	Q	Q	Q	90	1Q	65
International Investment Position	Mar-24	Jun-24	Q	Q	Q	90	1Q	65

[1] Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.

[2] Both market-based and officially determined, including 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] Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual.; ("SA") semiannual; ("I") irregular; ("NA") not available or not applicable; and ("NLT") not later than.

[7] Encouraged frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected. For those countries that do not participate in the IMF Data Standards Initiatives, the required frequency and timeliness under the SDDS are shown for New Zealand, and the encouraged frequency and timeliness under the e-GDDS are shown for Eritrea, Nauru, South Sudan, and Turkmenistan.

[8] Based on the information from the Summary of Observance for SDDS and SDDS Plus participants, and the Summary of Dissemination Practices for e-GDDS participants, available from the IMF Dissemination Standards Bulletin Board (https://dsbb.imf.org/). For those countries that do not participate in the Data Standards Initiatives, as well as those that do have a National Data Summary Page, the entries are shown as "..."

Annex VII. Past IMF Policy Recommendations

IMF 2023 Article IV Recommendations	Implementation
Fiscal Policy	
Target energy support measures to the most vulnerable to reduce spending and contain the cash deficit.	The authorities amended the law on energy support to improve targeting of energy support measures.
To reduce the structural fiscal deficit in line with the medium-term fiscal path, lower tax exemptions broaden the bases of corporate income tax (CIT), personal income tax (PIT), and property taxes, and rationalize spending on goods and services.	The authorities are currently considering tax reform to increase revenue.
Link the official and early retirement ages to future life expectancy gains to encourage longer work lives once the retirement age reaches 65, and review the minimum contribution period required for a pension.	The government raised the minimum contribution required for a pension from 15 years to 20 years effective January 2025.
Reduce the labor tax wedge to strengthen work incentives and increase high-skilled labor supply.	The government does not plan to reduce the labor tax wedges but is considering a general tax reform.
Financial Sector Policies	
Continue regular, risk-based monitoring of banks' asset quality supported by tailored stress tests. Address problems related to variable-rate mortgage loans via consumer bankruptcy legislation. Consider increasing capital based macroprudential measures to further build resilience.	The Bank of Latvia enhanced use of stress testing to assess macrofinancial conditions and liquidity risks. The authorities adjusted macroprudential policy measures to build more buffers. They raised the countercyclical capital buffer requirement and will continue to increase it gradually to further build resilience.
Continue to strengthen the AML/CFT framework by addressing the few outstanding GRECO recommendations and implementing the country's Anticorruption Plan and National Strategy.	Latvia has strengthened its AML/CFT framework through the adoption of crypto assets regulation. The authorities have enhanced the beneficial ownership framework by establishing a foreign trust register.
Structural Reforms	
To address the shortage of high-skilled labor, 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.	To help alleviate labor market shortages, the authorities have been relying on ALMPs (including training and subsidy for mobility to regions with high unemployment rates) and migration.

IMF 2023 Article IV Recommendations	Implementation
Structural Reforms (concluded)	
Reforms in digital transformation should focus on enhancing connectivity, increasing adoption and use of digital technologies, unleashing digital innovation, and providing training on digital technologies.	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.
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.	The authorities are increasing investments in renewable energy (mainly wind energy). No measures are planned to extend carbon pricing.

Annex VIII. Rail Baltica[1]

Rail Baltica is the largest Baltic-region infrastructure project in the last 100 years. The rail transport infrastructure project, which is being implemented by the Baltic States, will integrate the Baltics in the European rail network and provide socio-economic benefits for the region. There have been large cost overruns in the Rail Baltica project for Latvia—originally estimated at 4.6 percent of GDP (EUR 1.97 billion[2]) and now at about 22.6 percent of 2024 GDP (about EUR 9.59 billion). This project therefore poses fiscal risks and can have large fiscal implications.

A. Overview

1. **Rail Baltica is a large railroad infrastructure project to be constructed in the Baltic countries and a priority transport project.**[3] It is currently one of the biggest investments in improving mobility and travel opportunities, as well as developing business, trade, tourism, and the exchange of goods in the region. It is the largest railroad infrastructure project to be constructed in the Baltic countries in the last hundred years. The Rail Baltica project is one of the priority transport projects of the European Union because it will remove bottlenecks, build missing cross-border connections, and promote modal integration and interoperability. This project will help to connect the Baltic states to the European railway network for the security of goods, ease of travelling, economic development, and common European security.

2. **The Rail Baltica project is owned and implemented by the three Baltic States – Estonia, Latvia, and Lithuania**.[4] The central coordinator and delivery organization of the global project is RB Rail AS – a joint venture of the Baltic States with its headquarters in Riga. RB Rail was established in October 2014 for the purpose of establishing the railway infrastructure and developing the Rail Baltica project. Its main business is the design, construction, and marketing of the railway. RB Rail also submits EU financing proposals for the Rail Baltica Global Project on behalf of the beneficiaries. It also serves as the central purchasing body for all parties for the procurement of studies, plans, designs for the global project, sub-systems, raw materials and key components, and cross-border track sections. The national implementing bodies Rail Baltic Estonia in Estonia, Eiropas Dzelzceļa līnijas in Latvia, and LTG Infra in Lithuania are responsible for national track

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[1] See https://www.railbaltica.org/.

[2] EUR 1.97 billion was the estimated cost of the project in 2017.

[3] Rail Baltica is a greenfield rail transport infrastructure project with a goal to integrate the Baltic States in the European rail network. The project includes five European Union countries – Poland, Lithuania, Latvia, Estonia and indirectly also Finland. It will connect Helsinki, Tallinn, Pärnu, Riga, Panevežys, Kaunas, Vilnius, Warsaw. The Baltic part of the Rail Baltica project is referred to as the Rail Baltica Global Project.

[4] Estonia's Ministry of Climate, Latvia's Ministry of Transport and Lithuania's Ministry of Transport and Communications established a joint venture, RB Rail AS, to be the Main Coordinator in 2014, for the purpose of completing the railway and developing the Rail Baltica project. Rail Baltic Estonia OU in Estonia, Eiropas Dzelzceļa līnijas SIA in Latvia, Rail Baltica statyba UAB and LTG Infra in Lithuania are the national Implementing Bodies.

construction, design and build of Rail Baltica international and regional stations and terminals under the supervision of the joint venture.

3. Rail Baltica will enable people of the Baltic region to connect and provide economic benefits. The project will provide better opportunities to commute for education and employment. There will also be more opportunities to access specialist health providers across the region. Moreover, the project itself is expected to generate 13,000 direct jobs and more than 23,000 indirect and induced jobs during the construction phase, as well as approximately 800 permanent jobs in operations and infrastructure management. The Rail Baltica project will create CO2 emission reduction benefits worth EUR 3.0 billion and air pollution reduction benefits of EUR 3.3 billion value – contributing greatly to the EU's global leadership in environmental sustainability.

B. Funding

4. The total estimated cost of the Rail Baltica project has increased more than four times. The estimated preliminary cost of developing the project has increased from EUR 5.8 billion to EUR 23.8 billion in all three countries.[5] Initially, implementing the project was estimated at: Estonia – EUR 1.35 billion (national share ~EUR 268 million); Latvia – EUR 1.97 billion (national share ~ EUR 393 million); Lithuania – EUR 2.47 billion (national share ~ EUR 493 million)[6]. The project is now estimated to cost EUR 4.03 billion for Estonia (an increase of 3.6 to 10.6 percent of 2024 GDP); EUR 9.59 billion for Latvia (an increase of 4.6 to 22.6 percent of 2024 GDP); and EUR 10.23 billion for Lithuania (an increase of 3.3 to 13.5 percent of 2024 GDP). The project is co-funded from the European Union up to 85 percent of the total eligible costs, through the framework of the Connecting Europe Facility (CEF) funding instrument. So far, the three Baltic states and RB Rail AS have received three grants from the CEF. There have been large cost overruns in the Rail Baltica project. The main reasons for the increase in the cost of the project include an increase in the project scope, inflation, and development and changes in the design guidelines.

5. There are risks to securing additional financing to complete the Rail Baltica project. A gap is expected in financing the project for the years 2027-2028, in line with the end of the current European Union funding period. In addition, there is no certainty that the CEF—which is the main financing tool for the project—will be continued in the upcoming EU financing period or that its budget or co-financing rate is known. Taking into account the new project budgets in each country and the already allocated funds, there are additional funds in the amounts of EUR 2.7 billion (7.1 percent of GDP) in Estonia, EUR 7.6 billion (17.9 percent of GDP) in Latvia and EUR 8.7 billion (11.5 percent of GDP) in Lithuania needed to complete the project. Increased financing from national budgets by taking a state loan has been deemed as the most viable alternative funding opportunity by the Project Parties. However, a final decision has not been made.

[5] See Review on the Rail Baltica Project (2024). These costs could be underestimated as the new cost benefit analysis only includes the cost of the project until the end of construction. Therefore, all operation and maintenance costs that occur after the construction phase when the railway starts operating are not included to the project budget.

[6] The national share is the amount funded by the budget.

6. To reach the project deadline set in the European Regulation (2030) and to manage increased costs, the Baltic countries have decided to implement the project in two phases. In the first phase, the Rail Baltica project will be built in a reduced scope, which will reduce estimated costs from EUR 4 billion to EUR 3.1 billion in Estonia, from EUR 9.6 billion to EUR 6.4 billion in Latvia and from EUR 10.2 billion to EUR 5.4 billion in Lithuania until the year 2030. This means that in the case of implementing the first phase of the project, the additional funding need for the whole project is EUR 10.1 billion, being EUR 1.8 billion (4.7 percent of GDP) in Estonia, EUR 4.4 billion (10.4 percent of GDP) in Latvia, and 3.9 billion (0.1 percent of GDP) in Lithuania.[7]

C. Conclusion

7. There are socio-economic benefits of the Rail Baltica project, but it poses a fiscal risk. The project will enable people of the Baltic region to connect faster and better, and provide job opportunities. However, given the large costs overruns and the uncertainty to further funding from EU funds, the project is likely to be completed using state resources—which are yet to be identified. This project therefore poses a fiscal risk and can have large fiscal implications.

Annex VIII. Table 1. Rail Baltica: Key Historical Timelines

2014	Joint Statement signed by the three Baltic Prime Ministers.
2016	Rail Baltica Contracting Scheme Agreement signed; EU CEF2 Grant Agreement signed; Inter-beneficiary agreement signed; Declaration adopted by the three Baltic States with Poland and Finland.
2017	Cost-Benefit Analysis completed.
2018	Rail Baltica Design Guidelines approved.
2019	The first design contract for the Rail Baltica main line signed.

[7] The construction period of the project was expected to be 10 years. The delivery of the first phase of the project is expected to be completed in 2030 which is at least five years later than the initial project's schedule which set the deadline for finishing the construction of the railway at the end of 2025. Currently there is no schedule for the second phase.

Reference

Review on the Rail Baltica Project (2024). National Internal Audit of Estonia, Republic of Latvia State Control, and NAO Lithuania.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 2, 2024

Prepared by | The European Department

CONTENTS

FUND RELATIONS

(As of June 30, 2024)

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)	305.24	91.86
Reserve Tranche Position	27.39	8.24

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	439.32	100.00
Holdings	440.36	100.24

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		
	2025	2026	2027
Principal	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00
Total	0.00	0.00	0.00

Exchange Rate Arrangement:

As of January 1, 2014, the currency of Latvia is the euro. 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. 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 September 12, 2023 (IMF Country Report No. 22/277). The Executive Board assessment is available https://www.imf.org/en/Publications/CR/Issues/2023/09/14/Republic-of-Latvia-2023-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-539172

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

Table 1. 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

Table 1. Latvia: Technical Assistance, 2009–22 (concluded)

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