Republic of Latvia
Rating Report

A- STABLE OUTLOOK

Credit strengths

- Sound institutional setup, underpinned by memberships 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 euro area membership, which ensures a robust framework for fiscal and economic policy. Its membership in NATO strongly mitigates external security risks in the context of the 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.

Solid fiscal position: The shocks related to Covid-19 and the war in Ukraine have resulted in significant fiscal scarring since 2020. We expect a gradual reduction of fiscal deficits from 4.4% of GDP in 2022 to 1-1.5% over the medium term, while public debt should stabilise at 40-43% of GDP over the coming five years, one of the lowest levels in the euro area.

Rating challenges: Latvia's ratings remain constrained by challenges relating to continued moderate per-capita income, unfavourable demographic trends constraining growth and the 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%	bb+	EUR [+1]	0	A-
Public Finance Risk		20%	aa		0	
External Economic Risk		10%	ccc		0	
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 Rating Methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook represents our view that the risks Latvia will face over the next 12 to 18 months are balanced.

Positive rating-change drivers

- Geopolitical risks in the region declining
- Solid economic growth and income convergence continuing through structural reform and investment
- Debt-to-GDP being anchored to moderate levels thanks to broadly balanced government finances
- External and/or financial vulnerabilities continuing to decline

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-/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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Bloomberg: RESP SCOP

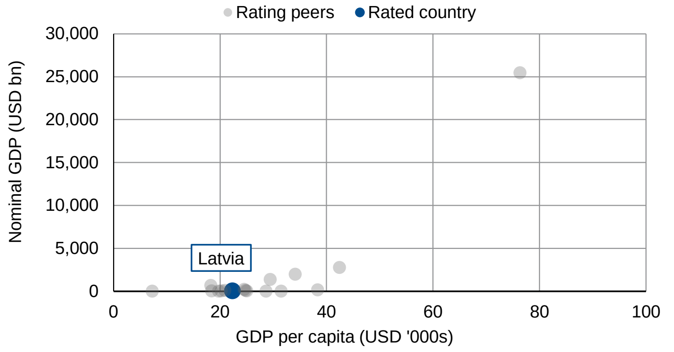
Domestic Economic Risks

- **Growth outlook:** The Latvian economy proved resilient to the Covid-19 shock, with real GDP growth of 2.8% and 4.3% in 2022 and 2021, following a contained contraction of 2.3% in 2020. The escalation of the war in Ukraine is, however, having a significantly impact, given Latvia's important (albeit declining) trade links with Russia and the exceptional shock on commodity prices. The economy proved resilient so far, with average quarterly growth of 0.3% last year. We expect some recovery over 2023-24, as energy prices are declining rapidly, but the outlook remains constrained by tightening financing conditions along with weaker confidence and external demand. GDP would grow moderately by 0.7% in 2023 and by 2.7% in 2024, then converge to an estimated growth potential of 2.5%. The outlook is supported by large allocations of EU funds exceeding 25% of (2021) GDP via the 2021-27 EU budget (Recovery and Resilience Facility, Cohesion Policy, Common Agricultural Policy), underpinning Latvia's continued convergence in income and productivity with euro area peers. A declining working-age population and skill shortages are, however, obstacles to sustained growth.
- **Inflation and monetary policy:** Along with the other Baltic states, Latvia is heavily affected by the exceptional inflationary pressures, owing to the large share of energy and food items in its consumption basket and the deregulation of gas and electricity markets. We expect inflation to normalise rapidly through the tightening monetary policy and lower energy prices. The (harmonised) inflation rate stood at 17.2% in March 2023, down from the peak of 22.0% in September 2022. At the same time, however, core inflation is still elevated (10.7%) and decreasing only moderately. We expect an annual inflation rate of about 10% for 2023, after 17.2% in 2022, then declining to 2-3% in 2024-25. The ECB is rapidly tightening monetary policy, with quantitative tightening and rate hikes of 350 bp since July 2022.
- **Labour market:** Labour market indicators are solid, though some weakening is expected over the coming months given the challenging economic outlook. Employment continued to recover through 2022, though still counting about 20,000 fewer people than before Covid-19. A large influx of Ukrainian refugees is likely to support employment and offset the decline in the working-age population. Participation and employment rates are rather high, at 77% and 71% in Q4 2022, respectively, while the unemployment rate is low at 6.7% as of February 2023. Skill mismatches continue to hinder an improvement of the unemployment rate, which we expect to stabilise at about 7.0% in 2023-2024, slightly up from 6.8% in 2022.

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

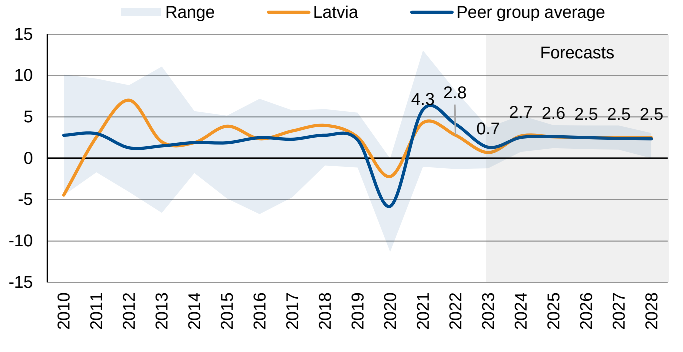
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Growth potential of the economy	Neutral	0	Solid economic growth prospects, although constrained by adverse demographics and barriers to employment growth
	Monetary policy framework	Neutral	0	ECB is a credible and effective 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

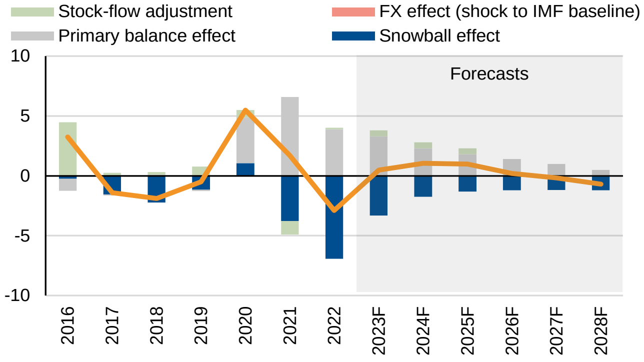
Public Finance Risks

- **Fiscal outlook:** Latvia had a good record of moderate fiscal deficits before Covid-19. The pandemic had a significant effect on the government budget, however, requiring large support to the health and social systems. The fiscal deficit has narrowed to a still elevated 4.4% of GDP in 2022, after 7.1% in 2021 and 4.4% in 2020. This was because robust growth in government revenue was offset in part by the still significant support needed for the Covid-19 and energy crises on top of spending for enhancing security. The 2023 budget, adopted in March after the new government was formed, sets aside less for the energy crisis, but includes higher resources for healthcare, education, public wages and investment, with the latter boosted by NGEU funds. We anticipate that the deficit will decline to about 4% of GDP in 2023 and then further to about 1-1.5% of GDP by 2028. Latvia's low tax revenue, at just above 30% of GDP, or more than 10 pp less than the EU average, remains a constraint for its fiscal policy. Continued efforts in combating the shadow economy and broadening the tax base could support a more rapid rebalancing of government finances.
- **Debt trajectory:** Latvia's public debt is low compared to that of its sovereign peers. We expect Latvia's general government debt to slightly rise to 41.3% of GDP in 2023, up from 40.8% in 2022, and then stabilize at about 40-43% 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 (below 2% of GDP) and 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 relatively long, at close to seven years, which will help to keep the government's annual gross financing needs moderate at 5-8% of GDP over the coming years. Liquidity management is prudent under the current volatile market conditions, with a large cash buffer of 6% of GDP as of February 2023 supporting funding flexibility. The debt portfolio is 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.

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

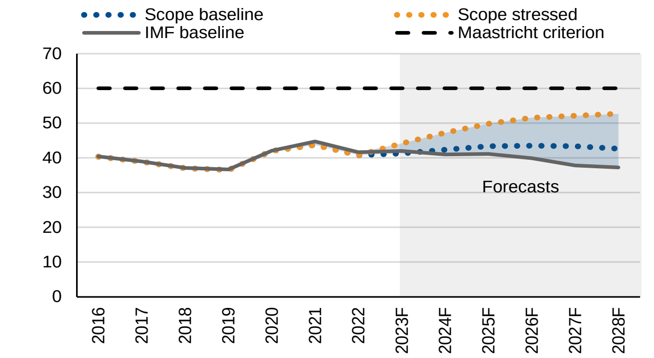
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Record of fiscal prudence, but large shadow economy and comparatively restricted tax base
	Debt sustainability	Neutral	0	Moderate debt levels, expected to decline in the medium term
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

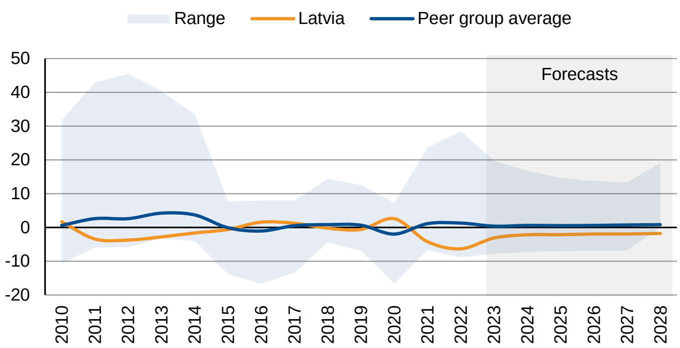
External Economic Risks

- **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 to a 6.4% deficit in 2022. This deterioration followed the impacts of soaring energy and raw materials prices, but also the stockpiling of resources, large imports of aircrafts and exceptional import volumes related to trade flows with Russia in anticipation of sanctions coming into power. These factors are largely of temporary nature. However, in view of Latvia's still significant, albeit declining, trade exposures to Russia, which accounts for 5-6% of exports, and the loss of Russian import markets for raw materials at low prices, we expect the recovery of the current account to be gradual, with deficits of 2-3% of GDP over the coming years. This, also as the exceptional inflation of current years is likely to have some lasting impact on external competitiveness.
- **External position:** The external position of Latvia's economy is improving steadily, with its net debtor position declining from 51.5% of GDP in 2017 to 27.0% in 2022. Around 41% of total external liabilities relate to foreign direct investment, while only about 13% are portfolio investments, limiting risks of sudden capital flows in times of market stress. Latvia's external debt is elevated relative to its Baltic peers, at 100.6% of GDP in 2022, albeit clearly declining, down from over 140% in 2017. Most external debt is owed by the Latvian public sector (over 62% of total). A significant 60% of external debt (excluding direct investment) is short-term, which is more than 53% of GDP, above the levels in Lithuania (31%) and Estonia (35%).
- **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 over 70% of GDP. The Russia-Ukraine war is having significant direct and indirect negative impacts on the country's economy, primarily through the inflation shock. At the same time, we do not expect the conflict to cause permanent economic scarring, thanks to the continued improvement of Latvia's energy security, which has allowed a rapid substitution of Russian energy imports. Further, the connection of the Baltic states' and continental Europe's electricity networks is due for completion by 2025, with synchronisation under emergencies already possible. Latvia benefits from the euro's status as an international reserve currency, significantly mitigating risk from currency sell-off and sudden stops of capital flows.

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

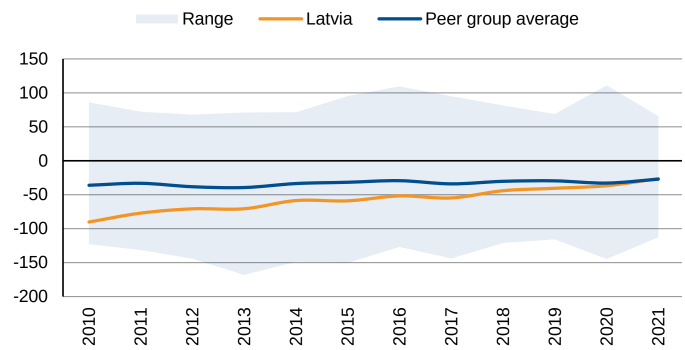
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Neutral	0	Improvements in export diversification but high share of lower value-added exports
	External debt structure	Neutral	0	Elevated, albeit declining, external debt, but limited risks of capital flows
	Resilience to short-term external shocks	Neutral	0	Very small and open economy; euro-area membership mitigates exposure to international markets

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:** Latvian banks present limited contingent liability risk to the government balance sheet. The sector's resilience is bolstered by strong capitalisation and asset quality metrics, with aggregate CET 1 and non-performing loan ratios of 21.3% and 1.8% as of Q4 2022, respectively, as reported by Latvija Banka. Profitability is also robust, as reflected in an aggregate return on equity of 10.1% as of Q4 2022. Low cost-to-income ratios should support profitability over the coming years, even with the risks stemming from the challenging economic outlook and the uncertainty over the global banking sector following a rapid normalisation in monetary policies. The sector's liquidity position is solid, as reflected in a high liquidity coverage ratio of above 222% in Q4 2022, while exposures to and deposits from Russian counterparts are limited.

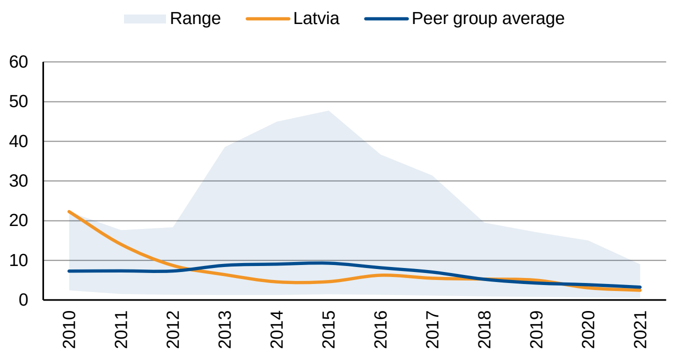
- **Private debt:** Private sector debt is low relative to other euro area peers. Households' and non-financial corporates' debt stood at 17.6% and 42.1% of GDP, respectively, as of Q4 2022. Total private debt is thus below 60% of GDP, against 163% for the euro area. Still, households and businesses are exposed to interest rate risks, because over 90% (on average) of new loans since 2015 were on variable rate terms. Debt service ratios are thus expected to increase in line with the ECB tightening of monetary policy, but we expect the overall effect to be manageable thanks to the low debt-to-income ratios of Latvian households (about 34%), one of the lowest in the EU. However, the low private debt also creates obstacles to accessing finance, in particular for SMEs.

- **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 15.4% of the total as of Q4 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. The reduced share also significantly lowers risks of a re-emergence of money laundering in the Latvian banking sector, supported by 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 a stable domestic customer deposit base.

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

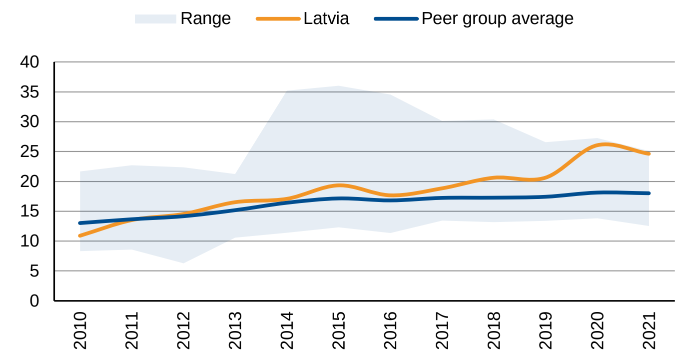
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector with moderate non-performing loans
	Banking sector oversight	Neutral	0	Oversight under the Bank of Latvia and the ECB as part of the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

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

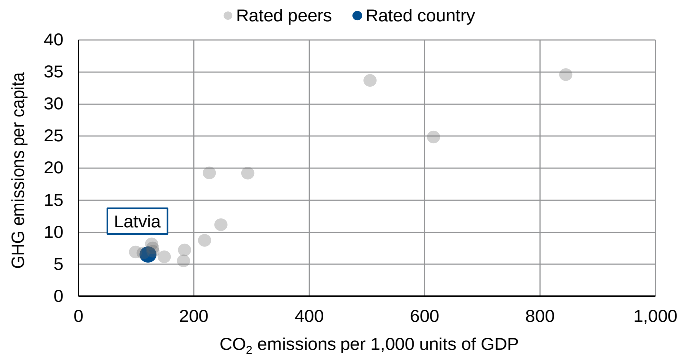
ESG Risks

- **Environment:** Latvia already meets a large share of its domestic energy consumption with renewables (44% as of 2021), the highest share in the EU after Sweden and Finland. The country's system of environmental taxation yields around 3% of GDP in government revenue annually, one of the highest levels in the EU. The country, however, faces challenges from rising emissions outside of the Emissions Trading System due to a fossil fuel-reliant transport system and an energy-intensive building stock. 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 to accelerate the scaling-up of the country's renewable energy generation and its energy independence, including relaxing regulatory barriers for the development of wind and solar energy projects.
- **Social:** Latvia's social outcomes suffer from adverse demographic trends and low funding for its welfare system. The UN projects that Latvia's working-age population will decline cumulatively by 20% over the next 20 years. 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, at significantly above the EU average. This is despite high labour participation, reflecting an inclusive labour market and high activity rates among young people and women.
- **Governance:** Latvia's institutional quality is strong compared with that of most Central and Eastern European peers. Policymaking in the country has been underpinned by the country's EU and euro area memberships and has enjoyed relative continuity despite its multi-party political system. The October 2022 elections produced large gains for incumbent Prime Minister Krišjānis Kariņš' party, which formed 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' memberships in NATO strongly limit 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*

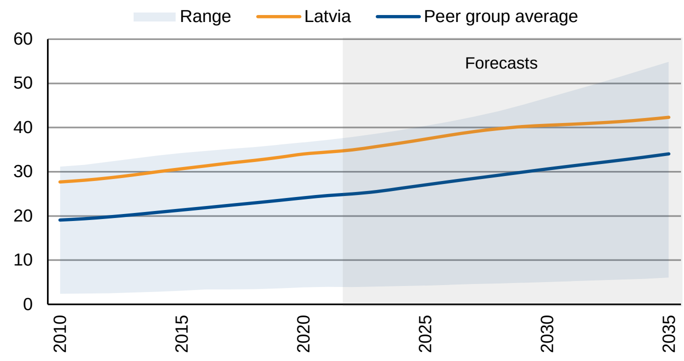
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental factors	Neutral	0	High share of renewables in the energy mix; transition risks in line with peers
	Social factors	Neutral	0	Inclusive labour market but still elevated poverty and income inequality; unfavourable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

Emissions per GDP and per capita, $mtCO_2e$



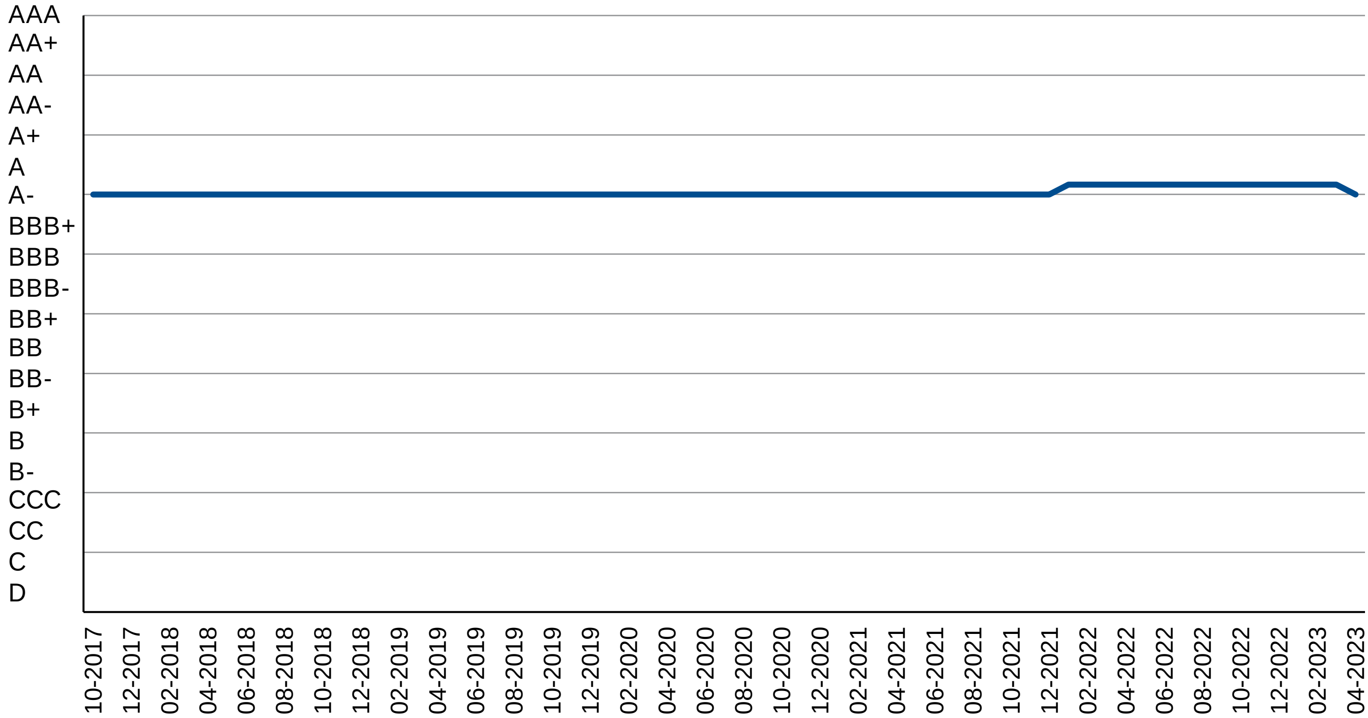
Source: European Commission, Scope Ratings

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*
Croatia
Cyprus
Estonia
France
Italy
Lithuania
Poland
Portugal
Slovakia
Spain
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 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	2018	2019	2020	2021	2022	2023
Domestic Economic	GDP per capita, USD '000s	IMF	17.8	17.9	18.1	21.0	22.3	25.1
	Nominal GDP, USD bn	IMF	34.4	34.3	34.6	39.8	42.2	47.4
	Real growth, %	IMF	4.0	2.6	-2.2	4.1	2.0	0.4
	CPI inflation, %	IMF	2.6	2.7	0.1	3.2	17.2	9.7
	Unemployment rate, %	WB	7.4	6.3	8.1	7.5	-	-
Public Finance	Public debt, % of GDP	IMF	37.1	36.7	42.1	44.7	41.6	42.0
	Interest payment, % of revenue	IMF	2.5	2.3	2.3	2.0	1.4	1.4
	Primary balance, % of GDP	IMF	0.2	0.5	-2.8	-4.7	-3.1	-4.2
External Economic	Current account balance, % of GDP	IMF	-0.2	-0.6	2.6	-4.2	-6.3	-3.1
	Total reserves, months of imports	IMF	2.2	2.3	2.9	2.3	-	-
	NIIP, % of GDP	IMF	-44.0	-40.5	-36.7	-26.3	-26.7	-
Financial Stability	NPL ratio, % of total loans	IMF	5.3	5.0	3.1	2.5	1.8	-
	Tier 1 ratio, % of risk-weighted assets	IMF	20.6	20.6	26.0	24.6	21.6	-
	Credit to private sector, % of GDP	WB	36.6	34.3	33.5	-	-	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	143.3	136.2	121.5	120.9	-	-
	Income share of bottom 50%, %	WID	17.4	18.0	17.9	17.9	-	-
	Labour-force participation rate, %	WB	78.1	77.7	-	-	-	-
	Old-age dependency ratio, %	UN	32.6	33.2	34.0	34.4	34.9	35.7
	Composite governance indicators*	WB	0.8	0.9	0.8	0.9	-	-

* 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)	88

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