Republic of Latvia
Rating Report

SCOPE A- POSITIVE OUTLOOK

Credit strengths

- Sound institutional setup, underpinned by membership in the euro area and NATO
- Solid economic growth prospects
- Moderate public debt

Credit challenges

- Moderate income
- Adverse demographic trends
- Exposure to external economic and financial shocks

Rating rationale:

Sound institutions: Latvia's effective policymaking is underpinned by its status as a member of the euro area, ensuring a robust framework for fiscal and economic policy. Its membership in NATO strongly mitigates external security risks in the context of heightened geopolitical tensions.

Strong economic fundamentals despite Russia-Ukraine war: Despite the escalation of the war, which is significantly affecting Latvia's economy through trade and inflationary pressures, we expect medium-term growth of 2.5% and inflation to subside after very high rates in 2022 and 2023.

Effective fiscal policy: We expect a gradual reduction of fiscal deficits from above 6% of GDP in 2022 to 1% over the medium term, and public debt to decline from 43.6% of GDP at YE 2021 to around 41% over the coming five years. Market access and debt structure are both favourable. Still, low tax revenues, also driven by the large shadow economy, remain a structural challenge.

Rating challenges: Latvia's ratings remain constrained by challenges relating to continued moderate per-capita income, unfavourable demographic trends constraining growth and exposure to external economic and financial shocks, given a large export sector relative to the size of the economy and the dependence of its financial sector on large Nordic banks.

Latvia's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb-	EUR [+1]	0	A-
Public Finance Risk		20%	aa-		0	
External Economic Risk		10%	b-		-1/3	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Factors	5%	aaa		0	
	Social Factors	7.5%	b-		0	
	Governance Factors	12.5%	a		0	
Indicative outcome		**a-**			**0**	
Additional considerations					**0**	

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Positive Outlook represents our view that Latvia will weather the economic fallout from the Russia-Ukraine war without its credit fundamentals deteriorating; and that sound policies, paired with swift absorption of EU funds, will support further economic and fiscal improvements.

Positive rating-change drivers

- Solid economic growth continuing through structural reform and investment
- Debt-to-GDP anchored to moderate levels in the medium run
- Improved external and/or financial sector resilience

Negative rating-change drivers

- Deterioration in public debt dynamics
- Increasing macroeconomic imbalances, weakening growth prospects
- Deterioration in external position and/or re-emergence of financial sector risks
- Heightened geopolitical risk undermining macroeconomic stability

Ratings and Outlook

Foreign currency

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

Local currency

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

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Bloomberg: RESP SCOP

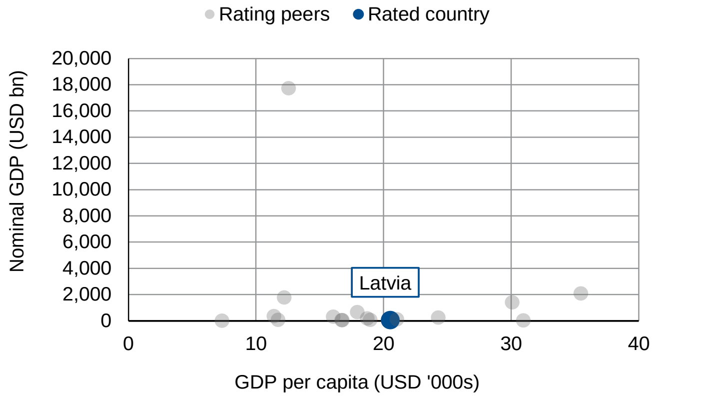
Domestic Economic Risks

- **Growth outlook:** The Latvian economy entered 2022 on a solid recovery path from the Covid-19 shock, after real GDP growth of 4.1% in 2021 and a contained contraction of 2.2% in 2020. The escalation of the war in Ukraine is significantly affecting the economy, given Latvia's important, albeit declining, trade links with Russia and the exceptional shock on energy and commodity prices, on top of weakening economic sentiment. Despite a resilient performance in the first half of this year, we expect growth to slow down in the coming months, resulting in a growth rate of 2.4% in 2022, followed by a contained contraction of 0.1% in 2023. The economy should start to recover in the second part of next year and rebound to 3% in 2024, then converging to the estimated growth potential of 2.5%. The economic outlook is supported by large allocations of EU funds for about 28% of GDP via the Recovery and Resilience Facility and the Cohesion Policy and Common Agricultural Policy of the 2021-27 EU budget. These underpin Latvia's convergence in income and productivity with euro area peers, though a declining working-age population and skill shortages are key obstacles to sustainable growth.
- **Inflation and monetary policy:** Along with the other Baltic states, Latvia is heavily affected by the current, exceptionally high inflationary pressures. Even before the war, the economy was at risk of overheating given a tight labour market and loose monetary policy. A large share of energy and food items in its consumption basket, on top of deregulated gas and electricity markets, makes Latvia heavily exposed to current supply-side price shocks. Inflation stood at 21.7% in October and is broad-based, as reflected in a core ratio of 9.5%. We expect an annual inflation rate of 17% for 2022, followed by a lower but still elevated 8% in 2023. The ECB is rapidly normalising monetary policy, with rate hikes of 200 bps so far this year. The resulting tighter financing conditions will contribute to the near-term economic slowdown.
- **Labour market:** Labour market indicators are solid, though likely to worsen over the coming months as the economy weakens. Employment continued to recover through Q2 2022, though still counting about 20,000 fewer people than before Covid-19. The large influx of Ukrainian refugees is likely to support employment following their integration in the labour market. The unemployment rate started turning upwards after months of decline, to 6.6% in September. Skill mismatches continue to be impediments to an improvement of the unemployment rate, which we expect to rise from 6.8% this year to about 7.5% in 2023-24.

Overview of Scope's qualitative assessments for Latvia's *Domestic Economic Risks*

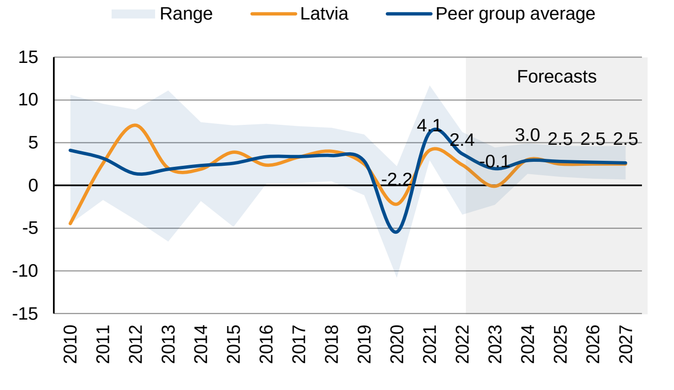
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Growth potential of the economy	Neutral	0	Solid economic growth prospects, although constrained by adverse demographics and barriers to employment growth
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; effective policy framework and transmission over the cycle
	Macroeconomic stability and sustainability	Neutral	0	Limited economy size and diversification, solid productivity and labour market metrics

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

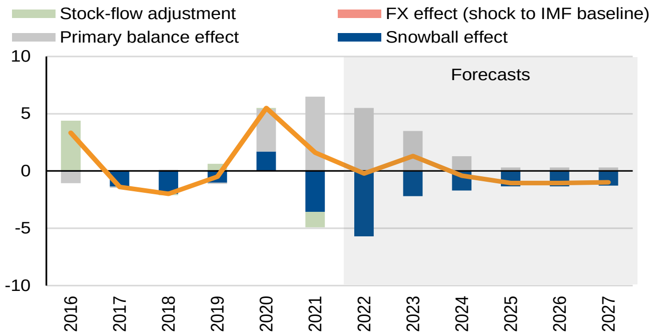
Public Finance Risks

- **Fiscal outlook:** Latvia had a good record of moderate fiscal deficits before Covid-19, reflecting prudent fiscal management. The pandemic significantly scarred the government budget, however, requiring large support packages to the health and social systems. We expect the fiscal deficit to remain high relative to GDP in 2022, above 6%, after 4.3% in 2020 and 7.0% in 2021, despite robust revenue growth, given still significant Covid-19 support measures, as well as a large fiscal package to mitigate energy costs for households and businesses, and to enhance energy and external security. Given the ongoing government formation, the 2023 budget is likely to be approved in the beginning of next year, following a technical extension. We expect the deficit to decline to about 4% of GDP, anticipating still sizeable measures against the cost-of-living shock and from defence spending, and then to gradually converge to 1% of GDP by 2025. Low tax revenue, at just above 30% of GDP, remains a constraint for Latvia's fiscal policy. In this respect, continued efforts in combating the shadow economy and broaden the tax base could support a more rapid rebalancing of government finances.
- **Debt trajectory:** Latvia's public debt is moderate compared to that of its sovereign peers. We expect Latvia's general government debt to slightly rise to 45% of GDP in 2023, up from just above 43% this year, and then gradually decline to about 41% of GDP over the next five years. This is supported by solid nominal growth and gradually narrowing fiscal deficits in the medium term. Also, the interest payment burden will remain moderate despite rising interest rates, underpinning strong debt affordability. Contingent liabilities in the form of government guarantees as well as implicit costs of the ageing population are also contained vis-à-vis peers, though here we expect some downside risks given the current modest spending levels for healthcare and pensions, especially after the pandemic and the cost-of-living shock.
- **Debt profile and market access:** Latvia's debt outlook benefits from a robust debt profile and favourable financing conditions, despite rising interest rates in the euro area and heightened market volatility. The average maturity is long, over 7.5 years, which will help to keep the government's gross financing needs relatively moderate at about 8% of GDP annually over 2022-23 and below 6% in the medium term. Liquidity management is prudent, with a large cash buffer supporting funding flexibility. The debt portfolio is almost entirely denominated in euros and mostly carries a fixed rate. Debt securities are mostly issued on international capital markets, although Latvia is developing its creditor base by tapping existing Eurobonds in the domestic market. Last year Latvia issued its first sustainability bond.

Overview of Scope's qualitative assessments for Latvia's *Public Finance Risks*

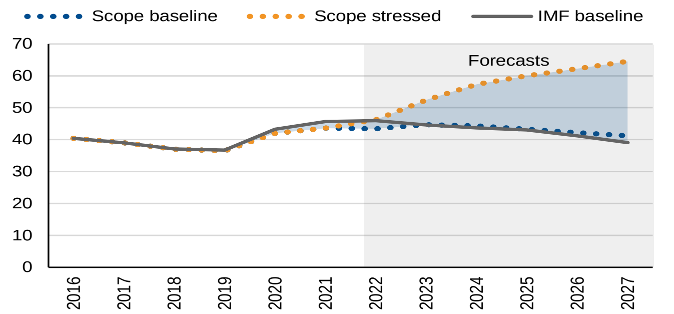
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Fiscal policy framework	Neutral	0	Record of fiscal prudence, but large shadow economy and comparatively restricted tax base
	Debt sustainability	Neutral	0	Moderate debt levels, expected to decline in the medium term
	Debt profile and market access	Neutral	0	Robust debt structure, moderate funding needs, ability to issue on favourable terms in the capital markets

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

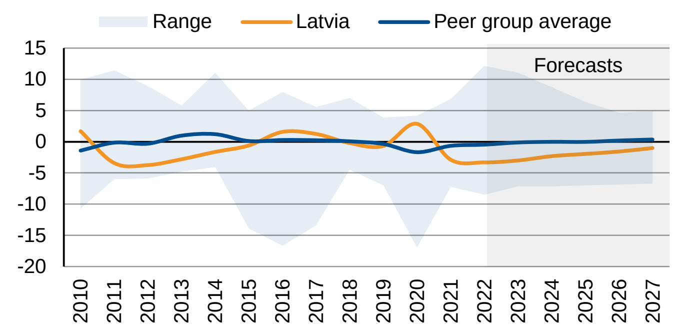
External Economic Risks

- **Current account:** Latvia's current account remained close to balance in the pre-pandemic period, with deficits in the goods and primary income balances broadly offset by surpluses in the services and secondary income accounts. After swinging to a 4.2% of GDP deficit in 2021, from a 2.6% surplus in 2020, the current account balance worsened further to a 5.5% deficit in the year through Q2 2022 (four-quarter moving sum). This deterioration primarily reflects soaring nominal energy and raw materials imports, as well as the negative impact of the Russia-Ukraine conflict, in view of the country's comparatively significant trade exposure to Russia, at around 5-6% of exports, despite having significantly declined over the past decade. While recent trade data indicates a successful reorientation of Latvia's export sectors away from Russia, these headwinds will weigh on the recovery of the external balance, supporting our expectation of an only gradual reduction of current account deficits over the medium term.
- **External position:** Latvia's net international investment position has improved steadily, with its net debtor position declining from 54% of GDP in 2016 to 28% in Q2 2022. Around 40% of total external liabilities relate to inward foreign direct investment, partially limiting risks related to sudden capital flows in times of market stress. Latvia's external debt is elevated relative to Baltic peers, at 105% of GDP, albeit on a clear declining trend, down from nearly 150% in 2016. Most external debt is owed by the Latvian public sector (58% of total), followed by the non-financial private sector (24%). A significant 59% of external debt (excluding direct investment) is short-term, amounting to more than 54% of GDP, well above levels observed in Lithuania (32%) and Estonia (34%).
- **Resilience to shocks:** Latvia's small, open economy remains vulnerable to external shocks in view of its large export and import sectors, each amounting to about two-thirds of GDP. The Russia-Ukraine war is having significant direct and indirect negative impacts on the country's economy, primarily due to shortages of raw materials and weaker growth among key trading partners. Nevertheless, we do not expect the conflict to cause permanent scarring of the country's growth potential. This in part reflects Latvia's large renewable energy generation capacities as well as its sizable LNG storage and import capacities, managed through close collaboration with Baltic neighbours, which allowed for a swift diversification of natural gas supplies away from Russia after the outbreak of the war. The connection of Baltic states to mainland Europe's electricity networks is due to be completed by 2025 and synchronisation during emergencies is already possible.

Overview of Scope's qualitative assessments for Latvia's *External Economic Risks*

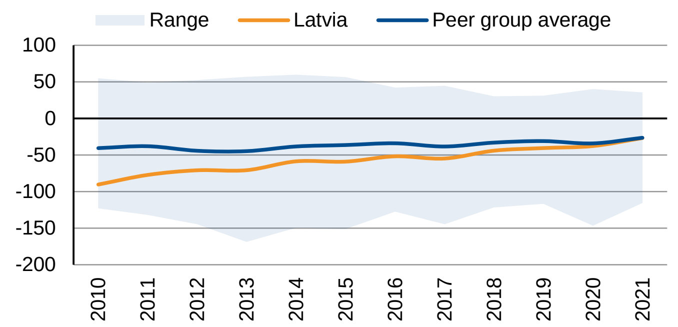
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Current account resilience	Neutral	0	Improvements in export diversification but high share of lower value-added exports
	External debt structure	Neutral	0	Elevated, albeit declining, external debt, still high share of short-term external debt
	Resilience to short-term external shocks	Weak	-1/3	Very small and open economy

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

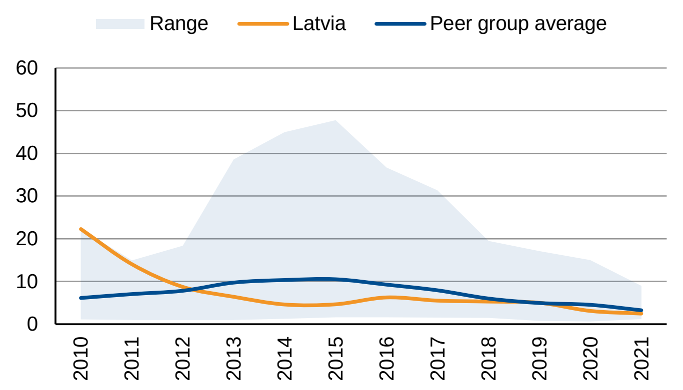
Financial Stability Risks

- **Banking sector:** Latvia's banking sector presents limited contingent liability risk to the sovereign balance sheet and stands in a good position to weather the current economic slowdown. The sector's resilience is bolstered by very strong capitalisation and asset quality metrics, with aggregate CET-1 and non-performing loan ratios of 23.2% and 2.2% as of Q2 2022, respectively, as reported by the Financial and Capital Market Commission. Profitability is robust despite some moderation relative to last year, reflected in an aggregate return on equity ratio of 8.6% as of Q2 2022. Favourable cost-to-income ratios relative to euro area peers and rising interest rates will support profitability over the medium term, despite the deteriorating economic outlook. Liquidity risks are low, given a very high liquidity coverage ratio, above 320% in Q2 2022. Exposures to and deposits from Russian counterparts are limited.
- **Private debt:** Despite a significant pickup in housing loans in the wake of the pandemic, household indebtedness remains low relative to peers, amounting to 18% of GDP as of Q2 2022. Non-financial corporate debt is moderate as well, at 44% of GDP (36% when considering consolidated data). This also reflects obstacles to credit supply, however, particularly for SMEs. The Latvian private sector is exposed to interest risks due to a very large share of variable-rate loans, with more than 90% of new loans having variable-rate terms. Debt service ratios should therefore increase as a result of ECB policy tightening, albeit from a low level.
- **Financial imbalances:** Latvian banks have reduced their reliance on short-term non-resident deposits, which has not affected banking sector liquidity or the favourable business environment. The share of non-resident deposits stood at 16.4% of total as of Q2 2022, down from above 40% in 2018, which mitigates Latvia's exposure to possible global financial stress and capital flight in times of market volatility. This also significantly lowers risks of a re-emergence of money laundering in the Latvian banking sector, together with the country's progress in strengthening its anti-money laundering framework. Latvia's banking sector is exposed to concentration and spillover risks due to its integration with the Nordic and Baltic banking systems. At the same time, reliance on cross-border parent banking group funding is limited by the strong, stable domestic customer deposit base.

Overview of Scope's qualitative assessments for Latvia's *Financial Stability Risks*

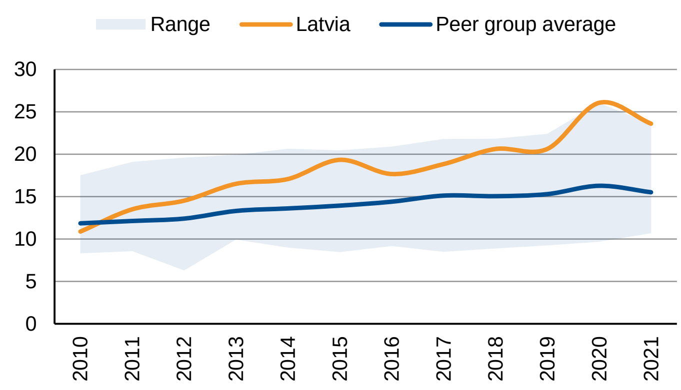
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector with moderate non-performing loans
	Banking sector oversight	Neutral	0	Oversight under the Bank of Latvia and the ECB as part of the Banking Union
	Financial imbalances	Neutral	0	Concentration and spillover risks in the banking system from Nordic banking groups, obstacles to credit growth

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

ESG Risks

- **Environment:** Latvia meets a large share of its domestic energy consumption with renewables (43% as of 2021), the highest share in the EU after Sweden and Finland. The country's system of environmental taxation yields over 3% of GDP in government revenue annually, one of the highest levels in the EU. Latvia faces challenges from rising emissions outside of the Emissions Trading System due to a fossil fuel-reliant transport system. The government plans to address these challenges via large public investments under its Recovery and Resilience Plan, 38% of which is allocated to climate objectives. The Latvian government recently approved proposals aimed at accelerating the scaling up of the country's renewable energy generation and its energy independence, including relaxed regulatory barriers for the development of new onshore and offshore wind as well as resident solar energy projects.

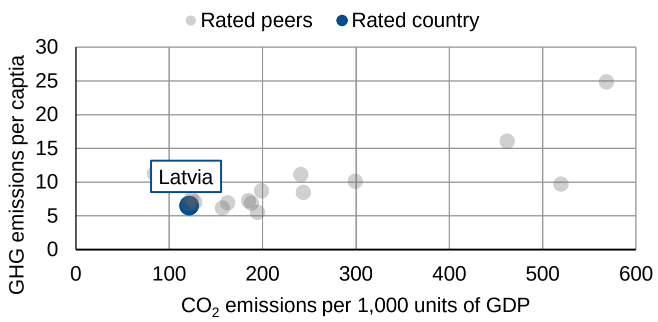
- **Social:** Latvia's social outcomes suffer from adverse demographic trends and low funding for its welfare system. According to UN population projections, over the next 20 years, Latvia's working-age population will decline cumulatively by 20% from today's levels. At the same time, the population aged over 85 will grow by almost 30%, with important social, economic and fiscal implications. Latvia also has high income inequality and poverty, significantly above the EU average. On the positive side, labour participation is quite high, reflecting high activity among young people and women. While the employment gap between men and women is very low, the pay gap is, however, significantly above the EU average.

- **Governance:** Latvia's institutional quality is strong compared with that of most Central and Eastern European sovereign peers. Policymaking in the country has been underpinned by the country's EU and euro area membership and has enjoyed relative continuity despite its multi-party political system. The October 2022 parliamentary elections produced large gains for incumbent Prime Minister Krišjānis Kariņš' party, which is leading the formation of a new centre-right coalition government. External security risks for Latvia have increased since the escalation of the war in Ukraine. However, we believe that Latvia's and other Baltic states' membership in NATO strongly limits the risk that the conflict will expand into the Baltic region. Both NATO and Latvia have continually confirmed their commitment to Article 5, which states that if one member of the alliance is subject to an armed attack, other members will consider this as an armed attack against all members and will provide necessary support.

Overview of Scope's qualitative assessments for Latvia's *ESG Risks*

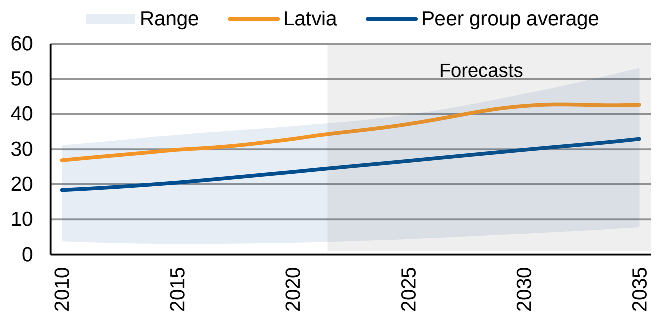
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental factors	Neutral	0	High share of renewables in the energy mix, transition risks in line with peers
	Social factors	Neutral	0	Inclusive labour market but high poverty and income inequality, and unfavourable demographic trends
	Governance factors	Neutral	0	Stable governance, supported by EU, euro area and NATO memberships

Emissions per GDP and per capita, $mtCO_2e$



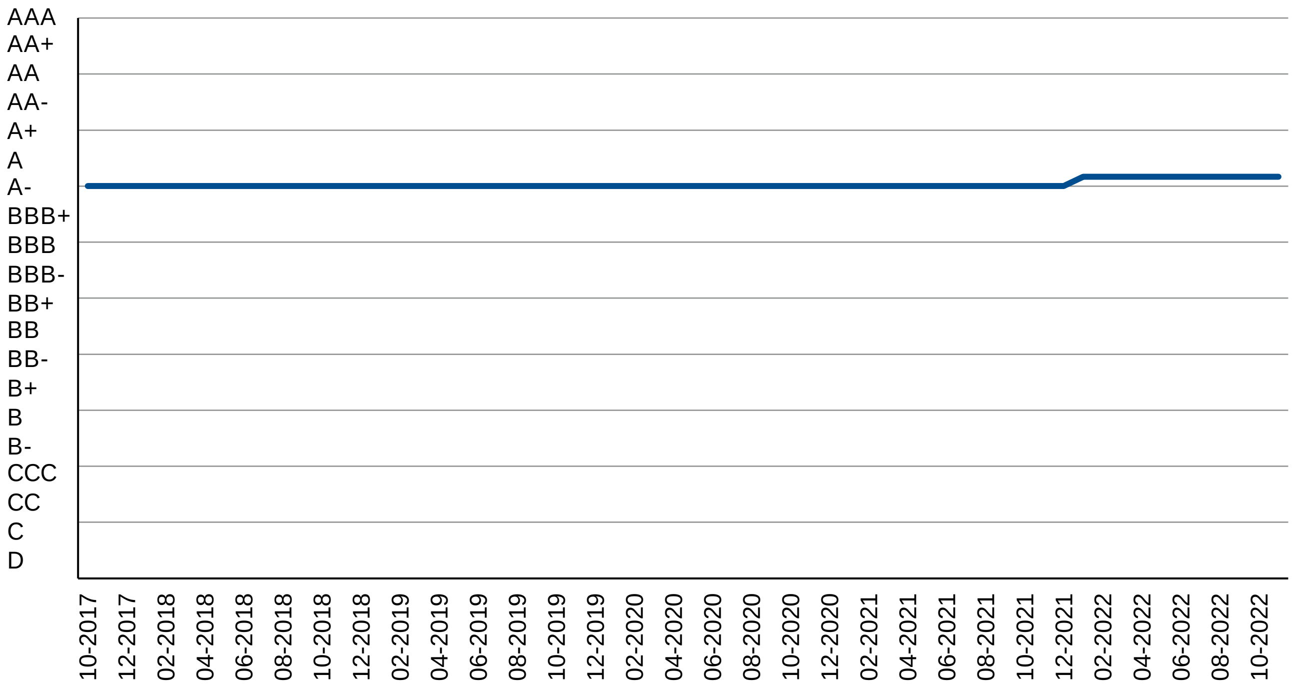
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Bulgaria
China
Croatia
Cyprus
Hungary
Italy
Poland
Portugal
Slovakia
Spain

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD '000s**	IMF	15,626	17,807	17,871	17,623	20,546
	Nominal GDP, USD bn	IMF	30.5	34.4	34.3	33.6	38.9
	Real growth, %	IMF	3.3	4.0	2.5	-3.8	4.5
	CPI inflation, %	IMF	2.9	2.6	2.7	0.1	3.2
	Unemployment rate, %	WB	8.7	7.4	6.3	8.1	7.6
Public Finance	**Public debt, % of GDP**	IMF	39.0	37.1	36.7	43.3	45.7
	Interest payment, % of revenue	IMF	3.1	2.5	2.3	2.3	2.0
	Primary balance, % of GDP	IMF	0.3	0.2	0.5	-2.9	-4.8
External Economic	**Current account balance, % of GDP**	IMF	1.3	-0.2	-0.7	2.9	-2.9
	Total reserves, months of imports	IMF	2.7	2.2	2.3	3.0	2.3
	NIIP, % of GDP	IMF	-54.7	-44.0	-40.5	-37.7	-26.9
Financial Stability	**NPL ratio, % of total loans**	IMF	5.5	5.3	5.0	3.1	2.5
	Tier 1 ratio, % of RWA	IMF	17.9	20.1	21.5	24.0	24.1
	Credit to private sector, % of GDP	WB	42.1	36.6	34.4	34.4	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	137.0	143.3	136.2	121.5	120.9
	Income share of bottom 50%, %	WID	17.4	17.4	18.0	17.9	17.9
	Labour-force participation rate, %	WB	77.3	78.1	77.7	-	-
	Old-age dependency ratio, %	UN	30.7	31.3	32.1	32.9	33.9
	Composite governance indicators*	WB	0.8	0.8	0.9	0.8	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps)	117

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