1 July 2022

Sovereign and Public Sector

Republic of Latvia
Rating Report

A- POSITIVE OUTLOOK

Credit strengths

- EU, euro area and NATO memberships
- Solid economic growth prospects
- Moderate public debt

Credit challenges

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

Rating rationale

Euro area membership: Latvia is a member of the euro area, benefitting from a highly credible monetary policy, and rigorous financial sector oversight through the ECB.

Strong macro-economic fundamentals despite Russia-Ukraine war: Despite the escalation of the Russia-Ukraine war, which is significantly affecting Latvia's economy given the trade relations with the two countries and Latvia's energy dependence on Russia, we expect 2022-23 growth of around 2.5% and inflation to subside next year to around 6%, from about 13.5% this year.

Effective fiscal policy: We expect a gradual reduction of fiscal deficits from about 7% of GDP in 2022 to less than 1% over the medium term, and public debt to decline to around 40% of GDP from 46% this year 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 exposures 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 scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	bbb+		-1/3	A-
Public Finance Risk		25%	aa		-1/3	
External Economic Risk		10%	bb-		-2/3	
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**	**-2**	

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 be able to weather the economic fallout from the Russia-Ukraine war without deteriorating its credit fundamentals and that continued economic and fiscal reform progress, alongside the effective absorption of EU funds, will further improve economic fundamentals and set the conditions for fiscal rebalancing over the coming years.

Positive rating-change drivers

- Improved growth prospects through reforms and investment raising employment and productivity
- Sustained downward path in public debt, supported by fiscal consolidation
- Reduction in external vulnerabilities and/or financial sector risks

Negative rating-change drivers

- Deterioration in public debt dynamics
- Deterioration in external position and/or re-emergence of financial sector risks
- External shocks or heightened geopolitical risk undermining macro-economic 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

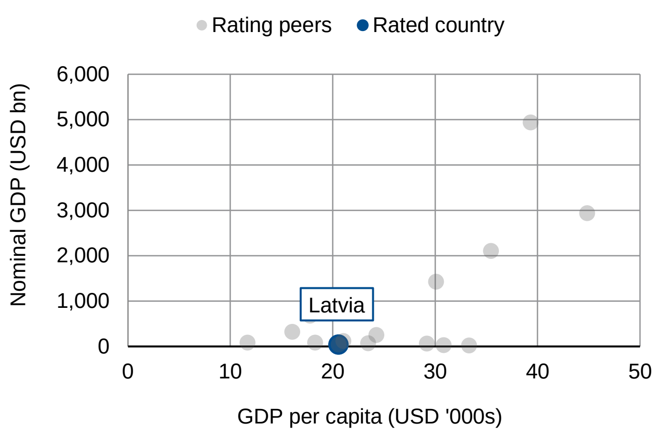
Domestic Economic Risks

- **Growth outlook:** The Latvian economy entered 2022 on a solid recovery path after the Covid-19 shock, with real GDP growth of 4.5% in 2021, after a contained contraction of 3.8% in 2020. The escalation of the Russia-Ukraine war is however significantly affecting Latvia's economy, given the significant trade relations with the two countries and Latvia's energy dependence on Russia, exacerbating shocks on energy prices. Despite solid real growth in the first quarter of this year (3.6% QoQ) driven by the relaxation of Covid-19 restrictions, we expect growth to slow down significantly in the remaining months of 2022, with an overall growth rate of 2.5% in 2022 and 2023. Over the medium term, Latvia's economic outlook is supported by large allocations of EU funds via EUR 1.8bn (5.5% of 2021 GDP) of grants from the Recovery and Resilience Facility and EUR 7.2bn (22% of 2021 GDP) from the Cohesion Policy and Common Agricultural Policy of the 2021-27 EU budget. We estimate Latvia's medium-term growth potential at 2.5%, balancing the significant room for convergence in productivity with euro area peers with its declining working-age population and structural barriers to employment growth.
- **Inflation and monetary policy:** The Russia-Ukraine war is exacerbating price pressures, especially on food and energy, resulting in high inflation rates in recent months, over 10% since March this year, rising to 16.9% in May 2022. We expect inflation to remain high over the coming months for an overall annual rate of about 13.5%, followed by a still high 6% in 2023. The ECB has taken some steps towards the normalisation of its monetary policy, with the end of net asset purchases under its quantitative easing programme and first-rate hikes as of July 2022. Financing conditions are nevertheless expected to remain broadly accommodative over the coming months.
- **Labour market:** The labour market is recovering from the Covid-19 crisis, with the unemployment rate declining to 6.6% in April, down from 8.8% in July 2020. Employment still counts about 30,000 people less than before the pandemic, however. Skill shortages and mismatches continue to be important impediments to a further reduction of the unemployment rate, which we expect to stand at about 7.5% and 7.0% in 2022 and 2023, respectively.

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

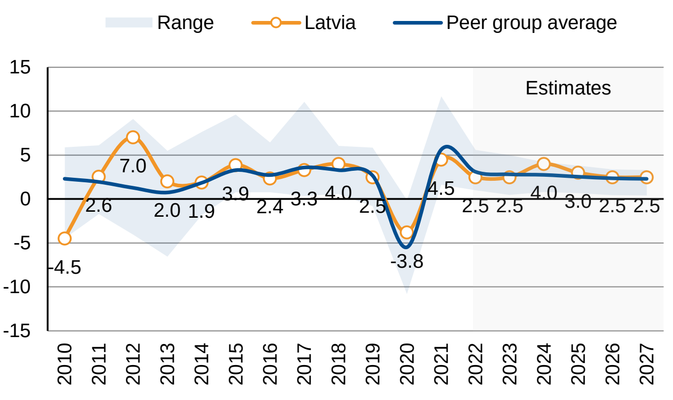
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Neutral	0	Solid economic growth prospects, although constrained by adverse demographics and barriers to employment growth
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Weak	-1/3	Limited economy size and diversification, low productivity, labour market slack

Nominal GDP and GDP per capita, USD '000s



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

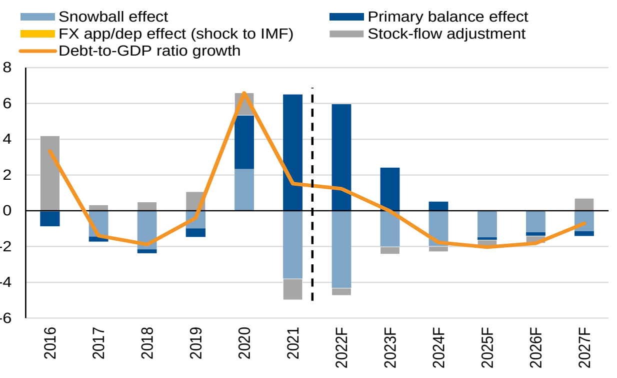
Public Finance Risks

- **Fiscal outlook:** Latvia had a good record of moderate fiscal deficits before the Covid-19 crisis, reflecting its commitment to prudent fiscal management and debt reduction. The pandemic scarred the government budget requiring the implementation of sizeable emergency measures to support the healthcare and social systems despite a relatively contained economic shock. We expect the fiscal deficit to remain high relative to GDP in 2022, close to 7%, after 4.5% in 2020 and 7.3% in 2021, given still significant Covid-19 support measures, as well as a large fiscal package to mitigate high energy costs for households and businesses and to manage the fallout from Russia's military aggression against Ukraine. The deficit should then rapidly decline to 3.5% of GDP next year and then converge towards 0.8% of GDP over the medium term. Low tax revenue relative to GDP, at just above 30%, remains a structural constraint for Latvia's fiscal policy and limits progress in improving the country's welfare system. In this context, the country's efforts in combating the large shadow economy are welcome.
- **Debt trajectory:** Latvia's public debt is moderate compared to that of its sovereign peers, even after factoring in the Covid-19-related shock to public finances. We expect Latvia's general government debt to stabilise at 46% of GDP in 2022-23, up from 44.8% last year, and then gradually return 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. Contingent liabilities in the form of government guarantees as well as implicit costs of the ageing population are also relatively contained vis-à-vis peers.
- **Debt profile and market access:** Latvia's debt outlook benefits from a robust debt profile and favourable, although rising, financing costs, as is the case across European sovereigns. The yield on the 10-year government bond was above 2.7% at the time of writing, up from below zero last year, reflecting shifting expectations about the monetary policy stance. The average maturity of Latvian debt is long at over eight years, which will help to keep the government's gross financing needs relatively moderate at below 10% of GDP annually over 2022-23, then declining towards 6% in the medium term. The debt portfolio is almost entirely denominated in euro and mostly carries a fixed rate. Debt securities are mostly issued on international capital markets, although Latvia is gradually 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*

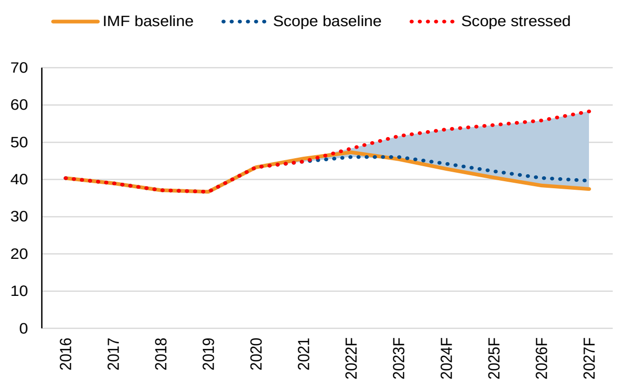
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Weak	-1/3	Record of fiscal prudence, but large shadow economy and comparatively restricted tax base
	Debt sustainability	Neutral	0	Moderate debt levels, expected to decline in the medium term
	Debt profile and market access	Neutral	0	Robust debt structure, ability to issue on favourable terms in the capital markets

Contributions to changes in general government debt, pp of GDP



According to IMF classification

General government debt forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

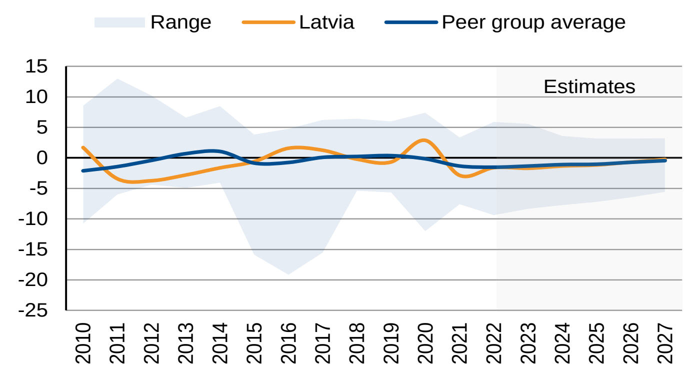
External Economic Risks

- **Current account:** Latvia's current account has remained close to balance in recent years, with deficits in the goods and secondary income balances broadly offset by surpluses in the services and primary income accounts. Over time, Latvia's global export market share has grown, supported by improvements in export diversification and competitiveness. Latvia's current account deficit widened to -2.9% of GDP last year, owing to the recovery in internal demand and the spike in energy prices. We expect Latvia's trade performance to remain subdued in the medium-term in the wake of the Russia-Ukraine war. Trade exposure to Russia declined markedly since 2014 but remained significant until the escalation of the conflict, at about 7.4% and 9% of total goods exports and imports, respectively. Re-exports made up about a third of exports to Russia, somewhat limiting the impact of trade disruptions. We expect the country's trade relations with Russia to essentially stop over the coming months, following Latvia's decision to halt natural gas imports from the country in 2023. The current account should see moderate deficits over the medium term.
- **External position:** Latvia's net debtor position is large although significantly declining over time, with the net international investment position having improved to -28% of GDP in 2021 from below -50% in 2017. Its composition is favourable, with almost two-thirds of net external liabilities in the form of direct investment. Latvia's external debt is high, at 112% of GDP as of end-2021, well above the other Baltic states, albeit on a clear declining trend, having decreased from almost 150% in 2016. Over half of external liabilities are related to the public sector. Short-term external debt remains high, about twice that of the other Baltic economies relative to the economy's size.
- **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 amounting to about two-thirds of GDP. Together with other euro area member states, Latvia benefits from the euro's status as an international reserve currency, significantly mitigating risk from currency sell-off and sudden stops in capital flows.

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

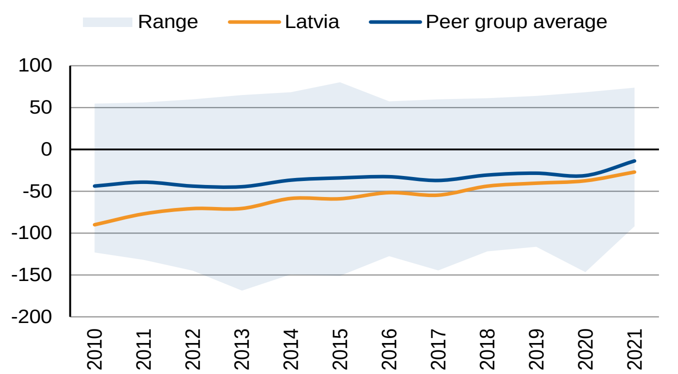
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Current account resilience	Neutral	0	Improvements in export diversification, high share of lower value-added exports
	External debt structure	Weak	-1/3	Elevated external debt, still high share of short-term external debt
	Resilience to short-term 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

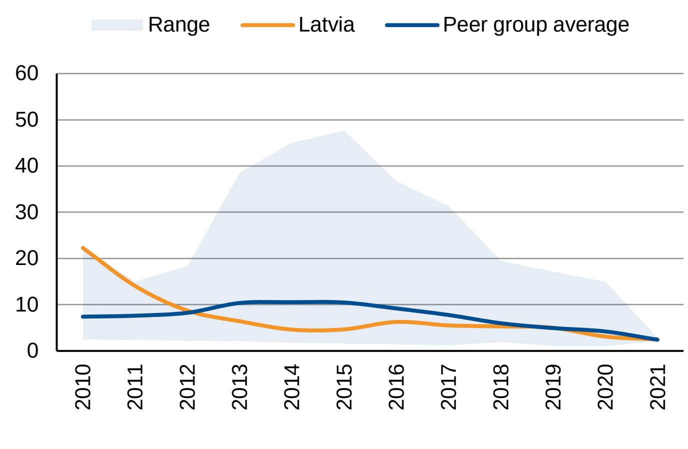
Financial Stability Risks

- **Banking sector:** Latvia's banking sector presents a limited contingent liability for the sovereign balance sheet and can absorb the current economic shocks given its solid capitalisation and profitability metrics. The sector Tier 1 capital ratio was above 24% by end-2021, against 17% on average in the EU. Profitability is also above regional peers, as reflected in a generally higher system-wide ROE and ROA. Asset quality is also favourable and was not significantly impacted by the Covid-19 pandemic, with the non-performing loan ratio continuing to decline in recent years, to below 2.5% by Q1 2022, according to the Financial and Capital Market Commission. Liquidity risks are limited, given a very high liquidity coverage ratio, close to 350% in Q1 2022. Direct exposures to and deposits from Russian counterparts are limited.
- **Private debt:** Private sector indebtedness relative to GDP has declined steadily since the great financial crisis, down to 68% at end-2021, less than half of 2010 levels. Private debt ratios of the household and non-financial corporation segments stand at 20% of GDP and 48% of GDP respectively, continued to decline throughout the Covid-19 crisis and are currently among the lowest in the EU. While low private indebtedness supports macroeconomic resilience, it also reflects subdued credit growth over the last years, which could adversely affect investment activity and productivity growth.
- **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 fell below 15% of total deposits in the banking sector in Q1 2022 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 the risk 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. Two Swedish banking groups, Swedbank and SEB, account for close to half of Latvia's total bank assets.

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

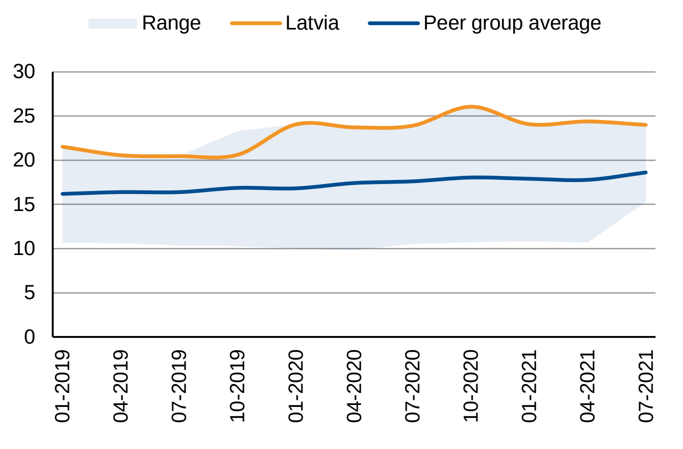
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector with moderate non-performing loans
	Banking sector oversight	Neutral	0	Oversight under the Bank of Latvia and the ECB as part of the Banking Union
	Financial imbalances	Weak	-1/3	Concentration and spillover risks in the banking system from Nordic banking groups, obstacles to credit growth

Non-performing loans, % of total loans



Source: World Bank, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

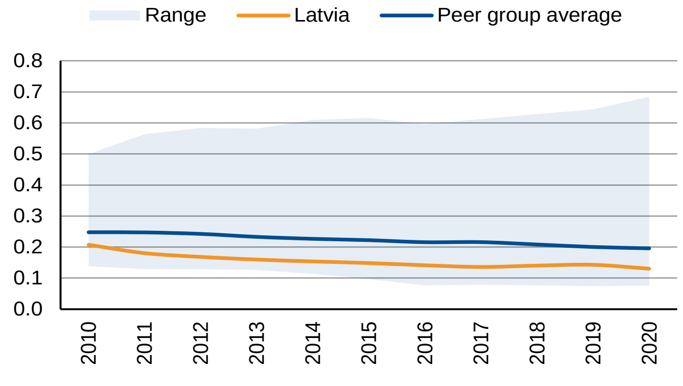
ESG Risks

- **Environment:** Latvia meets a large share (44% as of 2020) of its domestic energy consumption with renewables, the highest share in the EU after Sweden and Finland. The country has implemented a strong system of environmental taxation, which 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 and disparities in the building stock. The country also needs to continue its efforts for shifting to a circular economy. The government plans to address these challenges via public investments under its Recovery and Resilience Plan, 38% of which is allocated to climate objectives. In March 2022, the Latvian government approved proposals aimed at accelerating the scaling up of the country's renewable energy generation and its energy independence.
- **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 presents high income inequality and poverty, significantly above the EU average. On the positive side, labour participation is quite high, reflecting low inactivity 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, as assessed under the World Bank's Worldwide Governance Indicators. 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 next parliamentary elections are scheduled for October 2022, with current Prime Minister Krišjānis Kariņš' centre-right party expected to score large gains. Geopolitical risks for Latvia, which shares a border with Russia, have increased since the start of the Russia-Ukraine war. However, Latvia's and the other Baltic states' NATO membership strongly limits the risk of the conflict expanding into the region. Latvia's security guarantees are underpinned by NATO's Article 5, which states that if one member of the Alliance is subject to an armed attack, this is considered as a direct attack against all members, who will provide the necessary military support.

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

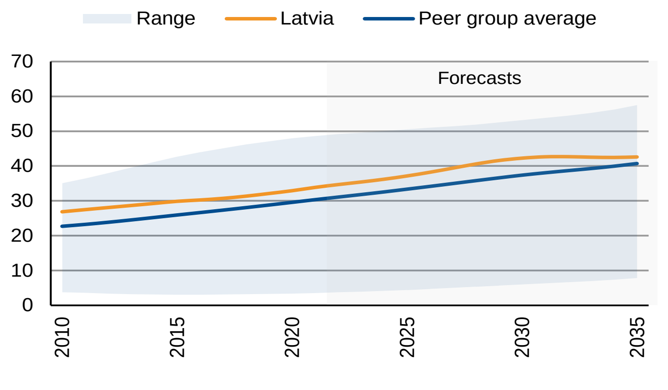
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Neutral	0	High share of renewables in the energy mix, transition risks in line with peers
	Social risks	Weak	-1/3	Above-EU-average poverty ratio, high income inequality, unfavourable demographic trends
	Institutional and political risks	Neutral	0	Stable governance, supported by EU, euro area and NATO memberships

CO_2 emissions per GDP, $mtCO_2e$



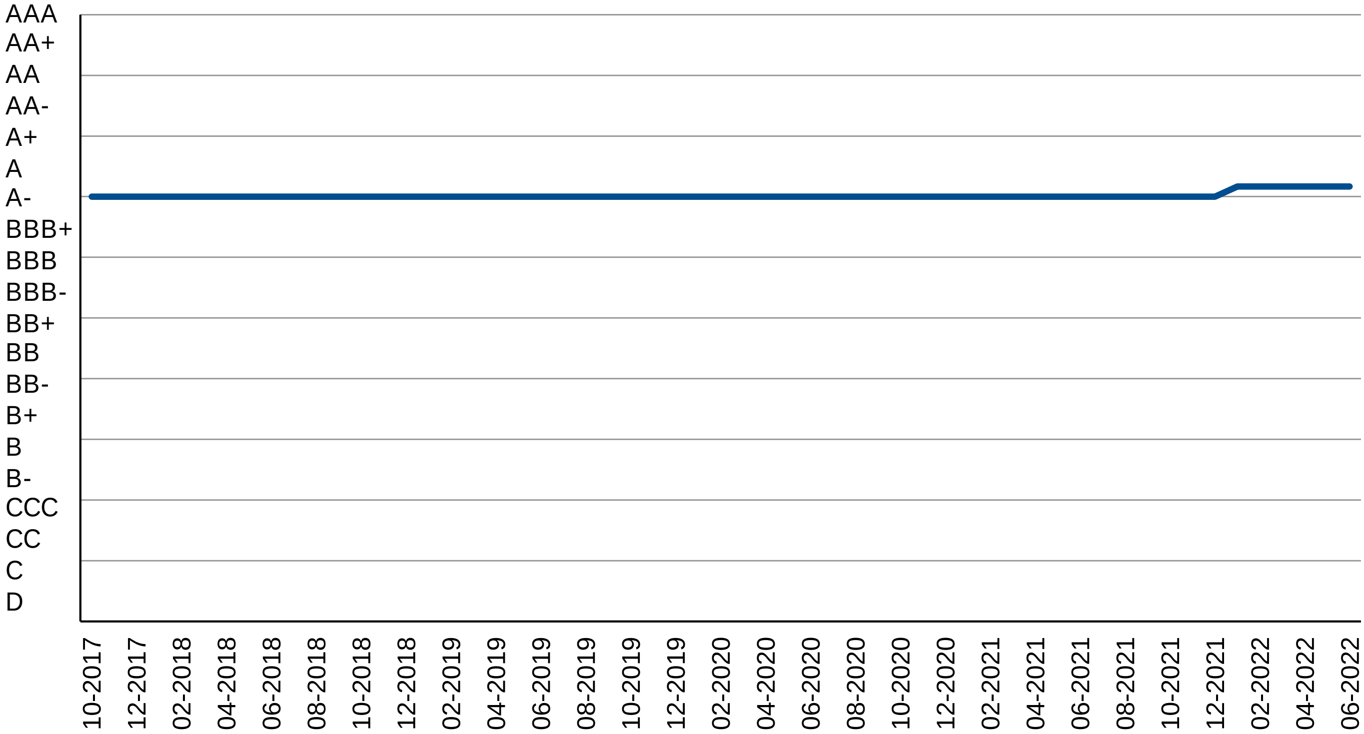
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

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 embedding a methodological reserve-currency adjustment.

Peer group*
Bulgaria
Cyprus
France
Italy
Japan
Lithuania
Malta
Poland
Portugal
Slovakia
Slovenia
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 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	14.3	15.6	17.8	17.9	17.6	20.6	21.3	22.9
Nominal GDP, USD bn	28.1	30.5	34.4	34.3	33.6	39.0	40.3	43.1
Real growth, %[1]	2.4	3.3	4.0	2.5	-3.8	4.5	2.5	2.5
CPI inflation, %	0.1	2.9	2.6	2.7	0.1	3.2	10.0	3.9
Unemployment rate, %[1]	9.6	8.7	7.4	6.3	8.1	7.6	7.5	7.0
Public Finance Risk								
Public debt, % of GDP[1]	40.4	39.0	37.1	36.7	43.3	44.8	46.0	46.0
Interest payment, % of government revenue	3.4	3.1	2.5	2.3	2.3	2.0	1.5	1.6
Primary balance, % of GDP[1,2]	1.0	0.1	-0.1	0.1	-3.8	-6.8	-6.3	-2.8
External Economic Risk								
Current account balance, % of GDP	1.6	1.3	-0.2	-0.7	2.9	-2.9	-1.6	-1.7
Total reserves, months of imports	2.3	2.7	2.2	2.3	3.0	2.3	-	-
NIIP, % of GDP[2]	-54.2	-51.4	-45.2	-40.1	-34.7	-28.1	-	-
Financial Stability Risk								
Non-performing loan ratio, % of total loans[3]	6.3	5.5	5.3	5.0	3.1	2.5	-	-
Tier 1 ratio, % of risk-weighted assets[3]	17.7	18.8	20.6	20.6	26.0	23.6	-	-
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, WB WDI	6.0	6.3	6.0	5.9	-	-	-	-
Labour force participation rate, (15-64), %, WB WDI	76.5	77.3	78.1	77.7	-	-	-	-
Old-age dependency ratio, %	30.2	30.7	31.3	32.1	32.9	33.9	34.7	35.4
Composite governance indicator[4]	0.8	0.8	0.8	0.9	0.8	-	-	-

[1] Forecasted values are produced by Scope

[2] According to Eurostat classification

[3] Based on international sources (World Bank, IMF), may differ from the text above

[4] Average of the six World Bank Worldwide Governance Indicators

Source: European Commission, IMF WEO, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
Five-year USD CDS spread (bps)	83.3

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