INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/194

REPUBLIC OF LATVIA

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT

July 2017

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on May 31, 2017, with the officials of the Republic of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2017.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

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FOR IMMEDIATE RELEASE
July 7, 2017

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with the Republic of Latvia

On July 7, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia, and considered and endorsed the staff appraisal without a meeting.[2]

Growth eased to 2 percent in 2016, as gross investment contracted significantly by 11.7 percent on the back of lower than expected absorption of EU funds. This effect was compounded by a drag from net exports, as import volume growth accelerated markedly, while export growth remained modest. Despite a strong rise in imports, the current account recorded a surplus of 1.5 percent in 2016 as the terms of trade, driven largely by falling energy prices, improved by over 4.7 percent—the largest improvement in 10 years.

Growth accelerated in Q1 2017, to 4.0 percent year-on-year, faster than expected, driven by strong consumption and exports, and a pick up in investment. Growth is expected to pick up to 3.2 percent in 2017 on the back of an accelerated pace of disbursement of EU funds and continued robust private credit growth. Inflation remained low in 2016, but picked up quickly in the first months of 2017, reaching 3.3 percent in April, on the back of increasing international energy prices and strong base effects.

The general government structural balance recorder a surplus of 0.2 percent of GDP (ESA definition). Revenues overperformed, following measures adopted by the authorities, while expenditures were under executed.

Supported by the broader economic environment and low inflation, together with a decrease in debt levels, the financial position of domestic borrowers improved and credit growth started to

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussionss.

pick-up in 2016. Credit to the non-financial private sector grew by 2.3 percent y-o-y in March 2017, reflecting growth of 5.1 percent to corporates and -1.1 percent to households.

Executive Board Assessment

In concluding the Article IV consultation with the Republic of Latvia, Executive Directors endorsed the staff's appraisal as follows:

Latvia has made great strides since the crisis. After some modest slowing in 2013–16, growth is expected to rebound in the short term to around 3.2 percent on the back of a resumption of EU funds and a recovery of domestic credit alongside a favorable external environment. However, post-crisis growth seems to have settled at a more modest pace than the rapid pace achieved immediately post-crisis: low hanging fruits from productivity gains have been picked, and the challenge now is to raise potential growth by addressing crisis legacies and combatting economic headwinds such as demographics.

Policies to raise potential growth will need to focus on boosting productivity. For Latvia to accelerate its convergence path with western Europe, policies should focus on hiking TFP, raising investment and capital utilization, and strengthening the labor market. In addition to tax reform, broader priorities should include: i) structural and institutional reforms to boost TFP growth, for example protection of property rights, improving the legal system, increasing access to finance and reducing regulatory and administrative burdens; ii) raising investment and capacity utilization including through efficient use of EU funds, improved energy and transportation networks, and attracting FDI, and iii) improved labor market policies, such as active labor market policies, tax and benefit reform to improve incentives and efforts to reduce skills and regional mismatches. Many of these reforms could also help reduce incentives to participate in the shadow economy.

Fiscal policy, if properly calibrated, can support medium term growth, but needs to become more neutral over the medium term. With low gross financing needs and public debt, and given the small yet still negative output gap, there is some fiscal space to accommodate a temporary boost to the economy. In the short term, the main challenge for fiscal policy is to make the most efficient use of the large inflow of EU investment funds and allocate these resources to growth-enhancing investments. In addition, action is needed to boost the revenue share to compensate for the future loss of EU funds and finance stronger social safety nets. Looking forward, fiscal policy should become more neutral over the medium term, to avoid risks of procyclical policy.

The initiative to reform the tax system is welcome. The goals of supporting growth, increasing equity, and boosting revenues are appropriate. As the details of the final proposal are yet to be determined, the authorities face three immediate challenges to ensure these objectives can be achieved: i) finalizing plans swiftly to reduce uncertainty for households and firms, ii) carefully managing the macro impact to avoid procyclical policy and undermining future competitiveness, and iii) sustainably boosting the revenue share to ensure robust public finances even after EU funds phase out.

Continued efforts to address the shadow economy can bring multiple benefits. The shadow economy hinders economic development—preventing Latvia from reaching its full potential—and complicates policy making. Efforts to improve the business environment, reduce regulatory and administrative barriers, and improve transparency, will not only strengthen incentives to operate in the formal economy, but will also support growth. Reducing the share of the shadow economy is also associated with greater tax compliance and higher revenues. In parallel, such efforts can support credit growth by increasing financial inclusion, and improving the transparency of corporate and household balance sheets.

Financial stability is the necessary foundation for sustainable credit growth to boost output in the medium term. Recent financial indicators suggest that the credit cycle in Latvia has turned, yet credit growth remains somewhat constrained by demand and supply factors. Continued and sustainable credit growth will be needed to support investment and boost long term growth. The authorities should pursue policies to address lingering market failures from the crisis, including by promoting programs that facilitate SMEs access to credit, and continuing the implementation of insolvency reforms. Furthermore, vigilant supervision and enforcement are needed to safeguard financial stability and underpin sustainable credit growth. Continued strengthening implementation of AML/CFT measures will also support this objective.

Latvia: Selected Economic Indicators, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
							Projections	
National accounts	(Percentage change, unless otherwise indicated)							
Real GDP	6.4	4.0	2.6	2.1	2.7	2.0	3.2	3.2
Private consumption	3.0	3.1	5.0	1.3	3.5	3.4	3.3	3.2
Public consumption	3.0	0.3	1.6	2.1	3.1	2.7	3.5	3.4
Gross capital formation	49.8	-1.0	-5.8	-4.3	-0.9	2.2	8.6	7.5
Gross fixed capital formation	24.0	14.4	-6.0	0.1	-1.8	-11.7	8.0	7.5
Exports of goods and services	12.0	9.8	1.1	3.9	2.6	2.8	3.1	3.3
Imports of goods and services	22.0	5.4	-0.2	0.5	2.1	4.6	4.8	5.0
Nominal GDP (billions of euros)	20.3	21.9	22.8	23.6	24.4	25.0	26.6	28.0
GDP per capita (thousands of euros)	9.8	10.7	11.3	11.8	12.3	12.7	13.6	14.4
Savings and Investment								
Gross national saving (percent of GDP)	22.0	22.6	21.2	21.2	21.3	21.4	20.8	20.7
Gross capital formation (percent of GDP)	25.2	26.2	23.9	23.2	22.1	19.9	21.3	22.1
Private (percent of GDP)	21.1	22.4	20.2	19.5	18.3	17.3	18.3	18.8
HICP Inflation								
Period average	4.2	2.3	0.0	0.7	0.2	0.1	3.0	2.5
End-period	3.9	1.6	-0.4	0.3	0.4	2.1	2.5	2.5
	(Percent of GDP, unless otherwise indicated)							
Labor market								
Unemployment rate (LFS; period average, percent)1/	16.2	15.0	11.9	10.8	9.9	9.6	9.3	9.0
Real gross wages	0.0	1.5	4.5	6.1	6.7	4.9	3.0	3.0
Consolidated general government 1/								
Total revenue	35.6	37.4	36.7	36.1	36.2	36.2	37.3	37.6
Total expenditure	38.8	37.2	37.3	37.8	37.7	36.7	38.2	38.1
Basic fiscal balance	-3.2	0.2	-0.6	-1.7	-1.5	-0.4	-0.8	-0.5
ESA balance	-3.4	-0.8	-0.9	-1.6	-1.3	0.0	-0.7	-0.7
General government gross debt	37.5	36.7	35.8	38.5	34.8	37.2	35.9	34.5
Money and credit								
Credit to private sector (annual percentage change)	-8.3	-11.6	-6.6	-7.4	-2.3	3.5	6.2	5.5
Broad money (annual percentage change)	1.5	4.5	2.0	35.5	7.5	6.6	7.3	6.7
Balance of payments								
Current account balance	-3.2	-3.6	-2.7	-2.0	-0.8	1.5	-0.4	-1.4
Trade balance	-12.4	-12.0	-11.5	-9.3	-8.4	-7.0	-8.3	-9.1
Gross external debt	145.8	138.2	133.9	143.0	141.6	147.3	140.2	134.8
Net external debt 2/	47.0	39.8	36.6	32.9	28.5	28.6	26.1	22.6
Exchange rates								
U.S. dollar per euro (period average)	1.39	1.29	1.33	1.33	1.11	1.11	...	...
REER (period average; CPI based, 2005=100)	124.0	120.1	120.1	121.9	120.4	121.6	...	...
Terms of trade (annual percentage change)	3.0	-2.8	0.6	-1.2	0.7	4.7	-1.0	-0.2

Sources: Latvian authorities; Eurostat; and IMF staff estimates.

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.
2/ Gross external debt minus gross external debt assets.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

June 20, 2017

KEY ISSUES

Context. Macroeconomic conditions are broadly sound: fiscal and current account deficits remain at prudent levels; public debt persists at a low level; and unemployment continues to fall. For the first time in the last 5 years, credit growth to the private sector is positive, signaling that the credit cycle has turned. However, growth seems to have settled at a more modest pace, and staff estimate that the post-crisis medium-term potential growth rate is lower than previously thought, with implications for the convergence path.

Challenges. In the short term, a key challenge is to increase the absorption of EU funds and use them efficiently for productive investments that are growth enhancing and help the authorities achieve their equity goals. Successful implementation of tax reform, to complement broad based structural reforms, is needed to support growth, improve equity and boost revenues. Over the medium term, continued and sustainable credit growth is needed to support private investment and drive growth as EU funds unwind. Structural reforms need to focus on measures to increase productivity and lift potential.

Staff views.

- Determined policy action can raise growth, despite the slowdown in potential output. Priority should be given to improving the quality of institutions, increasing access to financial services; higher investment and improved capacity utilization; and policies to improve labor market conditions.
- The proposals for tax reform are welcome. The authorities should seize this opportunity to implement reforms that support growth, improve work incentives, reduce inequality, and increase revenues. The fiscal impact of the final tax reform package should be carefully assessed to ensure that Latvia's record of prudent macro policy making is maintained, and competitiveness is preserved.
- Efforts to combat the shadow economy can play an important role in strengthening the tax system and, also in reducing inefficiencies that hamper productivity growth.
- The authorities should continue to address market failures in the provision of credit and implementation of insolvency reforms to support lending to the private sector to boost investment and support medium term growth.

Authorities' views. The authorities broadly agreed with the assessment of the outlook and challenges facing Latvia. In particular, they agreed with the importance of an effective tax reform to complement ongoing structural reforms and to raise potential growth.

Approved By
P. Gerson (EUR) and
V. Kramarenko (SPR)

Discussions were held in Riga during May 18–31, 2017. The team comprised Ben Kelmanson (Head), Karina Garcia, Borislava Mircheva and Andreas Tudyka (all EUR). Marco Marini (STA), and Yasmin Almeida and Emmanuel Mathias (LEG) joined for some meetings. Ms Jekabsone (OED) also joined the discussions. Ms. Nguyen and Ms. Jung supported the mission from headquarters.

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CONTEXT

1. **Latvia continues to make steady economic progress, but growth seems to be settling at a more modest pace.** Macroeconomic conditions remain sound: the economy has grown consistently since the crisis; the current account and fiscal deficits have been reduced to sustainable levels; public debt is low; and domestic credit is recovering. Nevertheless, growth over the past 3 years has averaged only 2¼ percent, and income per capita remains about 40 percent below the EU-15 average. Indicators suggest that the economy is operating below, but, close to its potential.

2. **Investment needs are very large and remain a key obstacle to catching up with Western Europe.** Latvia lags EU countries in various investment-related respects: it has the lowest capital-output ratio in the EU-28; and capacity utilization, despite having rebounded strongly since the crisis, is still lower than in most EU countries. Therefore, higher investment rates and modernizing the capital stock are key to raising potential medium-term growth.

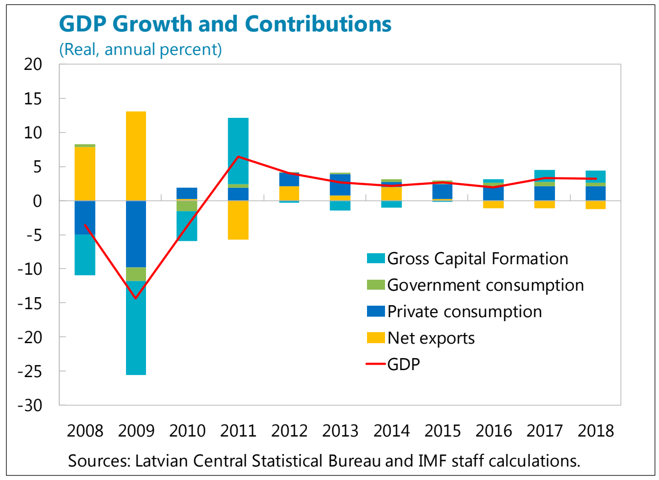
3. **Lingering effects from the global financial crisis are likely hindering potential growth.** While some productivity gains have been reaped in the recent past, there are signs that scars left by the global financial crisis (GFC)—tight credit markets, weak investment environment, and high structural unemployment—may be constraining further productivity gains and limiting potential growth. In addition, pre-existing structural conditions—unfavorable demographic trends, lack of investment in innovation—represent headwinds that will make the road to convergence more challenging.

4. **A number of the 2016 Article IV policy recommendations have been broadly implemented.** Notably, the authorities are considering a tax reform package with elements consistent with Fund advice, including lowering the tax burden on labor, enhancing equity and boosting the revenue share. Efforts to reform the insolvency regime and judicial system are ongoing. Vigilant supervision of banks servicing foreign clients (BFSFCs), along with strengthened AML/CFT frameworks and enforcement are further strengthening the sector. Reforms in education to reduce skills mismatches are progressing.

RECENT ECONOMIC DEVELOPMENTS

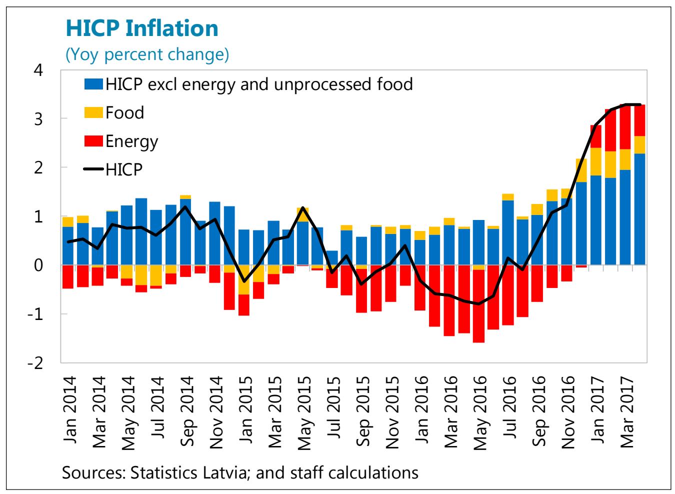
5. **Growth slowed somewhat in 2016, held back by the slow absorption of EU funds.** Growth, driven primarily by consumption, eased to 2 percent, as gross investment contracted significantly by 11.7 percent on the back of a lower than expected absorption of EU funds. Stricter EU regulations for the current investment cycle, as well as reforms to the domestic implementation

system are cited as reasons for slower absorption.[1] This effect was compounded by a drag from net exports, as import volume growth accelerated markedly while export growth remained modest. Growth accelerated in Q1 2017, to 4.0 percent year-on-year, faster than expected, on the back of strong consumption and exports, and a pick up in investment.



6. The current account balance rebounded strongly, turning into a surplus in 2016. Despite a strong increase in import volumes, the current account reached a surplus of 1.5 percent in 2016 as the terms of trade, driven largely by falling energy prices, improved by over 4.7 percent—the largest improvement in 10 years.

7. Inflation remained low in 2016, but picked up quickly in the first months of 2017. Headline HICP inflation in 2016 at 0.1 percent was well below the ECB's 2 percent target for the Eurozone, with the largest drivers being declining energy prices and very low food price inflation throughout the year. Core inflation increased moderately to 1.3 percent but has been rising in recent months.[2] Similarly, headline inflation has increased strongly, reaching 3.3 percent in April, on the back of increasing international energy prices and strong base effects.



8. Labor market conditions remain challenging. Despite a slight decrease in employment in 2016, the unemployment rate fell modestly to 9.6 percent, as the decline in the number of jobseekers outpaced the decline in the economically active population. Still, unemployment remains high, reflecting a large structural component (about 41 percent of total unemployment in 2016 was long-term) along with skills and regional mismatches. Tight conditions are still observed in some segments of the labor market, especially in the high skilled segment.

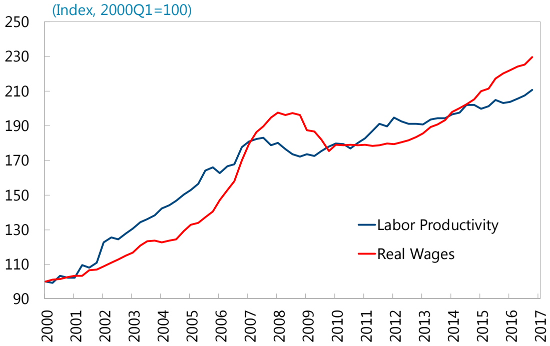
9. Wage pressures eased somewhat, but competitiveness must be preserved. Real wage growth decelerated slightly to 4.6 percent in 2016, but still exceeded productivity growth by about 2.6 percentage points. Unit labor cost increases have outpaced peer countries', and, if continued,

[1] During the previous cycle, there were 6 contracting agencies; under the new system, there is only one. Looking forward this should help reduce the time for designing and approving strategic project documents.

[2] Core inflation is defined as HICP inflation excluding energy and unprocessed food.

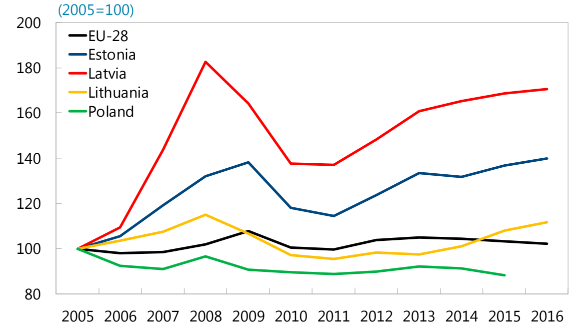
this trend could potentially harm company profitability, further constrain investment, and erode Latvia's external competitiveness in the medium term.

Labor Productivity and Wages
(Index, 2000Q1=100)



Sources: Haver and IMF staff estimates.

Latvia: Unit Labor Cost - Manufacturing
(2005=100)



Sources: Haver Analytics and IMF staff calculations.

10. The general government deficit narrowed significantly in 2016. The general government basic deficit (on a cash basis) narrowed to -0.4 percent of GDP, an improvement of more than 1 percent of GDP from 2015. This translated into a structural surplus of 0.2 percent of GDP (ESA definition) compared to the 2016 deficit target of 0.9 percent of GDP. Total revenues (excluding foreign assistance) overperformed by about 0.4 percent of GDP, following measures adopted by the authorities.[3] At the same time, expenditures were under executed; both investment related, due to lower than projected disbursement of EU investment Funds (by about 0.8 percent of GDP), and other current spending (by about 0.2 percent of GDP).

11. The financial system remains well capitalized, liquid, and profitable, despite pressures on BSFCs. The capital adequacy ratio, at 21.1 percent in 2016, exceeds the regulatory minimum; the share of liquid assets in total assets is high at 33.8 percent in 2016, and Latvijas Banka's stress tests show that banks' capacity to absorb potential liquidity shocks is adequate. Banks remain profitable, maintaining a wide spread between lending and deposit rates. While resident deposits grew by 12.2 percent y-o-y through 2016, system wide deposits declined by 7.4 percent led by a decline of 26.5 percent of non-resident deposits (NRDs). The decline in NRDs, which started in late 2015, together with the significant reduction in USD clearing volumes, has continued in the context of ongoing strengthening of enforcement of AML/CFT requirements and sanction regimes, financial sanctions against Russia, and loss of European-based correspondent banking relationships. Against this background, banks servicing foreign clients are actively exploring options to maintain or re-establish US dollar clearance for their clients. Despite this changing landscape, financial stability has not been impaired to date (Annex II).

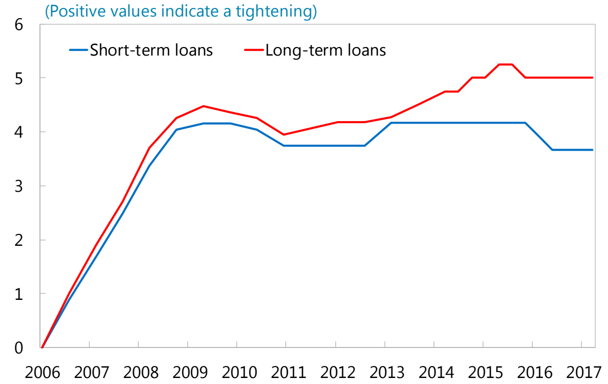
12. Credit growth is resuming, albeit slowly. Supported by the moderate economic environment and low inflation, together with a decrease in debt levels, the financial position of domestic borrowers improved and credit growth started to pick-up in 2016 (Figure 4). Credit to the non-financial private sector grew by 2.3 percent y-o-y in March 2017, reflecting growth of

[3] These included the introduction of the so-called solidarity tax, an increase in excise duties, as well as measures to broaden the tax base and improve tax compliance.

5.1 percent to corporates and -1.1 percent to households. In the case of households, the demand for loans improved as credit institutions eased their credit standards somewhat, and partly on the back of the steadily rising disposable income. However, even though the loan portfolios of households are shrinking at an increasingly slow pace, the annual rate of change remains negative. At the same time, the quality of the loan portfolio improved. The share of loans past due over 90 days shrank to 4.9 and 2.9 percent by end-March 2017 for household and corporates respectively (from 7.6 and 4 percent in 2015).

Cumulative Changes in Lending Standards to NFC

(Positive values indicate a tightening)



Sources: European Commission and IMF staff calculations.

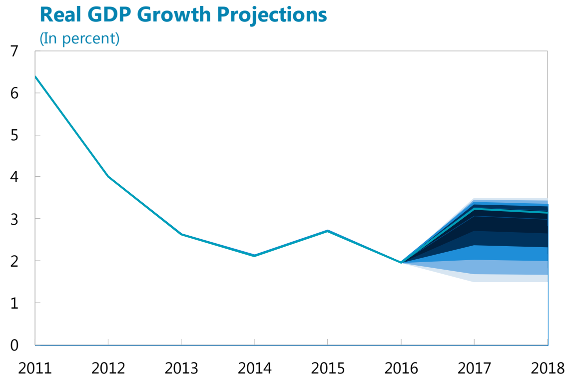
OUTLOOK AND RISKS

13. Growth is expected to pick up to 3.2 percent in 2017, and the current account to return to deficit. An accelerated pace of disbursement of EU funds in 2017 will provide a boost to investment and public consumption as EU-funded projects come on stream. At the same time, private consumption growth is expected to remain robust, supported by slowing, but continued wage growth, a recovery of domestic credit, and improving sentiment. While the general government deficit is projected to increase to accommodate EU-funded investment projects, it is expected to remain within its structural deficit target of 1 percent of GDP. Headline HICP inflation is projected to rise significantly to 3 percent on average in 2017 due to rising energy prices and stronger external price pressures. Second-round effects from the pass through of energy prices, as well as continued real wage growth, will likely affect core inflation, albeit at a much slower pace. The current account is projected to return to a deficit, and widen in the medium term, driven by domestic demand, increasing investment, and the unwinding of the 2016 terms of trade gains. The external position is currently assessed to be stronger than implied by medium term fundamentals (Annex I).

14. A sustained rise in inflation could pose policy challenges. Core inflation, which accounts for about 75 percent of overall inflation, is projected to increase moderately to 2 percent in 2017. While the uptick in headline inflation to 3 percent is projected to be temporary, a continued rebound in energy prices and sustained wage pressures, if not equally matched by productivity gains, could pose risks to the inflation outlook—particularly against the backdrop of a closing output gap. Higher EU fund absorption and thus public investment spending and an increase in minimum wages by 2.7 percent in 2017 could add further demand pressures. The challenge will be to ensure the most efficient use of such investment to boost productive capacity over the medium term.

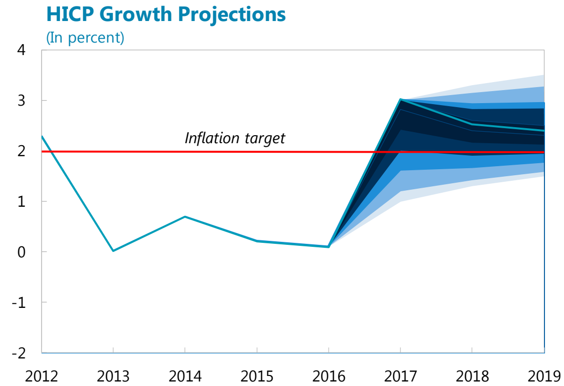
15. While growth is forecast to pick up in the short run, prospects for further acceleration over the medium term are challenging. A faster absorption of EU structural funds is expected to boost growth in the short run. However, staff's outlook for potential growth for the medium term has been revised down to 3 percent, due to projected slow growth of total factor productivity (TFP), especially compared to pre-crisis levels, along with low investment, and a persistent demographic drag. This phenomenon—of slower potential growth—is common amongst both advanced and emerging economies. Redoubling of the authorities' efforts to implement growth-friendly policies will be vital to raise potential growth further. (See section A below).

The growth path is subject to uncertainty, even with a lower forecast of potential growth



Sources: Statistical Office of Latvia and IMF staff calculations.

...as is the outlook for inflation, where risks are still tilted to the downside in the short term, but less so than before



Sources: Statistical Office of Latvia and IMF staff calculations.

Note: Upper and lower bou nds of the fans are based on staff judgement, taking into account risks to the forecasts, with uniform probability distribution between the central projection and the bounds.

16. Lower potential growth will tend to slow the pace at which Latvia can converge with the rest of the EU. Absent relative purchasing power movements over time, a change in relative potential—and by extension actual—growth rates over time will directly impact the speed of Latvia's income convergence. Staff simulations suggest that a 1 percentage point decrease in potential growth could delay the closure of the income gap with the EU-15 by about 12 years.[4] As the labor force is projected to decline faster than the overall population, implementation of policies to increase investment and support TFP growth will be essential to ensure more rapid income convergence going forward.

17. Risks to the baseline are more balanced, but are still tilted to the downside. Slower than projected absorption of EU funds and/or failure of credit to the economy to resume would hold back domestic demand, and undermine future growth. While core inflation is projected to remain below the ECB target, headline inflation could remain above 3 percent or rise further should energy prices continue to increase. Failure to implement structural reforms would hold back productivity growth, erode competitiveness, and undermine prospects for increasing potential

[4] This assumes that the historical relationship between real GDP growth and PPP GDP per capita income convergence remains the same going forward,

growth. On the external side: structurally weak growth in advanced economies and a retreat from cross-border integration would pose a risk as an additional drag on the external sector, as would an intensification of security dislocation in Europe. Risks of regional financial instability could impact the domestic economy and financial sector. (Box 1).

Authorities' view

18. The authorities broadly agreed with staff's outlook and risk assessment. They agreed that the economy was gaining momentum, but noted that there are no current concerns regarding overheating, with exports performing relatively well and credit to the economy only recently starting to pick up. At the same time, they acknowledged that pressures could materialize in the medium term in some sectors, such as construction, as EU funds and large investment projects come on line. While the external position is assessed to be stronger than implied by fundamentals, the authorities noted that this is largely driven by temporary factors, in particular the recent terms of trade gain. Regarding risks to the outlook, the authorities agreed that efficient absorption of EU funds is key to boosting growth. They noted that economic exposure to some geopolitical risks was more limited than in the past, and identified regional financial links as more pertinent to monitor. They noted that maintaining prudent policies, effectively implementing their tax reform, and continuing their strong record of structural reforms are keys to mitigating risks, and boosting medium term growth.

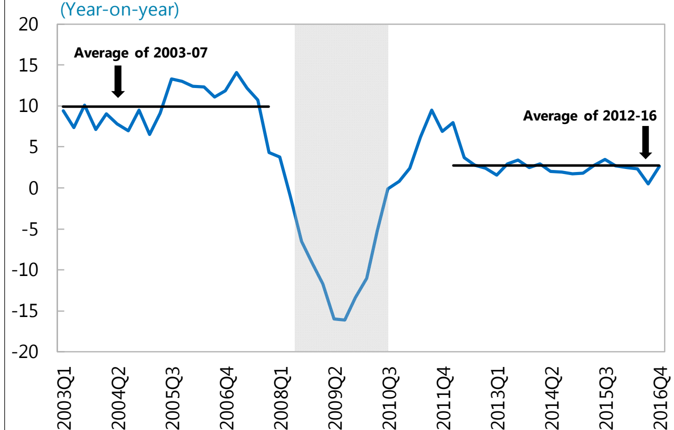
POLICY DISCUSSIONS: MEDIUM-TERM CHALLENGES

Policy discussions centered on the outlook for medium-term potential growth, and the key policies to enhance productivity to increase the pace of convergence with Western Europe. Structural policies will need to focus on addressing legacies from the financial crisis and structural headwinds. Carefully calibrated fiscal policy can play an important role through measures to boost productive investment, improve labor supply, and strengthen social safety nets. Financial sector policies to unlock credit growth are key to boosting investment and supporting medium-term growth.

A. Potential Growth Outlook: Confronting Crisis Legacies

19. Growth rates appear to have settled on a much lower path after the GFC, affecting the outlook for Latvia's convergence path. While pre-crisis growth, which was unsustainably high during boom years, averaged 9.9 percent over 2003–07, average growth slowed significantly to about 2.7 percent over 2012–16. This phenomenon is common amongst many ad vanced and emerging economies as crisis legacies in the form of weak corporate balance sheets combined with tight credit conditions, an

Latvia: Real GDP Growth
(Year-on-year)



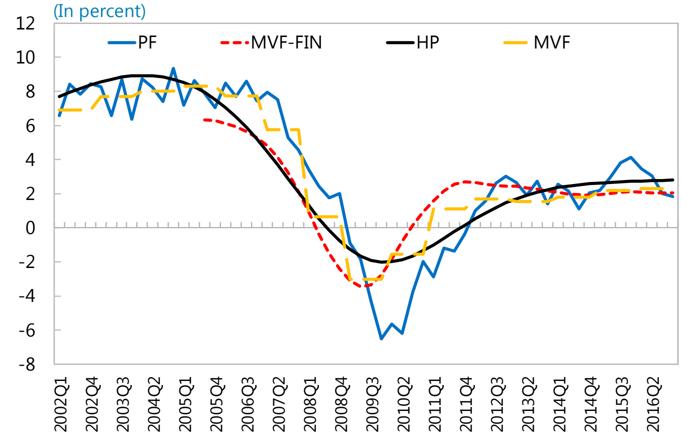
Sources: Latvian Statistical Office and IMF staff calculations.

adverse feedback loop of weak aggregate demand, investment, and capital-embodied technological change, and elevated economic and policy uncertainty have undermined particularly TFP growth.[5] From a demand-side perspective, the largest factor contributing to this slowdown was gross fixed investment with its contribution to growth dropping from 4.8 percent to about -0.2 percent on average over these horizons. As noted previously, if this trend persists, the convergence path for Latvia, whose GDP per capita (in purchasing power standards) was about 62 percent of the EU-15 average in 2015, would flatten significantly.

20. New estimates suggest that the potential growth rate of the economy is lower than before the crisis. Staff's estimates suggest that potential growth has declined considerably, on average from about 6.9 percent in the pre-crisis period (2003–07), to about 2.2 percent more recently (2012–16). And while the immediate post-crisis period saw a spurt in potential growth, this proved short-lived having settled at a much lower level, about 2.5 percent in 2016. The output gap in 2016 is estimated to be about -0.5 percent suggesting that the economy is operating close to its potential. Such an assessment is borne out by inflation below the ECB target in 2016 and an unemployment rate, which is close to the NAIRU. And although pre-crisis growth rates were unsustainable and thus undesirable going forward, this represents a significant downward shift in potential growth, reflecting the lasting effects of the GFC, which seem to have undermined a significant part of the economy's productive capacity.

Latvia: Potential Growth Estimates

(In percent)



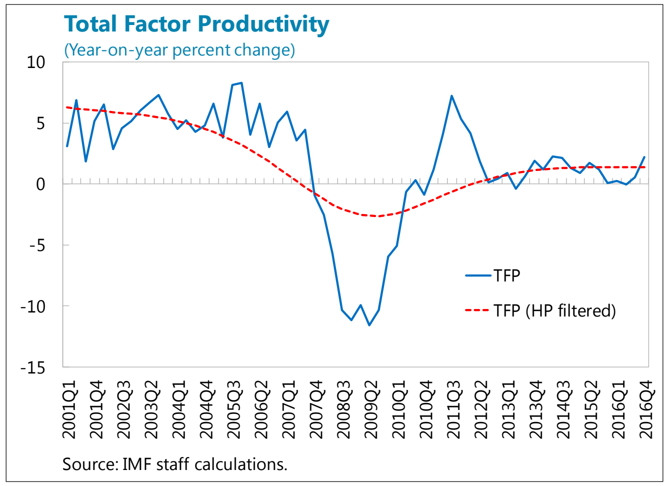
Sources: Statistics Latvia; Haver; and IMF staff calculations.

21. Multiple factors contributed to the decline in potential growth, with the largest being total factor productivity (TFP). A growth accounting exercise, which takes factor utilization into account, shows that while capital accumulation contributed about 48 percent to overall potential growth in 2003–07 and about 54 percent in 2012–16, the contribution of TFP decreased from 50 percent to about 3 percent in the same period. (see Republic of Latvia-2017 Selected Issues Paper) This drastic reduction is in line with other countries, which are displaying symptoms of "TFP hysteresis."[6]

[5] International Monetary Fund (IMF), 2015, "Where Are We Headed? Perspective on Potential Output," in *World Economic Outlook*, April, Chapter 3, p. 69–110 (Washington).

[6] The persistent TFP loss from a large and seemingly temporary shock (see International Monetary Fund (IMF), 2017a, "Gone with the Headwinds: Global Productivity," Staff Discussion Note. April, Washington, D.C.).

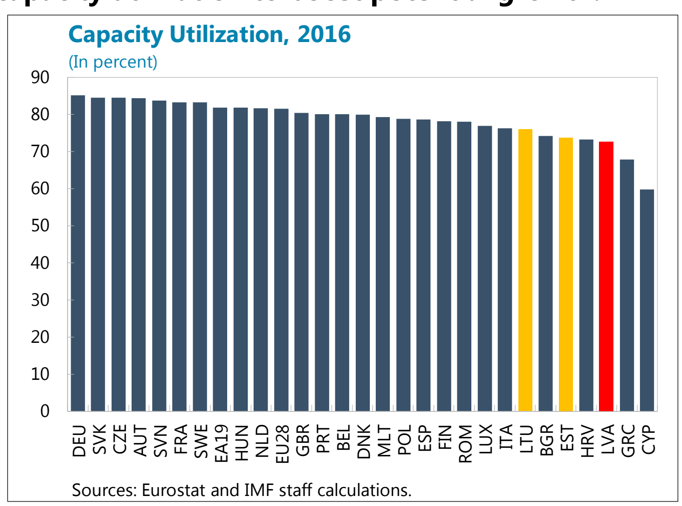
22. Nevertheless, there is scope to raise growth—a goal of the authorities—through strong reform efforts. Raising TFP will require redoubling policy efforts as crisis scars are limiting potential (so called "TFP-hysteresis"). This effort is the most important given that negative demographics will limit the contribution of labor, while gains from improved capacity utilization are finite. Labor utilization through increased hours worked can also provide further gains. Productivity-friendly structural policies, stepped up high-return public investments, and improved labor market performance are key to raising TFP. **Drawing on cross country, and Latvia-specific, analysis, priority should be given to three areas:** [7]



Source: IMF staff calculations.

- **Structural and institutional reforms to improve the allocation, and efficient use, of resources.** The largest efficiency gains are likely to come from improving the quality of institutions (such as protection of property rights, upgrading legal systems including insolvency and judicial reforms), and increasing access to financial services (especially for small, but productive firms). Furthermore, reducing regulatory and administrative burdens on businesses and further improving corporate governance of state-owned enterprises would foster competition and efficient resource allocation, as would greater technology diffusion. Fiscal structural reforms, aimed at improving efficiency in the tax system, can also boost firm-level productivity by reducing resource misallocation.

- **Higher investment rates and improved capacity utilization to boost potential growth.** Latvia has the lowest capital-output ratio in the EU-28. Improving and modernizing the capital stock would therefore provide significant scope to lift potential growth above the baseline. Higher public investment in infrastructure, such as further improving the connectivity to the EU electric network, enhancing the quality of transport infrastructure, and promoting port efficiency, may induce greater private investment and risk-taking and



Sources: Eurostat and IMF staff calculations.

[7] International Monetary Fund (IMF), 2016a, "Selected Issues Paper: Post-crisis adjustment in Latvia: Evidence from firm level data", IMF Country Report No. 16/17; International Monetary Fund (IMF), 2016, "Regional Economic Issues: Central, Eastern and Southeastern Europe", chapter II. How to Get Back on the Fast Track? published May 2016, Washington, D.C., International Monetary Fund. 2017b. Fiscal Monitor. Washington, DC, April.

improve capital allocation, provided high-return projects are undertaken and compatibility with fiscal space is ensured. This makes rapid and efficient absorption of EU structural funds even more important. Attracting more foreign investment could also provide avenues going forward. Capacity utilization, despite having rebounded strongly since the crisis, is still lower than in most EU countries and increasing it would provide further, yet limited scope for higher medium-term growth.

- **Strengthening labor market policies to help offset negative demographic dynamics, and preserve competitiveness.** Active labor market policies, along with tax and benefit reform aimed at improving incentives for work would support labor force participation and generate higher employment (e.g., in-work tax credits, improvements in tapering of benefits to reduce the high labor tax wedge especially for low-income earners). Efforts to reduce skill mismatches will improve labor market performance and help ameliorate wage pressures (e.g., strengthening vocational education and improving links with employers, further efforts to attract high-skilled foreign workers). Care should also be taken to avoid wages outstripping productivity gains, including by prudent increases in the minimum wage.

23. Structural reforms designed to boost the potential of the economy can also reduce incentives to participate in the shadow economy. Policies aimed at improving the overall environment for doing business (e.g. reducing the regulatory burden and red tape, and improving the quality of government services) would boost incentives for businesses and individuals to participate in the formal economy, and reduce opportunities for corruption. By the same token, minimizing skills mismatches (e.g. by helping students develop skills demanded on the labor market) would improve incentives and scope to participate in the formal economy and also lower structural unemployment.

Authorities' View

24. The authorities broadly shared staff's analysis of the drivers of potential growth and agreed with the need to continue with reforms to raise it. They pointed out that heightened risk aversion lingers post-crisis, but could slowly unwind as the external environment improves. Moreover, the turning of the credit cycle could lift potential growth as investment picks up. They noted that in addition to their tax strategy, a broad structural reform agenda is underway to boost TFP, including several elements: education and health reforms, an action plan to combat the shadow economy, gas market liberalization, and work to improve the insolvency regime. The scope for increases in the labor force through immigration is limited, but tax and benefit reform along with active labor market policies have a role to play.

B. Fiscal Policy: Addressing Fiscal Headwinds

25. The 2017 budget is in line with Latvia's Fiscal Discipline Law and its European commitments. The expenditure measures in the budget include an increase in funding for education and social protection as well as growing defense spending, and an increase of about

2.7 percent in the average monthly minimum wage.[8] With a surge of EU investment funds expected in 2017, a corresponding increase in project investment is also foreseen. On the revenue side, several revenue-enhancing measures were adopted, including an increase in excise and natural resource taxes and a reduction of some tax exemptions. A comprehensive expenditure review was also conducted allowing for some prioritization and expenditure savings, including tightening of eligibility requirements for receiving unemployment benefits. In addition, the budget makes use of national and EU-permitted flexibility for financing structural reforms in the healthcare and pension systems.[9]

26. Considering the smaller-than-budgeted deficit in 2016, the 2017 fiscal stance is expansionary.[10] With no financing constraints, modest gross financing needs and low public debt there is fiscal space to accommodate such a stance without threatening fiscal or debt sustainability. Furthermore, in the context of a small, yet still negative, output gap this seems appropriate as it can provide a needed boost to investment and growth without raising overheating concerns. Moreover, there is little evidence to suggest Latvia is at risk of a wage-price spiral: real wage growth is expected to be more muted than in previous years, and broadly in line with productivity growth.[11] Fiscal policy is therefore not expected to put competitiveness at risk.

27. Fiscal policy over the medium term is consistent with fiscal sustainability, but fiscal headwinds are on the horizon. [12] Based on the current medium term objectives outlined in the 2017–20 Stability Program—under a no tax reform scenario—the fiscal stance is expected to become broadly neutral over the medium term as the economy reaches its potential, and public debt is expected to remain at low levels, and on a downward path (see Annex III). Such a stance seems appropriate. Looking towards the medium to long-term, the possible reduction of revenues associated with the phasing out of EU funds (which account for an average of 3 percent of GDP over the next 4 years) would pose a challenge for meeting their medium-term growth objectives. This means that the authorities will need to prepare well in advance to find revenue-enhancing measures. Looking forward:

- **The authorities need to be mindful of policy constraints within the currency union.** Fiscal stimulus this year needs to be followed by a more neutral stance over the medium term, especially if inflation continues to rise. To this end, the quality of spending will play a key role in ensuring that spending is directed to investments that help reduce economic

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[8] These measures are in line with the authorities' medium-term policy priorities outlined in the Stability Program for 2016–19.

[9] The budget accommodates a deviation from the national medium term objective—MTO—for funding of the reforms of the pension and health care systems.

[10] The 2016 budget targeted a structural deficit of 0.9 percent of GDP. Compared to the original target, the fiscal stance in 2017 would have implied a much smaller fiscal impulse.

[11] Evidence suggests that productivity-adjusted real wage growth has had little impact on core inflation, other than during the pre-crisis boom years, when such wages grew by nearly 10 percent on average.

[12] The tax reform package is not included in the baseline as its final details have not been determined, and hence have not yet been legislated. It is expected that the package will be legislated in the context of the 2018 budget.

slack in 2017 and support medium term growth. Given the large share of EU funds in total revenues, their efficient allocation in areas that have been identified as having the highest return in Latvia (e.g. upgrading infrastructure) will be key in achieving these objectives[13] Furthermore, if growth disappoints on the downside, automatic stabilizers should be allowed to operate fully.

- **Efforts to develop a tax strategy are welcome and could help address medium-term challenges.** The authorities have presented draft proposals to reform their tax system with the goal of adopting measures that would help raise growth, improve equity, and gradually raise tax revenues to around 1/3 of GDP. These efforts are broadly in line with staff's previous calls for reform which have been anchored on key principles: i) improving work incentives; ii) increasing tax compliance (including by addressing the shadow economy); and iii) adopting revenue-enhancing policies.

- **The fiscal impact of the final tax package should be carefully assessed.** The tax package as currently formulated is estimated to entail a fiscal cost of about 1.5% of GDP over the first three years of implementation. While this could be mitigated through a positive indirect impact from the changes (particularly for labor and corporate taxes), the extent of such benefits need to be assessed carefully. Taken in isolation, various individual elements seem to go in the right direction; however, some measures may yield less than expected, or may support one objective, but conflict with another (Box 2). While a system based on taxation of distributed earnings has attractive features (e.g. neutrality towards investment), this may result in a suboptimal outcome if corporates lock in cash and pass on other (potentially profitable) investment opportunities. Furthermore, the proposed increase in the minimum wage, while likely positive on equity grounds, could have some negative employment or competitiveness impact on low wage sectors and regions. While likely bringing some growth and equity benefits, the draft tax reform package is estimated to entail a short-term revenue loss, making even more challenging the authorities' objective of raising tax revenues to 1/3 of GDP. Against this background, the final package should include measures to sustainably achieve this goal. Measures could focus on property, environmental, or consumption taxes, and/or a reduction in exemptions.

- **A carefully calibrated tax reform can also help combat the shadow economy, and vice versa.** Experience in other European countries shows that various measures can boost revenues, and help to reduce the shadow economy, including: increased tax compliance for high-net-worth taxpayers; the mandatory use of certified invoicing programs for SMEs; and cross-checking VAT declarations with merchant point-of-sale transactions. Strengthening revenue administration and improving capacity to address compliance risks can also play a role. Combining both "sticks" and "carrots", can be an effective tool in curtailing the shadow economy and boosting revenues.

[13] Latvia is one of the major beneficiaries of the European Structural and Investment Funds. Its allocation for the current investment cycle (2014–20) is over EUR 5.6 billion. With a national contribution of EUR 1.27 billion, Latvia has a total budget of EUR 6.9 billion—over 25 percent of GDP—to be invested in various areas, from creating jobs and growth to promoting innovation as well as protecting the environment and supporting social inclusion. See link to Box 2.1 for a detailed allocation of these resources.

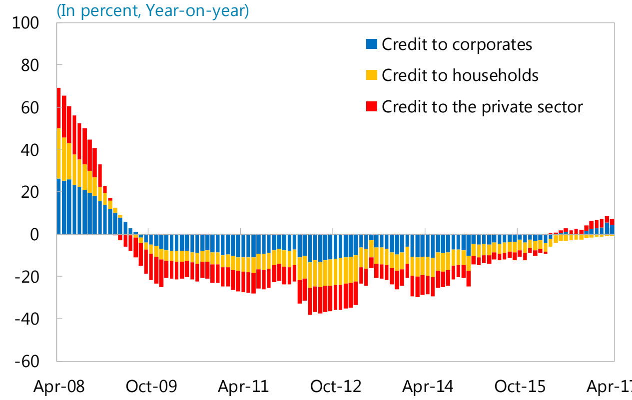
Authorities' View

28. The authorities agree on the importance of maintaining prudent fiscal policies and compliance with fiscal rules. They see the proposed tax reform as a necessary step to address the economic challenges ahead. To this end, their priorities are to support growth, increase equity, and boost revenues. They are aware of the revenue costs of some individual measures, but expect that the reform package will stimulate growth and, over time, revenues. Over the medium term, they see improved incentives for labor participation and investment, along with ongoing efforts to reduce the size of the shadow economy, as the basis for revenue gains. They see the increase in the minimum wage as a necessary measure to reduce income inequality, and see little effect on competitiveness, in part given the relatively higher wages in the tradable sector. Nevertheless, they acknowledge the importance of maintaining competitiveness over the medium term, and hence the need to avoid procyclical policy, and ensuring that wage increases remain aligned with productivity growth over time.

C. Financial Sector: Unlocking Credit Growth while Maintaining Financial Stability

29. Latvia's protracted period of credit stagnation is ending. While turning points are difficult to pinpoint, indicators suggest that Latvia's credit cycle has turned (Figure 4).[14] Households have been deleveraging since the crisis, and along with non-financial corporates, their debt servicing capacity has strengthened. Following a long period of balance sheet repair, NPL ratios, both for households and corporates, continue to shrink. At the same time, credit growth has returned at the aggregate level and across most segments, although the household sector is lagging. In addition, the credit gap—on some measures—calculated as the percentage deviation of credit to GDP from its long-run trend, has turned slightly positive. Taken together these indicators suggest that Latvia is in the very early stage of the expansion phase of the credit cycle.

Credit Growth
(In percent, Year-on-year)



Sources: Bank of Latvia; and IMF Staff Calculations .

30. However, credit growth remains constrained by both demand and supply factors. Demand factors tend to be more relevant for larger firms, while supply constraints tend to be more relevant for SMEs and households.[15] A survey by the ECB suggests that credit standards have been eased slightly by credit institutions in Latvia.[16] However, they are still conservative when lending to

[14] Using October 2015 GFSR methodology.

[15] See Latvia 2016 Article IV Consultation.

[16] See https://www.bank.lv/images/stories/pielikumi/publikacijas/FSR_2016_en.pdf

non-financial corporations (NFCs) and point to insufficient equity, lack of positive credit history, shortcomings of the legal framework, and the shadow economy as the main reasons to be cautious. At the same time, credit demand from NFCs may be constrained as they are putting investment plans on hold due to economic and geopolitical uncertainty. As investment related to the new programing period of EU structural funds picks up, this constraint may be alleviated and the demand for credit stimulated. For households, the demand for loans has been picking up in part due to the state guaranteed mortgage loan program, which has also helped push housing prices slightly upwards.[17] However, the relatively low level of income as well as savings, constrains households' overall credit demand.

- **Turning the persistently weak lending around, particularly for SMEs, would be key to boosting investment and growth**. Stimulating credit growth is essential as the ability of companies to self-finance investment, which is needed to support growth in the medium and long term, remains weak. The implementation of programs of the European Fund for Strategic Investments would be helpful in this respect. Within this framework, more SMEs would be eligible to receive guarantees from the Development Finance Institution Altum as well as directly from the European Investment Bank. These programs would improve access to financing for SMEs that lack credit history. Specifically, firms and individuals shifting out the shadow economy, diminishing the regulatory burden, and promoting an investment-friendly environment could boost credit to the private sector.

- **Closer monitoring of financial interconnectedness is appropriate.** Banks in the Nordic-Baltic region are highly interconnected via banks' group structures, and have common exposures at the firm level and in the property sector.[18] Even though the reliance of Latvian subsidiaries on parent bank financing has decreased considerably, closer monitoring as well as supervisory collaboration, building on the informal Nordic-Baltic Macroprudential Forum, is appropriate. Specifically, cross-border crisis preparedness and management would help address potential spillovers from vulnerabilities in Nordic parent banks.

- **Continued strengthening of supervision and enforcement, including of AML/CFT, can safeguard financial stability, underpin sustainable credit growth, and support Latvia's role as a regional financial center.** For banks servicing domestic clients, strong capital and funding positions, along with ample liquidity, provide the foundation to expand credit portfolios. For BSFCs, while the recent decline of the sector's size may reduce vulnerabilities, ongoing strengthening of AML/CFT supervision, along with banks' own efforts to improve their internal compliance processes, should help bolster the sector as it responds to the changing landscape of dwindling business, withdrawal of correspondent banking

[17] Under this program the state guarantees loans to families with children granted by credit institutions for house purchase or construction. The guarantee covers 10 to 20 percent of the loan depending on the number of children in the family.

[18] See Sweden 2016 FSAP: IMF Country Report No 16/355.

relationships, and a continued reduction of deposits. Close monitoring of financial innovations such as crowdfunding and virtual currencies is also encouraged.

- **Shifting segments of the shadow economy into the formal sector would help increase financial inclusion and thus boost credit to the economy**. More economic agents participating in the formal economy would stimulate credit demand as more people and firms would have the necessary proof of income and assets to apply for credit.

Authorities' View

31. The authorities concurred with staff that the credit cycle has turned, and that the resumption of credit is key to boosting investment and growth. They shared the view that both supply and demand factors constrain credit growth to varying degrees for corporates and households. However, measures to boost credit growth should not come at the expense of financial stability, and prudential standards should be maintained. They agreed that shifting segments of the shadow economy to the formal sector would support financial inclusion. The authorities are also of the view that close monitoring of regional financial interconnectedness is important, and are working with Baltic and Nordic neighbors. Furthermore, the authorities underscored the importance of continued vigilant supervision and regulation of the banking sector, along with their ongoing efforts to strengthen implementation of AML/CFT measures and enforcement. Taken together this will support Latvia's role as a regional financial center.

STAFF APPRAISAL

32. Latvia has made great strides since the crisis. After some modest slowing in 2013–16, growth is expected to rebound in the short term to around 3.2 percent on the back of a resumption of EU funds and a recovery of domestic credit alongside a favorable external environment. However, post-crisis growth seems to have settled at a more modest pace than the rapid pace achieved immediately post-crisis: low hanging fruits from productivity gains have been picked, and the challenge now is to raise potential growth by addressing crisis legacies and combatting economic headwinds such as demographics.

33. Policies to raise potential growth will need to focus on boosting productivity. For Latvia to accelerate its convergence path with western Europe, policies priorities should include: i) structural and institutional reforms to boost TFP growth, for example protection of property rights, improving the legal system, increasing access to finance and reducing regulatory and administrative burdens; ii) raising investment and capacity utilization including through efficient use of EU funds, improved energy and transportation networks, and attracting FDI, and iii) improved labor market policies, such as active labor market policies, tax and benefit reform to improve incentives and efforts to reduce skills and regional mismatches. Many of these reforms could also help reduce incentives to participate in the shadow economy.

34. Fiscal policy, if properly calibrated, can support medium term growth, but needs to become more neutral over the medium term. With low gross financing needs and public debt, and given the small yet still negative output gap, there is some fiscal space to accommodate a temporary boost to the economy. In the short term, the main challenge for fiscal policy is to make the most efficient use of the large inflow of EU investment funds and allocate these resources to growth-enhancing investments. In addition, action is needed to boost the revenue share to compensate for the future loss of EU funds and finance stronger social safety nets. Looking forward, fiscal policy should become more neutral over the medium term, to avoid risks of procyclical policy.

35. The initiative to reform the tax system is welcome. The goals of supporting growth, increasing equity, and boosting revenues are appropriate. As the details of the final proposal are yet to be determined, the authorities face three immediate challenges to ensure these objectives can be achieved: i) finalizing plans swiftly to reduce uncertainty for households and firms, ii) carefully managing the macro impact to avoid procyclical policy and undermining future competitiveness, and iii) sustainably boosting the revenue share to ensure robust public finances even after EU funds phase out.

36. Continued efforts to address the shadow economy can bring multiple benefits. The shadow economy hinders economic development—preventing Latvia from reaching its full potential—and complicates policy making. Efforts to improve the business environment, reduce regulatory and administrative barriers, and improve transparency, will not only strengthen incentives to operate in the formal economy, but will also support growth. Reducing the share of the shadow economy is also associated with greater tax compliance and higher revenues. In parallel, such efforts can support credit growth by increasing financial inclusion, and improving the transparency of corporate and household balance sheets.

37. Financial stability is the necessary foundation for sustainable credit growth to boost output in the medium term. Recent financial indicators suggest that the credit cycle in Latvia has turned, yet credit growth remains somewhat constrained by demand and supply factors. Continued and sustainable credit growth will be needed to support investment and boost long term growth. The authorities should pursue policies to address lingering market failures from the crisis, including by promoting programs that facilitate SMEs access to credit, and continuing the implementation of insolvency reforms (e.g., through promoting the rescue of viable businesses, strengthening the oversight and supervision of insolvency administrators, and developing a system to assess the efficiency of the insolvency framework). Furthermore, vigilant supervision and enforcement are needed to safeguard financial stability and underpin sustainable credit growth. Continued strengthening implementation of AML/CFT measures will also support this objective.

38. The next Article IV is expected to be completed on the standard 12-month cycle.

Box 1. Risk Assessment Matrix [1]

Source of Risk and Likelihood	Impact if Realized	Policy Recommendations Mitigation/Response
High **Retreat from cross-border integration:** A fraying consensus about the benefits of globalization could lead to protectionism and economic isolationism, leading to reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	High As a small open economy, Latvia could be significantly impacted mainly through trade channels.	Pursue structural policies that enhance productivity. Continue to diversify product and export markets. Participate in coordinated policy response at the European level.
High/Medium **Structurally weak growth in key advanced and emerging economies.** Low productivity growth, a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation undermine medium-term growth in advanced economies. Resource misallocation and policy missteps, including insufficient reforms, exacerbate declining productivity growth in emerging markets.	High The Euro Area remains Latvia's single largest trade partner. A protracted slowdown would have a direct impact on exports while also eroding business and consumer confidence.	Participate in coordinated policy response at the European level. Allow automatic stabilizers to operate. If the shock is of sufficient magnitude, discretionary fiscal action could be considered.
Financial conditions: High/Medium **Significant further strengthening of the US dollar and/or higher rates. (High)** Investors reassess policy fundamentals, term premia decompress, or there is a more rapid Fed normalization **European bank distress.** (Medium) Strained bank balance sheets amid a weak profitability outlook could lead to financial distress in one or more major banks. **Reduced financial services by correspondent banks - "de-risking"-. (High):** Significant curtailment of cross-border financial services in emerging and developing economies**.**	Low/Medium Could lower funding for Nordic parent banks reliant on wholesale funding, raising the cost of financing and hindering credit growth. Non-resident deposits (NRDs) could be susceptible to sudden stops in case of a sufficiently constrained access to clearing services in USD.	Euro area monetary policy is first line of defense against liquidity stress, supported if needed, by activation of backstops and resolution mechanism. Risk from correspondent banks retreat are mitigated by separation between BSFC and the domestic economy, with BSFC not playing a material role in domestic lending or attracting domestic deposits. Continue strengthening risk-based implementation of AML/CFT framework.
Medium/Low **Failure of credit growth to pick up in a sustained manner**	Medium Persistently weak bank credit growth would constrain investment and growth.	Purse policy to address market failures, and ensure appropriate macro-prudential policy settings.
Medium/Low **Failure to continue advancing on structural reforms.**	High In the absence of structural reforms productivity growth and the business environment would suffer, harming competitiveness and employment.	Seek to build base for support to continue with the reform agenda focusing on improving the business environment, labor markets, infrastructure, and human capital.

1\ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Box 2. Proposed Tax Reform

The authorities have presented a set of "tax policy guidelines" to form the basis of a reform of the tax system. The reform aims to support growth, increase equity, and boost revenues. Three elements underpin the reform: i) a review of tax structure and rates; ii) efforts to improve tax administration; and iii) steps to reduce the shadow economy.

Several changes are proposed to the current tax structure: i) reforming the labor tax system, including by the introduction of a phased out tax-free allowance system, along with a lower PIT rate for lower incomes and a higher tax rate for people with high incomes, eliminating the "solidarity tax", and a 13% increase in the minimum monthly wage; ii) reforming the CIT system to tax reinvested profits at 0% and raise the rate on distributed profits to 20%; iii) equalizing PIT rates for various types of income; and iv) reforming the regime for micro-enterprises and small or "lifestyle" businesses. Some revenue raising measures to compensate for losses include: reductions in VAT registration thresholds, a gradual increase in excise taxes, and a higher ceiling on social security contributions.

Steps to improve tax administration and combat the shadow economy are a key element of the reform. The authorities are focusing on improving the efficiency of tax administration activities, including the introduction of single accounts, and improving the accessibility and quality of services. In their efforts to combat the shadow economy, a key measure is the expansion of the application of the "reverse" VAT payment in key "problematic sectors" as well as reduction of VAT thresholds and introduction of online trade transactions register.

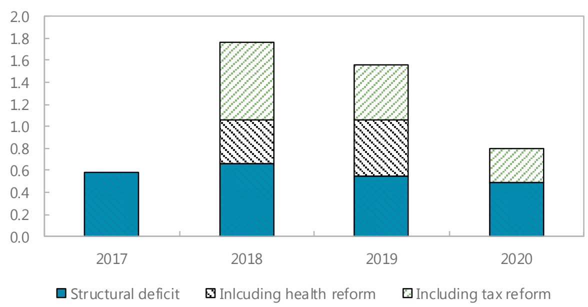
Various elements seem to move in the right direction to meet the authorities' objectives, but an overall assessment is not yet possible. On personal taxation, a phased-out tax free allowance, and a progressive marginal tax schedule with a lower tax rate for people on lower incomes, support the equity goal, and would also help reduce the tax wedge on labor. The new CIT proposal would introduce neutrality towards investment, aimed at supporting growth. However, the elimination of the solidarity tax is both revenue losing and moves in the opposite direction of improving equity. In addition, increasing the PIT rate for capital gains alongside the proposed CIT reform could create incentives for tax planning.

The tax reform will entail direct fiscal costs in the near term. Based on authorities' estimates, the direct fiscal impact of the tax reform could imply an increase in the deficit of about 0.7 percent, 0.5 percent and 0.3 percent of GDP from 2018 through 2020. The largest revenue loss would come from the introduction of the progressive PIT regime and differentiated non-taxable minimums, and the change in the CIT regime, estimated at 1 percent and 0.6 percent of GDP respectively. At the same time, the authorities estimate that the tax reform would also provide an indirect positive impact on the economy via changes in behavior of workers and enterprises, which through higher growth could over the medium term partly offset the initial negative impact on public finances. While some of these growth benefits may well materialize, their magnitude is uncertain and needs to be carefully assessed, to avoid overestimating the impact on the economy. This is particularly difficult for measures where there is little empirical evidence (e.g. the impact of the new CIT regime on boosting investment).

Box 2. Proposed Tax Reform (concluded)

A tax package along these lines would impart a fiscal impulse into the economy in the first year, and risks of procyclical policy will need to be offset by targeting a neutral fiscal stance over the medium term. This said, considering only the direct impact of the fiscal measures, the stimulus implied by the tax reform is estimated to have a limited impact on GDP given Latvia's likely small fiscal multipliers and the assumed subsequent unwinding of the fiscal stimulus.

Structural Deficit (share of GDP)



Fiscal Impulse (share of GDP)

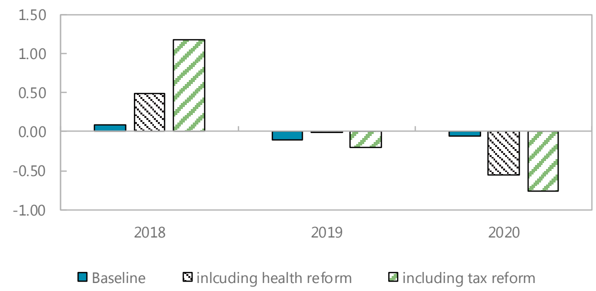
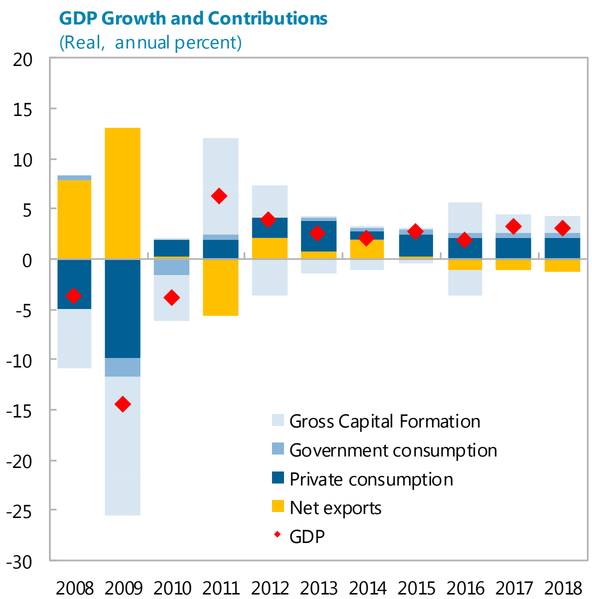
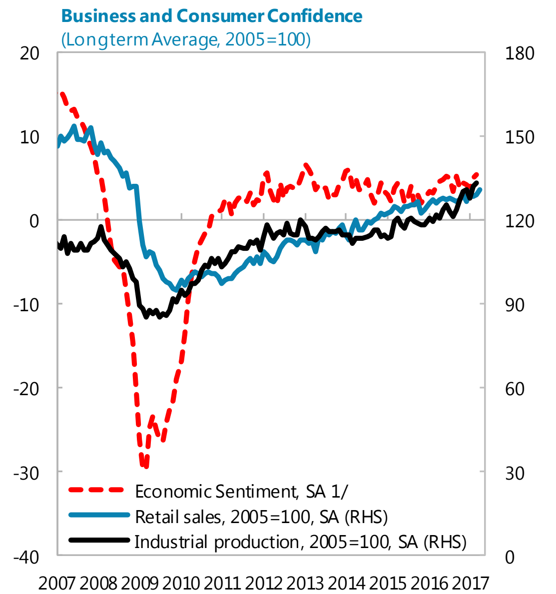


Figure 1. Republic of Latvia: Real Sector

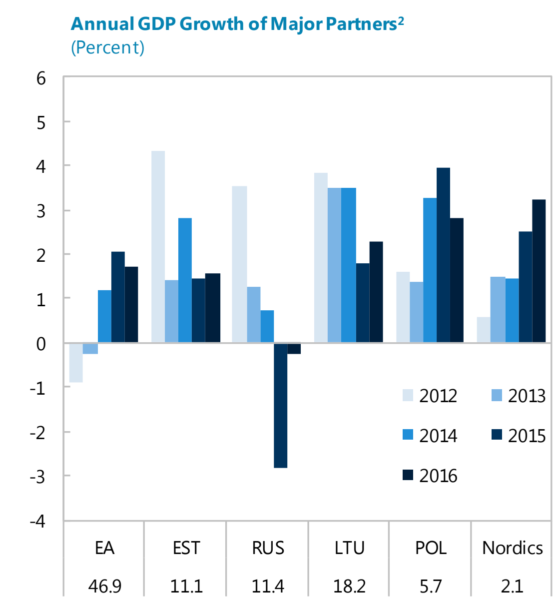
Consumption-led growth remained strong in 2016…



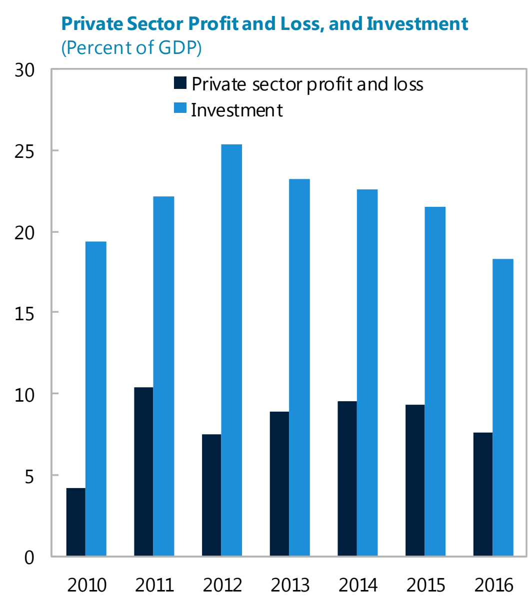
…underscored by robust sentiment and strong retail sales.



The external environment in 2016 was still subdued…



….and investment continued slowing down.



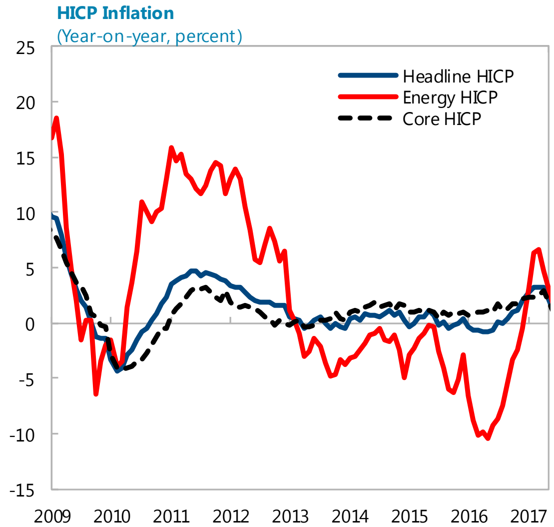
Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.

1/ Difference with long-term average.

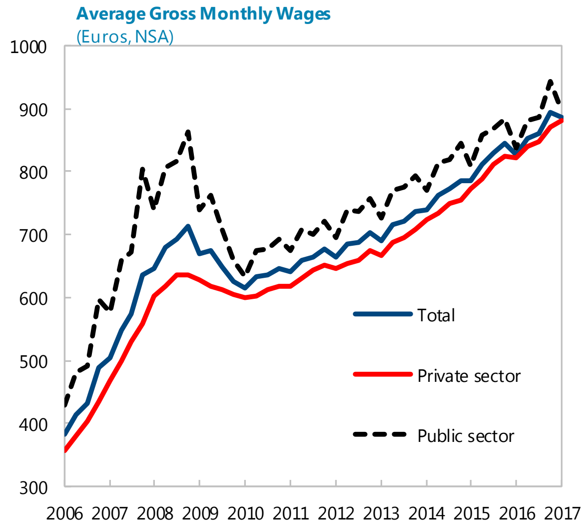
2/ Numbers under country label are Latvia's export shares in 2016.

Figure 2. Republic of Latvia: Inflation and the Labor Market

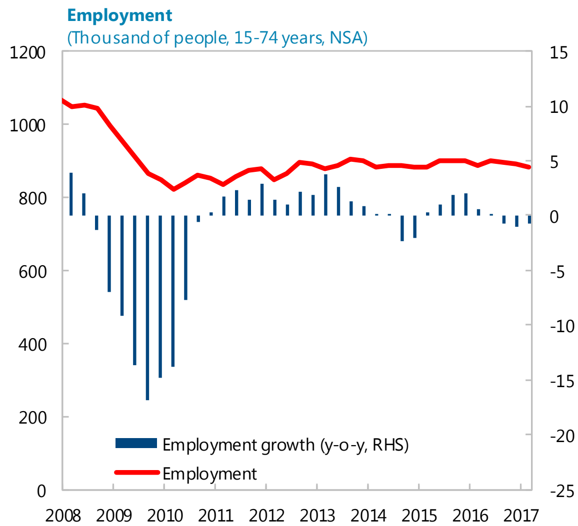
Inflation was low in 2016, but picked up quickly in early 2017…



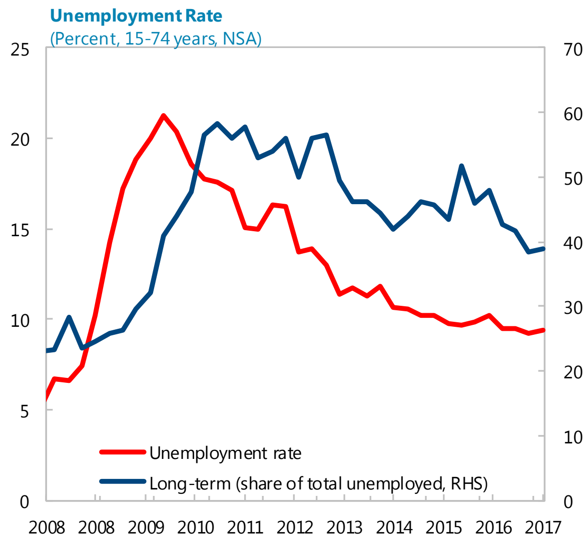
….and wage growth remains strong.



The labor market has been stable….



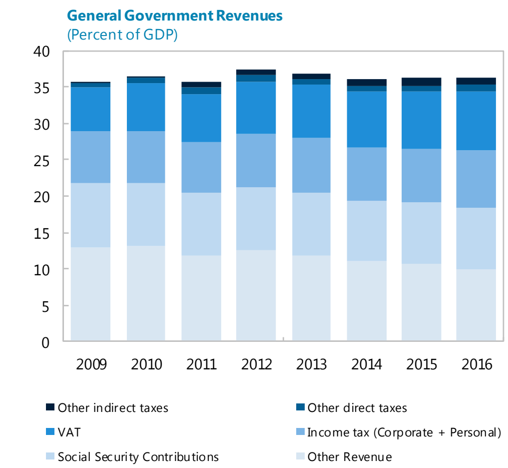
….and the unemployment rate has fallen steadily.



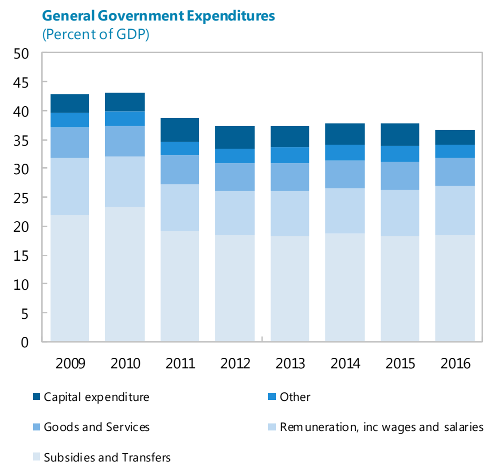
Sources: Eurostat; Haver Analytics; Latvian Central Statistical Bureau; and IMF staff calculations.

Figure 3. Republic of Latvia: Fiscal Developments

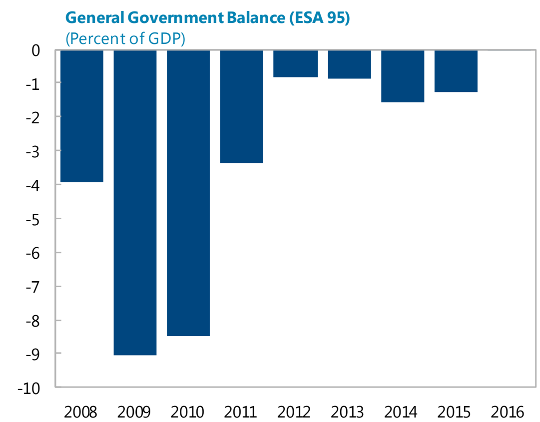
Effective administration has offset past tax cuts…



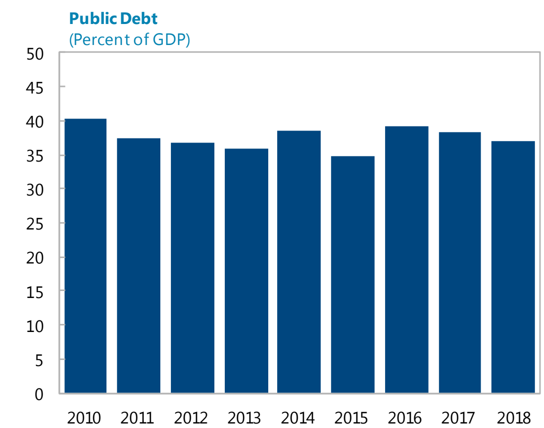
…while fiscal discipline has contained spending.



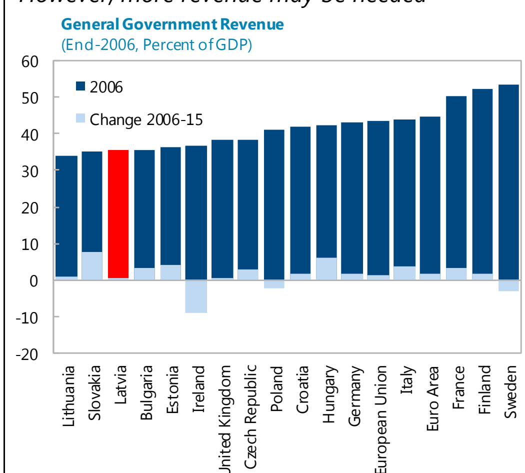
Brining the deficit down to a sustainable level…



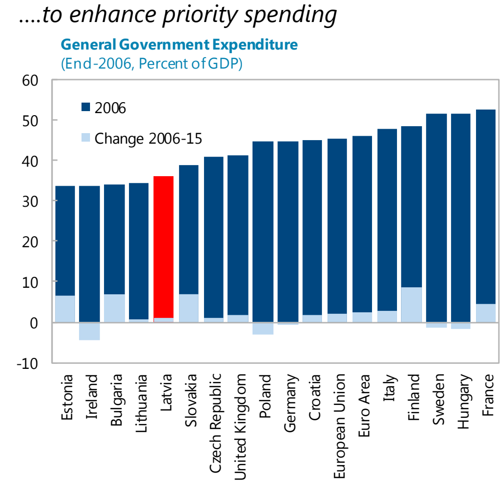
….and keeping public debt under control



However, more revenue may be needed



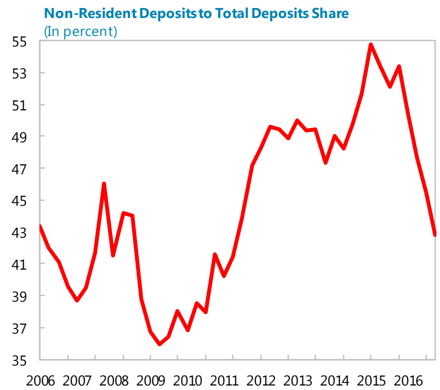
….to enhance priority spending



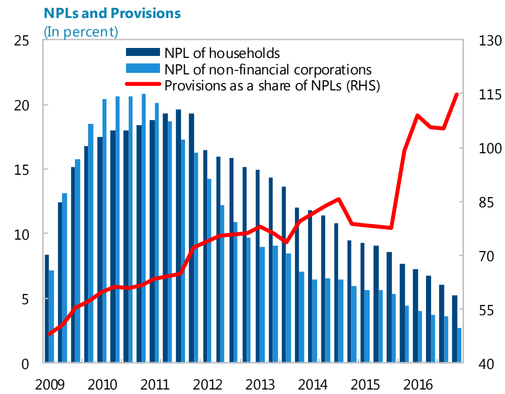
Sources: Latvian authorities; Haver Analytics; and IMF staff estimates.

Figure 4. Republic of Latvia: Banking Sector Development

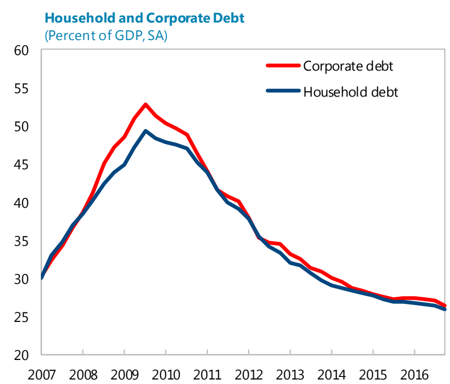
Non-resident deposit outflows continued...



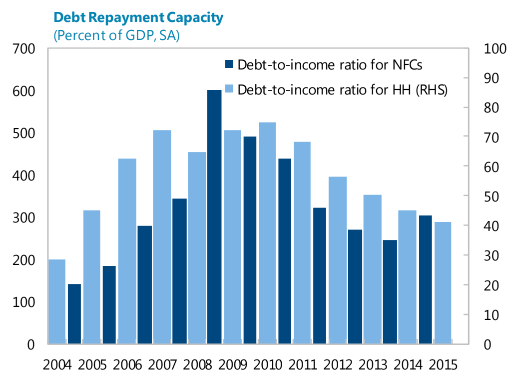
NPLS declined steadily while coverage ratio increased



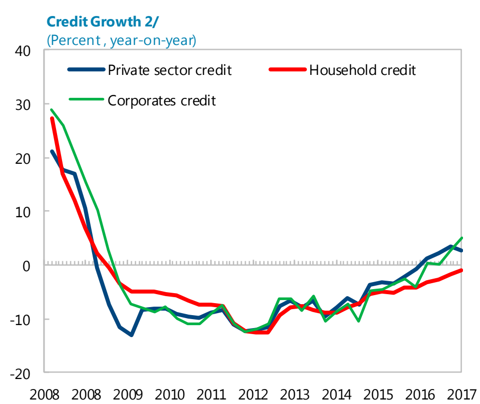
Households and firms continue to deleverage...



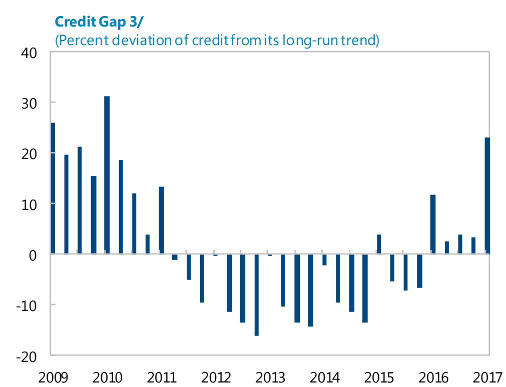
....and their debt servicing capacity is increasing



Credit has recently turned positive....



....as has the credit gap



Source: Bank of Latvia; FCMC; and IMF staff calculations.

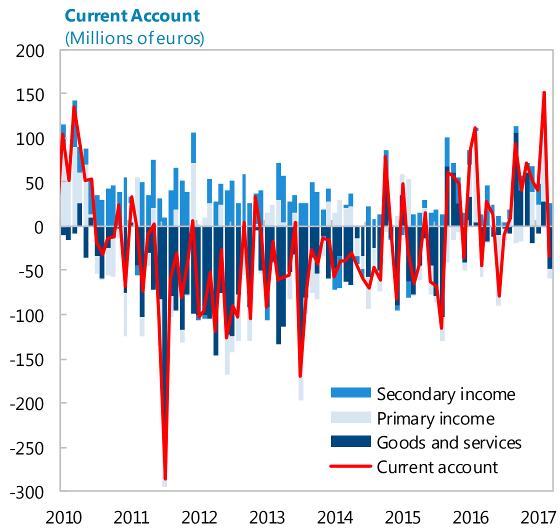
1/ Data from January 2012 onwards exclude Parex Bank, which lost its banking license in March 2012, and Latvijas Krajbanka, which was suspended in November 2011 and lost its banking license in May 2012.

2/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

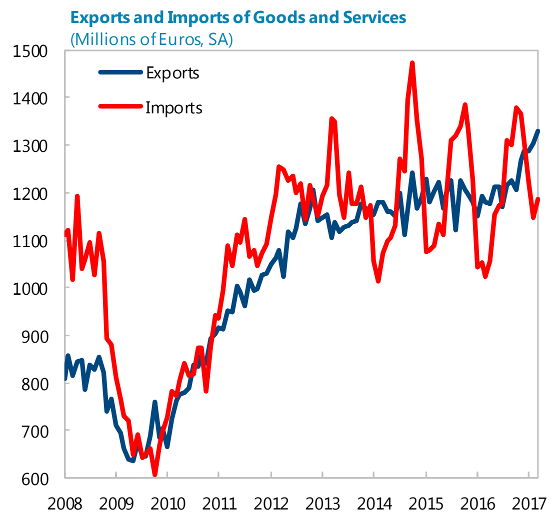
3/Alternative methodologies to estimate the credit gap may deliver different findings.

Figure 5. Republic of Latvia: Balance of Payments, 2007–16

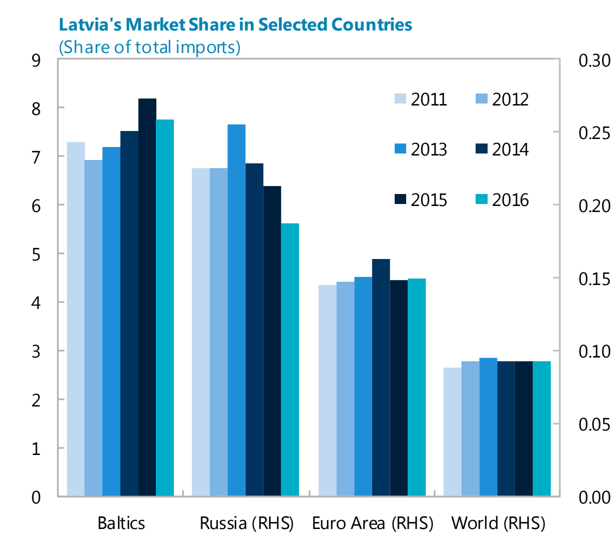
The current account turned atypically positive....



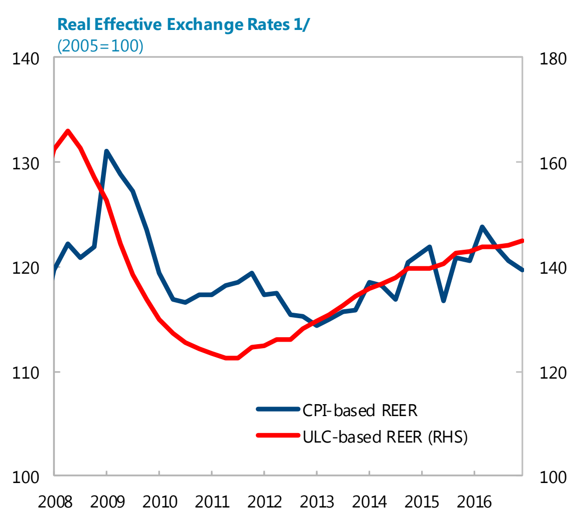
....as low energy prices suppressed imports.



Market shares in key export markets are stabilizing....



.... while effective exchange rates are trending upward.

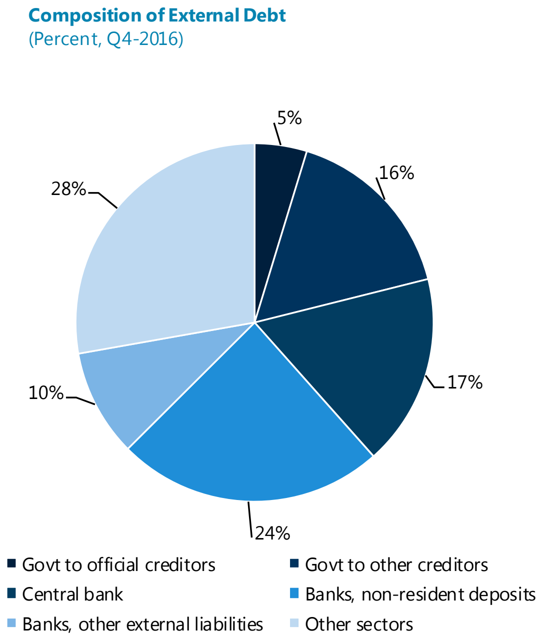


Sources: Bank of Latvia; ECB; EC; and IMF staff calculations.

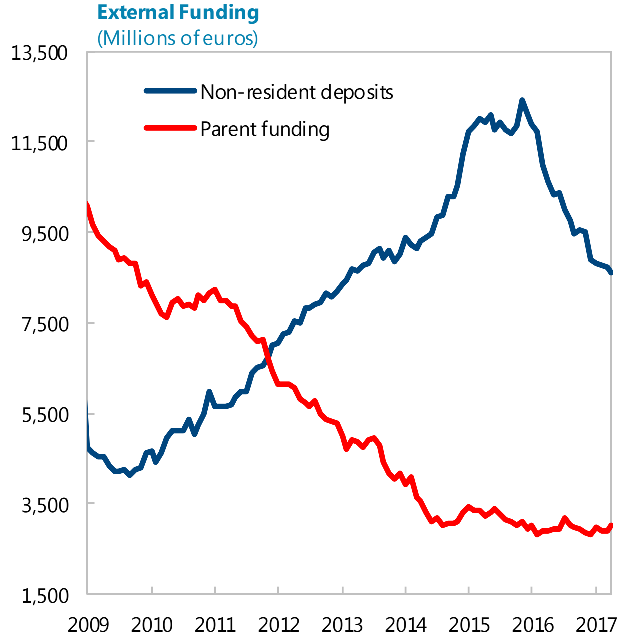
1/ Real effective exchange rates are based on IC-37 countries for ULC and IC-42 countries for CPI.

Figure 6. Republic of Latvia: External Debt and Vulnerabilities in the Banking System

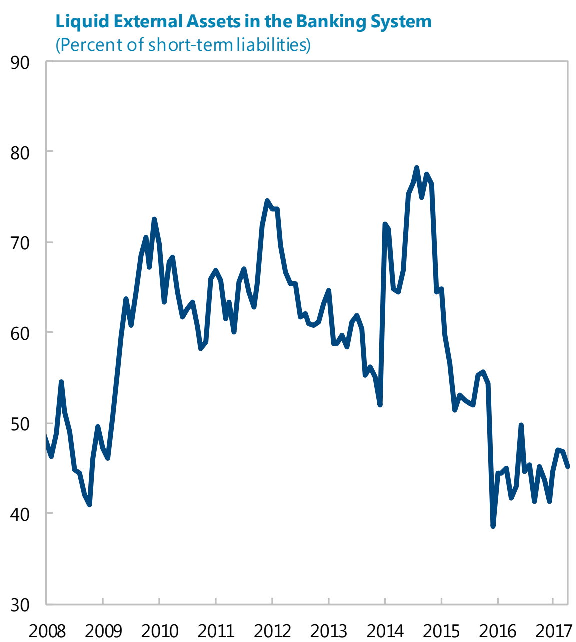
The banking sector comprises the lion share's external debt.



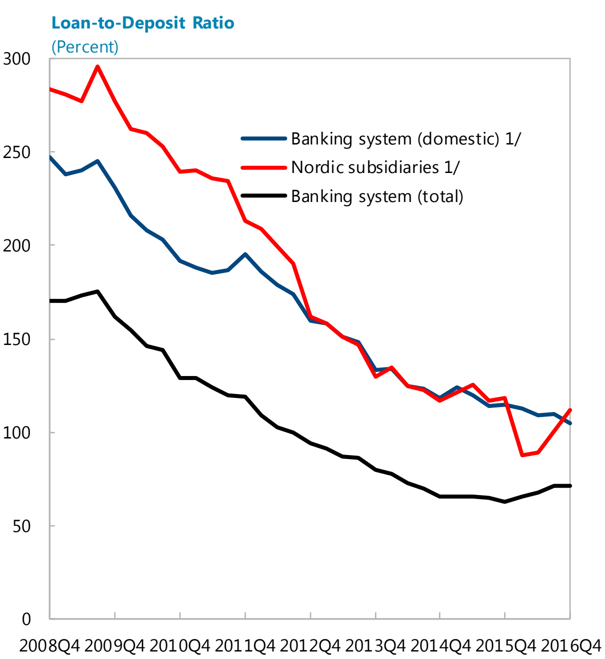
Parent bank funding has stabilized, while NRDs continue to decline…



Liquidity in the banking systems is adequate…



….and loan to deposit ratios have improved significantly since the crisis.



Sources: Bank of Latvia; FCMC; and IMF staff calculations.

1/ Exclude foreign loans and non-resident deposits.

Table 1. Latvia: Selected Economic Indicators, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
							Proj.	
National accounts	(Percentage change, unless otherwise indicated)							
Real GDP	6.4	4.0	2.6	2.1	2.7	2.0	3.2	3.2
Private consumption	3.0	3.1	5.0	1.3	3.5	3.4	3.3	3.2
Public consumption	3.0	0.3	1.6	2.1	3.1	2.7	3.5	3.4
Gross capital formation	49.8	-1.0	-5.8	-4.3	-0.9	2.2	8.6	7.5
Gross fixed capital formation	24.0	14.4	-6.0	0.1	-1.8	-11.7	8.0	7.5
Exports of goods and services	12.0	9.8	1.1	3.9	2.6	2.8	3.1	3.3
Imports of goods and services	22.0	5.4	-0.2	0.5	2.1	4.6	4.8	5.0
Nominal GDP (billions of euros)	20.3	21.9	22.8	23.6	24.4	25.0	26.6	28.0
GDP per capita (thousands of euros)	9.8	10.7	11.3	11.8	12.3	12.7	13.6	14.4
Savings and Investment								
Gross national saving (percent of GDP)	22.0	22.6	21.2	21.2	21.3	21.4	20.8	20.7
Gross capital formation (percent of GDP)	25.2	26.2	23.9	23.2	22.1	19.9	21.3	22.1
Private (percent of GDP)	21.1	22.4	20.2	19.5	18.3	17.3	18.3	18.8
HICP Inflation								
Period average	4.2	2.3	0.0	0.7	0.2	0.1	3.0	2.5
End-period	3.9	1.6	-0.4	0.3	0.4	2.1	2.5	2.5
Labor market								
Unemployment rate (LFS; period average, percent) 1/	16.2	15.0	11.9	10.8	9.9	9.6	9.3	9.0
Real gross wages	0.0	1.5	4.5	6.1	6.7	4.9	3.0	3.0
	(Percent of GDP, unless otherwise indicated)							
Consolidated general government 1/								
Total revenue	35.6	37.4	36.7	36.1	36.2	36.2	37.3	37.6
Total expenditure	38.8	37.2	37.3	37.8	37.7	36.7	38.2	38.1
Basic fiscal balance	-3.2	0.2	-0.6	-1.7	-1.5	-0.4	-0.8	-0.5
ESA balance	-3.4	-0.8	-0.9	-1.6	-1.3	0.0	-0.7	-0.7
General government gross debt	37.5	36.7	35.8	38.5	34.8	37.2	35.9	34.5
Money and credit								
Credit to private sector (annual percentage change)	-8.3	-11.6	-6.6	-7.4	-2.3	3.5	6.2	5.5
Broad money (annual percentage change)	1.5	4.5	2.0	35.5	7.5	6.6	7.3	6.7
Balance of payments								
Current account balance	-3.2	-3.6	-2.7	-2.0	-0.8	1.5	-0.4	-1.4
Trade balance	-12.4	-12.0	-11.5	-9.3	-8.4	-7.0	-8.3	-9.1
Gross external debt	145.8	138.2	133.9	143.0	141.6	147.3	140.2	134.8
Net external debt 2/	47.0	39.8	36.6	32.9	28.5	28.6	26.1	22.6
Exchange rates								
U.S. dollar per euro (period average)	1.39	1.29	1.33	1.33	1.11	1.11	...	...
REER (period average; CPI based, 2005=100)	124.0	120.1	120.1	121.9	120.4	121.6	...	...
Terms of trade (annual percentage change)	3.0	-2.8	0.6	-1.2	0.7	4.7	-1.0	-0.2

Sources: Latvian authorities; Eurostat; and IMF staff estimates.

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.
2/ Gross external debt minus gross external debt assets.

Table 2. Latvia: Macroeconomic Framework, 2012–22

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Proj.					
	(Percentage change, unless otherwise indicated)										
National accounts											
Real GDP	4.0	2.6	2.1	2.7	2.0	3.2	3.2	3.1	3.0	3.0	3.0
Consumption	2.5	4.3	1.4	3.4	3.3	3.3	3.3	3.2	3.1	3.1	3.0
Private consumption	3.1	5.0	1.3	3.5	3.4	3.3	3.2	3.2	3.1	3.1	3.1
Public consumption	0.3	1.6	2.1	3.1	2.7	3.5	3.4	3.1	2.9	2.9	2.8
Gross capital formation	-1.0	-5.8	-4.3	-0.9	2.2	8.6	7.5	5.1	4.3	3.9	3.7
Gross fixed capital formation	14.4	-6.0	0.1	-1.8	-11.7	8.0	7.5	6.0	5.0	4.5	4.5
Exports of goods and services	9.8	1.1	3.9	2.6	2.8	3.1	3.3	3.7	4.0	4.0	4.0
Imports of goods and services	5.4	-0.2	0.5	2.1	4.6	4.8	5.0	4.5	4.5	4.3	4.2
Contributions to growth											
Domestic demand	1.7	1.9	0.1	2.5	3.1	4.5	4.3	3.8	3.5	3.4	3.4
Net exports	2.1	0.8	2.0	0.3	-1.1	-1.1	-1.2	-0.7	-0.5	-0.4	-0.4
HICP inflation											
Period average	2.3	0.0	0.7	0.2	0.1	3.0	2.5	2.4	2.4	2.3	2.3
End-period	1.6	-0.4	0.3	0.4	2.1	2.5	2.5	2.4	2.4	2.3	2.3
Labor market											
Unemployment rate (LFS, percent)	15.0	11.9	10.8	9.9	9.6	9.3	9.0	8.7	8.6	8.5	8.5
Employment (period average, percent)	1.6	2.1	-1.0	1.3	-0.3	0.3	0.2	0.0	0.0	0.0	0.0
Real gross wages	1.5	4.5	6.1	6.7	4.9	3.0	3.0	3.0	3.0	3.0	3.0
	(Percent of GDP)										
Consolidated general government 1/											
Total revenue	37.4	36.7	36.1	36.2	36.2	37.3	37.6	36.9	36.6	36.2	35.6
Total expenditure	37.2	37.3	37.8	37.7	36.7	38.2	38.1	37.5	36.8	36.6	36.0
ESA balance	-0.8	-0.9	-1.6	-1.3	0.0	-0.7	-0.7	-0.5	-0.5	-0.3	-0.3
ESA structural balance	-0.4	-0.7	-1.0	-1.2	0.2	-0.6	-0.7	-0.6	-0.5	-0.3	-0.3
General government gross debt	36.7	35.8	38.5	34.8	37.2	35.9	34.5	33.3	31.8	30.7	29.5
Saving and investment											
Gross national saving	22.6	21.2	21.2	21.3	21.4	20.8	20.7	20.8	20.9	20.8	20.7
Private	18.2	17.7	18.4	18.1	17.6	17.2	16.1	16.5	16.3	16.7	16.6
Public 2/	4.4	3.5	2.8	3.2	3.8	3.6	4.5	4.3	4.6	4.1	4.1
Foreign saving 3/	3.6	2.7	2.0	0.8	-1.5	0.4	1.4	1.7	1.7	1.9	2.1
Gross capital formation	26.2	23.9	23.2	22.1	19.9	21.3	22.1	22.4	22.6	22.8	22.8
Private	22.4	20.2	19.5	18.3	17.3	18.3	18.8	19.2	19.5	20.0	20.1
Public	3.8	3.8	3.7	3.8	2.7	3.0	3.3	3.2	3.1	2.8	2.7
External sector											
Current account balance	-3.6	-2.7	-2.0	-0.8	1.5	-0.4	-1.4	-1.7	-1.7	-1.9	-2.1
Net IIP	-67.8	-66.5	-64.2	-62.5	-58.2	-53.3	-48.3	-44.2	-40.5	-37.5	-35.0
Gross external debt	138.2	133.9	143.0	141.6	147.3	140.2	134.8	132.7	129.7	123.8	122.3
Net external debt 4/	39.8	36.6	32.9	28.5	28.6	26.1	22.6	19.7	17.2	15.1	13.6
Memorandum items:											
Nominal GDP (billions of euros)	21.9	22.8	23.6	24.4	25.0	26.6	28.0	29.6	31.2	32.8	34.5
Output gap (percent)	-2.4	-0.7	-0.5	-0.3	-0.5	-0.2	0.0	0.1	0.0	0.0	0.0
Potential output growth (percent)	0.3	0.9	1.9	2.5	2.2	2.9	2.9	3.0	3.1	3.0	3.0
Terms of trade (annual percentage change)	-2.8	0.6	-1.2	0.7	4.7	-1.0	-0.2	-0.1	0.0	-0.2	-0.2

Sources: Latvian authorities; and IMF staff estimates.

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.

2/ Includes bank restructuring costs.

3/ Current account deficit

4/ Gross external debt minus gross external debt assets.

Table 3. Latvia: General Government Operations, 2012–22[1]

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections					
						(percent of GDP)					
Total revenue and grants	37.4	36.7	36.1	36.2	36.2	37.3	37.6	36.9	36.6	36.2	35.6
Tax revenue	27.9	28.2	28.3	28.7	29.7	29.9	30.0	29.9	29.9	29.8	29.8
Direct Taxes	16.6	16.9	16.5	16.7	17.2	17.3	17.4	17.3	17.4	17.4	17.4
Corporate Income Tax	1.6	1.6	1.5	1.6	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Personal Income Tax	5.7	5.8	5.9	5.9	6.1	6.2	6.2	6.2	6.2	6.3	6.3
Social Security Contributions	8.6	8.7	8.4	8.4	8.4	8.4	8.5	8.5	8.6	8.6	8.6
Real Estate and Property Taxes	0.8	0.8	0.8	0.8	0.9	0.9	0.8	0.8	0.8	0.8	0.7
Indirect Taxes	11.3	11.3	11.7	12.1	12.5	12.6	12.6	12.6	12.5	12.5	12.4
VAT	7.3	7.3	7.6	7.8	8.1	8.2	8.3	8.3	8.3	8.4	8.4
Excises	3.2	3.2	3.2	3.3	3.4	3.4	3.3	3.3	3.2	3.1	3.1
Other indirect taxes	0.8	0.8	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Non Tax, self-earned and other revenue	4.0	3.6	3.3	3.3	3.6	3.2	3.2	3.0	2.5	2.5	2.5
EU and miscellaneous funds	5.5	4.9	4.5	4.1	3.0	4.2	4.4	4.0	4.1	3.8	3.2
Total expenditure 2/	37.2	37.3	37.8	37.7	36.7	38.2	38.1	37.5	36.8	36.6	36.0
Current expenditure	33.4	33.5	34.1	33.9	34.0	35.2	34.8	34.3	33.7	33.8	33.3
Remuneration	7.5	7.7	7.9	8.2	8.4	8.6	8.5	8.3	8.2	8.1	8.1
Wages and Salaries	5.8	6.0	6.1	6.3	6.4	6.6	6.5	6.4	6.3	6.2	6.2
Goods and Services	4.7	4.9	4.8	4.8	4.8	5.3	5.5	5.4	5.4	5.2	5.2
Subsidies and Transfers	18.6	18.2	18.7	18.1	18.5	19.1	18.7	18.5	18.0	18.4	18.0
Subsidies to companies and institutions	7.9	7.5	8.2	7.4	7.6	8.2	7.7	7.5	7.0	7.4	6.9
Social Support	10.5	10.5	10.4	10.6	10.8	10.8	10.9	11.0	11.0	10.9	10.9
Pensions	8.1	8.0	7.7	7.5	7.4	7.3	7.3	7.4	7.4	7.3	7.3
Other	2.4	2.6	2.7	3.1	3.4	3.5	3.6	3.6	3.6	3.6	3.6
International cooperation	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	1.0	1.2	1.2	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	1.5	1.4	1.5	1.8	1.2	1.1	1.1	1.0	1.0	0.9	0.9
Capital expenditure	3.8	3.8	3.7	3.8	2.7	3.0	3.3	3.2	3.1	2.8	2.7
Fiscal balance	0.2	-1.2	-1.7	-1.5	-0.4	-0.8	-0.5	-0.6	-0.2	-0.4	-0.4
Financing (net)	-0.2	1.2	1.7	1.5	0.4	0.8	0.5	0.6	0.2	0.4	0.4
Domestic financing	2.1	2.4	-3.3	6.4	-3.1	0.9	0.5	-2.4	-1.7	1.6	-2.3
External financing	-2.3	-1.2	5.0	-4.8	3.5	-0.1	0.0	3.0	1.9	-1.1	2.7
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items											
ESA balance	-0.8	-0.9	-1.6	-1.3	0.0	-0.7	-0.7	-0.5	-0.5	-0.3	-0.3
ESA structural balance 3/	-0.4	-0.7	-1.0	-1.2	0.2	-0.6	-0.7	-0.6	-0.5	-0.3	-0.3
General government debt	36.7	35.8	38.5	34.8	37.2	35.9	34.5	33.3	31.8	30.7	29.5
Nominal GDP (billions of euros)	21.9	22.8	23.6	24.4	25.0	26.6	28.0	29.6	31.2	32.8	34.5

Sources: Latvian authorities; and IMF staff estimates.

1/ Fiscal accounts are on a cash basis as provided by the authorities

2/ The bank restructuring costs are calculated in accordance with ESA 95 definitions.

3/ In computing structural balances part of the bank restructuring costs are treated as one-offs.

Table 4. Latvia: Medium-Term Balance of Payments, 2012–22

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections					
	(Percent of GDP, unless otherwise indicated)										
Current account	-3.6	-2.7	-2.0	-0.8	1.5	-0.4	-1.4	-1.7	-1.7	-1.9	-2.1
Goods and services (fob)	-4.6	-3.7	-1.9	-1.1	0.5	-1.0	-2.1	-2.6	-2.9	-3.1	-3.4
Goods (fob)	-12.0	-11.5	-9.3	-8.4	-7.0	-8.3	-9.1	-9.5	-9.7	-10.0	-10.1
Exports	44.1	43.1	43.2	42.4	41.0	41.3	40.9	40.8	40.6	40.6	40.6
Imports	-56.1	-54.5	-52.5	-50.7	-48.0	-49.5	-50.1	-50.3	-50.3	-50.6	-50.7
Services	7.4	7.8	7.4	7.2	7.5	7.3	7.1	6.9	6.9	6.8	6.8
Credit	17.2	17.1	16.3	16.6	17.0	17.1	16.9	16.9	16.8	16.8	16.8
Debit	-9.8	-9.3	-8.9	-9.3	-9.5	-9.8	-9.9	-9.9	-9.9	-10.0	-10.0
Primary Income	-0.6	-0.3	-0.1	-0.2	0.2	-0.5	-0.3	0.0	0.1	0.1	0.1
Compensation of employees	2.4	2.3	2.8	2.6	2.4	2.2	2.2	2.2	2.2	2.2	2.2
Investment income	-4.3	-3.8	-3.7	-3.7	-3.4	-3.6	-3.4	-3.0	-2.8	-2.8	-2.8
Secondary Income	1.6	1.3	0.1	0.6	0.7	1.0	1.0	0.9	1.1	1.2	1.2
Capital and financial account	2.0	1.5	0.5	3.6	-1.1	0.4	1.4	1.7	1.7	1.9	2.1
Capital account	3.0	2.5	3.2	2.8	1.0	3.5	3.6	3.3	3.1	2.9	2.8
Financial account	-0.9	-1.0	-2.7	0.8	-2.1	-3.0	-2.2	-1.6	-1.4	-1.0	-0.7
Direct investment	3.3	1.6	1.6	2.3	-0.2	1.9	1.9	1.8	1.8	1.8	1.8
Portfolio investment and financial derivatives	4.5	0.1	-0.3	-9.2	-4.5	0.2	-0.9	5.1	3.2	0.1	4.0
of which: general government net issuance	7.4	-0.3	6.9	-0.6	3.9	0.3	0.4	5.1	2.0	-1.1	2.9
Other investment	-5.1	-1.0	-4.5	8.9	3.1	-5.1	-3.1	-8.6	-6.4	-2.9	-6.5
Reserve assets	-3.6	-1.7	0.5	-1.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.6	1.2	1.5	-2.8	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent change, unless otherwise indicated)										
Goods and Services											
Export value (fob)	13.9	2.2	2.6	2.1	1.0	6.8	4.7	5.1	4.9	5.4	5.1
Import value (fob)	12.7	0.9	-0.3	0.8	-1.8	9.7	6.7	5.9	5.4	5.8	5.5
Export volume	9.8	1.1	3.9	2.6	2.8	3.1	3.3	3.7	4.0	4.0	4.0
Import volume	5.4	-0.2	0.5	2.1	4.6	4.8	5.0	4.5	4.5	4.3	4.2
Gross reserves (billions of euros)	5.7	5.8	2.7	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Gross external debt (percent of GDP)	138.2	133.9	143.0	141.6	147.3	140.2	134.8	132.7	129.7	123.8	122.3
Medium and long term (percent of GDP)	87.9	78.8	77.4	70.6	74.6	71.0	70.2	69.1	68.1	67.1	66.0
Short term (percent of GDP)[1]	50.4	55.1	63.8	65.7	67.3	66.5	66.1	65.6	65.2	64.6	63.9
Net external debt (percent of GDP)[2]	39.8	36.6	32.9	28.5	28.6	26.1	22.6	19.7	17.2	15.1	13.6
Memo items											
Nominal GDP (billions of euros)	21.9	22.8	23.6	24.4	25.0	26.6	28.0	29.6	31.2	32.8	34.5
U.S. dollar per euro (period average)	1.29	1.33	1.33	1.11	1.11	…	…	…	…	…	…

Sources: Latvian authorities; and IMF staff estimates.

1/ Based on detailed data until 2013. Extrapolated for debt outside the public sectors and MFIs starting 2014.

2/ Gross external debt minus gross external debt assets.

Table 5. Latvia: Financial Soundness Indicators, 2007–16

(In percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Commercial banks										
Capital Adequacy										
Regulatory capital to risk-weighted assets 1/	11.1	11.80	14.6	14.6	17.4	17.60	18.9	21.0	22.8	21.5
Regulatory Tier I capital to risk-weighted assets 1/	9.8	10.50	11.5	11.5	14.2	15.20	17.3	18.3	19.8	18.2
Capital and reserves to assets	7.9	7.30	7.4	7.3	7.5	9.36	9.9	9.9	10.4	10.1
Asset Quality										
Annual growth of bank loans	37.2	11.2	-7.0	-7.1	-8.1	-10.9	-6.5	-6.1	0.1	3.1
Annual growth of bank loans to residents	30.3	15.8	67.2	-8.7	-8.3	-10.5	-6.2	-7.6	-1.5	3.1
Annual growth of bank loans to companies	36.3	16.9	-6.5	-8.0	-7.6	-9.0	-5.6	-9.6	-1.6	1.6
Sectoral distribution of loans (in % of total loans, stock)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture, hunting and related service activities	1.6	1.7	1.6	1.6	2.0	2.4	3.2	2.8	2.8	3.3
Construction and real estate activities	18.8	19.6	20.8	20.4	20.0	18.6	18.1	17.9	17.3	16.7
Industry and trade	21.6	23.1	22.3	22.0	22.0	24.3	24.2	22.7	23.3	22.5
Financial intermediation	6.0	6.0	4.5	3.2	2.8	2.7	3.6	4.7	5.1	7.6
Households	40.0	38.4	39.3	39.8	40.0	39.1	38.4	37.8	36.2	34.5
Foreign clients	12.1	11.2	11.4	13.1	13.2	12.9	12.6	14.0	15.4	15.4
Loans past due over 90 days	0.8	3.6	16.4	19.0	17.5	11.1	8.3	6.9	6.0	4.4
Loans to households	...	4.7	16.8	18.4	19.3	15.2	12.0	9.5	7.6	5.3
Loans to corporations	...	2.8	18.5	20.8	16.2	9.7	7.0	5.9	4.4	2.7
Earnings and Profitability										
ROA (after tax)	2.0	0.3	-3.5	-1.6	-0.9	0.6	0.9	1.1	1.3	1.5
ROE (after tax)	24.3	4.6	-41.6	-20.4	-11.2	5.6	8.7	11.1	12.5	14.3
Liquidity										
Liquid assets to total assets	25.0	21.6	21.1	27.3	27.4	32.3	36.5	39.9	40.2	33.8
Liquid assets to short term liabilities	55.7	52.8	62.8	67.9	63.9	59.8	64.4	63.1	66.7	61.9
Customers deposits to (non-interbank) loans	68.2	58.8	61.9	77.5	84.1	106.3	124.9	151.3	158.5	141.2
Sensitivity to Market Risk										
FX deposits to total deposits 2/	70.7	69.4	74.5	72.6	73.5	76.2	75.9	40.3	43.1	34.2
FX loans to total loans 2/	81.8	85.0	87.1	88.9	86.3	84.5	88.5	13.0	13.8	12.5
Memorandum Items										
Share of non-resident deposits to total deposits	41.7	44.0	38.0	41.6	47.2	48.9	47.3	51.7	53.4	42.8

Source: CSB, BoL, FCMC, Latvian Leasing Association, staff calculations

1/ Regulatory Tier 1 capital to risk weighted assets as from Dec 2009 is calculated as Tier 1 capital (including deduction)/risk-weighted assets

Regulatory capital to risk-weighted assets and Regulatory Tier 1 capital to risk-weighted assets in the column of Dec 2014 uses data from Sep 2014.

2/ Euro-denominated positions are included in and before 2013, but not in 2014.

Annex I. External Sector Assessment

Foreign assets and liabilities. The NIIP has improved gradually and stood at around -58 percent of GDP by end 2016; it is projected to continue declining to about -35 percent of GDP over the medium term. Gross assets stood at 134 percent of GDP in 2016, while gross liabilities stood at 192 percent. Debt securities comprised only 15 percent of these liabilities. At the same time, net external debt stood at 29 percent of GDP at the end of 2016.

Current account. The current account moved to a surplus of 1.5 percent of GDP in 2016, driven by large terms of trade gains, weak investment growth, and a lower-than-budgeted fiscal deficit. This outturn was atypical, with the current account having averaged a deficit of -2.4 percent of GDP over 2011–15.[1] The current account is projected to swing back into modest deficit in 2017 and 2018 as investment gathers steam and consumption continues to be strong. While the current account position is stronger than implied by fundamentals and desirable policies, the unusually strong cyclical components inflate the gap estimates. In addition, the CA regression does not properly account for certain features of economies like Latvia's, especially the impact of demography-related variables.[2] Taking into consideration all these caveats, results from the CA approach are subject to some uncertainty, thus suggesting a range for the CA gap of around 2–4 percent of GDP in 2016.

Real exchange rate. The REER appreciated by about 1 percent between 2015 and 2016. The CA regression model suggests an undervaluation of 5–15 percent using standard trade elasticities. However, many of the factors accounting for the unusually strong current account should unwind, bringing down the balance without a need for the exchange rate to adjust. The EBA-lite REER model finds a small overvaluation of around 1 percent, which is largely consistent with the evolution of the REER (Figure 5) and rising unit labor costs.

Capital and financial accounts. The capital account is dominated by EU structural fund inflows, which slowed in 2016, but are expected to increase in 2017–18. FDI inflows slowed in recent years, making portfolio and other investment flows the main drivers of the financial account. High foreign holdings of government bonds and cross-border linkages of the banking sector in the region indicate potential vulnerabilities.

FX intervention and reserves level. The Euro has the status of a global reserve currency. As such, reserves held by euro area economies are typically low to standard metrics, but the currency is free floating.

The external position in 2016 was stronger than implied by medium term fundamentals and desirable policies. This is broadly in line with the CA-based REER assessment. However, this largely reflects temporary improvements in the CA driven by improved terms of trade, slowing investment, and a lower-than-budgeted fiscal deficit. A widening of the current account deficit from 2017 onwards is expected, on the back of a pick-up in investment and unwinding of terms of trade gains.

[1] Assuming 2016 trade volumes at 2015 prices, i.e. absent any terms of trade effects, the current account deficit would be -1.3 percent.

[2] The CA regression is sensitive to the underlying series and projections used, which vary by source, coefficients for demographic variables are derived from a very broad sample, and are thus likely not particularly applicable to the Latvian economy, which is aging rapidly.

Annex II. Banks Servicing Foreign Clients (BSFCs) in Latvia

The banking sector in Latvia has a dual nature, with a sizeable segment servicing foreign clients. The two segments have distinct business models: domestically active banks (comprising 7 branches and 3 subsidiaries), mainly from the Nordic countries cater predominantly to the Latvian population and are responsible for most of the lending in the economy; the remaining 13 banks cater predominantly to foreign clients, with limited participation in the domestic economy, and with a large share of their deposit base coming from foreign clients, mostly from the CIS. In light of their business model, BSFCs depend on correspondent banking relationships (CBRs), which allow them to make direct settlements in foreign currencies.

Despite a changing landscape, with dwindling business, and a sharp decline in deposits and turnovers, BSFCs remain broadly sound. System wide non-resident deposits declined by 26.5 percent y-o-y through 2016, with some BSFCs experiencing declines well in excess of that amount. USD clearing declined by 39 percent over the same period. The sharp decline of non-resident deposits has been attributed to the withdrawal of global correspondent banks; ongoing strengthening of AML/CFT requirements and enforcement; and financial sanctions and economic downturn in Russia. While most banks servicing foreign clients have found alternative arrangements to CBRs with global banks, ongoing pressures could lead to further decline in deposits and turnover.

So far, no risks to financial stability have been identified. In part this reflects the banks' strong capital and liquidity buffers, the fact that investments are made mostly in foreign liquid assets and deposits with Latvijas Banka, and the limited linkages between the BSFCs and the domestic banking sector. In addition, the FCMC applies more stringent liquidity and capital requirements to BSFCs, and is closely monitoring developments, including by stress testing the sector for scenarios of further outflow of NRDs. Furthermore, BSFCs, in dialogue with the FCMC have undertaken independent audits of their AML/CFT frameworks, procedures, and practices and are working together to implement recommendations. There are also limited linkages between the domestic economy and BSFCs, which do not play a material role in lending to residents (accounting for around only 12 percent of such lending), or seeking domestic deposits.

Going forward, and building on the authorities' ongoing efforts, continued vigilant supervision is needed to mitigate real and reputational risks The FCMC continues to take welcome steps to tighten as well as strengthen the enforcement of AML/CFT requirements, notably in BSFCs, and additional resources have been dedicated to AML/CFT supervision. While the decline in non-resident deposits should lower banks' risks associated with these types of deposits, further strengthening internal controls and addressing the AML/CFT shortcomings identified by the 2016 independent audits are central to mitigating risks and ensuring the sustainability of BSFCs. Some of these banks affected by the withdrawal of USD CBRs and experiencing a decline in non-resident deposits are also reviewing their business models, including by considering switching from a transactional to an investment model, broadening the customer base beyond the CIS region, and increasing their presence in the domestic market

Annex III. Public Debt Sustainability Assessment

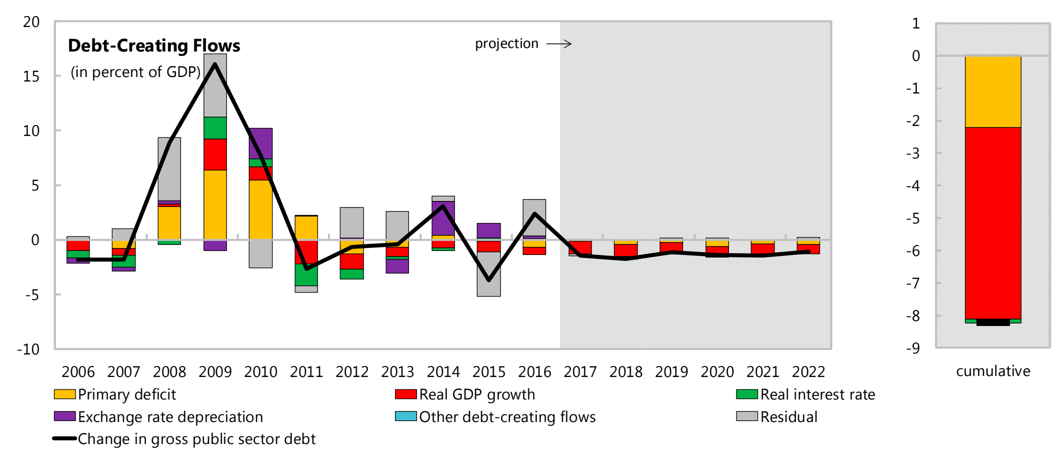
Latvia Public DSA–Composition of Public Debt and Baseline Scenarios

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of April 07, 2017		
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022	Sovereign Spreads		
Nominal gross public debt	27.5	34.8	37.2	35.8	34.1	32.9	31.5	30.1	29.0	EMBIG (bp) 3/		67
Public gross financing needs	2.0	10.7	1.7	6.1	4.6	5.5	5.4	4.8	1.9	5Y CDS (bp)		58
Real GDP growth (in percent)	1.7	2.7	2.0	3.2	3.2	3.1	3.0	3.0	3.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	5.2	0.4	0.7	2.9	2.3	2.3	2.3	2.2	2.2	Moody's	A3	A3
Nominal GDP growth (in percent)	7.5	3.1	2.7	6.2	5.5	5.5	5.3	5.3	5.2	S&Ps	A-	A-
Effective interest rate (in percent) [4/]	4.9	4.8	3.6	3.1	2.1	2.2	2.2	2.2	2.3	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	3.2	-3.7	2.4	-1.4	-1.8	-1.1	-1.4	-1.4	-1.1	-8.2	
Identified debt-creating flows	1.4	0.4	-0.9	-1.3	-1.6	-1.3	-1.6	-1.3	-1.2	-8.2	
Primary deficit	1.6	-0.1	-0.7	-0.1	-0.4	-0.2	-0.6	-0.4	-0.4	-2.2	-0.8
Primary (noninterest) revenue and grant	35.1	36.0	36.1	37.2	37.4	36.7	36.4	36.1	35.5	219.3	
Primary (noninterest) expenditure	36.8	35.9	35.4	37.0	37.0	36.5	35.8	35.7	35.1	217.1	
Automatic debt dynamics [5/]	-0.2	0.5	-0.3	-1.1	-1.2	-1.1	-1.0	-0.9	-0.8	-6.0	
Interest rate/growth differential [6/]	-0.6	-0.9	-0.6	-1.1	-1.2	-1.1	-1.0	-0.9	-0.8	-6.0	
Of which: real interest rate	-0.3	0.2	0.1	0.0	-0.1	-0.1	0.0	0.0	0.0	-0.1	
Of which: real GDP growth	-0.3	-1.0	-0.7	-1.1	-1.1	-1.0	-0.9	-0.9	-0.9	-5.9	
Exchange rate depreciation [7/]	0.4	1.3	0.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits (+	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroa	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.7	-4.1	3.4	-0.2	-0.2	0.2	0.2	-0.1	0.2	0.0	



Sources: Bloomberg Finance L.P. and IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

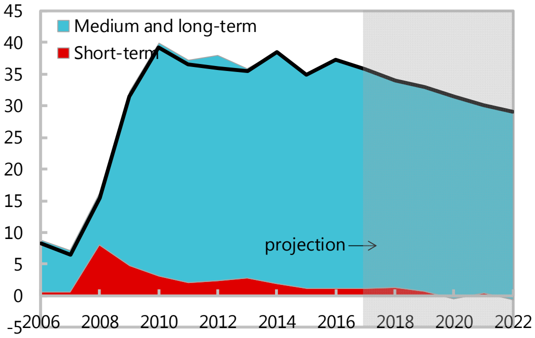
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Latvia Public DSA–Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

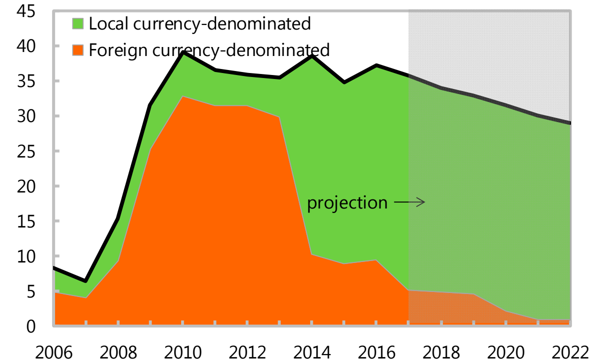
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

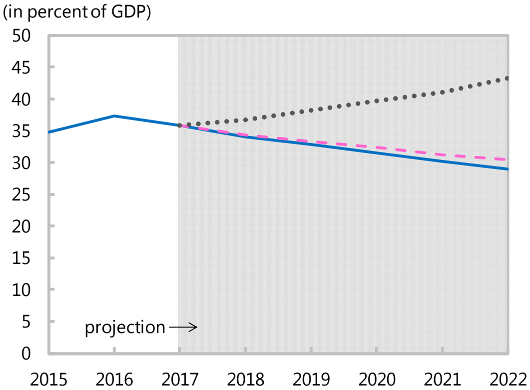


Alternative Scenarios

Baseline Historical Constant Primary Balance

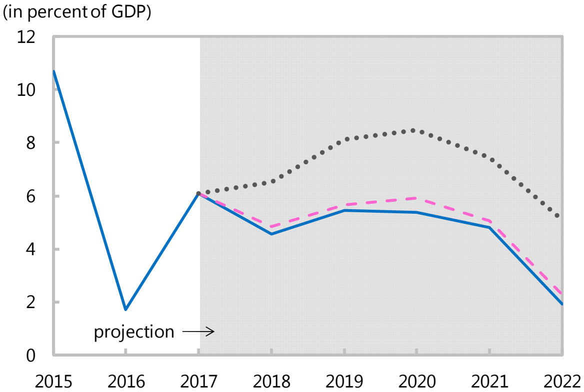
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.2	3.2	3.1	3.0	3.0	3.0
Inflation	2.9	2.3	2.3	2.3	2.2	2.2
Primary Balance	0.1	0.4	0.2	0.6	0.4	0.4
Effective interest rate	3.1	2.1	2.2	2.2	2.2	2.3
Constant Primary Balance Scenario						
Real GDP growth	3.2	3.2	3.1	3.0	3.0	3.0
Inflation	2.9	2.3	2.3	2.3	2.2	2.2
Primary Balance	0.1	0.1	0.1	0.1	0.1	0.1
Effective interest rate	3.1	2.1	2.2	2.3	2.2	2.4

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.2	0.8	0.8	0.8	0.8	0.8
Inflation	2.9	2.3	2.3	2.3	2.2	2.2
Primary Balance	0.1	-1.4	-1.4	-1.4	-1.4	-1.4
Effective interest rate	3.1	2.1	2.5	2.8	3.0	3.4

Source: IMF staff.

Republic of Latvia: External Debt Sustainability Framework, 2012–22

(in percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	138.2	133.9	143.0	141.6	147.3			**140.2**	**134.8**	**132.7**	**129.7**	**123.8**	**122.3**	**-5.7**
2 Change in external debt	-6.3	-4.3	9.1	-1.4	5.7			-7.1	-5.5	-2.1	-3.0	-5.8	-1.6	
3 Identified external debt-creating flows (4+8+9)	-6.5	-5.8	-4.6	2.0	-4.8			-6.0	-4.6	-4.1	-3.9	-3.6	-3.2	
4 Current account deficit, excluding interest payments	-0.8	-0.6	-1.3	-1.9	-3.8			-2.9	-1.2	-1.0	-1.3	-0.6	0.0	
5 Deficit in balance of goods and services	4.6	3.7	1.9	1.1	-0.5			1.0	2.1	2.6	2.9	3.1	3.4	
6 Exports	61.3	60.2	59.5	58.9	58.0			58.3	57.9	57.6	57.4	57.4	57.4	
7 Imports	65.9	63.9	61.4	60.1	57.4			59.3	59.9	60.2	60.2	60.5	60.7	
8 Net non-debt creating capital inflows (negative)	-3.3	-1.8	-1.8	-2.8	0.3			-1.9	-1.9	-1.8	-1.8	-1.8	-1.8	
9 Automatic debt dynamics 1/	-2.4	-3.4	-1.6	6.7	-1.2			-1.2	-1.5	-1.3	-0.7	-1.2	-1.5	
10 Contribution from nominal interest rate	4.5	3.3	3.2	2.7	2.4			3.3	2.6	2.6	3.0	2.5	2.1	
11 Contribution from real GDP growth	-5.9	-3.4	-2.7	-4.5	-2.7			-4.6	-4.1	-3.9	-3.8	-3.7	-3.5	
12 Contribution from price and exchange rate changes 2/	-1.0	-3.3	-2.1	8.5	-0.9			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	0.1	1.4	13.7	-3.4	10.5			-1.1	-0.9	2.1	0.9	-2.2	1.6	
External debt-to-exports ratio (in percent)	225.5	222.5	240.2	240.3	254.0			240.4	232.9	230.2	226.0	215.7	213.2	
Gross external financing need (in billions of US dollars) 4/	20.1	22.3	22.4	22.7	20.0			22.2	23.3	24.1	25.4	26.2	25.2	
in percent of GDP	71.4	73.6	71.3	84.1	72.1	10-Year	10-Year	76.4	75.2	73.6	73.6	72.3	66.5	
Scenario with key variables at their historical averages 5/								**140.2**	**140.5**	**142.4**	**142.9**	**139.5**	**139.9**	**-2.1**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	4.0	2.6	2.1	2.7	2.0	0.8	6.7	3.2	3.2	3.1	3.0	3.0	3.0	
GDP deflator in US dollars (change in percent)	-5.0	4.8	1.6	-16.2	0.4	2.9	14.9	1.6	3.4	2.5	2.3	1.9	1.7	
Nominal external interest rate (in percent)	3.0	2.6	2.5	1.6	1.7	4.4	3.0	2.4	2.0	2.1	2.4	2.0	1.8	
Growth of exports (US dollar terms, in percent)	4.4	5.6	2.7	-14.8	0.8	7.8	18.4	5.5	5.9	5.2	4.9	5.0	4.7	
Growth of imports (US dollar terms, in percent)	3.2	4.2	-0.2	-15.8	-2.1	4.4	22.0	8.3	7.9	6.1	5.5	5.5	5.1	
Current account balance, excluding interest payments	0.8	0.6	1.3	1.9	3.8	2.0	7.6	2.9	1.2	1.0	1.3	0.6	0.0	
Net non-debt creating capital inflows	3.3	1.8	1.8	2.8	-0.3	2.5	2.0	1.9	1.9	1.8	1.8	1.8	1.8	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

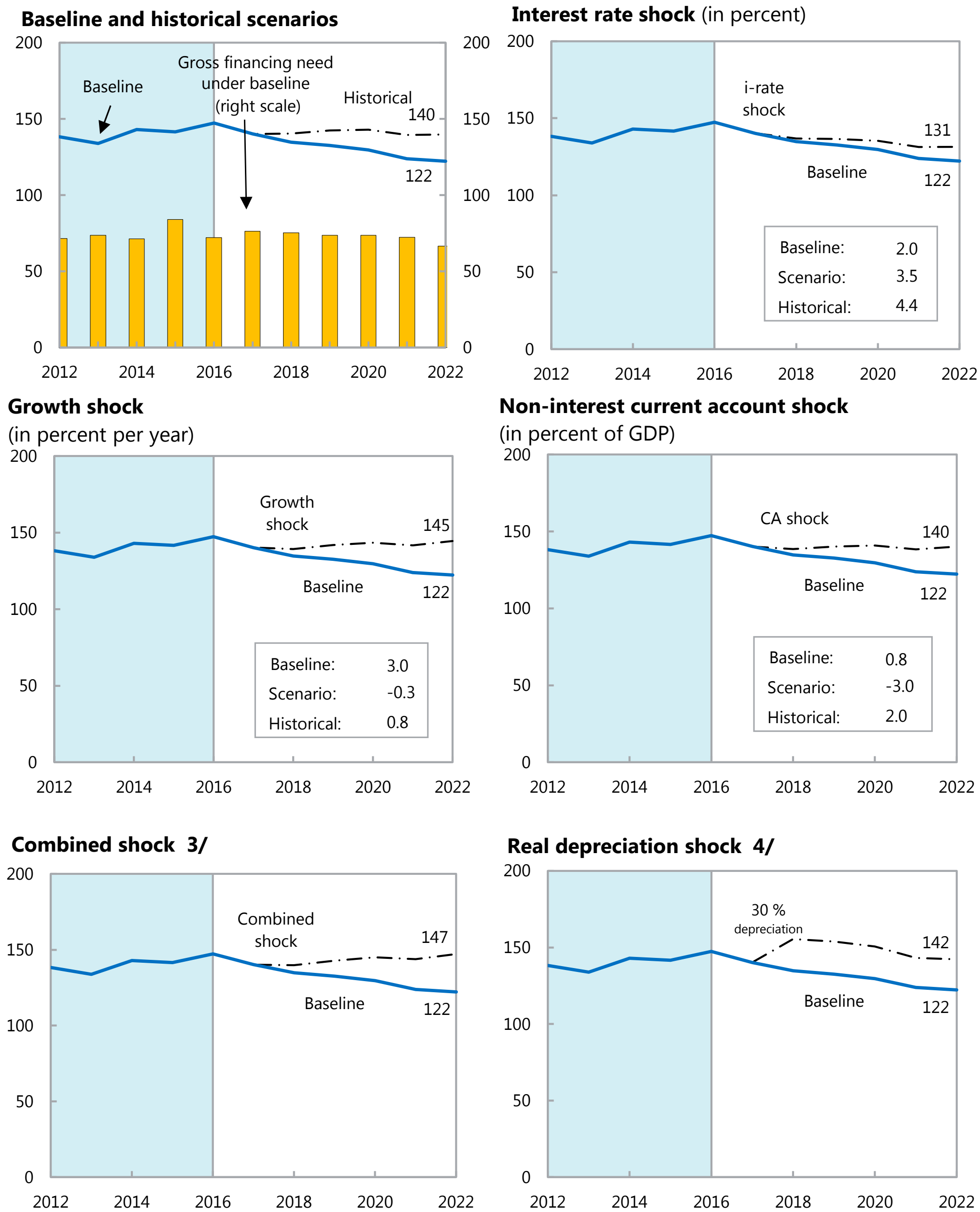
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Republic of Latvia: External Debt Sustainability, Bound Tests [1, 2]

(External Debt in Percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2017.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 20, 2017

Prepared By | European Department

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FUND RELATIONS

(As of June 1, 2017)

Membership Status: Joined May 19, 1992; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	332.30	100.00
Fund holdings of currency (Exchange Rate)	332.26	99.99
Reserve Tranche Position	0.06	0.02

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	120.82	100.00
Holdings	120.82	100.00

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Dec 23, 2008	Dec 22, 2011	1,521.63	982.24
Stand-By	Apr 20, 2001	Dec 19, 2002	33.00	0.00
Stand-By	Dec 10, 1999	Apr 09, 2001	33.00	0.00

Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2016	**2017**	**2018**	**2019**	**2020**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Exchange Rate Arrangement:

As of January 1, 2014, the currency of Latvia is the euro, which floats freely and independently against other currencies. Prior to 2014, the currency of Latvia was the lat, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ±1 percent band. On January 1, 2005, the lat was re-pegged to the euro at the rate 1 euro = 0.702804 lats, and on April 29, 2005, Latvia entered ERM II, maintaining the previous band width. Latvia maintains an exchange system free of restrictions on the payments or transfers for current international transactions. Exchange restrictions maintained for security reasons have been notified to the Fund for approval most recently in January 2013 (see EBD/13/3, January 28, 2013).

Previous Article IV Consultation:

Latvia is on the 12-month consultation cycle. The last Article IV consultation was concluded on June 10, 2016 (IMF Country Report No. 16/171). The Executive Board assessment is available at http://www.imf.org/external/pubs/ft/scr/2016/cr16171.pdf.

Safeguards Assessment:

The safeguards assessment completed on July 8, 2009 concluded that the Bank of Latvia (BoL) operates robust internal audit and control systems. The assessment recommended clarifying the respective roles of the BoL and the Treasury in holding, managing, and reporting to the Fund audited international reserves data. It also recommended amendments to the mandate of the BoL's audit committee and improvements to the financial statements' disclosures. The authorities have already taken steps to implement these recommendations, notably by establishing a formal arrangement between the BoL and the Treasury, revising the audit committee charter and expanding the existing accounting framework.

FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) during February 14–28, 2001. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (Country Report No. 02/10). An AML/CFT assessment mission took place during March 8–24, 2006, and the report was sent to the Board on May 23, 2007. A joint IMF-World Bank mission conducted an FSAP Update during February 27–March 9, 2007. A World Bank mission conducted an FSAP development module during November 8–18, 2011. Moneyval conducted a follow-up assessment during May 9–13, 2011, and the mutual evaluation report was adopted on July 5, 2012.

ROSC Modules

Standard/Code assessed	Issue date
Code of Good Practices on Fiscal Transparency	March 29, 2001
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002
Basel Core Principles for Effective Banking Supervision	January 2, 2002
CPSS Core Principles for Systemically Important Payment Systems	January 2, 2002
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002
IAIS Core Principles	January 2, 2002
OECD Corporate Governance Principles	January 2, 2002
Data Module	June 23, 2004

Republic of Latvia: Technical Assistance (2007–12)				
Dept.	**Project**	**Action**	**Timing**	**Counterpart**
FAD	Expenditure Policy	Mission	June 2007	Ministry of Finance
FAD	Tax Policy	Mission	March 2008	Ministry of Finance
FAD	Revenue Administration	Mission	January 2009	Ministry of Finance
MCM	Bank Resolution	Mission	January 2009	FCMC, Bank of Latvia
FAD	Public Financial Management	Mission	March 2009	Ministry of Finance
MCM/ LEG	Debt Restructuring	Mission	March 2009	Ministry of Finance, FCMC
LEG	Legal Aspects of P&A Transactions	Mission	Feb–March 2009	FCMC
MCM	Bank Intervention Procedures and P&A	Mission	March 2009	FCMC
FAD	Public Financial Management	Mission	April-May 2009	Ministry of Finance
FAD	Revenue Administration	Mission	July 2009	Ministry of Finance
FAD	Public Financial Management	Resident Advisor	July 2009– June 2010	Ministry of Finance
FAD	Cash Management	Mission	July–August 2009	Ministry of Finance
MCM	Mortgage and Land Bank	Mission	Sept. 2009	Ministry of Finance
MCM	Deposit Insurance	Mission	Sept. 2009	FCMC
MCM	Liquidity Management	Mission	November 2009	Bank of Latvia
LEG	Bank Resolution Legal Framework	Mission	January 2010	FCMC
FAD	Tax Policy	Mission	February 2010	Ministry of Finance
LEG	Bank Resolution Legal Framework	Mission	February 2010	FCMC
LEG	Corporate and Personal Insolvency Law	Mission	March 2010	Ministry of Justice
FAD	Public Financial Management	Mission	April 2010	Ministry of Finance
LEG	Corporate and Personal Insolvency Law	Mission	April 2010	Ministry of Justice
MCM	Stress Testing	Mission	June 2010	Bank of Latvia
FAD	Expenditure Policy	Mission	August 2010	Ministry of Finance
FAD	Revenue Administration	Mission	Sept. 2010	Ministry of Finance
LEG	Legal Framework for Foreclosure Procedures	Missions	November 2010	Ministry of Justice
FAD	Public Financial Management	Mission	Feb–March 2011	Ministry of Finance
FAD	Tax Administration	Mission	June 2011	Ministry of Finance
MCM	Bank Resolution	Mission	July 2012	FCMC
FAD	Expenditure Rationalization	Mission	October 2012	Ministry of Finance

Resident Representative Post: Mr. David Moore was appointed Resident Representative from June 11, 2009 to June 11, 2013.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund for surveillance purposes is adequate (A). Latvia is a subscriber of the Special Data Dissemination Standard (SDDS) and a link to Latvia's metadata is available at the IMF's website for the Dissemination Standards Bulletin Board (DSBB) ().

National Accounts: The CSB compiles and publishes quarterly national accounts with the production and expenditure approaches on a regular and timely basis. Since September 2011, national accounts are calculated with the NACE rev. 2 classifications, determined by the European Commission. However, there are discrepancies between the GDP estimates based on production and those based on expenditure. The statistical discrepancy is included in changes in inventories on the expenditure side.

The underlying data for the production approach are obtained primarily through a survey of businesses and individuals, and are supplemented by data from labor force surveys and administrative sources. The CSB believes that the basic data understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.

Government finance statistics: Fund staff is provided quarterly with monthly information on revenues and expenditures of the central and local governments and special budgets. With some limitations, the available information permits the compilation of consolidated accounts of the general government. The Government Finance Statistics database in the IMF's eLibrary website contains cash data in the GFSM 2001 format. Quarterly general government data on an accrual basis are provided through Eurostat for the International Financial Statistics on a timely basis.

Monetary statistics: The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB. The arrangement provides an efficient transmission of monetary statistics to the IMF and for publication in the IFS. Monetary statistics for Latvia published in the IFS cover data on central bank and other depository corporations (ODCs) using Euro Area wide and national residency criteria.

Financial sector surveillance: Latvia reports all 12 core and 13 encouraged financial soundness indicators (FSIs) for deposit takers on a quarterly basis. Also, 1 FSIs for non-financial corporations and 2 FSIs for real estate markets are reported on a quarterly basis.

Balance of payments: The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000. The data collection program is a mixed system, with surveys supplemented by monthly information from the international transactions reporting system (ITRS), and administrative sources. Contrary to international standards—but similar to a number of other EU countries—the BoL includes provisions for expected losses of foreign-owned banks. Between Q4 2008–Q2 2010, this treatment led to the recording of negative reinvested earnings (i.e., losses) of foreign-owned banks as negative outflows. These "inflows" in the income account of the balance of payments thus gave a positive contribution to the current account.

Data Standards and Quality: Latvia is a participant in the IMF's SDDS since November 1, 1996. A Data ROSC was published in June 2004.

Reporting to STA: The authorities are reporting data for the Fund's International Financial Statistics, Government Finance Statistics Yearbook, the Direction of Trade Statistics, and the Balance of Payments Statistics Yearbook.

Republic of Latvia: Table of Common Indicators Required for Surveillance

As of June 1, 2017

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological Soundness[8]	Data Quality – Accuracy and Reliability[9]
Exchange Rates	04/30/2017	04/30/2017	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/3/2017	04/30/2017	M	M	M		
Reserve/Base Money	03/31/2017	04/30/2017	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	03/31/2017	04/30/2017	M	M	M		
Central Bank Balance Sheet	03/31/2017	04/30/2017	M	M	M		
Consolidated Balance Sheet of the Banking System	03/31/2017	04/30/2017	M	M	M		
Interest Rates[2]	04/30/2017	03/28/2017	M	M	M		
Consumer Price Index	04/30/2017	05/15/2017	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	12/31/2016	04/21/2017	M	Q	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	12/31/2016	04/21/2017	M	Q	M		

Republic of Latvia: Table of Common Indicators Required for Surveillance (concluded)

As of June 1, 2017

Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/31/2016	04/21/2017	M	Q	M		
External Current Account Balance	3/31/2017	6/2/2017	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	04/30/2017	5/15/2017	M	M	M		
GDP/GNP	Q4 2016	04/4/2016	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q4 2016	02/22/2017	Q	Q	Q		
International Investment Position[6]	Q4 2016	03/6/2017	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

[2] Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability position vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC published in July 2004, the findings of the mission that took place during September 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.