27 April 2018

Public Finance

# Republic of Latvia
# Rating Report

STABLE OUTLOOK

A-

## Credit strengths

- Strong public finances
- Commitment to structural reforms
- Sound economic performance
- Euro area membership

## Credit weaknesses

- External vulnerabilities, including high non-resident debt in banking sector
- Unfavourable demographics
- Weak productivity gains

**Rating rationale and Outlook:** Latvia's A- rating is underpinned by i) the country's effective fiscal consolidation and prudent debt management, which contributes to the reduction in debt ratios; ii) commitment to structural reforms and sound economic performance, supported by the absorption of European Union (EU) funds; iii) and its euro area membership. The ratings are primarily constrained by challenges stemming from the large share of non-resident deposits in external liabilities, the falling labour supply and lagging productivity levels. The Stable Outlook reflects Scope's view that risks are broadly balanced going forward.

**Figure 1: Sovereign scorecard results**

| Scope's sovereign risk categories | Latvia | Peer comparison: Average | Lithuania | Slovakia |
|---|---|---|---|---|
| Domestic economic risk | | | | |
| Public finance risk | | | | |
| External economic risk | | | | |
| Financial risk | | | | |
| Political and institutional risk | | | | |
| Qualitative adjustment (notches) | -1 | | -1 | 1 |
| Final rating | A- | | A- | A+ |

AAA AA A BBB BB B CCC CC C

Source: Scope Ratings GmbH

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

## Positive rating-change drivers

- Sustained reduction of short-term external debt
- Further reduction of public debt
- Implementation of structural reforms driving higher growth potential

## Negative rating-change drivers

- Reversal of fiscal consolidation
- Lower-than-expected absorption of EU funds, weighing on growth
- Elevated financial sector vulnerabilities

## Ratings and outlook

**Foreign currency**

| | |
|---|---|
| Long-term issuer rating | A-/Stable |
| Senior unsecured debt | A-/Stable |
| Short-term issuer rating | S-1/Stable |

**Local currency**

| | |
|---|---|
| Long-term issuer rating | A-/Stable |
| Senior unsecured debt | A-/Stable |
| Short-term issuer rating | S-1/Stable |


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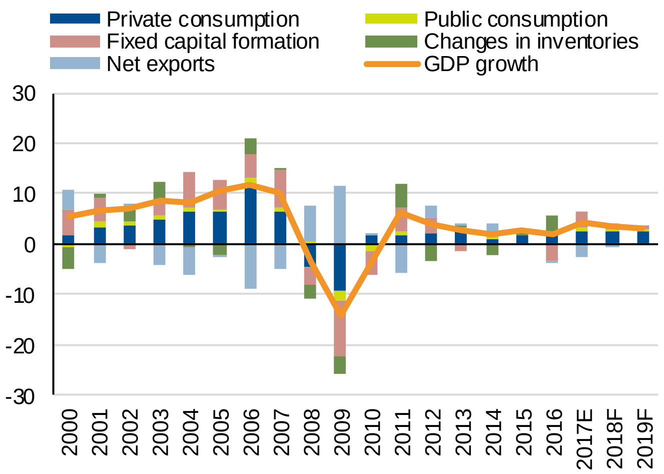
## Domestic economic risk

### Growth potential of the economy

**Strong economic performance and recovery in investments**

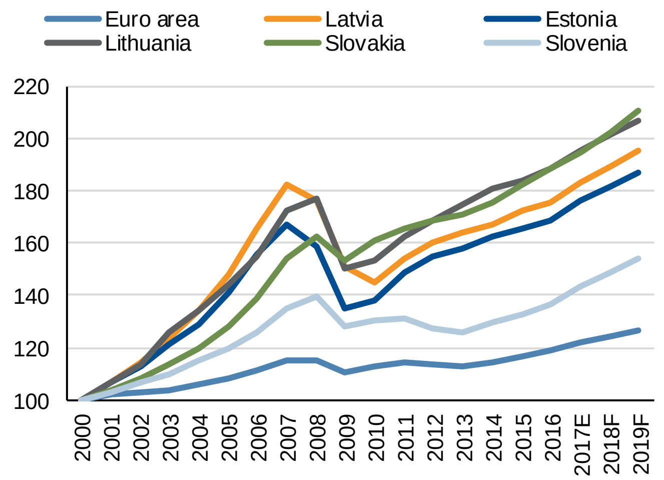
Latvia's economy performed strongly in 2017. Following relatively modest expansion in 2016 due to a lower-than-excepted absorption of EU funds, Latvia's GDP growth has accelerated to 4.5% in 2017, driven by a recovery in investment, as well as strong consumption and exports. Scope expects the Latvian economy to continue growing by 4% and 3.5% through 2018 and 2019. Robust private consumption buoyed by an upturn in real wages and domestic credit, alongside investments and a favourable external environment, will drive this growth. Labour supply and higher capacity utilisation will be important for economic performance in the medium term.

**Figure 2: Percentage-point contribution to real growth**




Source: European Commission

**Figure 3: Real GDP, 2000=100**




Source: European Commission, Scope Ratings GmbH

**Progress with structural reforms**

Latvia has progressed with structural reforms. Notably, the country ranks first regarding actions taken on structural reform priorities of the OECD's 2017 Going for Growth. Authorities have introduced a tax reform package proposing modifications to income and excise taxes, aimed at making taxation more equitable and supporting inclusive growth, as well as measures to improve the quality of education and public-sector efficiency by streamlining administrative procedures.

The private non-financial sector continued to deleverage in 2017, with household and company debt decreasing to 39.6% of GDP in Q4 2017. As a result, the credit-to-GDP gap[1] remained significantly negative at -27%, indicating more-than-adequate space for domestic credit to fuel economic activity. In line with this development, Scope expects credit growth to gain pace over the coming years, propelled by improved financial balance sheets among borrowers and decreasing financing costs.

The potential growth rate of the Latvian economy is improving, expected at 3.7% in 2018, spurred by investment and productivity gains. In the pre-crisis period (2003-2007), however, potential GDP grew by an average 7.6% on the back of a rapid expansion from a notably lower per-capita GDP. Scope notes that the country's labour productivity[2], while gradually increasing, amounts to only 64.8% of EU average, one of the lowest in Europe.

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[1] The credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-run trend
[2] Nominal labour productivity per person

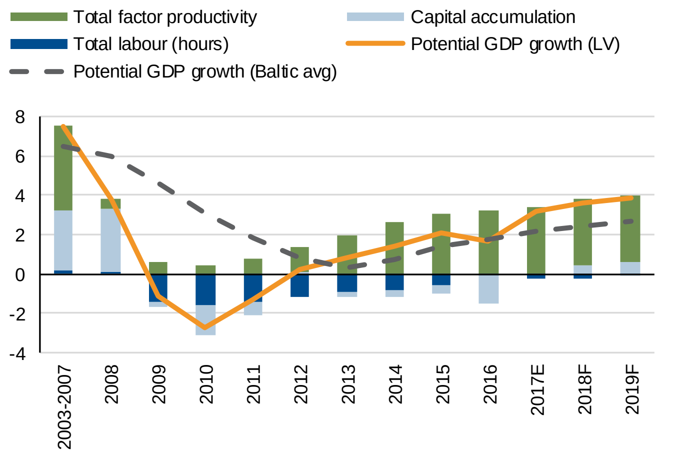
Economic diversification towards higher value-added production will be key to maintaining the steady catch-up process.

**Economic policy framework, and macroeconomic stability and imbalances**

**Falling labour supply constraining market outcome**

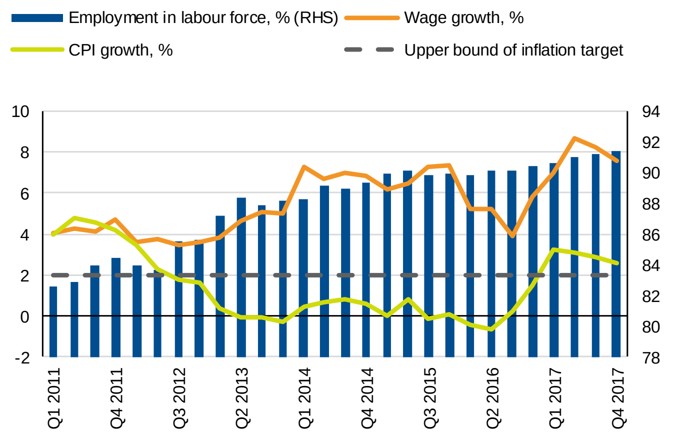
While the labour market has recovered with unemployment rate falling to 8% in February 2018, this figure remains somewhat higher than that in peers like Estonia (6.5%) and Lithuania (7.3%), reflecting persistent rigidities. The size of the labour force has continued to decline by an annual average of around 1% since 2012 due to negative demographics and net migration, weighing on employment outcomes.

**Figure 4: Percentage-point contribution to potential growth**




Source: European Commission, ECB, Scope Ratings GmbH

**Figure 5: Labour market and inflation developments**




Source: Central Statistical Bureau of Latvia, Eurostat, Scope Ratings GmbH

Real wage growth in 2017 was robust, averaging 4%, thanks to a higher minimum wage, the declining labour force and demand for high-skilled labour. Even so, the gap in growth between wages and productivity turned negative at -1.5pp for the first time since 2013, thanks to some labour efficiency increases.

**Wage growth driving inflation to 3%**

Inflation picked up in 2017 to a full-year average of 2.9%, in line with robust wage growth, primarily due to food, transport and the recovery in energy prices. Scope expects inflation to remain close to 3% in 2018, driven by a sustained rise in both wages and excise taxes.

The Latvian economy benefits from a favourable business environment and an improving energy infrastructure in the Baltic region following the 2014 launch of the Klaipėda liquid natural gas terminal in Lithuania, aimed at mitigating the dependence on Russian gas.

**Effective policy-making supported by EA membership**

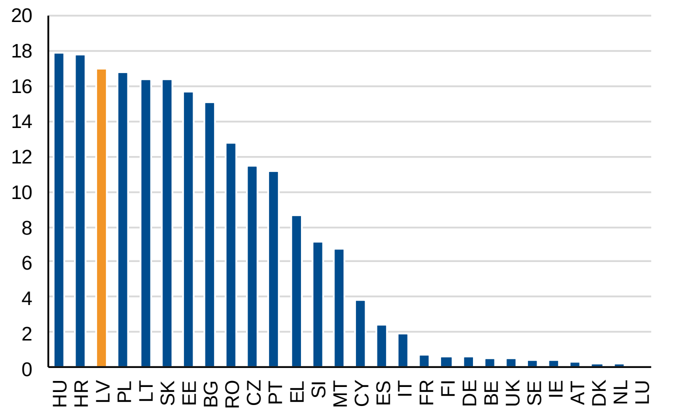
Latvia's A- rating is supported by the country's euro area membership, affording the advantages of a large common market, a strong reserve currency, the independent European Central Bank (ECB) effectively acting as a lender of last resort, and an economic governance and macro prudential framework sustaining credible macroeconomic policies.

Latvia is one of the largest recipients of European Structural and Investment Funds in relation to GDP and is expected to receive up to EUR 5.6bn by 2020. These funds aim to strengthen transport and energy infrastructure, environmental protection and competitiveness, among other areas.

Latvia has met Europe 2020[3] objectives for employment and poverty reduction. Progress on R&D intensity, however, remains limited and dependent on EU funds.

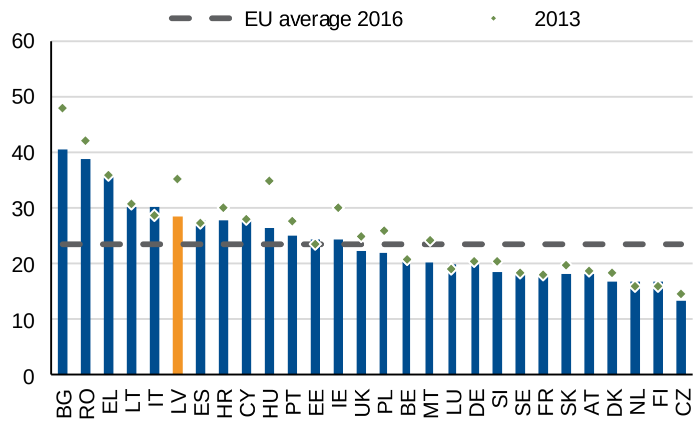
[3] The European Union's ten-year job and growth strategy, launched in 2010

Figure 6: EU structural funds allocation 2014-2020, % GDP




Source: European Commission, Scope Ratings GmbH

Figure 7: People at risk of poverty or social exclusion 2016 (%)




Source: Eurostat, Scope Ratings GmbH

## Public finance risk

Latvia has a track record of effective fiscal policy and prudent debt management, which has contributed to a sizeable reduction in indebtedness in the post-crisis period.

Medium-term fiscal plans have been formed around the 2017 tax reform, which introduces more progressive personal-income taxation and a lower tax burden for most businesses. These tax decreases will be counterbalanced partly by higher excise duties and measures to improve tax collection.

Much-needed tax reform package adopted

In Scope's opinion, the 2017 tax reform package is likely to have a moderately positive effect on growth. The main proposals are: i) the replacement of the personal income tax rate of 23% with progressive rates of 20%, 23% and 31.4%; ii) an increase in social security contributions by 1 pp to 35.09%; iii) the introduction of a 20% tax on distributed profits (in 2017 tax rate for CIT[4] is 15% and dividends are taxed at 10% PIT[5] rate, resulting in an effective tax rate of 23.5% for distributed profits), which means that undistributed (reinvested) profits are not taxed with corporate income tax; iv) a rise in excise duties; and v) new measures to fight the 'shadow economy' (currently estimated to be around 20.3%[6] of the total economy) such as expanding the reverse-charging VAT mechanism.

**Fiscal performance**

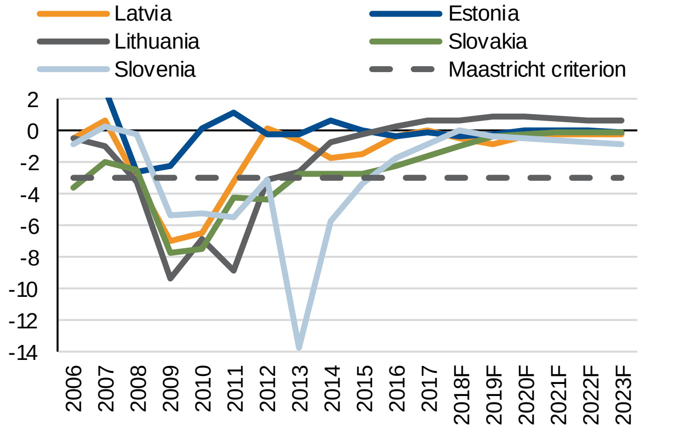
Adequate fiscal space supported by low indebtedness

Latvia's adequate fiscal space is supported by low and decreasing debt levels on the back of modest fiscal deficits, sound economic growth, and favourable financing costs underpinned by the ECB's accommodative monetary policy.

In 2017, Latvia recorded a headline deficit of 0.5% of GDP compared to the modest surplus of the previous year, in part due to expansionary measures reflecting the pickup in public investments linked to the improved take-up of EU funds. The 2018 budget targets a fiscal deficit of 1% of GDP (Scope expects the deficit to remain around 0.5%). Fiscal priorities include healthcare, demographics and defence. Scope anticipates the deficit to remain below 1% over the medium term, reflecting the broad fiscal discipline, tax reform and improved take-up of EU funds.

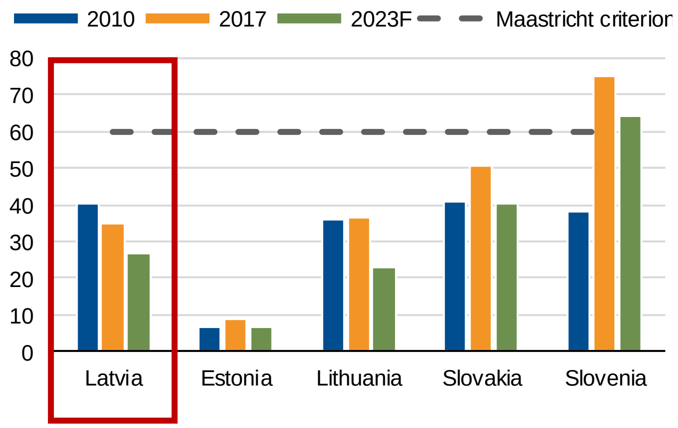
[4] Corporate income tax
[5] Personal income tax
[6] Stockholm School of Economics, 'Shadow Economy Index for the Baltic Countries 2009-2016'

**Figure 8: Fiscal balances, % of GDP**




Source: IMF

**Figure 9: Debt levels, % of GDP**

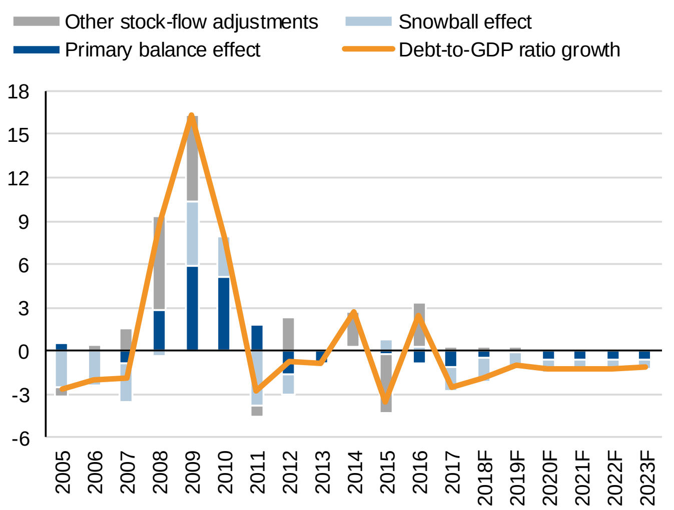



Source: IMF, Scope Ratings GmbH

**Debt sustainability**

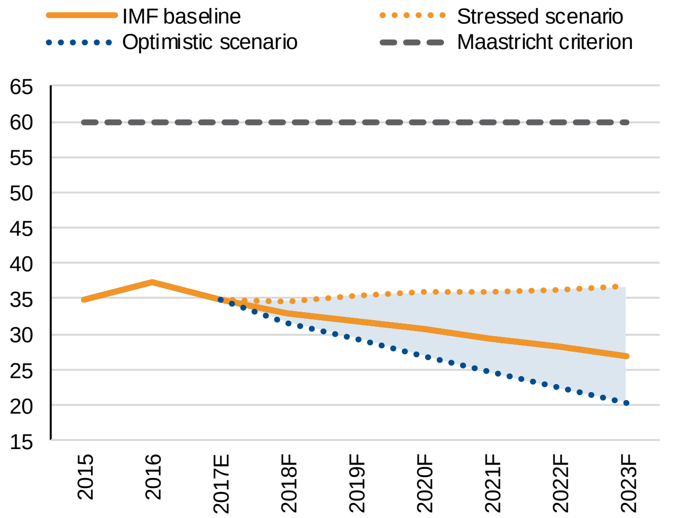
Scope assesses Latvia's medium-term public-debt dynamics as sound – the result of relative robustness across several scenarios, including a 'stressed scenario' in which Scope stressed the IMF's underlying assumptions with combined economic and financial shock such as lower economic growth, higher interest payments and fiscal loosening over the projection horizon to 2023 (Figure 11). According to IMF, general government debt stood at 34.8% of GDP in 2017. Scope expects this figure to fall under 27% of GDP by 2023, in line with the IMF's baseline scenario, driven by robust economic performance and low financing costs (interest expenditures relative to GDP are expected to remain at around 1% over this horizon).

**Figure 10: Contribution to gov't debt changes, % of GDP**




Source: IMF, calculations by Scope Ratings GmbH

**Figure 11: General government debt, % of GDP**




Source: IMF, Scope Ratings GmbH

**Long-term budgetary pressures from negative demographics**

Over the long run, however, unfavourable demographics and the need to improve the quality and accessibility of healthcare will put pressure on public finances, in Scope's view.

| Scenario | Time period | Real GDP growth (%) | Primary bal. (% of GDP) | Real eff. int. rate (%) | Debt end period (% of GDP) |
|---|---|---|---|---|---|
| History | 2013-2017 | 2.8 | 0.6 | 2.5 | 34.8 |
| IMF baseline | 2018-2023 | 3.4 | 0.5 | 0.2 | 26.9 |
| Optimistic scenario | | 4.1 | 1.0 | -0.4 | 20.3 |
| Stressed scenario | | 1.9 | -0.5 | 1.3 | 36.6 |

Source: IMF, Scope Ratings GmbH

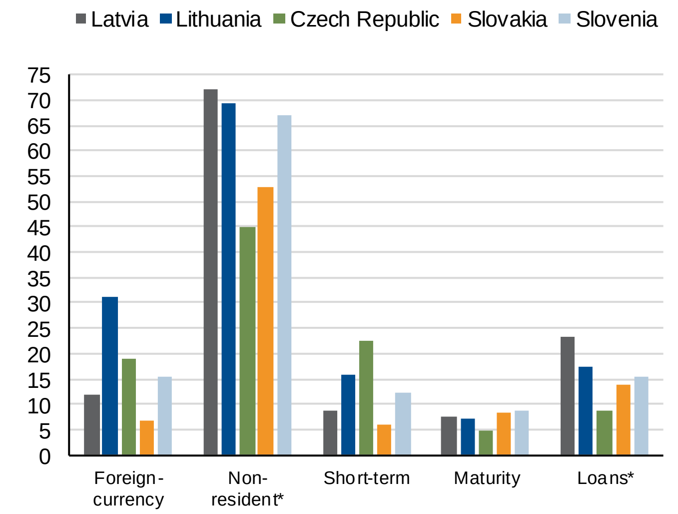
According to the European Commission, the old-age dependency ratio in Latvia is estimated to increase by circa 35 pp between 2016 and 2060 (from 30.5% to 65.2%[7]), one of the fastest such increases across EU countries. As a result, healthcare expenditure is projected to increase by 0.6 pp of GDP[8]. Acknowledging this, authorities have adopted measures to address the poor demographic outlook and low-pension concerns, such as increasing outlays for child benefits, indexing pension growth to 50% of wage growth, and raising the retirement age by three months annually to 65 years through 2025.

**Market access and funding sources**

**Favourable debt structure, low refinancing risks**

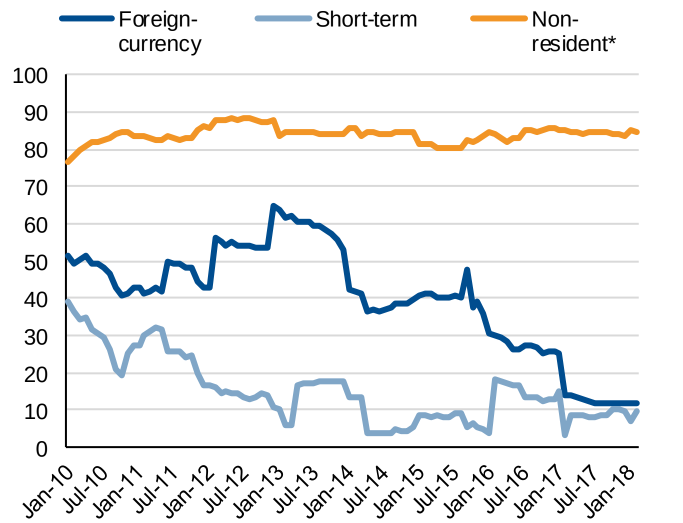
Latvia benefits from a favourable public-debt portfolio structure, reflected in a large portion of fixed-rate debt (around 94%) and low financing costs, as debt due within the next 12 months was only 10.2% of the total stock in Q1 2018. Most of the country's debt (89%) is issued in local currency[9]. The capital market in Latvia is regionally well-integrated, although still relatively small and dominated by government issuance.

**Figure 12: Government debt structure, comparison with peers, % of total debt securities, February 2018**




Source: European Central Bank, Eurostat, National central banks, Scope Ratings GmbH. Loans and Non-resident data refer to Q4 2016

**Figure 13: Development of Latvian government debt structure, % of total public-debt stock**




Source: European Central Bank, Republic of Latvia Ministry of Finance, Scope Ratings GmbH. Non-resident data refers to Central government debt

[7] European Commission, 'The 2018 Ageing Report'
[8] Between 2013 and 2060. European Commission, 'The 2015 Ageing Report'
[9] Central Government debt

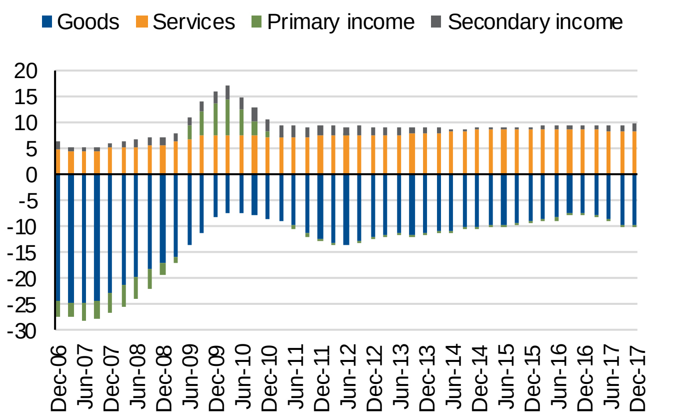
## External economic risk

### Current account vulnerabilities

**Small open economy vulnerable to external shocks**

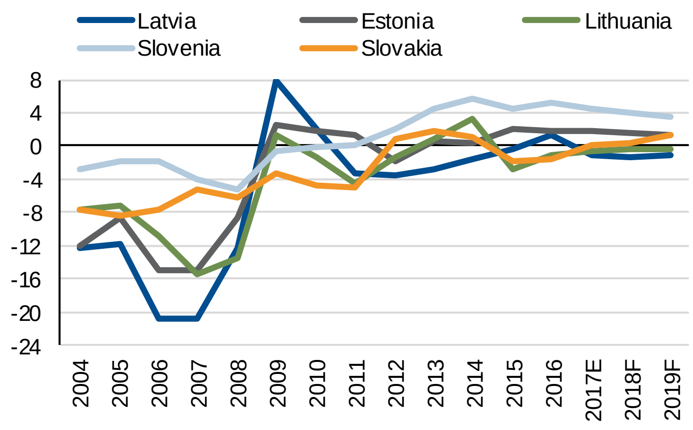
Latvia's small, open economy remains vulnerable to external shocks and is reliant on external demand, reflected in a large negative net international investment position of -56.5% of GDP at the end of 2017. Direct investment accounts for almost a third of external liabilities, with the financial sector holding the largest share of the FDI stock.

**Figure 14: Composition of current-account balance, % of GDP**




Source: Bank of Latvia, calculations by Scope Ratings GmbH

**Figure 15: Current-account balances, % of GDP**




Source: European Commission

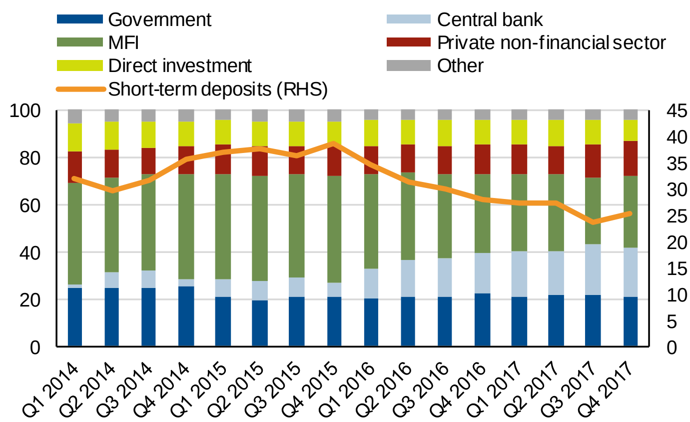
Latvia's current account moved into deficit in 2017, in line with the investment recovery and the corresponding increase in imports of investment goods which is expected to lead to the current-account balance remaining negative at around -2% of GDP in 2018. At the same time, the export base of the economy remains diversified, both in terms of goods and destination markets.

### External debt sustainability and vulnerability to short-term shocks

**High external debt levels, large share of short-term debt**

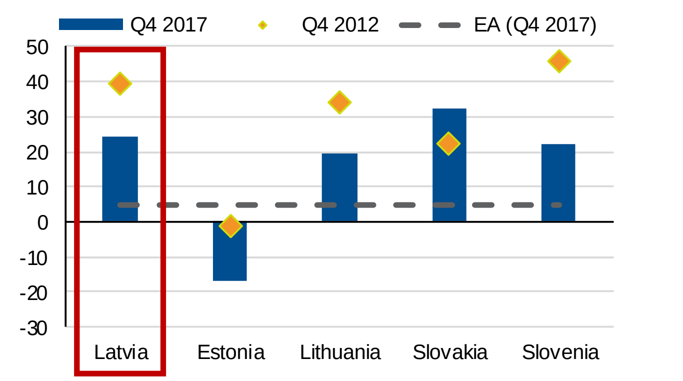
External debt stood at 141.4% of GDP at the end of 2017, almost unchanged compared to the same period in the previous year. This level is materially above Estonia's 82.7% of GDP and Lithuania's 80.6%. The largest portion of external debt represents bank borrowings. About 25% of the debt stock consists of short-term deposits, leaving the economy vulnerable to shifts in external investor confidence.

**Figure 16: Composition of external debt, % of total**




Source: Bank of Latvia, calculations by Scope Ratings GmbH

**Figure 17: Net external debt, % of GDP**




Source: European Commission, European Central Bank

However, non-resident debt in the banking sector has significantly declined in the Q1 2018 (by 2.2 bn euro or 27%). Furthermore, Latvia's external debt is mainly in local currency, with only 20% in foreign currency, bolstering resilience to exchange rate movements. A large share of external liabilities is counterbalanced by external assets, reflected in a significantly lower net external debt of 24.5% of GDP in 2017.

## Financial stability risk

**Dual nature of banking sector**

With bank assets above the country's GDP, Latvia is a leading financial centre in the Baltic region. The banking sector in Latvia consists of two different types of banks: i) Nordic banks, which dominate the sector and provide most of the credit to the economy; and ii) banks servicing mostly foreign clients, which have weak links to the economy as they are responsible for only a small portion of the domestic lending.

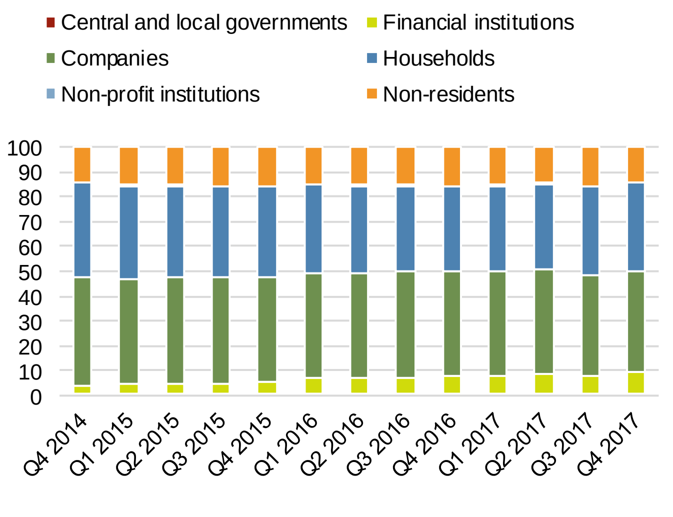
**Macro-financial vulnerabilities, and financial sector oversight and governance**

The liquidation of ABLV Bank, due to deposit outflow followed by the money laundering and corruption allegations mentioned in the U.S. Department of the Treasury's Financial Crimes Enforcement Network finding and notice of proposed rulemaking published on 13 February 2018, threatens to undermine investor confidence in Latvia, but Scope believes the long-term financial implications are limited. ABLV accounted for around 13% of total bank assets, corresponding to 13.8% of GDP as of December 2017. However, as a mostly non-resident bank with a sizeable share of foreign deposits, its links to the Latvian economy are weak. In addition, ABLV has already transferred the full amount for paying guaranteed deposits (EUR 480m) to Latvia's Deposit Guarantee Fund, which covers 88% of the bank's clients[10].Thus, Scope does not expect any material fiscal risks stemming from the liquidation of the ABLV bank

**Figure 18: Non-resident deposits, % of total deposits**


Source: Bank of Latvia, calculations by Scope Ratings GmbH

**Figure 19: Sectoral distribution of loans, % of total**




Source: Financial and Capital Market Commission, Scope Ratings GmbH

**Large share of non-resident deposits posing risks**

Non-resident deposits (mostly from Russia and other CIS countries) amounting to 41% of total deposits are prone to flight in times of market volatility and are concentrated in banks servicing foreign clients, adding to financial risks. Non-resident banks are subject to more stringent capital requirements, and the share of deposits from non-residents has declined significantly since 2015 due to regulatory initiatives by the Latvian Financial and Capital Market Commission combined with the Russian economic slowdown. Additionally,

[10] http://www.fktk.lv/en/media-room/press-releases/6912-fcmc-by-pay-out-of-guaranteed-compensations-deposits-will-be-completely-refunded-to-88-of-the-clients-of-ablv-bank-as.html

around a quarter of non-resident deposits represents parent bank funding from Scandinavian banks.

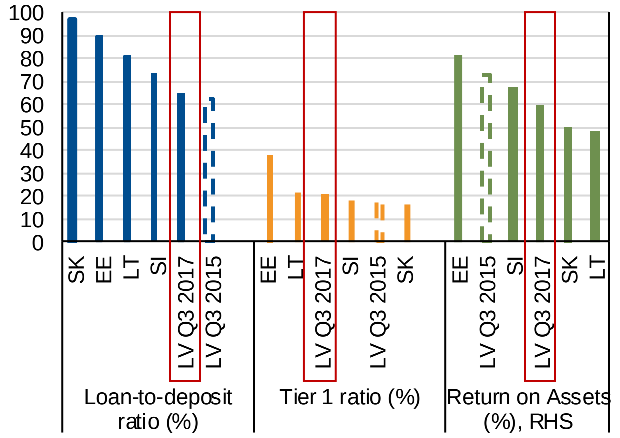
**Financial sector performance**

Profitable and well-capitalised banking sector

The profitability of Latvia's banking sector has remained robust over the period of the ECB's accommodative monetary policy. The return on assets, 0.9% for 2017, was one of the highest in the euro area. Banks have continued to be well-capitalised, reflected in average Tier 1 ratios of around 19% as of Q4 2017.

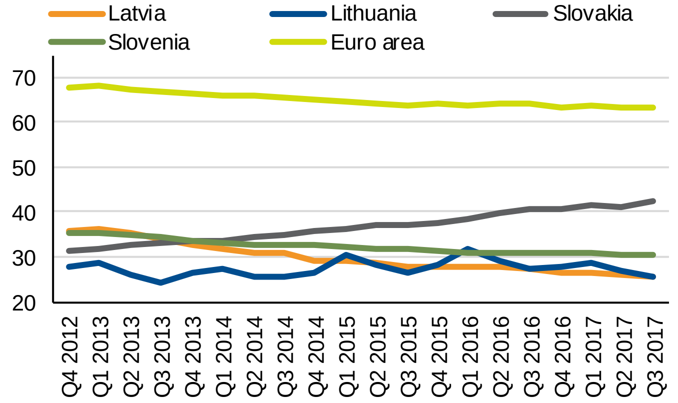
Despite the country's strong economic performance and improved borrowing capacity among households, the amount of both consumer and mortgage loans have remained broadly unchanged in 2017.

**Figure 20: Banking sector capitalisation and performance**




Source: ECB

**Figure 21: Household and NPISH debt, % GDP**




Source: Eurostat, National Central Banks

## Institutional and political risk

**Perceived willingness to pay**

Latvia joined the European Union in 2004 and has adopted the EU's regulatory framework, providing an anchor for institutional stability and predictability. In Scope's view, Latvia is as likely as any EU peer to honour debt obligations in full and on time.

**Recent events and policy decisions**

Sound political institutions

Centre-right, pro-EU parties dominate Latvia's political system. Notwithstanding the succession of short-lived governments, policymaking has enjoyed continuity and been able to build on relatively stable institutions. The current government, led by Māris Kučinskis of the Union of Greens and Farmers (ZZS), took office in February 2016 after Laimdota Straujuma of the Unity party resigned due to intra-coalition divisions. Since then, the coalition has remained unchanged and includes the ZZS, Unity and the National Alliance (NA).

Scope views positively Latvia's accession to the OECD in July 2016. Membership could enhance the country's appeal to investors and its economic prospects. Latvia's process to adhere to OECD principles has already significantly benefited state-owned enterprise management.

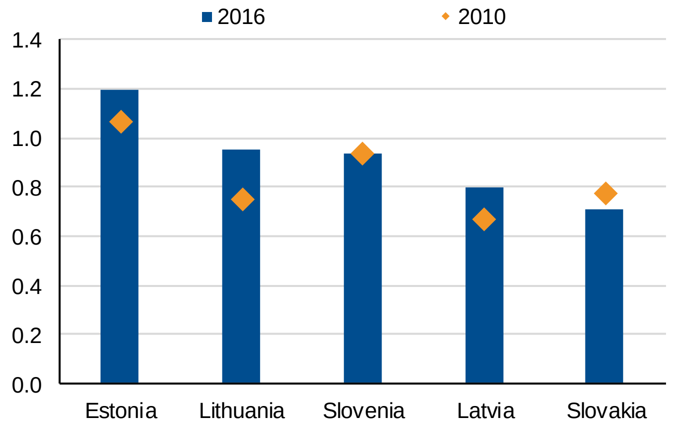
The next parliamentary elections are scheduled for October 2018. According to the March 2018 opinion polls[11], the dominance of centre-right political parties is set to continue. Scope excepts only a limited change in policy direction underpinned by the country's relatively sound institutions.

In Scope view, the new government's agenda will include, among other things, improving health and education systems, bolstering the strong fiscal situation, mitigating the falling labour supply, enhancing the investment environment and promoting border security.

**Geopolitical risks**

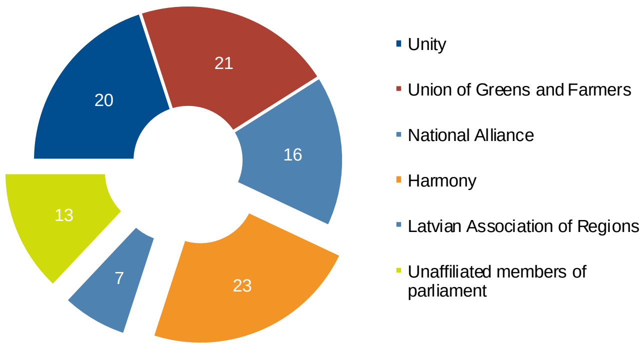
Latvia has been a member of NATO since 2004, supporting the country's allegiance and geostrategic importance to Western partners. Latvia is vulnerable to potential tensions with Russia, given its reliance on Russian gas as well as Russia's large share in its foreign trade (9.1% in exports and 7.4% in imports).

**Figure 22: World Bank Governance Indicators (average)**




Source: World Bank, Scope Ratings GmbH

**Figure 23: Political party representation in the parliament (Saeima)**




Source: Saeima

## Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available at www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on at https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA.

Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA) at http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at http://www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is not automatically ensured, however.

[11] SKDS survey, March 2018 Opinion polls: Harmony (20.4%), ZZS (13.9%), NA (6.3%), Unity (4.9%), New Conservative Party (3.6%). https://www.lsm.lv/raksts/zinas/latvija/pusgadu-pirms-saeimas-velesanam-neizlemuso-veletaju-klust-vairak.a273855/

## I. Appendix: CVS and QS results

### Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, signals an indicative 'A' ('a') rating range for Latvia. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings.

For Latvia, the QS signals a relative credit strength for the following analytical category: i) debt sustainability. Relative credit weaknesses are signalled for: i) macroeconomic stability and imbalances; ii) external debt sustainability; iii) vulnerability to short-term shocks; iv) geo-political risks; v) financial sector oversight and governance; and vi) macro-financial vulnerabilities and fragility. Relative credit strengths and weaknesses generate a downward adjustment of one notch and signal a sovereign rating of A- for Latvia. The results have been discussed and confirmed by a rating committee.

| Rating overview | |
|---|---|
| CVS category rating range | a |
| QS adjustment | A- |
| Final rating | A- |

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance assessments, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

### Foreign- versus local-currency ratings

Latvia's debt is predominantly issued in euros. Because of its history of openness to trade and capital flows, and the euro's reserve currency status, Scope sees no evidence that Latvia would differentiate among any of its contractual debt obligations based on currency denomination.

## II. Appendix: CVS and QS results

**CVS**

| Rating indicator | Category weight |
|---|---|
| **Domestic economic risk** | 35% |
| Economic growth | |
| Real GDP growth | |
| Real GDP volatility | |
| GDP per capita | |
| Inflation rate | |
| Labour & population | |
| Unemployment rate | |
| Population growth | |
| **Public finance risk** | 30% |
| Fiscal balance | |
| GG public balance | |
| GG primary balance | |
| GG gross financing needs | |
| Public debt | |
| GG net debt | |
| Interest payments | |
| **External economic risk** | 15% |
| International position | |
| International investment position | |
| Importance of currency | |
| Current-account financing | |
| Current-account balance | |
| T-W effective exchange rate | |
| Total external debt | |
| **Institutional and political risk** | 10% |
| Control of corruption | |
| Voice & accountability | |
| Rule of law | |
| **Financial risk** | 10% |
| Non-performing loans | |
| Liquid assets | |
| Credit-to-GDP gap | |
| **Indicative rating range** | a |
| **QS adjustment** | A- |
| **Final rating** | **A-** |

**QS**

*Maximum adjustment = 3 notches*

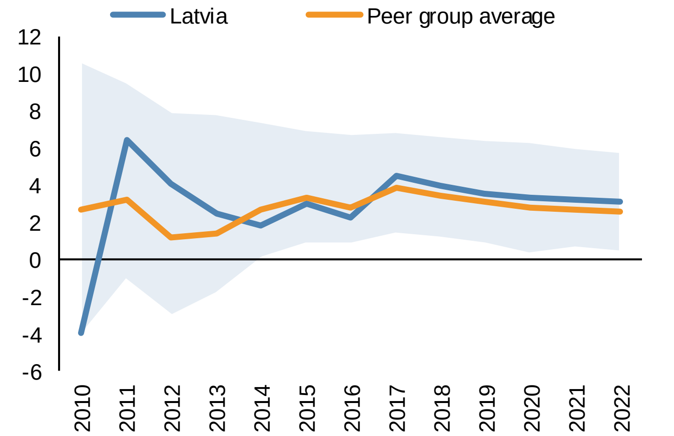
| | +2 notch | +1 notch | 0 notch | -1 notch | -2 notch |
|---|---|---|---|---|---|
| Growth potential of the economy | ○ Excellent outlook, strong growth potential | ○ Strong outlook, good growth potential | ◉ Neutral | ○ Weak outlook, growth potential under trend | ○ Very weak outlook, growth potential well under trend or negative |
| Economic policy framework | ○ Excellent | ○ Good | ◉ Neutral | ○ Poor | ○ Inadequate |
| Macroeconomic stability and imbalances | ○ Excellent | ○ Good | ○ Neutral | ◉ Poor | ○ Inadequate |
| Fiscal performance | ○ Exceptionally strong performance | ○ Strong performance | ◉ Neutral | ○ Weak performance | ○ Problematic performance |
| Debt sustainability | ○ Exceptionally strong sustainability | ◉ Strong sustainability | ○ Neutral | ○ Weak sustainability | ○ Not sustainable |
| Market access and funding sources | ○ Excellent access | ○ Very good access | ◉ Neutral | ○ Poor access | ○ Very weak access |
| Current-account vulnerabilities | ○ Excellent | ○ Good | ◉ Neutral | ○ Poor | ○ Inadequate |
| External debt sustainability | ○ Excellent | ○ Good | ○ Neutral | ◉ Poor | ○ Inadequate |
| Vulnerability to short-term shocks | ○ Excellent resilience | ○ Good resilience | ○ Neutral | ◉ Vulnerable to shock | ○ Strongly vulnerable to shocks |
| Perceived willingness to pay | ○ Excellent | ○ Good | ◉ Neutral | ○ Poor | ○ Inadequate |
| Recent events and policy decisions | ○ Excellent | ○ Good | ◉ Neutral | ○ Poor | ○ Inadequate |
| Geo-political risk | ○ Excellent | ○ Good | ○ Neutral | ◉ Poor | ○ Inadequate |
| Financial sector performance | ○ Excellent | ○ Good | ◉ Neutral | ○ Poor | ○ Inadequate |
| Financial sector oversight and governance | ○ Excellent | ○ Good | ○ Neutral | ◉ Poor | ○ Inadequate |
| Macro-financial vulnerabilities and fragility | ○ Excellent | ○ Good | ○ Neutral | ◉ Poor | ○ Inadequate |

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings GmbH

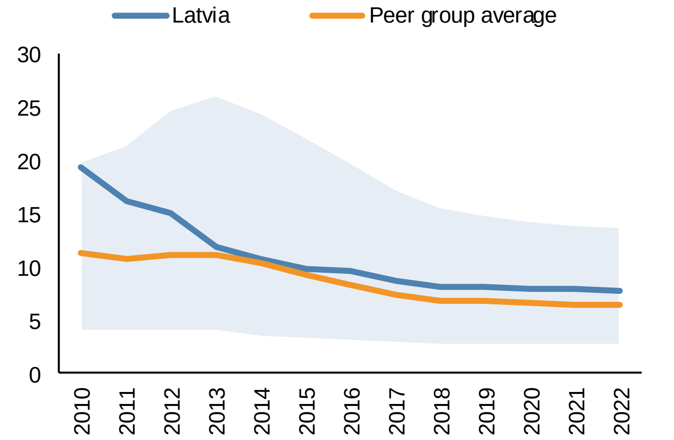
## III. Appendix: Peer comparison

**Figure 24: Real GDP growth**



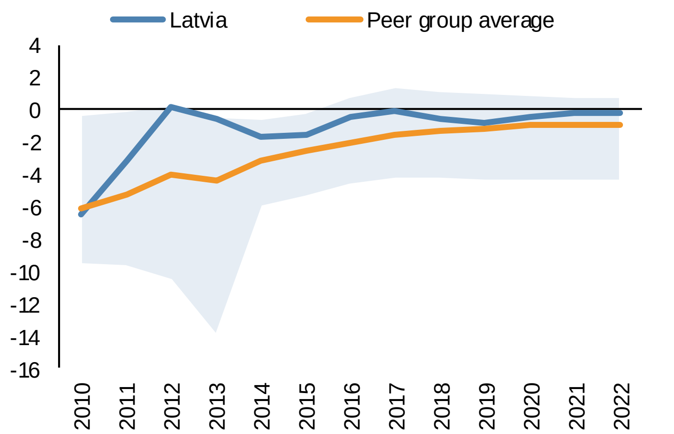

Source: IMF, Calculations Scope Ratings GmbH

**Figure 25: Unemployment rate, % of total labour force**



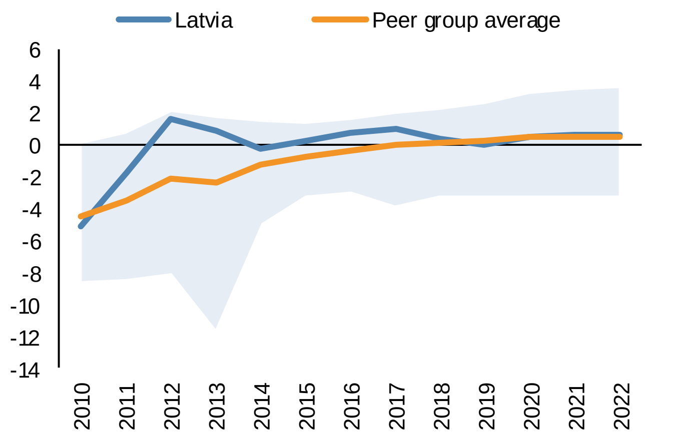

Source: IMF, Calculations Scope Ratings GmbH

**Figure 26: General government balance, % of GDP**



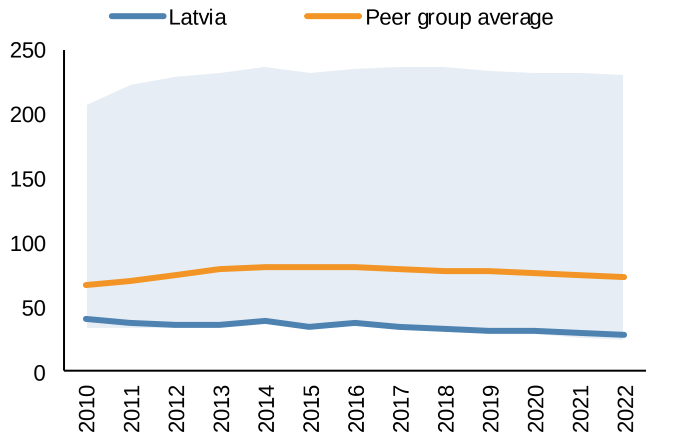

Source: IMF, Calculations Scope Ratings GmbH

**Figure 27: General government primary balance, % of GDP**



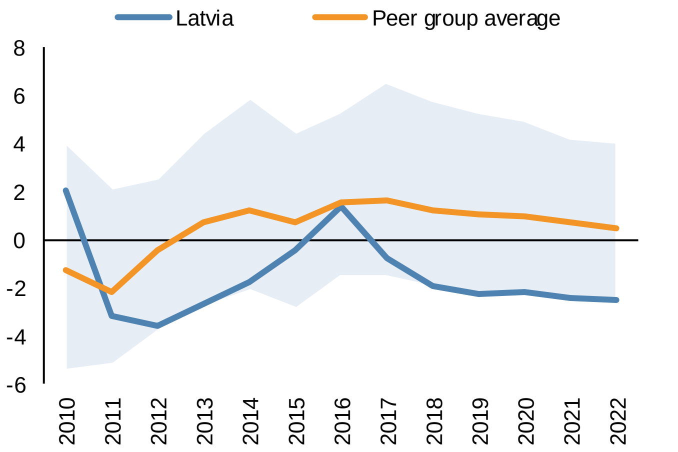

Source: IMF, Calculations Scope Ratings GmbH

**Figure 28: General government gross debt, % of GDP**




Source: IMF, Calculations Scope Ratings GmbH

**Figure 29: Current-account balance, % of GDP**




Source: IMF, Calculations Scope Ratings GmbH

## IV. Appendix: Statistical tables

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018E | 2019F |
|---|---|---|---|---|---|---|---|
| **Economic performance** | | | | | | | |
| Nominal GDP (EUR bn) | 22.8 | 23.6 | 24.3 | 24.9 | 26.9 | 29.0 | 30.8 |
| Population ('000s) | 2,024.0 | 2,001.0 | 1,986.0 | 1,969.0 | 1,950.0 | 1,944.0 | 1,938.0 |
| GDP per capita PPP (USD) | 22,676.4 | 23,808.0 | 24,510.2 | 25,587.4 | - | - | - |
| GDP per capita (EUR) | 11,259.2 | 11,800.4 | 12,245.3 | 12,659.8 | 13,769.0 | 14,900.0 | 15,888.8 |
| Real GDP, % change | 2.4 | 1.9 | 3.0 | 2.2 | 4.5 | 4.0 | 3.5 |
| GDP growth volatility (10-year rolling SD) | 8.3 | 8.1 | 7.6 | 6.7 | 6.1 | 6.1 | 2.7 |
| CPI % change | 0.0 | 0.6 | 0.2 | 0.1 | 2.9 | 3.0 | 2.5 |
| Unemployment rate (%) | 11.9 | 10.8 | 9.9 | 9.6 | 8.7 | 8.2 | 8.1 |
| Investment (% of GDP) | 24.3 | 22.7 | 22.2 | 19.6 | 21.5 | 23.1 | 23.5 |
| Gross national savings (% of GDP) | 21.6 | 20.9 | 21.8 | 21.0 | 20.8 | 21.2 | 21.2 |
| **Public finances** | | | | | | | |
| Net lending/borrowing (% of GDP) | -1.2 | -1.5 | -1.4 | 0.1 | -0.5 | -0.5 | -0.9 |
| Primary net lending/borrowing (% of GDP) | 0.3 | -0.1 | -0.1 | 1.1 | 0.4 | 0.4 | 0.1 |
| Revenue (% of GDP) | 36.6 | 36.6 | 36.9 | 37.2 | 37.5 | 37.0 | 35.9 |
| Expenditure (% of GDP) | 37.7 | 38.1 | 38.2 | 37.1 | 38.0 | 37.5 | 36.8 |
| Net interest payments (% of GDP) | 1.5 | 1.4 | 1.3 | 1.0 | 0.9 | 1.0 | 0.9 |
| Net interest payments (% of revenue) | 4.1 | 3.9 | 3.6 | 2.8 | 2.5 | 2.6 | 2.6 |
| Gross debt (% of GDP) | 35.8 | 38.5 | 34.9 | 37.4 | 34.8 | 32.9 | 31.9 |
| Net debt (% of GDP) | 26.1 | 27.1 | 29.2 | 28.0 | 26.9 | 25.6 | 25.0 |
| Gross debt (% of revenue) | 97.9 | 105.2 | 94.6 | 100.5 | 92.9 | 88.9 | 88.9 |
| **External vulnerability** | | | | | | | |
| Gross external debt (% of GDP) | 131.5 | 138.4 | 142.8 | 142.8 | 141.4 | - | - |
| Net external debt (% of GDP) | 36.5 | 33.7 | 29.3 | 28.8 | 24.4 | - | - |
| Current-account balance (% of GDP) | -2.7 | -1.7 | -0.5 | 1.4 | -0.8 | -1.9 | -2.2 |
| Trade balance [FOB] (% of GDP) | -11.5 | -10.0 | -9.0 | -7.7 | -10.3 | -10.4 | -10.4 |
| Net direct investment (% of GDP) | -1.6 | -1.2 | -2.6 | 0.0 | -2.1 | - | - |
| Official forex reserves (EOP, mil EUR) | 5,429.0 | 2,303.5 | 2,803.6 | 2,946.1 | 3,476.0 | - | - |
| REER, % change | -1.0 | 2.8 | 1.1 | 1.4 | -0.8 | - | - |
| Nominal exchange rate (EOP, USD/EUR) | 1.4 | 1.2 | 1.1 | 1.1 | 1.2 | - | - |
| **Financial stability** | | | | | | | |
| Non-performing loans (% of total loans) | 8.3 | 6.9 | 6.0 | 4.4 | 4.1 | - | - |
| Tier 1 ratio (%) | 17.3 | 18.3 | 19.8 | 18.2 | 19.0 | - | - |
| Private non-financial debt (% of GDP) | 54.4 | 47.8 | 44.9 | 44.1 | 39.6 | - | - |
| Domestic credit-to-GDP gap (%) | -35.8 | -36.1 | -32.7 | -27.8 | -26.7 | - | - |

Source: IMF, European Commission, European Central Bank, Central Statistical Bureau of Latvia, World Bank, Haver Analytics, Scope Ratings GmbH.

## V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Rating prepared by Levon Kameryan, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003.

The ratings/outlook were last updated on 27.10.2017.

The senior unsecured debt ratings as well as the short-term issuer ratings were last assigned by Scope on 27.10.2017.

The main points discussed by the rating committee were: (i) ABLV's liquidation and possible fiscal costs, ii) Latvia's growth outlook, (iii) economic imbalances and structural reforms, (iv) tax reform measures and debt sustainability, (v) short-term external debt, (vi) demographics and productivity, (vii) financial sector performance, (viii) recent geo-political developments, and (ix) peer considerations.

### Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: The Bank of Latvia, Central Statistical Bureau of Latvia (CSB), Ministry of Finance of Latvia, European Commission, Eurostat, ECB, IMF, OECD, WB and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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