Republic of Latvia
Rating Report

A- POSITIVE OUTLOOK

Credit strengths

- EU and euro area memberships
- Solid economic growth prospects
- Moderate levels of public debt

Credit challenges

- Adverse demographic trends
- Exposure to external shocks
- Banking spill-over risks

Rating rationale:

The Outlook revision to Positive on Latvia's ratings reflects the following two key drivers: i) the solid recovery prospects from the Covid-19 crisis, underpinned by the authorities' credible and effective macroeconomic policymaking and ongoing access to substantial EU investment and recovery fund inflows; and ii) lowered financial sector vulnerabilities reflecting a reduced reliance of banks on short-term non-resident funding, facilitated by the authorities' implementation of financial sector reforms.

The affirmation of A- long-term ratings considers Latvia's high institutional strength, underpinned by the country's EU and euro area memberships. The ratings recognise still-moderate levels of general government debt on the back of a pre-crisis track record of fiscal prudence.

Latvia's ratings remain constrained by credit challenges relating to: i) unfavourable demographic trends in the form of an ageing population and net emigration, alongside still moderate per-capita income relative to the euro-area average; ii) a large export sector relative to the size of the economy increasing its vulnerability to external shocks; and iii) risks in the banking sector related to the dependence on large Nordic banks.

Latvia's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a		-2/3	A-
Public Finance Risk		25%	aa-		-1/3	
External Economic Risk		10%	bb		-3/3	
Financial Stability Risk		10%	aaa		-1/3	
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	bb+		-1/3	
	Governance Risk	10%	a-		0	
Overall outcome		a+		+1	-3	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 GmbH.

Outlook and rating triggers

The Positive Outlook represents Scope's opinion that risks to the sovereign ratings are tilted to the upside over the next 12 to 18 months.

Positive rating-change drivers

- Higher growth potential through structural reforms in the labour market, innovation and education and/or infrastructure
- Sustained downward path in public debt, supported by fiscal consolidation
- Further sustained reduction in external vulnerabilities and/or financial sector risk

Negative rating-change drivers

- Deterioration in public debt dynamics
- Deterioration in external position and/or reemergence of financial sector risk
- External shock or heightened geopolitical risk undermining macro-economic stability

Ratings and Outlook

Local and foreign 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

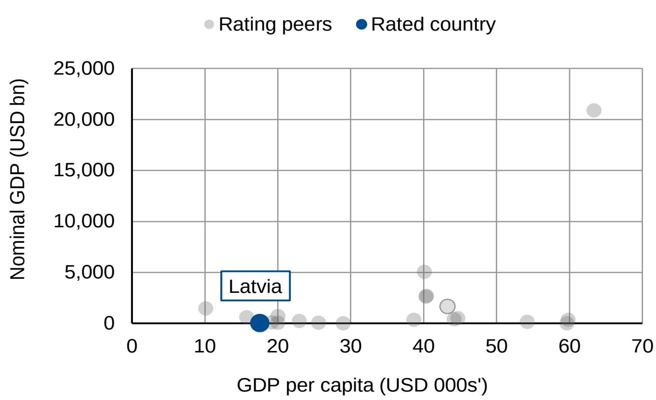
Domestic Economic Risks

- **Growth outlook**: Scope projects Latvia's real GDP to grow 4.6% in 2021 and 5% in 2022, after a relatively mild contraction of 3.6% in 2020, a reflection of Latvia's improved macroeconomic resiliency. The economic recovery is being advanced by an upturn in private consumption and investment assisted by Latvia's sturdy absorption of EU funds. Latvia has been allocated a sizeable EUR 1.8bn in grants (equivalent to around 6% of 2020 GDP) via the EU's Recovery and Resilience Facility (RRF). Another EUR 8bn (27% of 2020 GDP) of structural funds is accessible via the Cohesion Policy and Common Agricultural Policy under the new 2021-2027 EU budget. Scope estimates Latvia's medium-term potential growth at around 3% annually, bolstered by strategic public-infrastructure projects co-financed by the EU. The construction of Rail Baltica, which connects the Baltic region with the European rail network via Poland, is planned by 2026 for Latvia. The connection of the Baltic states' and continental Europe's gas and electricity networks is planned to be completed by 2022 for gas and by 2025 for electricity.
- **Inflation and monetary policy:** Higher energy prices and rising production costs due to shortage of intermediary goods are expected to raise inflation to 3% in 2021 and 3.3% in 2022. These factors are expected to slowly fade in the second half of 2022 and cause inflation to fall towards the 2% target in 2023. While some central banks have started tapering their asset purchase programmes or indicated interest rate rises in the near term, the ECB has signaled that it will maintain its accommodative monetary policy in the near term.
- **Labour market:** Labour market situation has been improving with a continuing economic recovery**.** Unemployment rate declined to 7% as of October, around the EU averages, but above the pre-crisis rate of 6%.

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

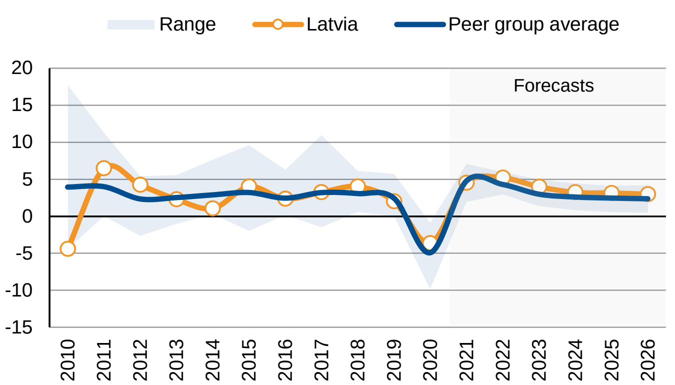
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Growth potential of the economy	Weak	-1/3	Medium-run growth potential faces challenges, including from adverse demographics
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; appropriate central bank response during the pandemic
	Macro-economic stability and sustainability	Weak	-1/3	Shortages of skilled labour

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

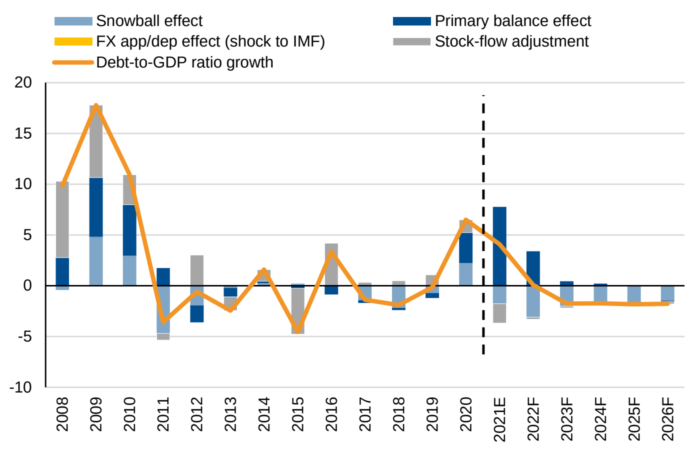
Public Finance Risks

- **Fiscal outlook**: Latvia has a good track record to effectively consolidate public finances, which should help repair the significant scarring to near-term fiscal dynamics due to the Covid-19 shock over time. Scope projects the general government deficit to narrow to 4.1% of GDP in 2022 and further to 2% in 2023, from 9% in 2021. This is being actively assisted by an improved outlook for tax revenue growth and a gradual expiry of Covid-19-related temporary support measures, the impact of which is estimated at around 7% of GDP for 2021.
- **Debt trajectory**: Latvia has moderate public debt compared to those of sovereign peers, even after factoring in the Covid-19-related shock to public finances. Scope projects that Latvia's general government debt will stabilise at 49% of GDP in 2022, well below the EU's 60% Maastricht threshold, and gradually return to close to pre-pandemic levels of about 40% of GDP over the next five years. This is supported by solid growth in nominal GDP and narrowing fiscal deficits in the medium term.
- **Market access**: Latvia's debt outlook benefits from favourable financing conditions and a supportive debt profile. The yield on the 10-year government bond was close to 0.4% at the time of writing, supported by the access to the European Central Bank's asset purchase facilities. The average maturity of Latvian debt is long at 8.5 years, which helps keep general government gross financing needs moderate at around 6% of GDP annually over 2022-23. The debt portfolio is almost entirely denominated in euros and carries a fixed rate.

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

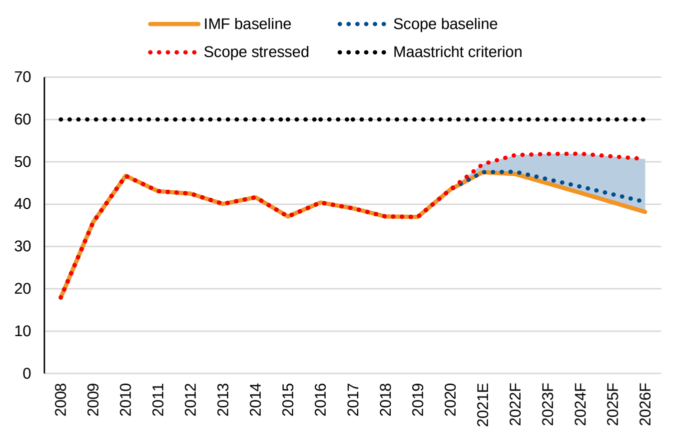
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Fiscal policy framework	Weak	-1/3	Track record of fiscal prudence, but still-sizeable shadow economy and comparatively restricted tax base
	Debt sustainability	Neutral	0	Moderate debt set to decline in the medium-term
	Debt profile and market access	Neutral	0	Favourable debt structure, ability to issue on favourable terms

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

External Economic Risks

- **Current account**: Latvia has gained global export market share over the last years, supported by improvements in export diversification. Scope projects Latvia's current-account deficit to be contained in the medium-term.

- **External position**: Latvia's net international investment position (external financial assets minus liabilities) improved to -31% of GDP in Q2 2021, from -41% of GDP in Q2 2019. Over one-third of gross external liabilities relate to inward foreign direct investment, which supports the long-term sustainability of the external position.

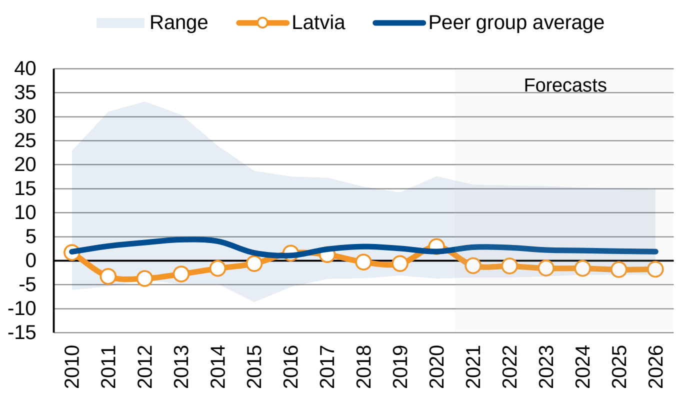
  Despite unit labour costs growing by 2.8% annually over the last five years relative to the euro-area average, the relative wage level in Latvia still compares favourably to relative productivity when compared with the euro-area averages, and wage growth has not severely undermined the competitiveness of Latvia's export sector. Net earnings in purchasing-power-standard terms amounted to around 50% of the euro-area average in 2020, while productivity per hour was 55% (and 67% per person) of the euro-area average in the same year.

- **Resilience to shocks:** Latvia's small, open economy is reliant on external demand and vulnerable to external shocks – such as an intensification of trade tensions and a prolonged period of subdued growth in western Europe. This is reflected in its large export sector (in goods and services) relative to the size of the economy, of around 63%.

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

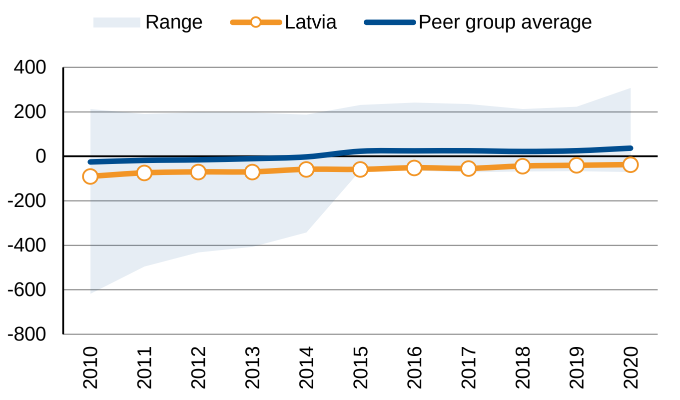
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Current account resilience	Weak	-1/3	Improvements in export diversification but high share of lower value-added exports
	External debt structure	Weak	-1/3	Elevated external debt, still substantial share of short-term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

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

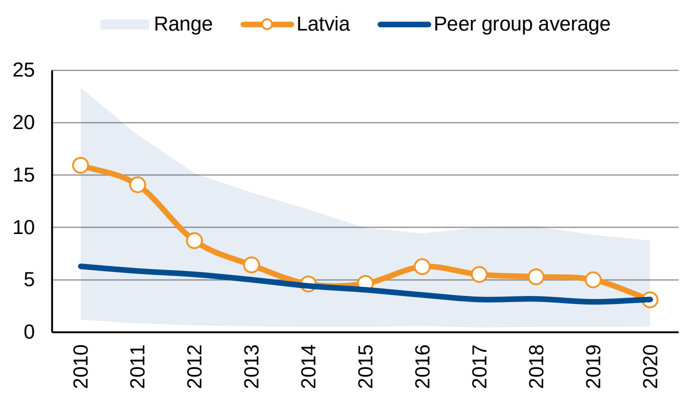
- **Banking sector**: Latvia's Nordic-dominated banking sector presents a limited contingent liability for the sovereign balance sheet and can absorb the current economic shock given its ample buffers. The banking sector is highly profitable compared with those of euro-area peers, is highly capitalised and displays strong asset quality. As of Q2 2021, the return on equity was 11.1% and the system-wide Tier 1 capital ratio was 25.1% of risk-weighted assets, both among the highest in the euro area, and the non-performing loan ratio was low at 1.7%.
- **Private debt**: Covid-19 crisis has not exacerbated Latvia's macroeconomic imbalances. Debt ratios of households and non-financial corporations (20% of GDP and 55% of GDP respectively at end-2020) are among the lowest in the EU and have remained virtually unchanged during the Covid-19 crisis.
- **Financial imbalances**: Latvian banks have been cutting 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 fell to 15% of total deposits of the banking sector in Q3 2021 from nearly half of total deposits in Q3 2017. This development mitigates Latvia's exposure to possible global financial stress, as short-term deposits are more prone to flight in times of market volatility, compared to other sources of inward investment such as long-term debt instruments or foreign direct investments. It also significantly lowers potential future money-laundering risks to Latvia's banking sector.

  Latvia's banking sector is exposed to concentration and spill-over risks due to its integration with Nordic and Baltic banking systems. Two Swedish banking groups, Swedbank and SEB, account for half of Latvia's total bank assets.

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

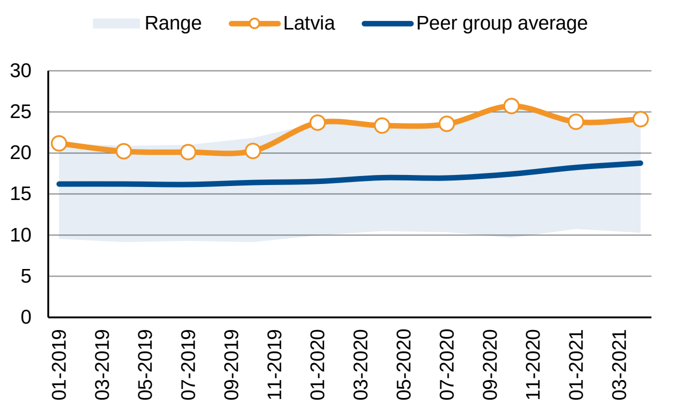
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector with moderate NPLs; profitability and asset quality impacted by Covid-19 crisis
	Banking sector oversight	Neutral	0	Oversight under the Bank of Latvia and the ECB as part of Banking Union
	Financial imbalances	Weak	-1/3	Concentration and spill-over risks in the banking system from dominant Nordic banking groups

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

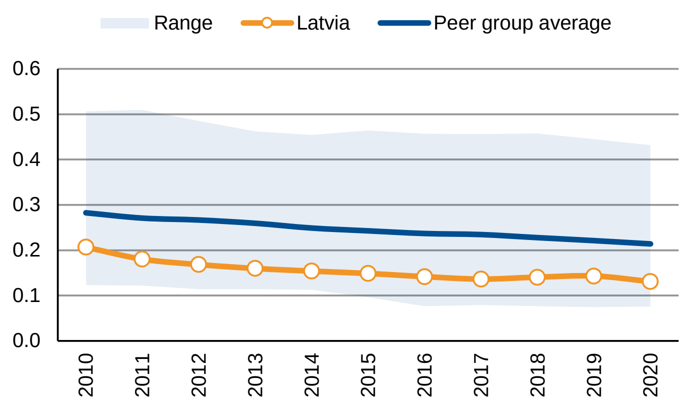
ESG Risks

- **Environment:** In 2020, around 53% of Latvia's electricity was produced from renewables. The share of renewable energy in total energy consumption in Latvia is estimated at 42.1% in 2020, which is the highest such share in the EU-27 after that of Sweden (60.1%) and Finland (43.9%).
- **Social:** Latvia's performance across key social factors is mixed. This is reflected in the above-EU-average poverty ratio, although the ratio is declining (26% of the population was at risk of poverty or social exclusion in 2020, compared with the EU-27 figure of 22%), the relatively high income-inequality, an unemployment rate (7% as of October) at around the EU average, and high labour participation rates. The European Commission's Digital Economy and Society Index 2021, which ranks the EU-27 countries for digital competitiveness, placed Latvia at 17th (average).
- **Governance:** Under governance-related factors, Latvia's performance is stronger than that of most Central and Eastern European peers as assessed under the World Bank's Worldwide Governance Indicators. In general, policymaking in Latvia has largely been effective and enjoyed relative continuity. Latvia's EU and euro-area memberships enhance the quality and stability of its governance framework.

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

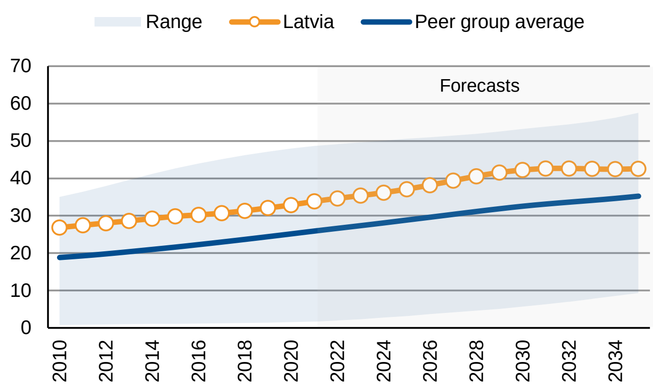
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental risks	Neutral	0	Relatively high share of renewable energy in energy consumption, transition risks in line with peers
	Social risks	Weak	-1/3	Above-EU-average poverty ratio, relatively high income inequality, demographic declines
	Institutional and political risks	Neutral	0	Stable governance framework, supported by EU and euro area memberships

CO2 emissions per GDP, mtCO2e



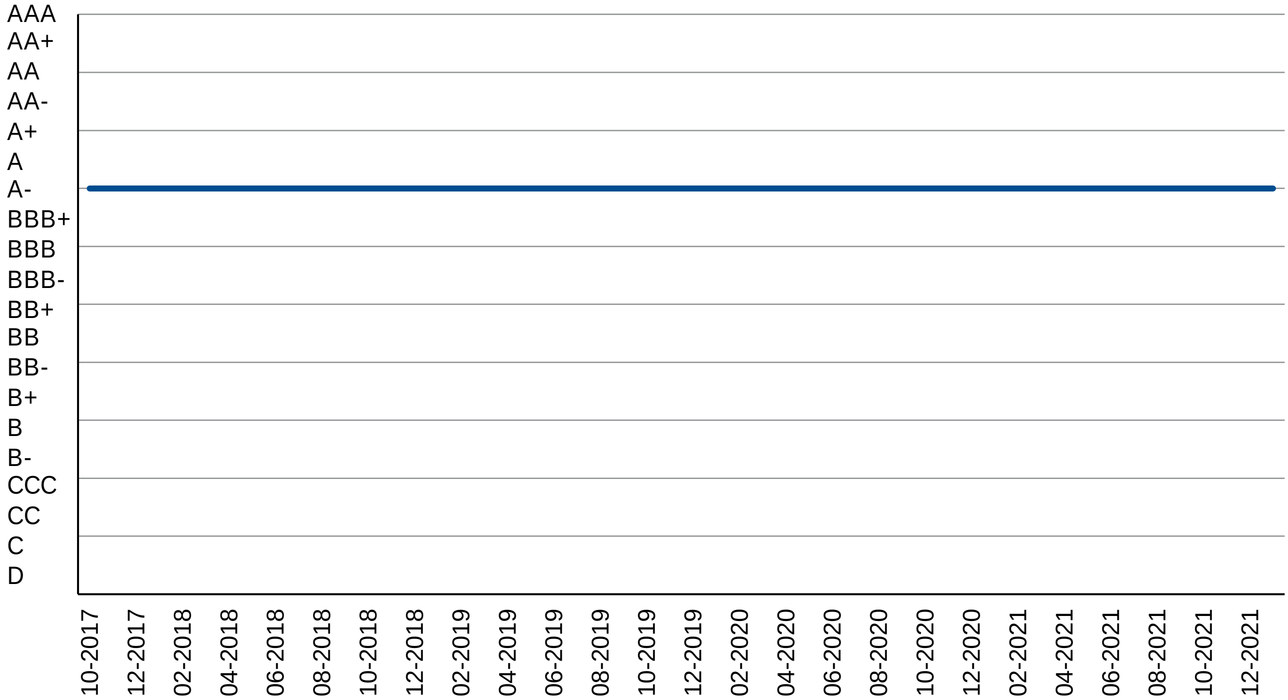
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



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.

Peer group
Belgium
Czech Republic
France
Japan
Lithuania
Malta
Poland
Russia
Slovakia
Slovenia
United States

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 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	14.3	15.6	17.8	17.7	17.5	19.5	21.5
Nominal GDP, USD bn	28.1	30.4	34.4	34.1	33.5	37.2	40.8
Real growth, %[1]	2.4	3.3	4.0	2.5	-3.6	4.6	5.0
CPI inflation, %	0.1	2.9	2.6	2.7	0.1	3.0	3.3
Unemployment rate, %[1]	9.6	8.7	7.4	6.3	8.1	7.5	6.8
Public Finance Risk							
Public debt, % of GDP[1]	40.4	39.0	37.1	36.7	43.2	49	49
Net interest payment, % of government revenue	3.4	3.1	2.5	2.3	2.3	2.2	1.9
Primary balance, % of GDP[1]	0.8	0.3	0.2	0.5	-3.0	-7.8	-2.9
External Economic Risk							
Current account balance, % of GDP	1.6	1.3	-0.2	-0.7	2.9	-2.7	-1.6
Total reserves, months of imports	2.3	2.7	2.2	2.3	3.0	-	-
NIIP, % of GDP	-51.6	-54.6	-43.8	-40.5	-37.5	-	-
Financial Stability Risk							
NPL ratio, % of total loans	6.3	5.5	5.3	5.0	3.1	-	-
Tier 1 ratio, % of risk weighted assets	17.3	18.5	20.3	20.2	25.7	-	-
Credit to private sector, % of GDP	46.7	42.1	36.6	34.4	34.4	-	-
ESG Risk							
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	141.7	136.3	140.6	143.2	130.8	-	-
Income quintile share ratio (S80/S20), x	6.0	6.3	6.0	-	-	-	-
Labour force participation rate, %	76.3	77.0	77.7	77.3	78.2	-	-
Old age dependency ratio, %	30.2	30.7	31.3	32.1	32.9	33.9	34.7
Composite governance indicator[2]	0.8	0.8	0.8	0.9	0.8	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 14 January 2022	48

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