



# REPUBLIC OF LATVIA

## 2012 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSIONS

January 2013

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 2012 Article IV Consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV Consultation and Second Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on November 27, 2012, with the officials of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 19, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Staff Statement** of January 17, 2013 updating information on recent developments.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board as expressed during its January 23, 2013 discussion of the staff report that concluded the Article IV Consultation and Second Post-Program Monitoring Discussions, and Ex-Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement with the Republic of Latvia
- **Statement by the Executive Director** for the Republic of Latvia.

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

Selected Issues Paper

Ex-Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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# REPUBLIC OF LATVIA

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSIONS

December 19, 2012

### KEY ISSUES

**Context:** Latvia intends to repay all outstanding obligations to the Fund early, using the proceeds from an international bond issue in December 2012. The economy continues to recover strongly. After contracting by 24 percent during the crisis, real GDP growth is set to exceed 5 percent for the second year in a row in 2012, despite the euro area recession. Labor market conditions are improving, underpinned by strong job creation, but unemployment is still high. Underlying inflation and the current account deficit remain low. After strong fiscal efforts, the budget deficit is set to fall to 1.7 percent of GDP in 2013, well below the Maastricht limit. The outlook is for a continued recovery, albeit at a somewhat slower pace. The authorities' objective of euro adoption in 2014 appears within reach, subject to technical uncertainties.

**Challenges:** Latvia's medium-term outlook is favorable, but risks are tilted to the downside because of the fragile external environment. High short-term external debt and weak reserve coverage ratios remain a source of vulnerability. Continued micro-economic reforms are needed to reduce high structural unemployment, preserve competitiveness and improve growth prospects within a fixed exchange rate regime.

**Staff views:** The authorities' plan to adopt the euro in 2014, subject to meeting the Maastricht criteria, remains justified on economic grounds. The 2013 budget further cements past fiscal gains, but some of its elements could have been better targeted and recent changes to social benefits should be reconsidered. Medium-term fiscal sustainability would be underpinned by expeditious passage of the Fiscal Discipline Law (FDL). Prefunding of future debt service payments remains appropriate. The rapid increase in non-resident deposits represents a source of vulnerability and warrants vigilance.

**Authorities' views:** The authorities largely concurred with staff's assessment, despite some differences on tax and benefit policies. They agreed on the importance of finalizing structural fiscal reforms, on prefunding debt repayments and on the need to reinforce bank supervision to contain risks associated with non-resident deposits.

Approved By  
**Mahmood Pradhan and  
 Elliott Harris**

Discussions were held in Riga during November 14–27, 2012. The team comprised Messrs. Aiyar (head), Castro, Gruss (all EUR) and Kangur (FAD), and Ms. Kaltani (SPR). Mr. Moore and Ms. Bukovska (Resident Representative’s Office) assisted the mission. Mr. Davidson (OED) joined the discussions. Several meetings were coordinated with visiting teams from the EC, the ECB, the World Bank, and the Swedish Ministry of Finance. The mission also briefly visited Stockholm to discuss banking sector linkages between Sweden and Latvia.

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## CONTEXT AND RECENT DEVELOPMENTS

**1. Latvia has rebounded vigorously from the crisis, after successfully undertaking a difficult adjustment program.** The defense of Latvia's peg to the euro required a sustained internal devaluation, achieved through sharp fiscal consolidation; and a restoration of competitiveness through declining unit labor costs (Box 1). These efforts were rewarded by restored external stability, resurgent economic growth, and a successful return to international capital markets. The country appears well placed to meet the Maastricht criteria for euro adoption. In December 2012 Latvia successfully issued a US dollar bond, and publicly announced its intention to repay all outstanding obligations to the Fund ahead of schedule.

### A. Strong Recovery Continued Through 2012

**2. Latvia's economic growth continues to surprise on the upside.** Following robust real GDP growth of 5½ percent in 2011, the momentum has been maintained in 2012 despite weakening conditions in trading partners. Output expanded by 5.7 percent year-on-year in the first three quarters of 2012, the fastest rate of growth in the European Union.

**3. The recovery so far has been well balanced between external and domestic demand.** Export performance has held up remarkably well given the external context, growing by 12 percent in January-September in nominal terms compared with the same period in 2011. This reflects Latvia's only partial exposure to the worst performing areas in Europe; the growing ability of Latvian exporters to access non-traditional markets; continued strong performance of major export product groups as well as entry into new, high-value-added niche products; and an extraordinary harvest in a year of high commodity prices. Private consumption and gross fixed capital formation have also expanded rapidly, on the back of pent-up demand from households and firms that postponed consumption and investment during the crisis. Higher employment and better margins for firms have helped finance this activity. Available indicators for the fourth quarter suggest that economic activity may decelerate somewhat from the strong pace of the third quarter, while nevertheless remaining strong.

**4. The labor market is improving but unemployment, especially long-term unemployment, is still high.** The unemployment rate decreased to 13.5 percent in the third quarter of 2012 from 16.2 percent on average in the first half of the year. While this rapid reduction partly reflects seasonal factors, it is underpinned by strong job creation. Employment grew by 2¾ percent (y-on-y) in the first three quarters of 2012, with the pace of improvement quickening to 3.4 percent in the third quarter. Moreover, this reduction in the unemployment rate occurred in the context of increasing participation in the labor market, which in the third quarter was almost 2 percentage points higher than a year ago. That said, the share of the long-term unemployed remains high and stable at about half of the total unemployed. Much of the unemployment is structural in nature. This is rooted in skill mismatches in the labor market and extensive informal economy including, reportedly, home production and barter networks, especially in rural areas. Staff estimates a remaining unemployment gap of about 2¾ percentage points. Real wage growth remains restrained at about 1½ percent per annum.

### Box 1. Ex-Post Evaluation of Latvia's Stand-By Arrangement: A Summary<sup>1</sup>

**Latvia's economic boom, which accelerated after EU accession in 2004, proved unsustainable.** Large private inflows fueled rapid growth, inflation accelerated, a real estate bubble developed, and a large current account deficit opened. By early 2008, growth was leveling off but vulnerabilities turned the slowdown into a crisis. Capital flows came to a sudden stop as global liquidity tightened. Uncertainty regarding the largest domestically-owned bank led to a run on its deposits and a system-wide liquidity shortage. These compounded the concerns over the sustainability of the currency peg.

**The Fund approved an SBA for Latvia on December 23, 2008** with exceptional access of 1,200 percent of quota (SDR 1.5 billion or approximately €1.7 billion) for 27 months, which was extended to 36 months. The SBA was part of an international effort co-financed and coordinated with the European Union, EBRD, the World Bank, Nordic countries, and other neighboring countries with total financing of €7.5 billion.

**The main objectives of the program were to arrest the liquidity crisis and ensure long-term external stability, while maintaining the exchange rate peg.** The program included measures to stabilize the financial sector and restore confidence, drawing on front-loaded official external support to bolster foreign exchange reserves. The program also contained measures to facilitate debt restructuring. For the medium term, the program included measures to foster real depreciation, including through income policies, and adjust fiscal policy to limit financing needs and create space to accommodate potentially large contingent financial sector liabilities. The program contained the explicit exit strategy of euro adoption.

**Immediate program objectives were met and progress was made towards longer-term objectives.**

Initial uncertainty, including regarding the authorities' commitment to program objectives, gave way to better policy implementation and a sharp improvement in financial conditions relative to program projections, particularly after the first review. The loss of reserves and drain on bank deposits were stemmed by the third quarter of 2009. Growth resumed by end-2009, earlier than expected. While the economic contraction and level of unemployment were much larger than initially projected, the turnaround in the current account was significant and rapid. Of the original €7.5 billion financing package, only €4.5 billion were drawn. But more remains to be done, as unemployment remains high and output below potential.

**The key lessons from the experience of Latvia are:**

- *Strong ownership* is critical to successful adjustment and reform. Strong ownership in Latvia was rooted in general public acceptance of difficult austerity measures.
- *An explicit and credible exit strategy*, euro adoption in Latvia's case, can help boost confidence and anchor program objectives.
- *Strong support by the international community and effective engagement by the private sector were instrumental.* Parent banks maintained their exposures in Latvia, and capitalized their subsidiaries.
- *The specific conditions prevailing in Latvia that helped internal adjustment are not easily replicable:* low initial public debt, strong ownership, a credible exit strategy, and a large upfront current account adjustment (which was mainly autonomous). Internal devaluation policies helped relative price adjustment including in the labor market.
- *Real-financial linkages play a major role in propagating shocks.* In Latvia, the underestimation of these linkages led to an underestimation of the impact of the financial crisis on real activity.
- *Flexibility in program design helped ensure that the program achieved its objectives.* Fiscal program design effectively adapted to evidence of a sharper than projected output collapse.

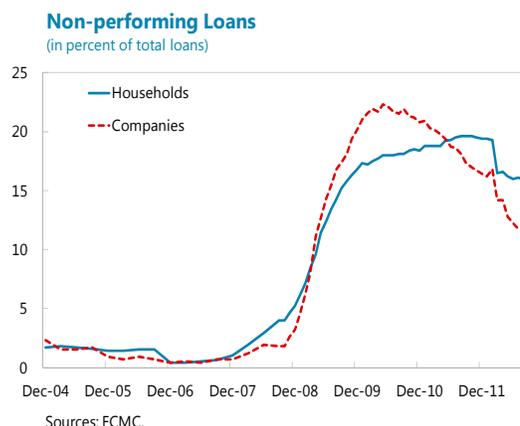
<sup>1</sup> See upcoming *Republic of Latvia: Ex-Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement*.

**5. Inflation has fallen sharply.** After peaking at about 4¾ percent (year on year) in mid-2011 owing to higher commodity prices and past indirect tax increases, consumer price inflation eased to 1.5 percent by end-November 2012, the lowest level of the last two years (Figure 2). Core inflation receded from 3¾ percent to almost zero over the same period. Energy price inflation currently stands at 5.6 percent, less than half the rate observed a year ago.

**6. Past consolidation efforts have brought the headline fiscal deficit well below the Maastricht criterion.** Following a 3.4 percent of GDP fiscal deficit (ESA 95 definition) in 2011, the original 2012 budget provided for further adjustment of 1.1 percent of GDP. Despite a mid-year cut in the statutory VAT rate by 1 percentage point, cyclical and broad based revenue over performance led to a 1.3 percent of GDP upwards revision to tax revenue. However, these gains were partially offset by the mid-year supplementary budget, which incorporated a 1 percent of GDP increase in spending on basic health care, road maintenance and pensions, as well as higher contributions to the EC budget and financing for loss-making hospitals. On balance, staff expects a headline deficit of 1.8 percent of GDP for 2012—well below the Maastricht criterion of 3 percent of GDP.

## B. Credit Conditions Are Improving Gradually

**7. The banking system is recovering.** Banks returned to profitability in 2011 and the average return on equity was around 10 percent in the first 9 months of 2012 (Figure 5). The share of non-performing loans (NPLs) has been decreasing steadily from its mid-2010 peak of about 19½ percent and now stands at 12½ percent. Loan loss provisions are more than ¾ of NPLs. The improvement in the corporate loan portfolio has been more marked than the household loan portfolio, partly because the latter was particularly hard hit by the collapse of the housing bubble (over three-fourths of household loans comprise mortgage lending). The share of NPLs is now about 11 percent for corporate loans but 16 percent for household loans. The system-wide capital adequacy ratio now stands at 17.4 percent, well above the 8 percent regulatory minimum.



**8. Credit to residents is still contracting but will likely level off soon.** The balance sheet of the banking system has shrunk substantially from its pre-crisis peak. Since end-2008 total assets of the banking sector have decreased by about L3½ billion (15 percent). The nominal stock of loans to residents is about 30 percent lower. The stock of credit outstanding is still decreasing as some borrowers, especially households, continue to deleverage. The still negative credit growth also reflects the ongoing process of dealing with insolvent loans (write-offs) and banks (Parex Bank and Latvijas Krajbanka were removed from the credit statistics in March and May respectively). Excluding these effects, loans to residents contracted by 2 percent year-on-year by end September, a

leveling-off from the 6 percent rate of contraction at end-2011. Meanwhile, new credit is increasing, especially to the corporate sector. The volume of new loans to residents granted in the first three quarters of 2012 was 28 percent higher than in the same period in 2011, and less than 18 percent of these new loans were to households.

**9. Deleveraging by foreign-owned banks has been large over recent years.** Subsidiaries of foreign banks in Latvia have reduced their liabilities to parent banks by about L3.5 billion since end-2008; of this, L3.2 billion correspond to deleveraging by Nordic banks (Figure 7). With stable or increasing deposits over the same period, the loan-to-deposit ratio (LTD) of subsidiaries of foreign banks has dropped significantly from almost 260 percent to 176 percent. The pace of deleveraging is still strong. Liabilities to parent banks decreased by 26 percent from end-2010 to end-2011, and by roughly the same rate in the first three quarters of 2012. However the rate of deleveraging by Latvian subsidiaries is expected to slow down in the coming quarters, given that the loan portfolio of these banks has stabilized, resident deposits are growing modestly and outstanding liabilities to foreign parent banks have declined to about 40 percent of their peak-levels. The recent pace of deleveraging seems to be driven mainly by the ongoing deleveraging of households and weak credit demand by firms, rather than funding constraints from abroad. That said, tighter lending standards applied by the subsidiaries themselves might be playing a non-negligible role.

**10. Non-resident deposits (NRDs) in the banking system have been expanding rapidly** (Appendix I). NRDs in Latvia increased by 19.7 percent in the year to end-September (15.7 percent if exchange rate effects are excluded), while resident private deposits have grown by only 1.3 percent over the same period. While NRDs have been historically high in Latvia, they now exceed deposits of private residents in the banking sector. The recent acceleration is believed to be mainly due to CIS depositors relocating their funds from countries with banks under stress in the euro area. The rise in NRDs has been associated with a strong accumulation of foreign assets, mostly liquid assets such as government securities and claims on MFIs.

**11. The financial regulator (FCMC) found significant undercapitalization in a mid-size bank specializing in non-resident clients.** Negotiations are ongoing with a strategic private investor who has already contributed to an injection of L8.2 million in fresh capital.

## OUTLOOK AND RISKS

### 12. Under staff's baseline scenario, economic activity will ease in 2013, but remain strong by regional standards.

- **Export growth**, while remaining strong, will decline as the pace of gains from exploiting new markets diminishes and economic activity in the euro area remains weak, resulting in a modest widening of the current account deficit. The boost to domestic demand associated with postponed investment and consumption is projected to diminish gradually. Overall, **output growth** is expected to slow down somewhat in the first half of 2013 before accelerating again in the second half as conditions in trading partners improve. With the phasing out of base effects that kept growth in 2012 above 5 percent, staff projects growth to decline to about 3¾ percent in 2013.
- **Credit to the private sector is projected to resume gradually.** In the aftermath of the crisis productivity growth continued to outstrip wage growth, allowing firms to finance investment from cash balances. But going forward the gap between productivity and wages is expected to shrink, and companies will increasingly turn to the banking system for credit. Nonetheless, credit growth will remain somewhat constrained by the weak equity position of companies on average and tighter lending standards than before the crisis. Credit to households will probably keep shrinking for some time as real estate prices are expected to remain low given the excess housing supply after the boom.
- **Employment is projected to grow somewhat more slowly over the next few quarters as the economy approaches its natural rate of unemployment.** Employment growth averaging 1.4 percent is expected in 2013, down from 2.5 percent in 2012. The level of unemployment is expected to decrease to about 13.7 percent in 2013—still above staff estimates of the natural unemployment rate of around 12 percent.
- **Inflation has probably bottomed but is nevertheless expected to remain contained given a still-negative output gap and high unemployment.** Staff projects modest average consumer price growth of 2.2 percent in 2013.

### 13. Over the medium term economic growth should converge to around 4 percent. The baseline assumes that Latvia adopts the euro in 2014, in line with the authorities' target.

- **The output gap** is expected to close by 2015–16 (see Selected Issues Paper on estimating potential output). Real GDP growth is projected at about 4.2 percent in 2014–15, based on a catch-up in business investment, continued recovery of consumption—fueled by an increase in disposable income due to cumulative improvements in labor market conditions and planned reductions in the personal income tax (PIT) rate over 2013–15—and a gradual increase in exports as global external conditions improve. After the effect of the tax cuts fades away, output growth is expected to average 4 percent per year from 2016 onwards, as projected productivity improvements are partially offset by a stagnant labor force given

demographic trends (Appendix II). **Inflation** should level off at about 2–2½ percent, reflecting low projected imported inflation. Higher growth than in trading partners, as well as the closing output gap, will lead to a modest widening of the **current account** deficit to about 3½ percent of GDP deficit in the medium term. This is expected to be financed by a gradual reduction in the pace of deleveraging by foreign banks, and a conservative pickup in FDI.

**14. Risks are skewed to the downside.** Adverse developments in the euro area could raise Latvia’s borrowing costs and slow the recovery (text table). Moreover, Latvia’s high external debt represents a significant vulnerability. According to the external DSA, shock to the baselines for growth and/or the current account could substantially delay a reduction of the debt burden. That said, Latvia does have upside potential if it can attract stronger than expected additional foreign direct investment and create more jobs more quickly; full implementation of a strong microeconomic reform agenda would make this favorable scenario more likely.

**Latvia: Risk Assessment Matrix<sup>1</sup>**

<b>Risk</b>	<b>Relative Likelihood</b>	<b>Impact if Realized</b>
<b>1. Strong intensification of the euro area crisis.</b>	<b>Medium</b> Several possible triggers at the European sovereign or area-wide levels. Financial stresses could escalate as bank-sovereign-real economy links re-intensify.	<b>High</b> Uncertainty could raise borrowing costs in the face of substantial external repayment obligations. Nordic parent banks could deleverage more quickly (see risk 3 below).
<b>2. Protracted period of slow European growth.</b>	<b>Medium</b> The damage to potential output from the financial crisis may be deeper than expected; or deleveraging may have a more severe impact on real activity.	<b>Medium</b> Spillovers may be mitigated if Russia and Sweden are less affected by euro area weakness.
<b>3. Renewed bank deleveraging and/or non-resident deposit (NRD) flight.</b>	<b>Medium</b> Nordic parents seem healthy, but NRD activities of domestic banks are more susceptible to quick reversals.	<b>Medium</b> Pressure on international reserves if NRD reversals cannot be covered by banks’ own foreign assets, or have contagion effects on domestic deposits.
<b>4. Global oil price shock.</b>	<b>Low</b> Geopolitical tensions in the Middle East could trigger an oil price shock; but weak global demand could cause prices to soften instead.	<b>Low</b> Risk to meeting Maastricht inflation criterion is mitigated by the backward-looking nature of the criterion.

<sup>1</sup> The RAM shows relatively low probability events that could materially alter the baseline discussed in this report. The relative likelihood of risks listed is the staff’s subjective assessment of risks surrounding this baseline.

## POLICY DISCUSSIONS

**15. Discussions centered on prospects for euro adoption; policies to address financial sector and external vulnerabilities; ensuring fiscal sustainability over the medium term while protecting the social safety net; and structural reforms to enhance competitiveness.**

### A. The Path to Euro Adoption

**16. The authorities are strongly committed to euro adoption in 2014—the “exit strategy” of the 2008-11 IMF-supported program.** They intend to request EC and ECB assessments of Latvia’s convergence, to be prepared in spring 2013. Pending euro adoption, Latvia will maintain its long-standing peg to the euro, and participation in ERM-2. The authorities are not open to alternative exchange rate regimes: they chose to maintain the peg through 2008–09 despite severe external pressures, relying instead on wage and price adjustment.

**17. Despite the euro area crisis, staff continues to believe that given the peg Latvia is better off inside than outside the euro.** Euro adoption would:

- Eliminate the risk of speculative attacks against Latvia’s exchange rate. This would benefit the wider EU as well as Latvia: contagion risks from Latvia to other CEE pegged exchange rate countries were a major concern in 2008–09.
- Address vulnerabilities stemming from foreign currency exposures; the financial system is already very highly euroized.
- Reduce sovereign borrowing costs in a durable way by removing exchange rate premia. Of course, joining the euro would not eliminate sovereign risk, as evidenced by the heterogeneity of spreads within the currency union.
- Further enhance financial sector stability by giving Latvian banks access to the ECB, which has greater capacity to provide emergency liquidity.

**18. Latvia appears on track to meet all the Maastricht criteria, subject to uncertainties on two criteria—inflation and interest rates—whose reference values are not yet determined.** Based on the fiscal outturn so far in 2012, the Maastricht criteria on the fiscal deficit and public debt should be met comfortably (Figure 8). Prospects for meeting the inflation and interest rates are more uncertain, since these criteria depend on the EU institutions’ determination of the countries to be used for the reference value calculation. The current level of inflation is below the Maastricht reference value and should remain under the projected reference rate at the time of the EC and ECB’s assessments of Latvian convergence.<sup>2</sup> Latvia’s harmonized long-term interest rate is on a downward path and fell to 3½ percent in October, suggesting that prospects for meeting this

<sup>2</sup> Based on IMF staff projections of the 3 EU countries with the lowest twelve month inflation rate in March 2013.

criterion in early 2013 are also good. However, the reference values for these criteria depend not only on price and interest rate developments in other EU countries, but also on the treatment of outlier countries for the reference value calculations, which makes the outcome particularly uncertain.<sup>3</sup> The authorities expressed concern that under plausible scenarios Latvia's interest rate could be compared with that of only one or two countries with abnormally low interest rates due to their safe-haven status (for example Sweden or Germany). During the mission, representatives from the EC and the ECB assured the authorities that the criteria would be applied fairly, based on economic judgment.

## B. International Reserves

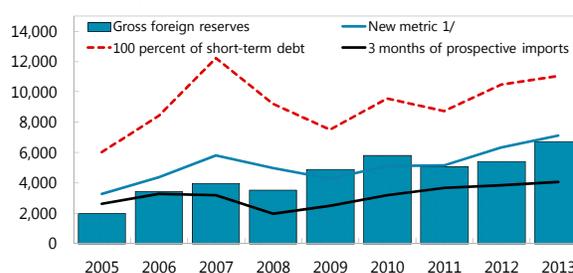
**19. Gross foreign reserves are low according to reserve adequacy metrics that focus on short-term debt, although there are mitigating factors.** In order to repay its public external obligations over the next three years without further eroding reserve adequacy indicators, the public sector needs to borrow €3 billion (about 14 percent of 2012 GDP) during 2013–15 in international markets. Repayments to the European Commission (€2.2 billion) are due in 2014–15, with additional repayments

scheduled in 2014 related to Eurobond debt. The projected reserve level of €5.4 billion at end-2012 is above the standard rule-of-thumb of three months' import cover. However the level of external short-term debt is a concern: the maturity profile of external debt is shortening as some banks receive short-term NRDs while others repay long-term loans to parent banks (deleveraging). Measures of reserve adequacy that account for Latvia's large short-term external debt are low, primarily because of the denominator effect from large NRD deposits. Reserves as a share of short-term external debt are projected at about 50 percent in 2012. Given Latvia's own 2008 experience whereby 40 percent of international reserves dissipated due to a substantial fall in NRDs, a prudent and vigilant stance is needed.

**20. Latvia plans to use the proceeds from a recent bond issue to prepay the Fund in full.**

In December 2012 Latvia issued an international US dollar bond that raised \$1.25 billion at a low yield of 2.9 percent, following ratings upgrades from Fitch and S&P. The authorities have announced that part of the proceeds will be used to repay outstanding obligations to the Fund of about SDR 603 million.<sup>4</sup> This early repayment would bring to a conclusion the Post-Program

**Latvia: Reserve Adequacy**  
(Millions of euros)



Sources: National authorities; and IMF staff estimates and projections.  
1/ The new metric of reserve adequacy depicted in the chart is constructed based on the empirically observed relative riskiness of different potential drains on reserves and the amount of liquid reserve assets that should be held against each of these risk factors. See IMF (2011) "Assessing Reserve Adequacy", IMF Policy Paper, Washington, DC.

<sup>3</sup> See IMF Country Report No. 12/171 (Latvia Staff Report for the 1<sup>st</sup> PPM) for a more detailed discussion of how reference values have been calculated historically.

<sup>4</sup> The repayment is expected to occur in December 2012, after this Staff Report is issued. All tables and charts incorporate this repayment.

Monitoring. Staff welcomed both the bond issue and the intention to repurchase Fund obligations, since the measures lock in current favorable yields and extend the maturity structure of external debt, thereby helping mitigate concerns about reserve cover.

## C. Banking Sector Vulnerabilities

**21. The rapid rise in non-resident deposits in the banking system is a potential source of vulnerability, with possible implications for Latvia's liquidity position and reputation** (Appendix I).

- Given their short maturity and higher volatility, NRDs are particularly prone to sudden reversals. This became apparent during the financial crisis, when NRDs fell by 30 percent in the 12 months following August 2008. Given the size of the sector, a sudden reversal of NRD flows, and the potential of contagion to resident deposits (largely denominated in foreign currency), represents a source of vulnerability to international reserves and a significant contingent fiscal liability (via sovereign backing for the deposit insurance system). Although banks specializing in non-resident clients allocate a significant share of their portfolio to liquid foreign assets, the quality and availability of some of these are harder to verify than for domestic assets (for example, the insolvency of Latvijas Krajbanka in November 2011 was triggered by the discovery that €140 million of assets in correspondent accounts were actually encumbered). The authorities recognize the higher risk of NRDs as a funding source and the potential of contagion to domestic depositors in the event of severe outflows. But they believe the risk to international reserves is small given the accumulation of liquid foreign assets by banks experiencing rapid growth in NRD deposits.
- The higher reputational risk associated with non-resident activity represents an additional source of vulnerability. Staff, the authorities and banks' managers agree that it is significantly more difficult to ensure compliance with AML/CFT regulation when dealing with non-resident clients, and that an incident in an individual institution could spill over to the reputation of the whole banking system. Staff welcomed the amelioration of previous deficiencies in AML/CFT regulation, particularly on prevention—as recently reported in the Council of Europe MONEYVAL report—but stressed the need for risk-based, comprehensive, and frequent supervision.

**22. The FCMC has appropriately adopted regulatory measures to reflect the higher risks associated with non-resident activities, and the implementation of Basel III regulation should maintain this approach.**

- Since mid-2011 the FCMC has required banks that hold either non-resident loans of over 5 percent of total assets or non-resident deposits of over 20 percent of total assets to hold additional capital. The extra capital requirement ranges from 0.5 to 9 percent of risk weighted assets, and depends on both the level and growth rate of the exposure to non-resident business. The authorities plan to keep higher capital requirements for non-resident

banking when adopting Basel III regulation—either within Pillar II or by applying a capital add-on to address systemic risk within Pillar I.

- Staff and the authorities agreed that the parameterization of the Liquidity Coverage Ratio (LCR) in the context Basel III implementation should ensure that NRDs are backed by more liquid assets than other deposits. The FCMC will start monitoring the new liquidity ratios from January 2013 and plans to deviate from the baseline specification as needed, in particular by applying higher run-off factors for NRDs.
- Given the large contingent fiscal liability associated with NRDs (45 percent of insured deposits comprise NRDs), staff discussed with the authorities the possibility of charging NRDs a higher contribution to the Deposit Guarantee Fund (DGF), consistent with the risk-based pricing of insurance schemes. The authorities argued that the *effective* premium charged is indeed higher for NRDs: their average size—and hence average DGF contribution—is significantly higher than for resident deposits, but the insured amount is restricted to 100,000 euros in both cases.

**23. Staff welcomed recent steps by the authorities to strengthen the supervision of banking activities with non-resident clients.** The FCMC has amended its off-site and on-site inspection framework to ensure a deeper focus on the dynamics and quality of banks' non-resident assets. Other measures include the more active use of the Pillar II framework to establish minimum requirements for maturity mismatches between assets and liabilities; and requiring banks to do periodic liquidity stress-tests based on FCMC prescribed scenarios.

**24. Progress had been made in restructuring the banking sector (Box 2).** Staff urged that the disposal of legacy assets proceed expeditiously, subject to the goal of obtaining value for taxpayers. Staff recommended that the authorities request a new FSAP to take stock of the transformation in the financial sector since the previous, pre-crisis FSAP. The authorities welcomed the suggestion and will consider undertaking an FSAP sometime in 2014.

## D. Fiscal Sustainability

**25. The 2013 budget further cements past fiscal gains.** Staff project that, taking account of a 2 percentage point redirection of state social contributions to the second pillar, the budget would achieve a structural improvement of 0.5 percent of GDP, thus complying with both the Maastricht criteria as well as Stability and Growth Pact (SGP) conditions. In addition to the one percentage point PIT cut already legislated for 2013, the budget increases tax allowances for dependents, and extends the range of tax rates on residential property from 0.2 to 1.5 percent while extending more flexibility to local governments in setting these rates. Additional priority spending is well allocated, aiming to reduce bottlenecks in health care, reform lower-end teachers' salaries and support demographics (see Appendix II). The budget incorporates a recent agreement between the central and local governments on lowering the maximum level of the Guaranteed Minimum Income (GMI) while decentralizing its financing, against IMF, World Bank and EC advice.

### Box 2. Completing the Restructuring of the Banking Sector

**The sale of the commercial part of Mortgage and Land Bank (MLB) is close to completion.** The sale of assets accounting for almost 60 percent of MLB's commercial activities by book value has been completed. The sale of the remaining commercial assets, comprising loans to real estate corporates and non-performing loans, is planned by 2013Q1, but the government has not excluded transferring these assets to the Latvian Privatization Agency if the price offers are deemed unsatisfactory. Staff agreed with the authorities that obtaining value for taxpayers is an important objective, while reiterating that the process should continue as expeditiously as possible.

**The authorities are making progress on the strategy to create a single development institution (SDI).**

The strategy envisages the merger of MLB's non-commercial part with other development institutions (the Latvian Guarantee Agency, Latvian Environmental Investment Fund and the Rural Development Fund) to form the SDI. A discussion on whether the Ministry of Finance or the Ministry of Economy should be the shareholder of the SDI is currently delaying further progress. Staff urged that the process be expedited, and that the SDI operate without a banking license to ensure that it does not enter into commercial activities in the future.

**The sales process for Citadele has been postponed due to weak market conditions, and the authorities are now planning to modify the restructuring plan.** Under new management, the bank has restructured its operations and increased its profitability. But the prospects of attracting an investor have been limited by the moribund global M&A market. The government intends to propose a new restructuring plan to the European Commission aimed at facilitating the sale process and maximizing the recovery for taxpayers. Its main elements are: i) postponing the original commitment date to sell the wealth management business, so that it can be sold together with the rest of the bank, thereby preserving the overall attractiveness of the bank; and ii) allowing partial sales of the State stake in Citadele to attract smaller investors.

**Progress has been made in recovering assets from Latvijas Krajbanka.** Krajbanka's administrator KPMG has already sold assets and repaid about L90 million to the deposit guarantee fund (DGF). The sale of the loan portfolio, with a book value of about L160 million, is underway. Final offers for loans grouped in five bundles will be received by end-January and the authorities expect the sales process to be concluded by the first quarter of 2013. While the progress to date is encouraging, asset sales will nevertheless be insufficient to fully compensate payments to depositors by the DGF, of about L340 million. Staff concurred with the authorities that legal action should be pursued to recover other missing assets in correspondent accounts (amounting to about L130 million).

**As the DGF was depleted after Krajbanka's failure, staff discussed plans to replenish the fund with the FCMC.** Deposit insurance premia have been raised by 50 percent. A proposal to extend the period of increased contributions is being considered; under current legislation higher contributions can only be charged for one year after the DGF covers deposits.

**26. Staff expressed broad support for the budget, while urging reconsideration of changes to the GMI benefit.** Social exclusion benefits in Latvia are already among the lowest in Europe, and should not be cut further. Moreover, there is a danger that under the decentralized scheme some income-constrained local governments will be unable to provide even the reduced benefit levels in full, and over time this could cause regional disparities in provision. Staff recommended instead that a broader reform of social assistance programs and benefits be undertaken following the recommendations of a World Bank study due in Spring 2013. The authorities were more sanguine about the ability of local governments to fund the decentralized GMI, but indicated that they may revisit the subject when the World Bank study is completed.

**27. Over the medium term, staff and the authorities agreed on the need to take advantage of the ongoing recovery to continue building fiscal space.** Fiscal policy will need to contend with several headwinds, including: preapproved personal income tax (PIT) cuts, which total 5 percentage points over 2013–15; restored indexation of paid-out pensions as of 2014; a gradual reduction in SOEs payout ratios from the current 90 percent level; second-pillar pension contributions, which are further increased over 2015–16 until they reach 6 percent; and increasing social insurance benefits for high-earners while restoring the ceiling on social contributions. Compensatory measures will be needed to ensure continued reduction in the structural fiscal balances in line with the Stability and Growth Pact (SGP).

**28. Staff urged reconsideration of the planned PIT cuts, at least from 2014 onwards.** The large cumulative size of the proposed cuts implies an excessive loss of fiscal space and a correspondingly greater need for compensatory measures. While some reduction in the tax wedge on labor would be desirable, untargeted cuts in the statutory PIT rate are not first-best from an efficiency or equity perspective: better options would be to introduce a two-tier PIT system<sup>5</sup>; to increase the minimum non-taxable allowance; and/or, in conjunction with the social assistance reform, to introduce an earned income tax credit program. The authorities however regard the tax cuts as an essential component of improving work incentives and addressing the informal economy, and prefer to focus on other measures to ensure fiscal sustainability.

**29. A broad range of revenue and expenditure reforms would help in building fiscal space while protecting the most vulnerable sections of society.**

- *Revenue:* A reform of the cadastre of properties to facilitate corrections and ensure fair and consistent valuations across regions should be followed by an increase in the lower bound for tax rates on property, while ensuring progressivity to protect the poorest. Reducing tax exemptions for dependents in conjunction with reforming state family benefits would increase progressivity of the family support programs. Other revenue reform options include reducing the tax allowance for pensions, eliminating exemptions on indirect taxes

<sup>5</sup> For example, in line with previous FAD technical advice, a two tier system could consist of two rates: 25 percent (the current rate in 2012), and 15 percent for lower income taxpayers. The threshold income could be chosen such that the measure is revenue enhancing compared to the current plan of an across the board cut.

such as the diesel exemption for farmers and increasing the revenue from environmental taxes to correct for negative externalities.

- *Expenditure:* Spending reforms should focus on improving the economic incentives stemming from public spending programs. Public transport subsidies could be reduced while designing a well-targeted cash transfer to compensate the poor for price increases. Family and child benefits, and non-contributory supplemental pensions, should be better targeted to ensure equality both within and across cohorts. Reducing the duration of parental, maternity and paternity benefits, while supporting child care could yield further savings while improving labor market efficiency. Without committing to reforms in any specific area, the authorities acknowledged the need to consider a broad range of possible measures.

**30. A series of structural fiscal reforms is in the pipeline.** The Law on Budget and Financial Management sets binding ceilings on central government spending for 3 years, which were approved together with the 2013 budget. Passing the Fiscal Discipline Law (FDL) and related constitutional amendments should now be given the highest priority. These would enhance fiscal sustainability going forward by avoiding pro-cyclical fiscal policies and ensuring the consistency of expenditure ceilings with both structural balance and expenditure growth rules. The authorities indicated that the FDL is pending in parliament and could be passed as early as January 2013. The authorities also pointed to progress in other structural areas, such as recent measures by the State Revenue Service (SRS) to terminate fictitious companies and restrict the activities of persons involved; to limit cash transactions; and to eliminate transactions designed to avoid income tax. Moreover, the SRS has embarked on a medium-term strategy to increase audit coverage.

## E. Structural Reforms to Enhance Competitiveness

**31. Latvia's competitiveness has been improving steadily.** Staff assess that the exchange rate is now broadly in line with fundamentals (Box 3). Latvia continues to gain market share in world imports—increasing its presence in established markets, but also penetrating new ones—helped by the continuing depreciation of the REER. Nonetheless, staff calculations—albeit subject to a wide range of uncertainty—suggest a modest remaining competitiveness gap of about 4.6 percent, which would need to be addressed through structural policies. The authorities concurred with staff on the need for continuing micro-economic reforms to bring down the stubbornly high rate of structural unemployment and enhance competitiveness within the fixed exchange rate regime.

**32. While Latvia's labor market demonstrated remarkable flexibility during the crisis, there remains scope to promote work incentives.** Several fiscal reforms should be considered from this perspective. The guaranteed minimum income (GMI) benefit—which currently phases out one-for-one with income—places a very high tax wedge for GMI recipients entering employment. Consideration should be given to reducing the benefit more gradually with rising income levels. Staff further urged shifting active labor market policies towards in-work tax credits and benefits, as these have proven to be effective in increasing employment of lower skilled workers. Reducing the

duration of family benefits while enhancing formal child care would also support labor force participation.

**33. The authorities have developed plans in a number of bottleneck areas:**

- **Judicial reform:** The authorities are seeking to address delays in the civil court system. Logistical measures include videoconferencing to speed up witness testimony, and publication of anonymized court decisions to promote transparency. Staff welcomed these and other measures to promote judicial efficiency. Meanwhile, measures to curb abuses of the insolvency framework remain under discussion. Staff urged retention of the single “cash-flow” test for insolvency—an international best practice introduced in the 2010 reform of the law (with LEG technical assistance)—but supported efforts to improve implementation.
- **State-owned enterprises (SOEs):** In May 2012, the government conceptually approved the introduction of a new, partially centralized institution to oversee SOE governance and enhance their financial reporting. But agreement on the necessary legislation remains pending. Meanwhile, a technical-level working group is reviewing each SOE to consider its future status.
- **Higher and vocational education:** The authorities acknowledge that the quality of higher education is lagging behind neighboring countries, with very limited resources being thinly spread over a large number of institutions, and student numbers falling. And vocational study programs have become increasingly misaligned with labor market needs. However, proposals to concentrate resources according to course quality in higher education are encountering strong stakeholder resistance.

### Box 3. Latvia: External Stability Assessment

**Application of the CGER methodology suggests that the real exchange rate is broadly in line with fundamentals**, with estimates varying depending on the approach used:

- **The Macroeconomic Balance (MB) and the External Sustainability (ES) approaches suggest a real exchange rate close to equilibrium—the deviation ranges between 0 and -2.1 percent respectively.** The MB results are premised on staff's baseline assumption of closing the output gap by 2017; a slower speed of recovery could imply greater real overvaluation. The ES estimate, in addition to being sensitive to the output gap assumption, hinges also on the level at which the NFA-to-GDP ratio is stabilized, which in the current analysis is fixed at the previous year's value. Stabilizing the NFA-to-GDP ratio at a smaller ratio would imply less real undervaluation.
- **A third methodology, the equilibrium real exchange rate approach (ERER), suggests an overvaluation of around 15 percent.** However, this estimate is extremely sensitive to the sample period—changing the sample period or selecting an ad hoc equilibrium year for the REER can swing the misalignment estimate by over 10 percent.

#### Latvia: Real Exchange Rate Assessment Using CGER Methodology

Approach	Estimated misalignment 1/ (in percent)
External sustainability	-2.1
Macroeconomic balance	0
Equilibrium exchange rate	15.8
<b>Average</b>	<b>4.6</b>

Source: Fund staff estimates.

1/ Positive (negative) numbers indicate over- (under-) valuation.

**The results remain subject to high levels of uncertainty.** The Latvian economy has experienced profound structural changes, and in the current account balance has been characterized by extreme volatility: peaking at a deficit above 20 percent of GDP in 2007, swinging to a surplus of nearly 9 percent of GDP in 2009, and then stabilizing at a small deficit in 2011–12.

**Alternative measures of competitiveness point to significant improvements:**

**The REER depreciated dramatically during the crisis and has continued to do so although at a slower pace.** By the second quarter of 2012 the ULC-based REER had depreciated by over 9 percent since end-2009. The PPI- and CPI-based REERs depreciated by over 6 percent to July and September 2012, respectively.

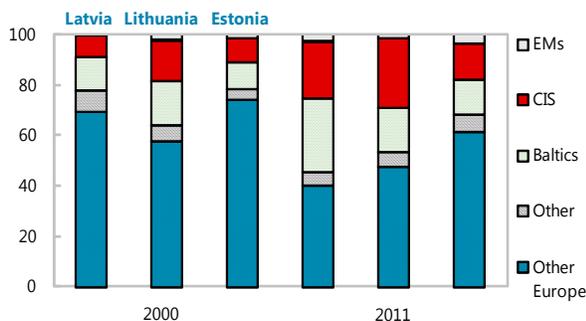
**Box 3. Latvia: External Stability Assessment (concluded)**

**Recent rapid export growth in Latvia represents not just strong performance in traditional areas, but encouragingly, increasing diversification into new products and markets.**

- Latvia’s improved export competitiveness was largely determined by the intensive margin. Bank of Latvia research indicates that while export market shares nearly doubled over a ten year period, this was mainly driven by Latvia’s producers increasing their presence in already conquered markets.

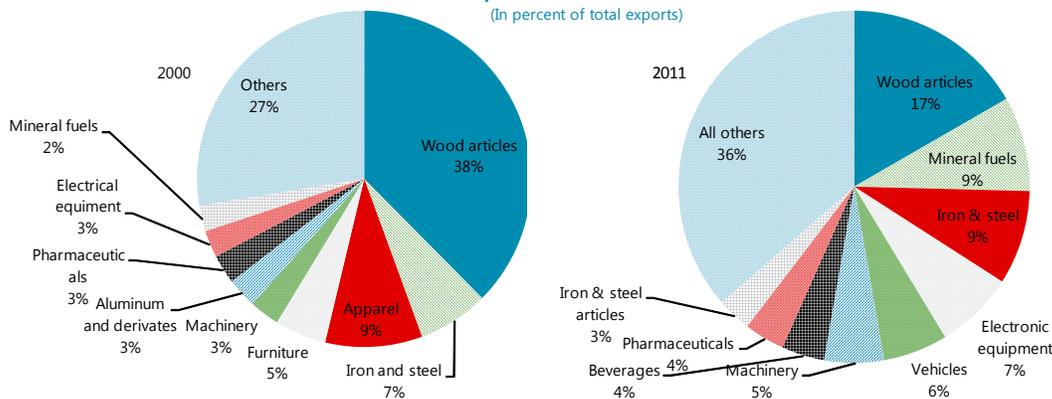
- Nevertheless, the extensive margin also increased as exporters expanded into new markets and products. Relative to a decade ago Latvia’s exports have diversified away from the wood and apparel sectors and into new, likely higher value added, sectors, including electrical equipment and machinery. Other sectors (i.e. sectors not ranking in the top ten for exports) have increased as a share of total exports, pointing to the emergence of small niche products, as also suggested by various government and private sector representatives. Relative to its Baltic neighbors, Latvia’s export share to traditional European markets has fallen more dramatically in the last decade, while exports to faster-growing CIS countries as well as major emerging markets are on the rise.

**Export Market Shares for Baltic Countries**  
(In percent of total exports)



Source: Direction of Trade Statistics.

**Export Product Diversification**  
(In percent of total exports)



Source: UN Comtrade.

**All the above results suggest an improvement in Latvia’s competitive position over the past two years, but with further structural reforms still needed.** During the 2010 Article IV consultation, staff had estimated the competitiveness gap at about 10 percent (based on end-2009 data). This update suggests a partial closing of the gap, consistent with continued depreciation of the REER (in CPI, PPI and ULC terms), and greater market and product diversification of the export base since that time.

## STAFF APPRAISAL

**34. Latvia's economy has been recovering strongly.** Economic growth is expected to exceed 5 percent in 2012 despite recession in the euro area. Inflation has fallen sharply, in the context of a still negative output gap. The unemployment rate is declining despite an increasing labor participation rate. But the level of unemployment—most of which is structural in nature—remains unacceptably high.

**35. Economic growth is expected to weaken slightly in 2013, before picking up in the medium term.** Credit to the private sector is projected to resume gradually, with lending to businesses picking up earlier than lending to households. The output gap is expected to close by 2015–16, with inflation leveling off at about 2–2½ percent. The current account deficit should widen modestly while remaining well within sustainable bounds. But risks are skewed to the downside. In particular, adverse developments in the euro area could derail the recovery and raise Latvia's borrowing costs.

**36. Euro adoption in 2014 appears within reach, subject to some technical uncertainties.** On the basis of fiscal outturns so far this year and the 2013 budget approved by parliament, the general government deficit and debt for 2012–13 would be below their respective Maastricht reference values. Inflation and interest rates have declined to low levels, although the reference values for these criteria are yet to be determined by the European institutions. On balance, euro adoption continues to make economic sense for Latvia. It would remove residual currency risk and, by addressing vulnerabilities stemming from foreign-currency exposures, enhance the stability of the already very highly euroized financial system.

**37. With the 2012 budget deficit coming in at under 2 percent of GDP, the 2013 budget further cements fiscal gains.** It should be consistent with both the Maastricht deficit criterion and the Stability and Growth Pact. Additional priority spending is well distributed, addressing some of the bottlenecks in health and reforming lower end teachers' salaries. However, the cuts to and decentralization of the guaranteed minimum benefit could adversely affect the most vulnerable segment of society. This measure should be reconsidered—and on the basis of the forthcoming World Bank study—replaced with benefit reforms consistent with both improving incentives to work and ensuring adequate safety net coverage.

**38. The authorities should take advantage of the ongoing recovery to continue building fiscal space over the medium term.** Large planned cumulative cuts in the PIT rate should be reconsidered: better options could include a two-tier system or an increase in the minimum non-taxable allowance. Compensatory measures will be needed to maintain the fiscal momentum in the face of this and other headwinds (such as restored indexation of pensions, partial restoration of second pillar pension contributions and the lowering of required dividend ratios for SOEs).

**39. The rapid increase of non-resident deposits (NRDs) in the banking system warrants vigilance.** While the expansion of NRDs is associated with an accumulation of foreign assets, the increasing size of the sector represents a source of vulnerability to international reserves and—

given sovereign backing for the deposit guarantee scheme—a significant contingent fiscal liability. The FCMC’s current and planned prudential measures to guard against such risks are welcome. The supervision of NRD-specialized banks should be sufficiently intensive and frequent.

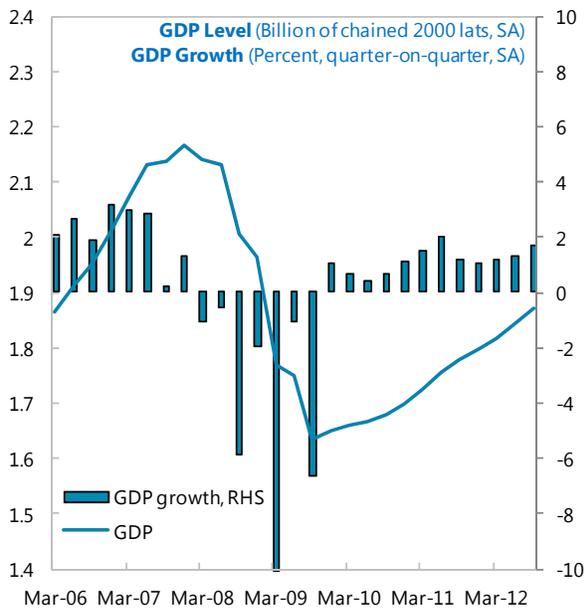
**40. Gross reserves are low in relation to short-term external debt.** The maturity profile of external debt is shortening as some banks receive short-term NRDs while others repay long-term loans to parent banks (deleveraging). In this context, the recent successful international bond issue—part of which will be used to prepay outstanding obligations to the Fund—is welcome. It extends the maturity profile of external debt while locking in current favorable yields.

**41. Maintaining the momentum on structural reforms will help underpin Latvia’s medium-term fiscal sustainability, competitiveness, and growth prospects.** In the fiscal area, the Fiscal Discipline Law would reduce the risks of pro-cyclical policy from re-emerging in the future. Other high priorities areas include reforms to the judicial system, to address court system delays and curb abuses of the insolvency framework; the governance structure and transparency of SOEs; and the quality of higher and vocational education. Timely implementation of planned reforms would result in a significantly better business environment, in turn improving prospects for sustainably higher investment, employment, and living standards.

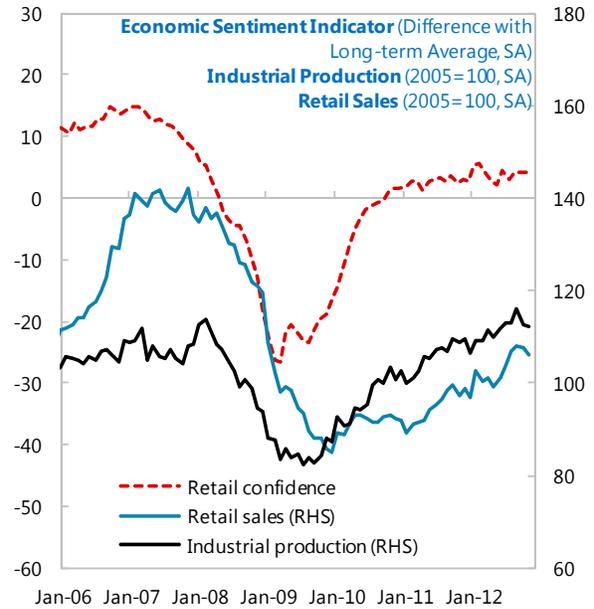
**42. Staff recommends that the next Article IV consultation be held on the standard 12-month cycle.**

**Figure 1. Latvia; Real Sector, 2006–12**

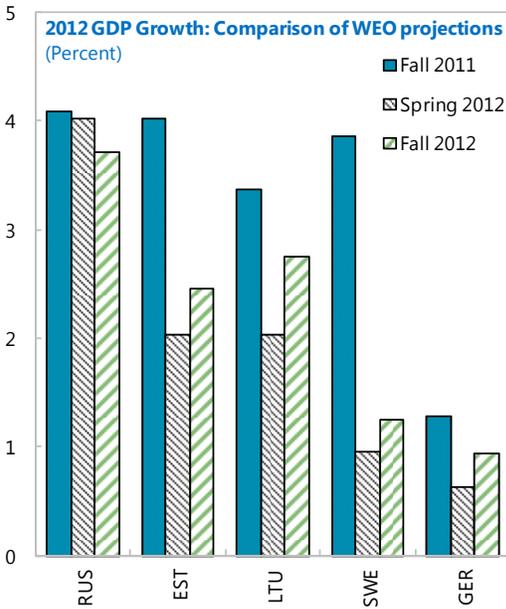
Growth remained robust in 2012



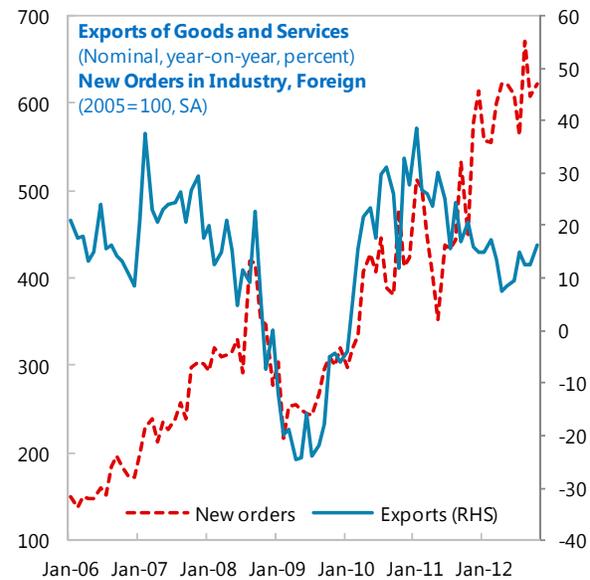
Production and retail sales are still growing at rapidly, while consumer confidence remains strong.



Despite the euro area crisis, growth prospects are relatively good in Latvia's main trading partners ...

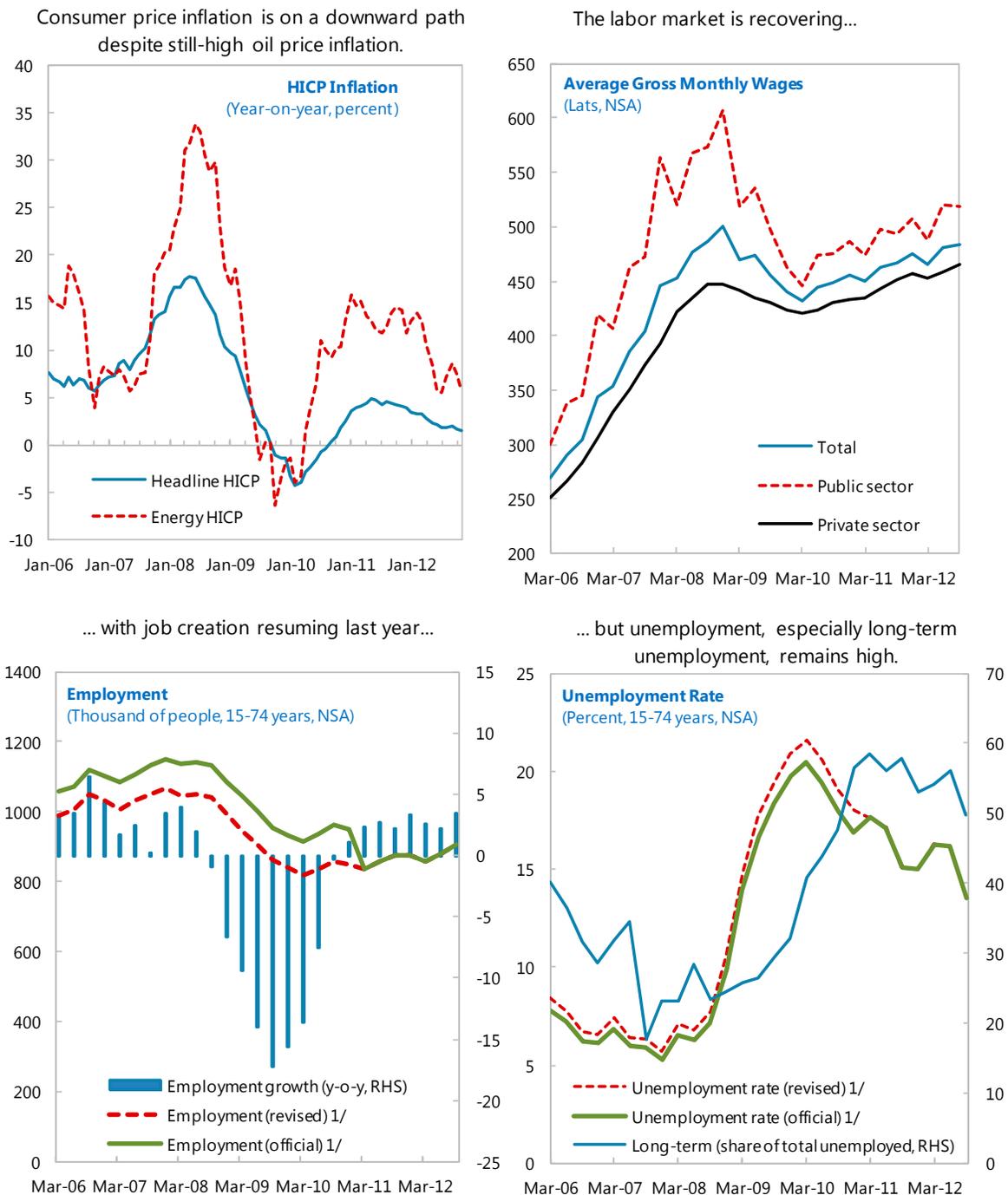


... and exports continue to show strength.



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

**Figure 2. Latvia: Inflation and the Labor Market, 2006–12**

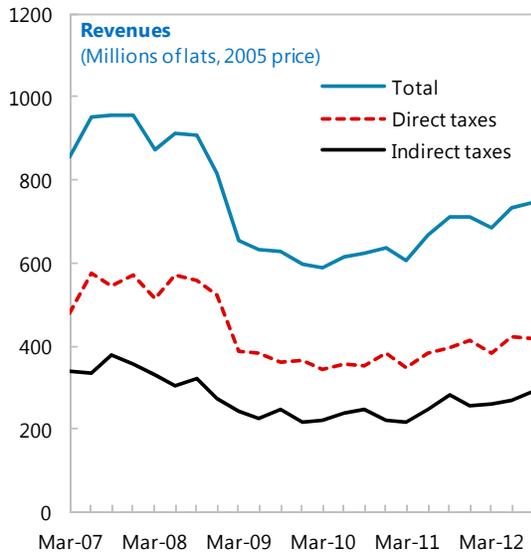


Sources: Eurostat; Haver Analytics; Latvian Central Statistical Bureau; and IMF staff calculations.

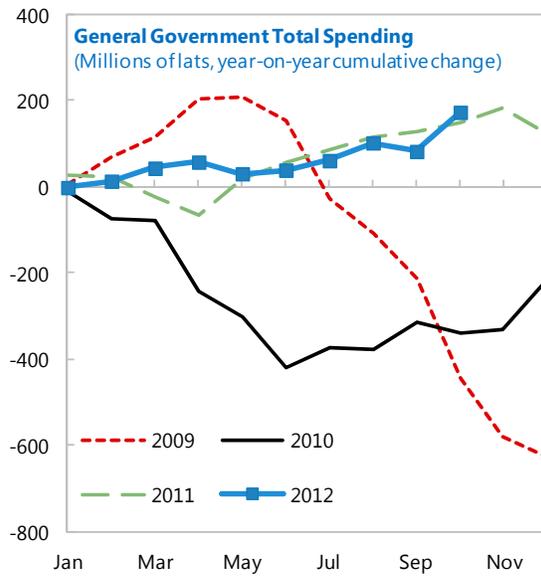
1/ Labor Force Survey. Unemployment data for 2011 was revised in compliance with the population census; official data before 2011 has not yet been revised; revised data is staff estimate based on 2011 correction.

**Figure 3. Latvia: Fiscal Developments, 2007–12**

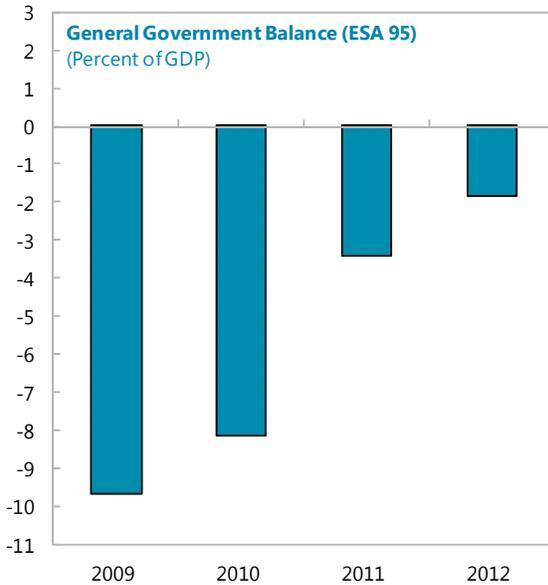
Tax revenue has been recovering across the board despite the mid-2012 cut in VAT rate.



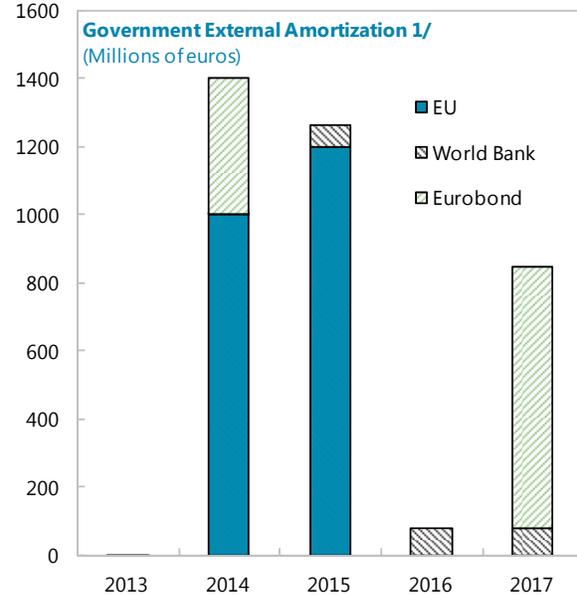
Spending has been strictly contained, despite supplementary budget spending in late 2012.



The 2012 fiscal deficit should be below 2 percent of GDP (ESA 95), meeting the Maastricht criterion.



IMF prepayment removes gross financing needs for 2013, which nonetheless remain high in future years.

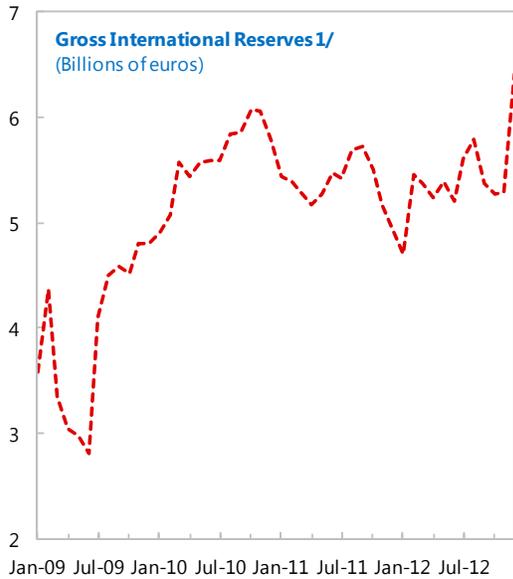


Sources: Latvian authorities; and IMF staff estimates.

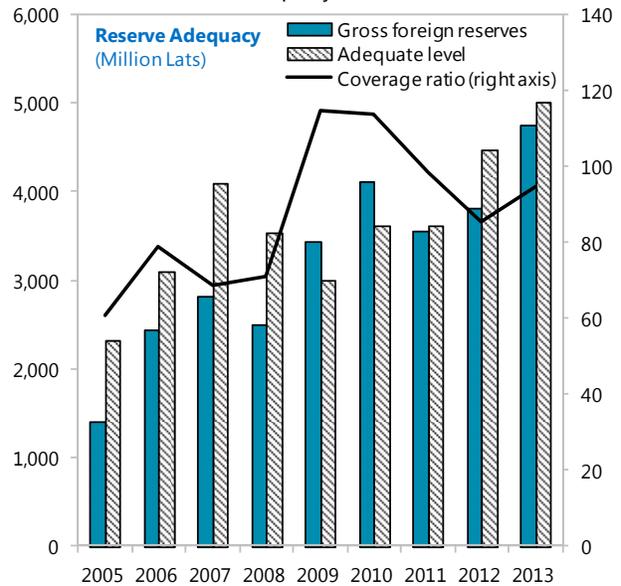
1/ Assumes full repayment of outstanding Fund obligations in December 2012.

**Figure 4. Latvia: International Reserves and Financial Market Developments, 2009–12**

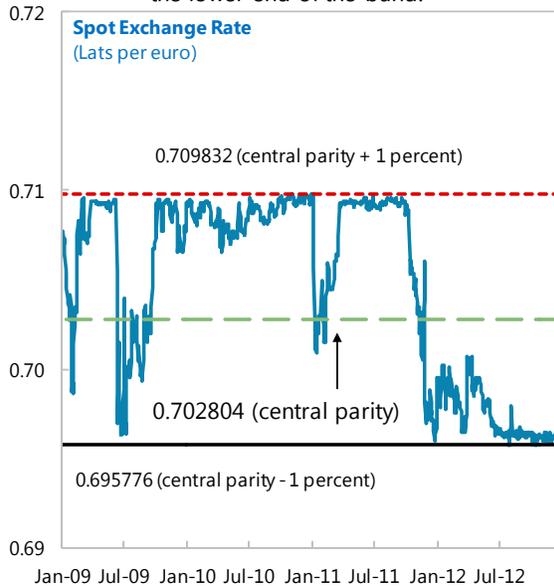
The two international bonds issued in 2012 have helped support reserves...



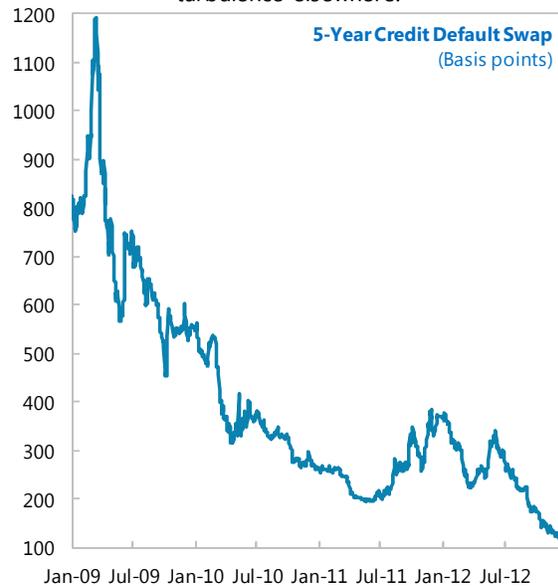
...which, nonetheless remain below the benchmark adequacy level.



The exchange rate has been fluctuating comfortably at the lower end of the band.



Latvia's CDS spreads have continued to ease, despite turbulence elsewhere.

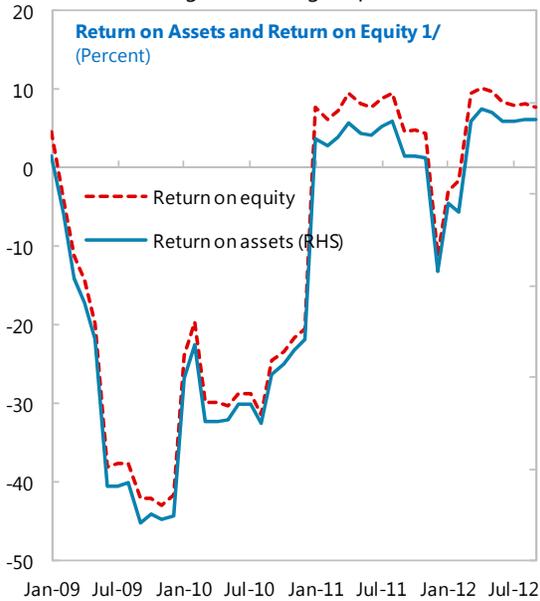


Sources: Bank of Latvia; Bloomberg; and IMF staff calculations.

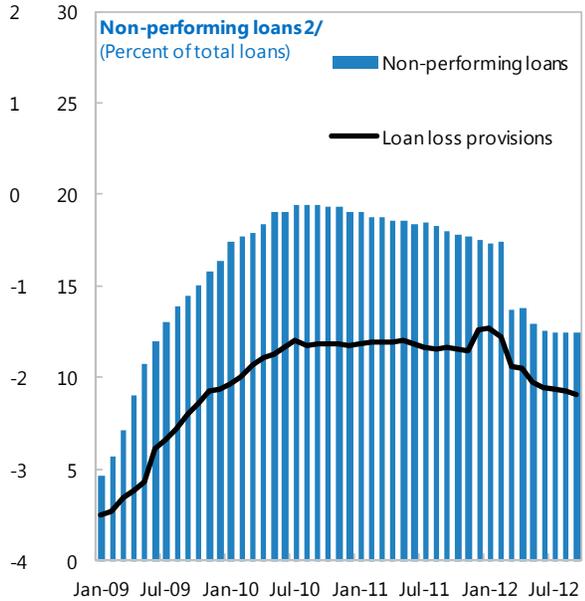
1/ Based on daily data from the Bank of Latvia up to December 14<sup>th</sup> 2012; does not incorporate the planned full repayment of outstanding Fund obligations.

**Figure 5. Latvia: Banking Sector Developments, 2007–12**

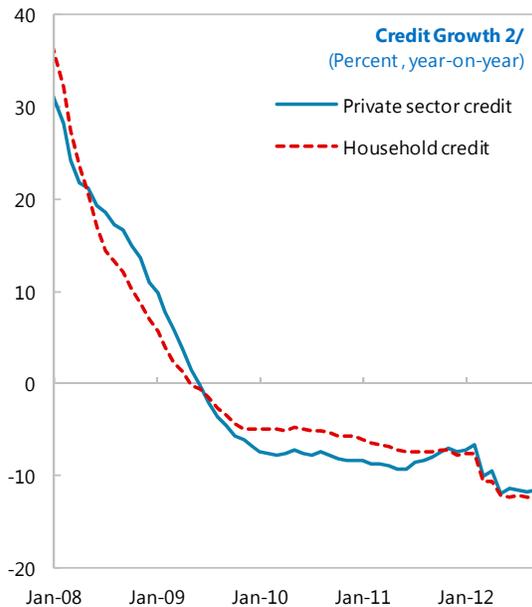
Despite losses related to Krajbanka and Parex Bank, the banking sector is again profitable...



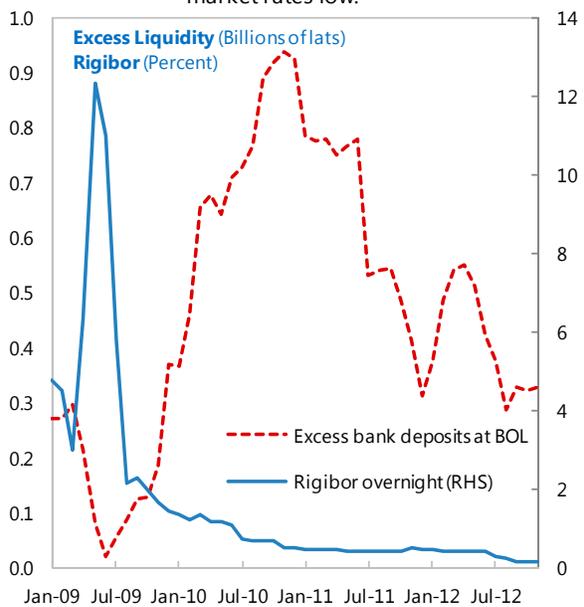
...and non-performing loans are gradually declining.



Credit growth remains negative after the bubble ...



...but the banking system is liquid and money market rates low.



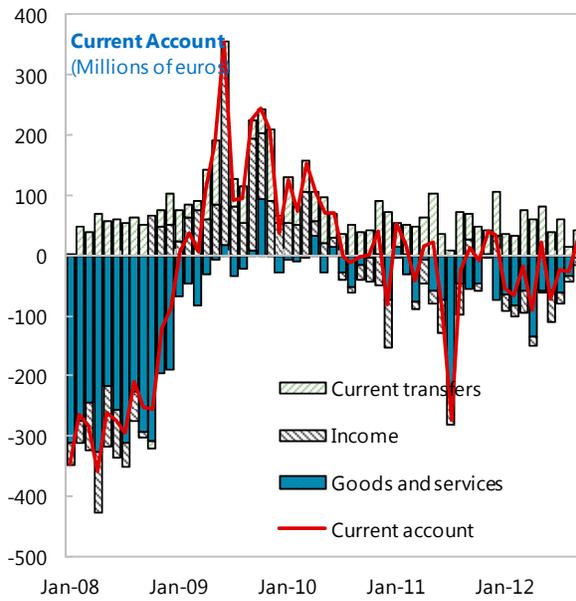
Source: Bank of Latvia; Bloomberg; FCMC; and IMF staff calculations.

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 licence in May 2012.

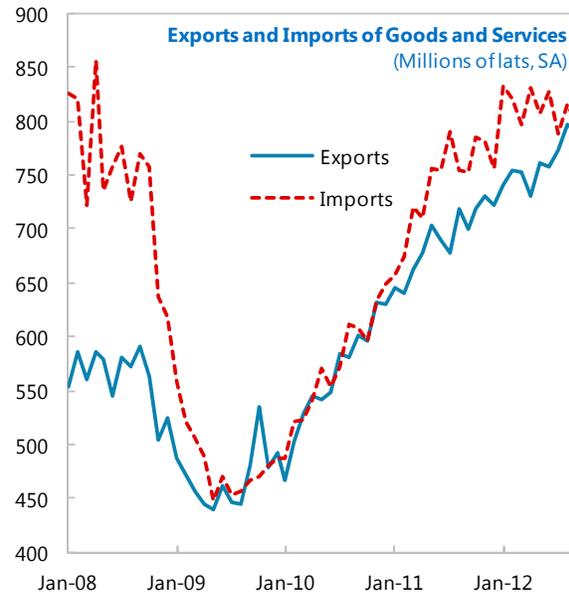
2/ Data from March 2012 onwards exclude Parex Bank and from May 2012 exclude Latvijas Krajbanka.

**Figure 6. Latvia: Balance of Payments, 2006–12**

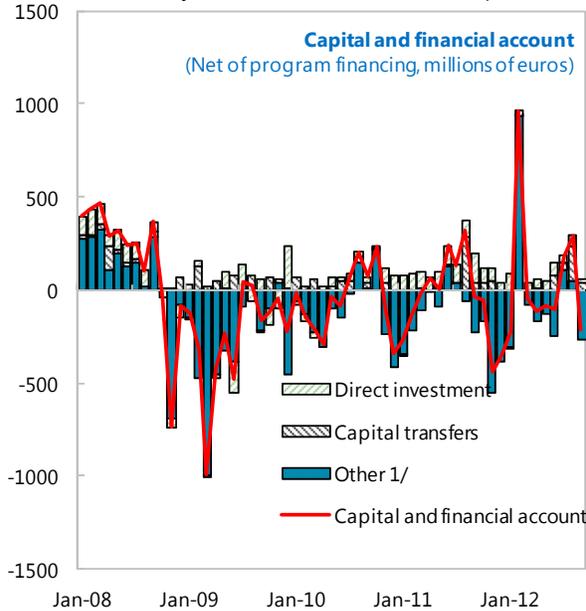
The current account deficit is modest...



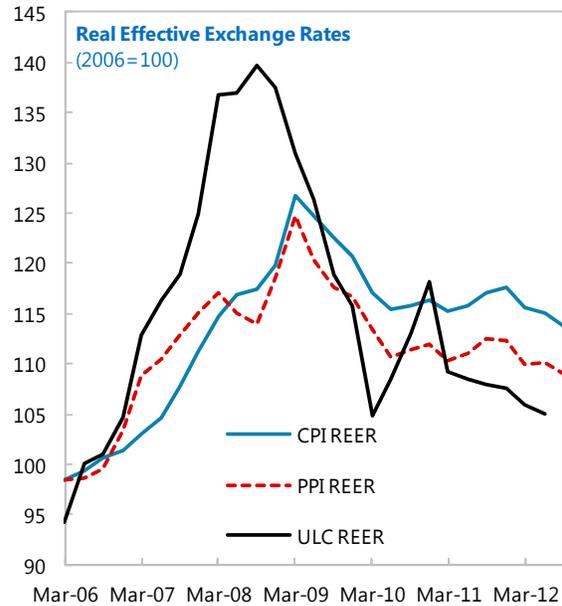
...with both exports and imports growing vigorously.



Deleveraging by foreign banks is increasingly offset by inflows of non-resident deposits.



Competitiveness continues to improve, albeit at a more gradual pace.



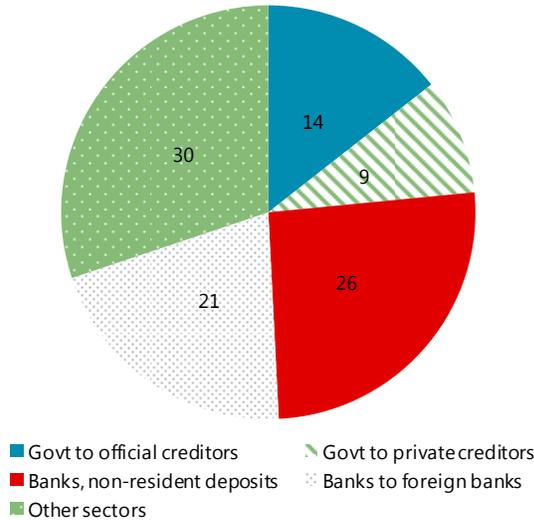
Sources: Bank of Latvia; ECB; and IMF staff calculations.

1/ Other is the sum of other investment and portfolio investment and derivatives. In February 2012, the increase is driven by the issuance of a USD 1 billion benchmark international bond.

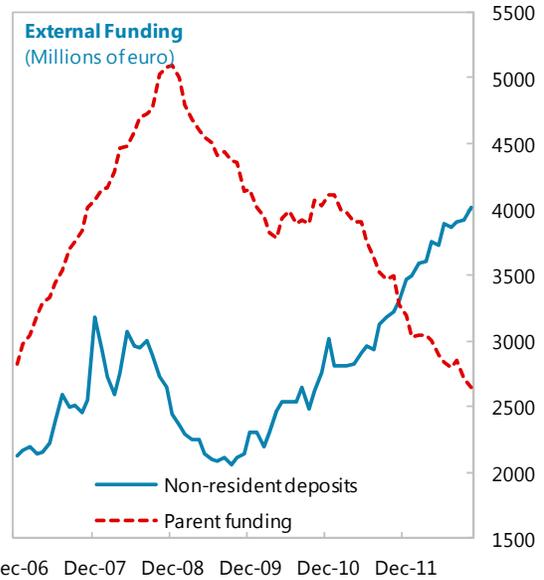
**Figure 7: External Debt and Vulnerabilities in the Banking System**

Banks account for nearly half of external debt and some rely heavily on potentially unstable non-resident deposits to fund themselves.

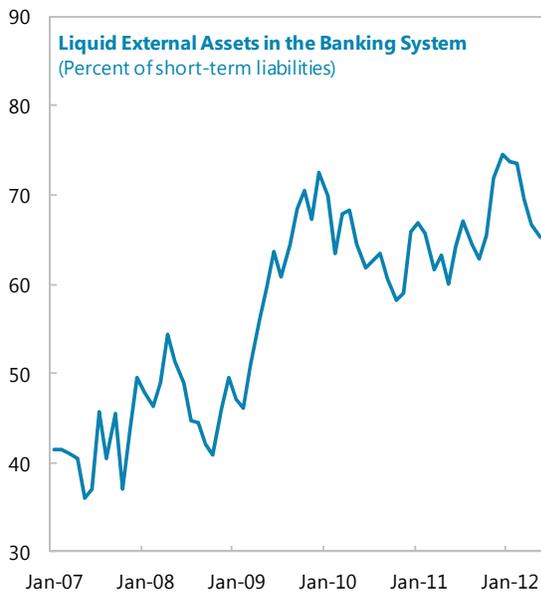
**Composition of External Debt**  
(Percent, end-June 2012)



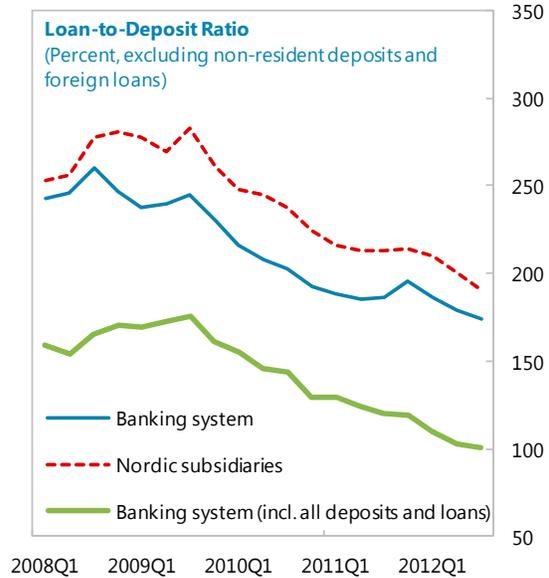
Nordic banks have been deleveraging quickly but in other banks NRDs are increasing rapidly.



However, banks are holding more FX liquid assets than before the crisis.



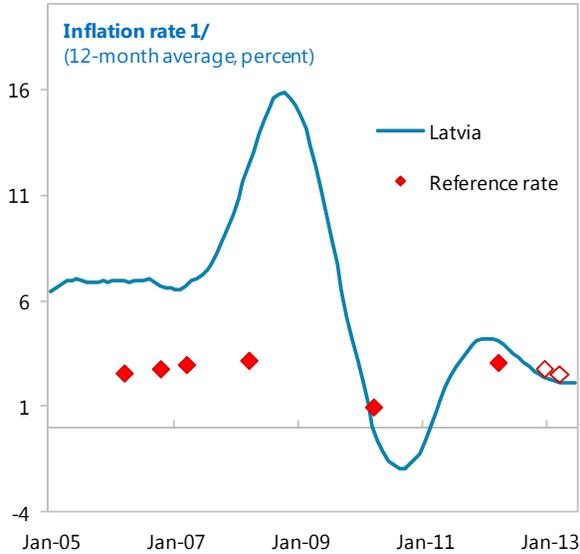
Despite heavy deleveraging, foreign-owned banks still have high loan-to-deposit ratios.



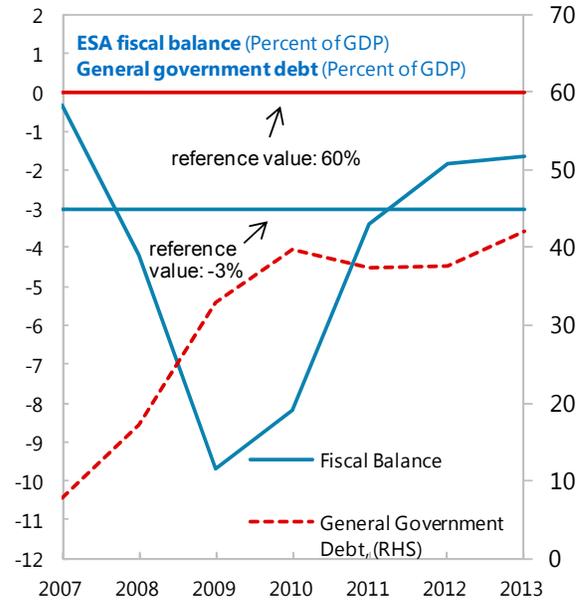
Sources: Bank of Latvia; FCMC; and IMF staff calculations.

**Figure 8. Latvia: Maastricht Criteria for Euro Adoption**

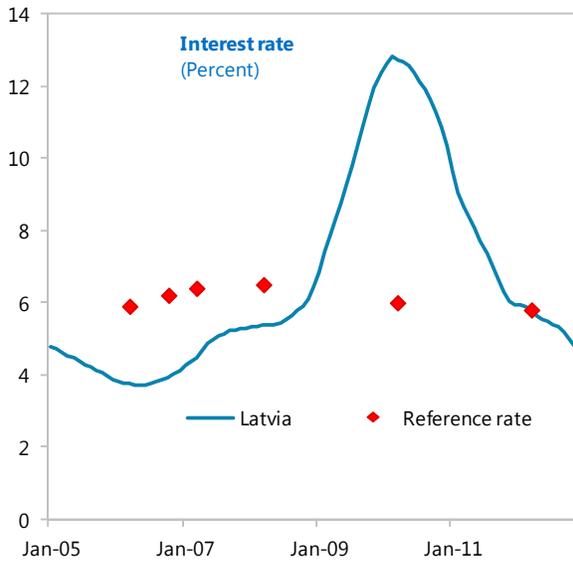
Inflation has recently fallen below the criterion reference rate.



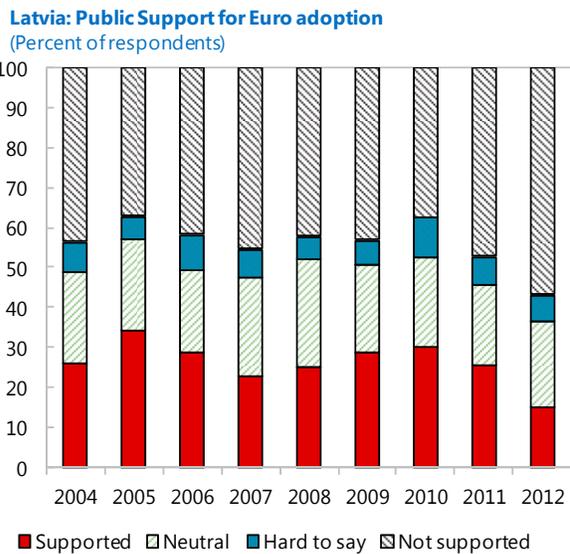
Latvia is expected to meet Maastricht fiscal criteria with ease in 2012.



The harmonized long-term interest rate is decreasing and in line with recent reference values.



The euro area crisis has affected public support for Euro adoption.



Source: Latvian authorities; Eurostat and IMF staff estimates and projections.

1/ The forecast of the Maastricht criterion reference rate is based on October 2012 WEO projections.

**Table 1. Latvia: Selected Economic Indicators, 2008–13**

	2008	2009	2010	2011	2012	2013
					Proj.	
(percentage change, unless otherwise indicated)						
National accounts						
Real GDP	-3.3	-17.7	-0.9	5.5	5.2	3.7
Private consumption	-5.8	-22.6	2.4	4.8	6.0	4.1
Gross fixed capital formation	-13.8	-37.4	-18.1	27.9	9.5	7.9
Exports of goods and services	2.0	-14.1	11.6	12.7	6.1	5.5
Imports of goods and services	-10.8	-33.3	11.4	22.7	7.0	6.6
Nominal GDP (billions of lats)	16.1	13.1	12.8	14.3	15.3	16.3
Nominal GDP (billions of euros)	22.7	18.6	18.2	20.5	21.8	23.1
GDP per capita (thousands of euros)	10.0	8.2	8.1	9.9	10.7	11.4
Savings and Investment						
Gross national saving (percent of GDP)	18.0	29.2	22.8	24.7	25.5	25.4
Gross capital formation (percent of GDP)	31.2	20.5	19.8	26.8	27.7	28.8
Private (percent of GDP)	26.6	17.2	16.8	22.7	23.6	25.6
HICP inflation						
Period average	15.3	3.3	-1.2	4.2	2.4	2.2
End-period	10.4	-1.4	2.4	3.9	2.2	2.0
Labor market						
Unemployment rate (LFS definition; period average, percent) 1/	7.5	16.9	18.7	16.2	15.0	13.7
Real gross wages	4.4	-6.8	-2.3	0.0	1.3	1.2
(percent of GDP, unless otherwise indicated)						
Consolidated general government 2/						
Total revenue	35.6	36.2	36.0	35.6	38.0	35.4
Total expenditure	39.0	43.3	42.4	38.7	38.7	36.6
Basic fiscal balance	-3.4	-7.1	-6.4	-3.1	-0.7	-1.2
ESA balance	-4.2	-9.7	-8.2	-3.4	-1.8	-1.7
General government gross debt	17.2	32.9	39.7	37.5	37.6	42.2
Money and credit						
Credit to private sector (annual percentage change)	11.0	-6.9	-8.4	-7.4	-9.0	1.2
Broad money (annual percentage change)	-3.9	-1.9	9.8	1.5	2.5	6.6
Residents' FX deposits (percent of total deposits)	48.6	55.6	50.3	51.7	54.1	53.8
Treasury Bill rate (365 days, eop, percent)	11.0	10.2	1.8	1.7	...	...
Money market rate (one month, eop, percent)	13.3	2.7	0.6	1.1	...	...
Balance of payments						
Gross official reserves (billions of euros)	3.7	4.8	5.8	4.9	5.4	6.7
(In months of prospective imports)	5.4	5.9	5.5	4.2	4.2	5.0
(percent of broad money and non-resident deposits)	75.2	96.0	119.0	112.8	147.4	163.5
Current account balance	-13.2	8.7	3.0	-2.1	-2.2	-3.4
Trade balance	-17.9	-7.1	-7.0	-10.7	-11.9	-12.3
Gross external debt	130.9	156.8	165.1	143.9	138.3	137.2
Net external debt 3/	57.5	58.8	54.2	46.0	39.5	35.1
Exchange rates						
Lats per euro (period average) 4/	0.71	0.70	0.70	0.70	...	...
Lats per U.S. dollar (period average)	0.48	0.51	0.53	0.50	...	...
REER (period average; CPI based, 2000=100)	104.5	110.2	103.6	103.8	...	...

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

1/ LFS statistics were revised in 2011 in compliance with population census; data before 2011 have not been revised yet.

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

3/ Gross external debt minus gross external debt assets.

4/ Lat is pegged to the euro at 1 EUR = 0.702804 LVL rate, with  $\pm 1$  percent band.

Table 2. Latvia: Macroeconomic Framework, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
	(percentage change, unless otherwise indicated)							
<b>National accounts</b>								
Real GDP	-0.9	5.5	5.2	3.7	4.2	4.2	4.0	4.0
Consumption	0.3	4.1	5.2	3.5	3.3	3.3	3.2	3.1
Private consumption	2.4	4.8	6.0	4.1	3.6	3.6	3.5	3.4
Public consumption	-7.9	1.1	1.5	0.4	1.5	1.5	1.5	1.5
Gross capital formation	-4.2	43.6	8.1	8.0	8.0	7.6	6.8	6.5
Gross fixed capital formation	-18.1	27.9	9.5	7.9	7.9	7.7	7.2	6.8
Stockbuilding (contribution to growth)	3.7	2.6	-0.2	0.1	0.1	0.1	0.0	0.0
Exports of goods and services	11.6	12.7	6.1	5.5	6.0	6.1	6.2	6.2
Imports of goods and services	11.4	22.7	7.0	6.6	6.1	6.1	6.0	5.9
<b>Contributions to growth</b>								
Domestic demand	-0.6	11.8	6.5	5.1	5.0	5.0	4.7	4.5
Net exports	-0.4	-6.3	-1.2	-1.3	-0.8	-0.7	-0.7	-0.5
<b>HICP inflation</b>								
Period average	-1.2	4.2	2.4	2.2	2.2	2.2	2.2	2.2
End-period	2.4	3.9	2.2	2.0	2.2	2.2	2.2	2.2
<b>Labor market</b>								
Unemployment rate (LFS definition; period average, percent) 1/	18.7	16.2	15.0	13.7	12.3	11.1	10.1	9.4
Employment (period average, percent change)	-5.4	2.6	2.5	1.4	1.2	0.9	0.7	0.4
Real gross wages	-2.3	0.0	1.3	1.2	1.2	1.1	0.9	0.9
<b>(percent of GDP)</b>								
<b>Consolidated general government 2/</b>								
Total revenue	36.0	35.6	38.0	35.4	34.0	32.0	31.0	30.3
Total expenditure	42.4	38.7	38.7	36.6	35.1	33.6	32.4	31.5
Basic fiscal balance	-6.4	-3.1	-0.7	-1.2	-1.1	-1.6	-1.4	-1.2
ESA balance	-8.2	-3.4	-1.8	-1.7	-1.6	-1.8	-1.8	-1.6
ESA structural balance	-2.9	-1.5	-1.1	-1.1	-1.3	-1.6	-1.8	-1.8
General government gross debt	39.7	37.5	37.6	42.2	37.7	34.1	34.1	33.0
<b>Saving and investment</b>								
Gross national saving	22.8	24.7	25.5	25.4	26.0	26.6	27.4	28.0
Private	27.1	23.8	22.1	23.6	23.9	25.2	25.9	26.2
Public 3/	-4.3	0.9	3.5	1.8	2.1	1.4	1.5	1.8
Foreign saving 4/	-3.0	2.1	2.2	3.4	3.5	3.6	3.5	3.5
Gross capital formation	19.8	26.8	27.7	28.8	29.5	30.2	30.9	31.5
Private	16.8	22.7	23.6	25.6	26.3	27.3	28.0	28.6
Public	3.0	4.1	4.1	3.2	3.2	2.9	2.9	2.9
<b>External sector</b>								
Current account balance	3.0	-2.1	-2.2	-3.4	-3.5	-3.6	-3.5	-3.5
Net IIP	-80.0	-72.8	-68.2	-65.7	-63.2	-61.3	-59.6	-58.1
Gross external debt	165.1	143.9	138.3	137.2	127.3	119.3	115.2	110.5
Net external debt 5/	54.2	46.0	39.5	35.1	31.0	28.0	24.0	21.1
<b>Memorandum items:</b>								
Gross official reserves (billions of euros)	5.8	4.9	5.4	6.7	6.2	5.9	6.3	6.4
Nominal GDP (billions of lats)	12.8	14.3	15.3	16.3	17.3	18.5	19.7	20.9
Nominal GDP (billions of euros)	18.2	20.5	21.8	23.1	24.7	26.3	28.0	29.8

Sources: Latvian authorities; and IMF staff estimates.

1/ LFS statistics were revised in 2011 in compliance with population census; data before 2011 have not been revised yet.

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

3/ Includes bank restructuring costs.

4/ Current account deficit (+ indicates a surplus)

5/ Gross external debt minus gross external debt assets.

**Table 3. General Government Operations, 2010–13**

	2010	2011	2012	2013	
	Actual	Actual	Proj.	Budget	Proj.
	(millions of lats)				
Total revenue and grants	4,607	5,085	5,833	5,695	5,756
Tax revenue	3,403	3,879	4,256	4,364	4,385
Direct Taxes	2,074	2,328	2,550	2,602	2,609
Corporate Income Tax	112	196	244	267	271
Personal Income Tax	779	792	864	873	879
Social Security Contributions	1,093	1,230	1,322	1,343	1,337
Real Estate and Property Taxes	90	110	120	119	122
Indirect Taxes	1,329	1,550	1,706	1,762	1,776
VAT	825	959	1,085	1,126	1,135
Excises	458	482	498	507	515
Other indirect taxes	46	110	123	129	127
Non Tax, self-earned and other revenue	604	543	645	531	573
Non-tax revenues	383	329	420	313	339
Self-earned revenues	213	208	218	218	226
Others	9	7	7	0	8
EU and miscellaneous funds	600	664	932	799	799
Total expenditure 1/	5,424	5,527	5,942	5,834	5,956
Current expenditure	5,034	4,941	5,310	5,323	5,431
Primary Current Expenditure	4,855	4,737	5,068	5,044	5,165
Remuneration	1,087	1,131	1,103	1,156	1,156
Goods and Services	691	729	676	671	696
Subsidies and Transfers	2,937	2,738	3,125	3,079	3,116
Subsidies to companies and institutions	1,178	1,111	1,508	1,434	1,439
E.U. funds related subsidies	784	717	819	736	736
Social Support	1,745	1,609	1,603	1,632	1,664
International cooperation	15	18	14	13	13
Payments to EU budget	121	131	152	159	159
Net lending and other current expenditure	18	7	12	-19	38
Interest	180	204	242	278	266
Capital expenditure	390	586	633	511	525
E.U. funds related capital expenditure	141	242	402	334	334
National capital expenditure	249	344	230	177	191
Basic fiscal balance	-817	-441	-109	-139	-200
Restructuring costs	118	10	-8	0	40
Bank restructuring costs	102	-47	-8	0	40
AirBaltic	16	57	0	0	0
Fiscal balance	-935	-451	-101	-139	-240
Financing (net)	935	451	101	139	240
Domestic financing	146	80	-299	...	-756
External financing	756	285	400	...	996
Errors and omissions	32	86	0	...	0
Net lending	14	-11	11	-19	37
ESA correction	-242	-34	-183	-68	-107
ESA balance	-1045	-486	-281	-227	-270

**Table 3. General Government Operations, 2010–13 (concluded)**

	2010	2011	2012	2013	
	Actual	Actual	Proj.	Budget	Proj.
	(percent of GDP)				
Total revenue and grants	36.0	35.6	38.0	35.0	35.4
Tax revenue	26.6	27.2	27.7	26.8	27.0
Direct Taxes	16.2	16.3	16.6	16.0	16.0
Corporate Income Tax	0.9	1.4	1.6	1.6	1.7
Personal Income Tax	6.1	5.5	5.6	5.4	5.4
Social Security Contributions	8.6	8.6	8.6	8.3	8.2
Real Estate and Property Taxes	0.7	0.8	0.8	0.7	0.8
Indirect Taxes	10.4	10.9	11.1	10.8	10.9
VAT	6.5	6.7	7.1	6.9	7.0
Excises	3.6	3.4	3.2	3.1	3.2
Other indirect taxes	0.4	0.8	0.8	0.8	0.8
Non Tax, self-earned and other revenue	4.7	3.8	4.2	3.3	3.5
EU and miscellaneous funds	4.7	4.6	6.1	4.9	4.9
Total expenditure 1/	42.4	38.7	38.7	35.9	36.6
Current expenditure	39.4	34.6	34.6	32.7	33.4
Primary Current Expenditure	38.0	33.2	33.0	31.0	31.7
Remuneration	8.5	7.9	7.2	7.1	7.1
Goods and Services	5.4	5.1	4.4	4.1	4.3
Subsidies and Transfers	23.0	19.2	20.4	18.9	19.2
Subsidies to companies and institutions	9.2	7.8	9.8	8.8	8.8
E.U. funds related subsidies	6.1	5.0	5.3	4.5	4.5
Social Support	13.6	11.3	10.4	10.0	10.2
International cooperation	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	0.9	0.9	1.0	1.0	1.0
Net lending and other current expenditure	0.1	0.0	0.1	-0.1	0.2
Interest	1.4	1.4	1.6	1.7	1.6
Capital expenditure	3.0	4.1	4.1	3.1	3.2
E.U. funds related capital expenditure	1.1	1.7	2.6	2.1	2.1
National capital expenditure	1.9	2.4	1.5	1.1	1.2
Basic fiscal balance	-6.4	-3.1	-0.7	-0.9	-1.2
Restructuring costs	0.9	0.1	-0.1	0.0	0.2
Bank restructuring costs	0.8	-0.3	-0.1	0.0	0.2
AirBaltic	0.1	0.4	0.0	0.0	0.0
Fiscal balance	-7.3	-3.2	-0.7	-0.9	-1.5
Memorandum items					
ESA balance	-8.2	-3.4	-1.8	-1.4	-1.7
ESA balance less bank restructuring 2/	-5.9	-3.1	-1.8	-1.4	-1.7
ESA cyclically adjusted balance	-4.6	-1.7	-1.1	-1.3	-1.1
ESA structural balance 3/	-2.9	-1.5	-1.1	-1.3	-1.1
General government debt	39.7	37.5	37.6	...	42.2
Primary basic balance	-5.0	-2.2	0.6	0.6	0.2
Nominal GDP (In billions of lats)	12.8	14.3	15.3	16.3	16.3

Sources: Latvian authorities; and IMF staff estimates.

1/ Total expenditure excludes net acquisition of financial assets and other bank restructuring costs.

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: Fiscal Balances and Public Debt, 2007–13**

	2007	2008	2009	2010	2011	2012	2013
	(percent of GDP)						
<b>Fiscal balances</b>							
Basic fiscal balance (excl. bank restructuring)	0.6	-3.4	-7.1	-6.4	-3.1	-0.7	-1.2
Alternative fiscal balances							
(i) Authorities' definition							
plus net lending	0.0	0.0	0.3	0.1	0.0	0.1	0.2
Basic fiscal balance, authorities' definition	0.6	-3.4	-6.8	-6.2	-3.0	-0.6	-1.0
(ii) Adjustment for 2nd pillar contribution diversion							
less gain from 2nd pillar contributions < 8 percent	0.0	0.0	1.2	1.6	1.6	1.6	0.3
Fiscal balance, adjusted for pension diversion 1/	0.6	-3.4	-8.3	-8.0	-4.6	-2.3	-1.5
(iii) Adjustment for EU-related operations							
less revenues from EU	3.1	2.7	4.1	4.7	4.6	6.1	4.9
plus EU-related spending	3.6	4.3	6.1	7.2	6.7	8.0	6.6
Non-EU basic balance	1.1	-1.8	-5.0	-3.9	-1.0	1.2	0.4
(iv) Primary balance							
plus interest	0.4	0.4	1.2	1.4	1.4	1.6	1.6
Primary basic balance	0.9	-3.2	-6.4	-5.0	-2.2	0.6	0.2
(v) Recognition of bank restructuring costs							
less bank restructuring costs	0.0	4.2	0.8	0.8	-0.3	-0.1	0.2
Overall balance 2/	0.6	-7.5	-7.8	-7.3	-2.8	-0.7	-1.5
(vi) Program-relevant ESA balance							
ESA definition less bank restructuring	-0.3	-4.2	-8.6	-5.9	-3.1	-1.8	-1.7
(vii) ESA deficit (relevant for euro adoption)							
plus ESA bank restructuring	0.0	0.0	1.1	2.3	0.3	0.0	0.0
ESA deficit	-0.3	-4.2	-9.7	-8.2	-3.4	-1.8	-1.7
<b>Public debt</b>							
Gross debt	7.8	17.2	32.9	39.7	37.5	37.6	42.2
of which foreign currency-denominated	4.4	9.9	25.6	32.4	31.6	32.0	36.3
Net debt (debt less government deposits)	4.7	13.2	23.0	31.3	32.3	30.7	30.4
Net debt if no more bank restructuring	4.7	13.2	23.0	31.3	32.3	30.8	30.5

Sources: Latvian authorities; and IMF staff estimates.

1/ Definition used at First Review.

2/ 2011 excludes non-bank restructuring costs.

Table 5. Latvia: Statement of Government Operations, 2010–13 1/

	2010	2011	2012	2013	2010	2011	2012	2013
	Actual		Proj.		Actual		Proj.	
	(millions of lats)				(percent of GDP)			
<b>Revenue</b>	<b>4592</b>	<b>5072</b>	<b>5819</b>	<b>5741</b>	<b>35.9</b>	<b>35.5</b>	<b>37.9</b>	<b>35.3</b>
Taxes	2347	2649	2977	3071	18.4	18.6	19.4	18.9
Taxes on income, profits, and capital gains	891	989	1109	1150	7.0	6.9	7.2	7.1
Taxes on payroll and workforce	....	0	0	0	....	0.0	0.0	0.0
Taxes on property	90	110	120	122	0.7	0.8	0.8	0.8
Taxes on goods and services	1340	1519	1712	1761	10.5	10.6	11.2	10.8
Taxes on international trade and transactions	17	21	23	24	0.1	0.1	0.2	0.1
Other taxes	9	10	13	14	0.1	0.1	0.1	0.1
Social contributions	1093	1230	1322	1337	8.6	8.6	8.6	8.2
Grants	600	664	932	799	4.7	4.6	6.1	4.9
Other revenue	552	530	588	534	4.3	3.7	3.8	3.3
<b>Expenditure</b>	<b>5508</b>	<b>5534</b>	<b>5910</b>	<b>5944</b>	<b>43.1</b>	<b>38.8</b>	<b>38.5</b>	<b>36.5</b>
<b>Expense</b>	<b>5131</b>	<b>4962</b>	<b>5292</b>	<b>5434</b>	<b>40.1</b>	<b>34.8</b>	<b>34.5</b>	<b>33.4</b>
Compensation of employees	1087	1131	1103	1156	8.5	7.9	7.2	7.1
Wages and salaries	846	888	858	899	6.6	6.2	5.6	5.5
Social contributions	241	243	245	257	1.9	1.7	1.6	1.6
Use of goods and services	688	729	676	696	5.4	5.1	4.4	4.3
Consumption of fixed capital	0	0	0	0	0.0	0.0	0.0	0.0
Interest	177	204	242	266	1.4	1.4	1.6	1.6
Subsidies	1171	1111	1508	1439	9.2	7.8	9.8	8.8
Grants	0	18	14	13	0.0	0.1	0.1	0.1
Social benefits	1744	1609	1603	1664	13.6	11.3	10.4	10.2
Other expense	263	159	146	200	2.1	1.1	0.9	1.2
Property expense other than interest	0	0	0	0	0.0	0.0	0.0	0.0
Miscellaneous other expense	263	159	146	200	2.1	1.1	0.9	1.2
Current	145	149	153	160	1.1	1.0	1.0	1.0
Capital	118	11	-8	41	0.9	0.1	0.0	0.2
Bank restructuring costs	102	-47	-8	40	0.8	-0.3	-0.1	0.2
AirBaltic	16	57	0	0	0.1	0.4	0.0	0.0
Other	0	0	0	1	0.0	0.0	0.0	0.0
<b>Net acquisition of nonfinancial assets</b>	<b>377</b>	<b>573</b>	<b>618</b>	<b>510</b>	<b>3.0</b>	<b>4.0</b>	<b>4.0</b>	<b>3.1</b>
<b>Gross Operating Balance</b>	<b>-539</b>	<b>110</b>	<b>527</b>	<b>307</b>	<b>-4.2</b>	<b>0.8</b>	<b>3.4</b>	<b>1.9</b>
<b>Net lending (+) / borrowing (-)</b>	<b>-916</b>	<b>-462</b>	<b>-91</b>	<b>-203</b>	<b>-7.2</b>	<b>-3.2</b>	<b>-0.6</b>	<b>-1.2</b>
<b>Net acquisition of financial assets</b>	<b>-148</b>	<b>-452</b>	<b>323</b>	<b>893</b>	<b>-1.2</b>	<b>-3.2</b>	<b>2.1</b>	<b>5.5</b>
Domestic	-148	-452	323	893	-1.2	-3.2	2.1	5.5
Foreign	0	0	0	0	0.0	0.0	0.0	0.0
<b>Net incurrence of liabilities</b>	<b>768</b>	<b>10</b>	<b>413</b>	<b>1096</b>	<b>6.0</b>	<b>0.1</b>	<b>2.7</b>	<b>6.7</b>
Domestic	14	-275	13	100	0.1	-1.9	0.1	0.6
Foreign	754	285	400	996	5.9	2.0	2.6	6.1

1/ Data on fiscal operations presented in GFSM 2001 format.

Table 6. Public Sector Debt Sustainability Framework, 2007–17

(in percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/ -0.6
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
<b>1 Baseline: Public sector debt 1/ o/w foreign-currency denominated</b>	7.8	17.2	32.9	39.7	37.5	<b>37.6</b>	<b>42.2</b>	<b>37.7</b>	<b>34.1</b>	<b>34.1</b>	<b>33.0</b>	
	4.4	9.9	25.6	32.4	31.6	32.0	36.3	31.6	27.8	27.7	26.5	
2 Change in public sector debt	-2.1	9.4	15.7	6.9	-2.3	0.1	4.6	-4.5	-3.6	0.0	-1.1	
3 Identified debt-creating flows (4+7+12)	-3.9	6.6	11.6	10.5	-0.6	-2.0	-0.7	-1.6	-0.8	-0.7	-0.9	
4 Primary deficit	-1.0	3.0	5.9	5.0	1.7	-0.9	-0.4	-0.5	0.1	0.0	-0.2	
5 Revenue and grants	36.3	35.6	36.2	36.0	35.6	38.0	35.4	34.0	32.0	31.0	30.3	
6 Primary (noninterest) expenditure	35.3	38.6	42.2	41.0	37.3	37.1	35.0	33.5	32.1	31.0	30.1	
7 Automatic debt dynamics 2/	-2.5	-0.2	5.0	4.7	-2.2	-1.0	-0.5	-1.1	-0.9	-0.7	-0.7	
8 Contribution from interest rate/growth differential 3/	-2.1	-0.3	5.1	2.1	-2.7	-1.0	-0.5	-1.1	-0.9	-0.7	-0.7	
9 Of which contribution from real interest rate	-1.3	-0.5	1.4	1.8	-0.8	0.8	0.8	0.6	0.6	0.6	0.6	
10 Of which contribution from real GDP growth	-0.7	0.2	3.8	0.3	-1.9	-1.8	-1.3	-1.7	-1.5	-1.3	-1.3	
11 Contribution from exchange rate depreciation 4/	-0.4	0.1	-0.2	2.6	0.5	...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.4	3.8	0.7	0.8	-0.1	-0.1	0.2	-0.1	-0.1	-0.1	0.0	
13 Privatization receipts (negative)	-0.4	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (bank recapitalization, AirBaltic)	0.0	4.2	0.8	0.9	0.1	-0.1	0.2	-0.1	-0.1	-0.1	0.0	
16 Residual, including asset changes (2-3) 5/	1.8	2.8	4.1	-3.6	-1.7	2.0	5.3	-2.9	-2.7	0.7	-0.1	
Public sector debt-to-revenue ratio 1/	21.4	48.3	90.7	110.3	105.2	98.8	119.1	110.8	106.5	109.9	109.0	
<b>Gross financing need 6/ in billions of U.S. dollars</b>	0.3	9.0	15.9	12.0	6.5	7.9	3.1	6.8	6.4	1.6	4.4	
	0.1	3.0	4.1	2.9	1.8	2.2	0.9	2.1	2.1	0.6	1.6	
<b>Scenario with key variables at their historical averages 7/ Scenario with no policy change (constant primary balance) in 2012-2017</b>						<b>37.6</b>	<b>42.9</b>	<b>39.5</b>	<b>36.4</b>	<b>36.9</b>	<b>36.6</b>	<b>-1.9</b>
						<b>37.6</b>	<b>44.3</b>	<b>39.4</b>	<b>34.8</b>	<b>33.9</b>	<b>32.2</b>	<b>-0.6</b>
<b>Key Macroeconomic and Fiscal Assumptions Underlying Baseline</b>												
Real GDP growth (in percent)	9.6	-3.3	-17.7	-0.9	5.5	5.2	3.7	4.2	4.2	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	4.7	5.6	5.4	4.2	4.0	4.5	4.6	4.0	4.2	4.3	4.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-16.0	-7.4	6.7	5.4	-1.9	2.4	2.4	1.6	1.9	2.0	2.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	10.7	-2.2	1.2	-8.6	-1.7	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	20.7	13.0	-1.2	-1.3	5.9	2.1	2.2	2.3	2.3	2.3	2.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.2	5.5	-10.0	-3.6	-4.1	4.9	-2.3	-0.1	-0.2	0.4	0.9	
Primary deficit	-1.0	3.0	5.9	5.0	1.7	-0.9	-0.4	-0.5	0.1	0.0	-0.2	

1/ The coverage refers to the general government; gross debt is used throughout.

2/ Derived as  $[(r - \pi(1+g) - g + \alpha\epsilon(1+r)] / (1+g+\pi+g\pi)$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\epsilon$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).3/ The real interest rate contribution is derived from the denominator in footnote 2/ as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .4/ The exchange rate contribution is derived from the numerator in footnote 2/ as  $\alpha\epsilon(1+r)$ .

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

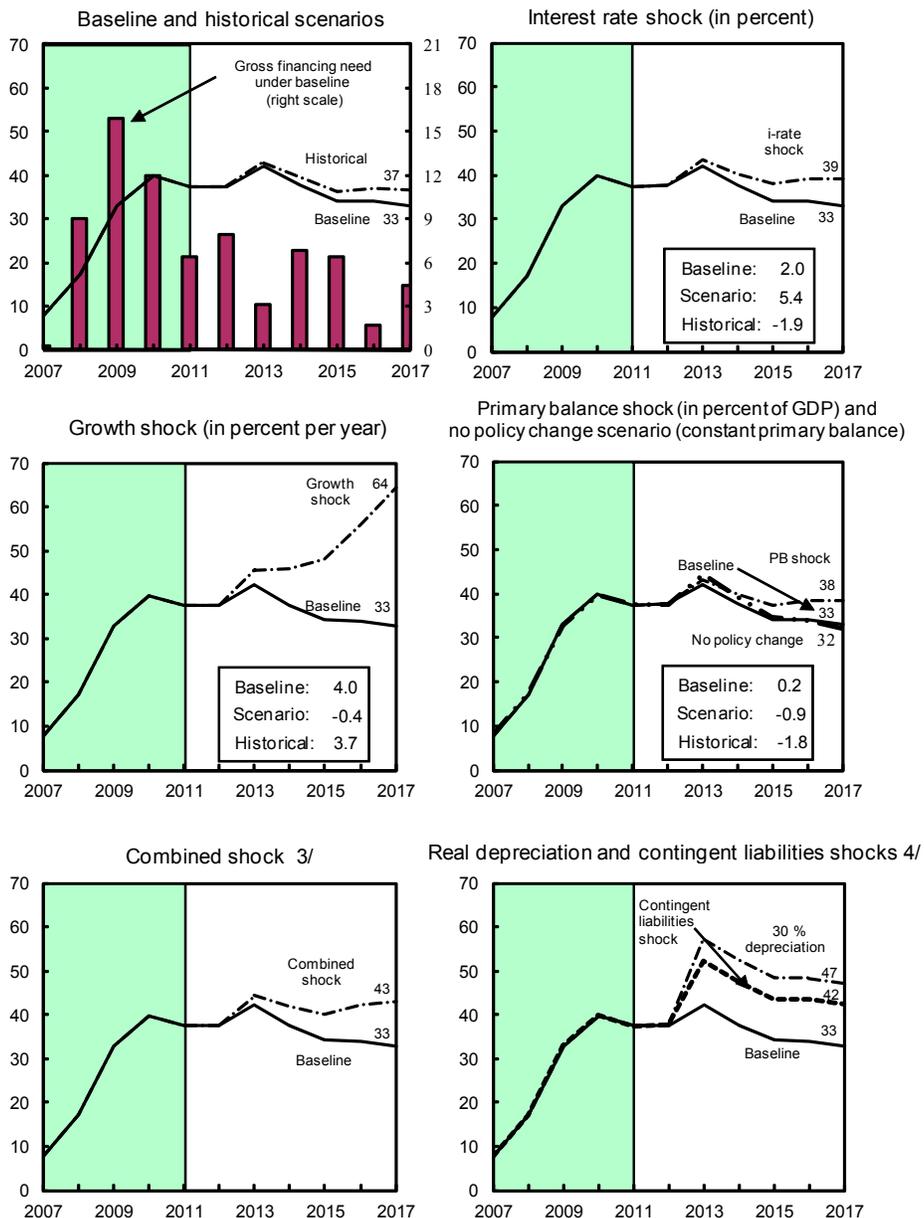
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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.

**Figure 9. Latvia: Public Debt Sustainability Bound Tests**

(Public 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 primary balance.

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 7. Latvia: Medium-Term Balance of Payments, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
	(millions of euros)							
Current account	540	-438	-483	-794	-858	-944	-980	-1,032
Goods (fb)	-1,280	-2,198	-2,594	-2,848	-2,972	-3,127	-3,311	-3,474
Exports	6,873	8,620	9,530	10,101	10,728	11,394	12,181	13,014
Imports	8,153	10,818	12,124	12,949	13,700	14,521	15,492	16,488
Services	1,107	1,319	1,430	1,475	1,577	1,680	1,802	1,937
Credit	2,787	3,196	3,533	3,860	4,100	4,354	4,655	4,973
Debit	1,680	1,877	2,104	2,385	2,523	2,674	2,853	3,036
Income	59	-182	-128	-133	-150	-171	-158	-207
Compensation of employees	430	464	527	576	605	635	667	686
Investment income	-371	-646	-656	-709	-755	-806	-826	-893
Current transfers	654	623	809	711	686	674	687	712
of which: EU (net)	373	302	464	338	277	221	185	177
Capital and financial account	-1,011	-490	2,207	2,123	1,337	1,859	1,469	1,229
Capital account	352	429	551	482	465	414	415	426
Financial account	-1,363	-919	1,656	1,641	872	1,445	1,054	803
Direct investment	270	1,000	781	850	931	988	1,113	1,188
of which: equity capital	480	643	592	702	771	815	926	986
Portfolio investment	-165	-457	1,236	1,216	188	455	450	-90
of which: general government	-15	225	1,725	1,420	397	797	500	237
Financial derivatives	-168	86	0	0	0	0	0	0
Other investment	-1,300	-1,548	-360	-426	-247	1	-509	-295
Assets	-662	-296	-501	-507	-462	-368	-911	-739
Liabilities	-639	-1,252	141	81	215	369	402	445
Banks, short-term	...	...	1,263	246	258	271	285	299
Banks, long-term	...	...	-1,126	-220	11	44	66	79
Errors and omissions	96	-70	-74	0	0	0	0	0
Overall balance	-375	-998	1,650	1,329	479	915	489	197
Financing	375	998	-1,650	-1,329	-479	-915	-489	-197
Change in reserve assets (+ denotes decline)	-725	904	-465	-1,326	523	346	-409	-117
IMF (net)	300	0	-1,182	0	0	0	0	0
Purchases	300	0	0	0	0	0	0	0
Repurchases	0	0	-1,182	0	0	0	0	0
Other official financing (net)	800	94	-3	-2	-1,002	-1,260	-80	-80
Disbursements	800	100	0	0	0	0	0	0
Repayments	0	-6	-3	-2	-1,002	-1,260	-80	-80

Table 7. Latvia: Medium-Term Balance of Payments, 2010–17 (concluded)

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
Memorandum items:	(percent of GDP, unless otherwise indicated)							
Current account	3.0	-2.1	-2.2	-3.4	-3.5	-3.6	-3.5	-3.5
Goods (fob)	-7.0	-10.7	-11.9	-12.3	-12.0	-11.9	-11.8	-11.7
Exports	37.8	42.1	43.6	43.6	43.5	43.3	43.5	43.7
Imports	44.9	52.9	55.5	55.9	55.5	55.2	55.3	55.3
Services	6.1	6.4	6.5	6.4	6.4	6.4	6.4	6.5
Credit	15.3	15.6	16.2	16.7	16.6	16.5	16.6	16.7
Debit	9.2	9.2	9.6	10.3	10.2	10.2	10.2	10.2
Income	0.3	-0.9	-0.6	-0.6	-0.6	-0.6	-0.6	-0.7
Compensation of employees	2.4	2.3	2.4	2.5	2.5	2.4	2.4	2.3
Investment income	-2.0	-3.2	-3.0	-3.1	-3.1	-3.1	-2.9	-3.0
Current transfers	3.6	3.0	3.7	3.1	2.8	2.6	2.5	2.4
of which: EU (net)	2.1	1.5	2.1	1.5	1.1	0.8	0.7	0.6
Net FDI	1.5	4.9	3.6	3.7	3.8	3.8	4.0	4.0
Export G&S growth (value, fob, percent change)	20.3	22.3	10.6	6.9	6.2	6.2	6.9	6.8
Import G&S growth (value, fob, percent change)	12.1	29.1	12.1	7.8	5.8	6.0	6.7	6.4
Export G&S price increase (percent change)	6.9	8.8	4.2	1.3	0.2	0.1	0.7	0.6
Import G&S price increase (percent change)	6.2	5.4	4.7	1.1	-0.3	-0.1	0.6	0.5
Gross reserves (billions of euros)	5.8	4.9	5.4	6.7	6.2	5.9	6.3	6.4
(in months of prospective imports)	5.5	4.2	4.2	5.0	4.3	3.8	3.9	3.7
Reserve cover 1/	41.1	37.1	40.0	44.0	40.0	39.6	39.1	38.9
Banks' short-term liabilities (billions of euros)	7.7	7.2	8.5	8.7	9.0	9.2	9.5	9.8
Total short-term debt (billions of euros)	9.6	9.2	10.7	11.1	11.3	11.7	12.2	12.6
Reserves (percent of short-term external debt)	60.3	53.6	50.6	60.9	54.8	50.0	51.6	50.8
External debt service ratio (%)								
Gross external debt (billions of euros)	30.0	29.5	30.2	31.8	31.4	31.4	32.3	32.9
Medium- and long-term (billions of euros)	20.4	20.2	19.5	20.7	20.1	19.7	20.1	20.3
Short-term (billions of euros)	9.6	9.2	10.7	11.1	11.3	11.7	12.2	12.6
Net external debt (billions of euros) 2/	9.8	9.4	8.6	8.1	7.6	7.4	6.7	6.3
Gross external debt	165.1	143.9	138.3	137.2	127.3	119.3	115.2	110.5
Medium- and long-term	112.2	98.9	89.3	89.4	81.4	74.7	71.8	68.3
Short-term	52.8	45.0	49.0	47.7	45.9	44.6	43.4	42.2
Net external debt 2/	54.2	46.0	39.5	35.1	31.0	28.0	24.0	21.1
Nominal GDP (billions of euros)	18.2	20.5	21.8	23.1	24.7	26.3	28.0	29.8
U.S. dollar per euro (period average)	1.33	1.39	...	...	...	...	...	...
Lats per euro (period average)	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70

Sources: Latvian authorities; and IMF staff estimates.

1/ Gross reserves in percent of total short-term liabilities and amortization minus the current account surplus.

2/ Gross external debt minus gross external debt assets.

Table 8. Latvia: External Debt Dynamics, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
(billions of euros)								
Gross external debt	30.0	29.5	30.2	31.8	31.4	31.4	32.3	32.9
Public 1/	6.0	6.5	7.0	8.4	7.7	7.2	7.6	7.7
Short-term	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Long-term	5.9	6.4	6.8	8.2	7.6	7.1	7.5	7.6
Private	24.0	22.9	23.2	23.4	23.7	24.2	24.7	25.2
Banks	15.6	13.9	14.1	14.1	14.4	14.7	15.0	15.4
Short-term	7.7	7.2	8.5	8.7	9.0	9.2	9.5	9.8
Long-term	7.9	6.7	5.6	5.4	5.4	5.5	5.5	5.6
Corporate	5.8	5.9	6.0	6.1	6.1	6.2	6.3	6.4
Short-term	1.8	1.9	2.1	2.2	2.2	2.4	2.5	2.6
Long-term	4.0	4.0	3.9	3.9	3.8	3.8	3.7	3.7
Other	2.6	3.1	3.1	3.2	3.3	3.3	3.4	3.4
(percent of GDP)								
Gross external debt	165.1	143.9	138.3	137.2	127.3	119.3	115.2	110.5
Public	33.1	31.8	31.9	36.2	31.3	27.5	27.2	26.0
Short-term	0.7	0.6	0.6	0.6	0.5	0.5	0.5	0.4
Long-term	32.4	31.2	31.3	35.6	30.8	27.0	26.7	25.5
Private	132.0	112.1	106.4	101.0	96.0	91.8	88.1	84.6
Banks	85.6	68.1	64.4	60.9	58.2	55.8	53.7	51.7
Short-term	42.2	35.1	38.7	37.6	36.3	35.1	34.0	32.9
Long-term	43.4	33.0	25.7	23.3	21.9	20.7	19.7	18.8
Corporate	32.0	29.0	27.6	26.3	24.6	23.4	22.4	21.3
Short-term	10.0	9.3	9.7	9.6	9.1	9.1	9.0	8.9
Long-term	22.0	19.7	17.9	16.7	15.5	14.4	13.4	12.4
Other	14.3	15.0	14.3	13.8	13.2	12.6	12.0	11.5
(debt dynamics, change in debt to GDP ratio)								
Total Debt to GDP	8.3	-21.1	-5.6	-1.1	-9.9	-8.0	-4.0	-4.7
Due to change in debt	4.9	-2.5	3.4	6.7	-1.3	-0.1	3.1	2.2
Due to nominal GDP	3.5	-18.6	-9.0	-7.9	-8.5	-7.9	-7.2	-6.9
Public Debt to GDP	7.3	-1.3	0.1	4.2	-4.9	-3.9	-0.3	-1.2
Due to change in debt	6.7	2.5	2.1	6.0	-2.6	-1.9	1.4	0.4
Due to nominal GDP	0.6	-3.7	-2.0	-1.8	-2.2	-1.9	-1.7	-1.6
Private Debt to GDP	1.0	-19.9	-5.7	-5.3	-5.0	-4.2	-3.7	-3.5
Due to change in debt	-1.9	-5.0	1.3	0.7	1.3	1.8	1.8	1.8
Due to nominal GDP	2.9	-14.9	-7.0	-6.0	-6.3	-6.0	-5.5	-5.3
Memorandum items:								
Nominal GDP (billions of euros)	18.2	20.5	21.8	23.1	24.7	26.3	28.0	29.8
Sources: Latvian authorities and IMF staff estimates.								
1/ Debt of general government, including Bank of Latvia.								

Table 9. Latvia: External Debt Sustainability Framework, 2007–17

(In percent of GDP, unless otherwise indicated)

	Actual											Debt-stabilizing non-interest current account 6/ -7.8
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
<b>1 Baseline: External debt</b>	128.4	130.9	156.8	165.1	143.9	<b>138.3</b>	<b>137.2</b>	<b>127.3</b>	<b>119.3</b>	<b>115.2</b>	<b>110.5</b>	
2 Change in external debt	13.7	2.6	25.8	8.3	-21.1	-5.6	-1.1	-9.9	-8.0	-4.0	-4.7	
3 Identified external debt-creating flows (4+8+9)	-12.2	1.5	23.3	-0.7	-20.5	-8.4	-5.3	-5.9	-5.4	-5.2	-5.2	
4 Current account deficit, excluding interest payments	18.4	7.8	-13.2	-6.9	-1.0	-1.1	-0.1	0.0	0.1	0.1	0.0	
5 Deficit in balance of goods and services	20.6	13.9	1.1	1.0	4.3	5.3	5.9	5.7	5.5	5.4	5.2	
6 Exports	41.6	42.3	43.3	53.2	57.7	59.8	60.3	60.1	59.8	60.1	60.4	
7 Imports	62.2	56.2	44.4	54.1	62.0	65.2	66.2	65.7	65.3	65.5	65.5	
8 Net non-debt creating capital inflows (negative)	-6.8	-1.4	2.5	-1.2	-4.1	-3.6	-3.9	-4.0	-4.0	-4.2	-4.3	
9 Automatic debt dynamics 1/	-23.8	-4.9	34.0	7.3	-15.5	-3.8	-1.4	-1.9	-1.6	-1.1	-0.9	
10 Contribution from nominal interest rate	4.1	5.4	4.6	3.9	3.1	3.3	3.5	3.5	3.4	3.4	3.4	
11 Contribution from real GDP growth	-8.3	3.9	28.4	1.5	-8.0	-7.1	-4.9	-5.4	-5.0	-4.5	-4.3	
12 Contribution from price and exchange rate changes 2/	-19.6	-14.2	1.0	1.9	-10.6	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	26.0	1.0	2.6	9.0	-0.6	2.8	4.2	-3.9	-2.6	1.1	0.5	
External debt-to-exports ratio (in percent)	308.7	309.6	362.2	310.4	249.3	231.1	227.4	211.9	199.3	191.7	183.1	
<b>Gross external financing need (in billions of euros) 4/</b>	14.9	19.5	11.0	9.6	14.1	13.3	13.5	15.3	15.5	14.8	16.0	
in percent of GDP	71.4	85.7	59.2	53.0	68.8	61.0	58.4	62.0	59.0	52.9	53.9	
<b>Scenario with key variables at their historical averages 5/</b>						<b>143.3</b>	<b>145.0</b>	<b>139.0</b>	<b>134.3</b>	<b>133.0</b>	<b>131.1</b>	<b>-10.3</b>
<b>Key Macroeconomic Assumptions Underlying Baseline</b>						Historical Average	Standard Deviation					
Real GDP growth (in percent)	9.6	-3.3	-17.7	-0.9	5.5	3.8	8.9	5.2	3.7	4.2	4.0	4.0
GDP deflator in euros (change in percent)	20.6	12.4	-0.7	-1.2	6.8	5.0	8.0	1.4	2.2	2.3	2.3	2.3
Nominal external interest rate (in percent)	4.7	4.6	2.9	2.4	2.1	3.1	0.9	2.4	2.7	2.9	3.0	3.2
Growth of exports (euro terms, in percent)	24.5	10.6	-16.4	20.3	22.3	12.7	12.8	10.6	6.9	6.2	6.9	6.8
Growth of imports (euro terms, in percent)	23.5	-1.7	-35.5	19.4	29.1	12.3	19.9	12.1	7.8	5.8	6.0	6.7
Current account balance, excluding interest payments	-18.4	-7.8	13.2	6.9	1.0	-5.7	10.4	1.1	0.1	0.0	-0.1	0.0
Net non-debt creating capital inflows	6.8	1.4	-2.5	1.2	4.1	3.1	2.7	3.6	3.9	4.0	4.0	4.3

Source: IMF staff estimates.

1/ Derived as  $[r - g - \rho(1+g) + \alpha\epsilon(1+r)] / (1+g+\rho+g\rho)$  times previous period debt stock, with  $r$  = nominal effective interest rate on external debt;  $\rho$  = change in domestic GDP deflator in euro terms,  $g$  = real GDP growth rate,  $\epsilon$  = nominal appreciation (increase in dollar value of domestic currency), and  $\alpha$  = share of domestic-currency denominated debt in total external debt.2/ The contribution from price and exchange rate changes is defined as  $[-\rho(1+g) + \alpha\epsilon(1+r)] / (1+g+\rho+g\rho)$  times previous period debt stock.  $\rho$  increases with an appreciating domestic currency ( $\epsilon > 0$ ) and rising inflation (based on GDP deflator).

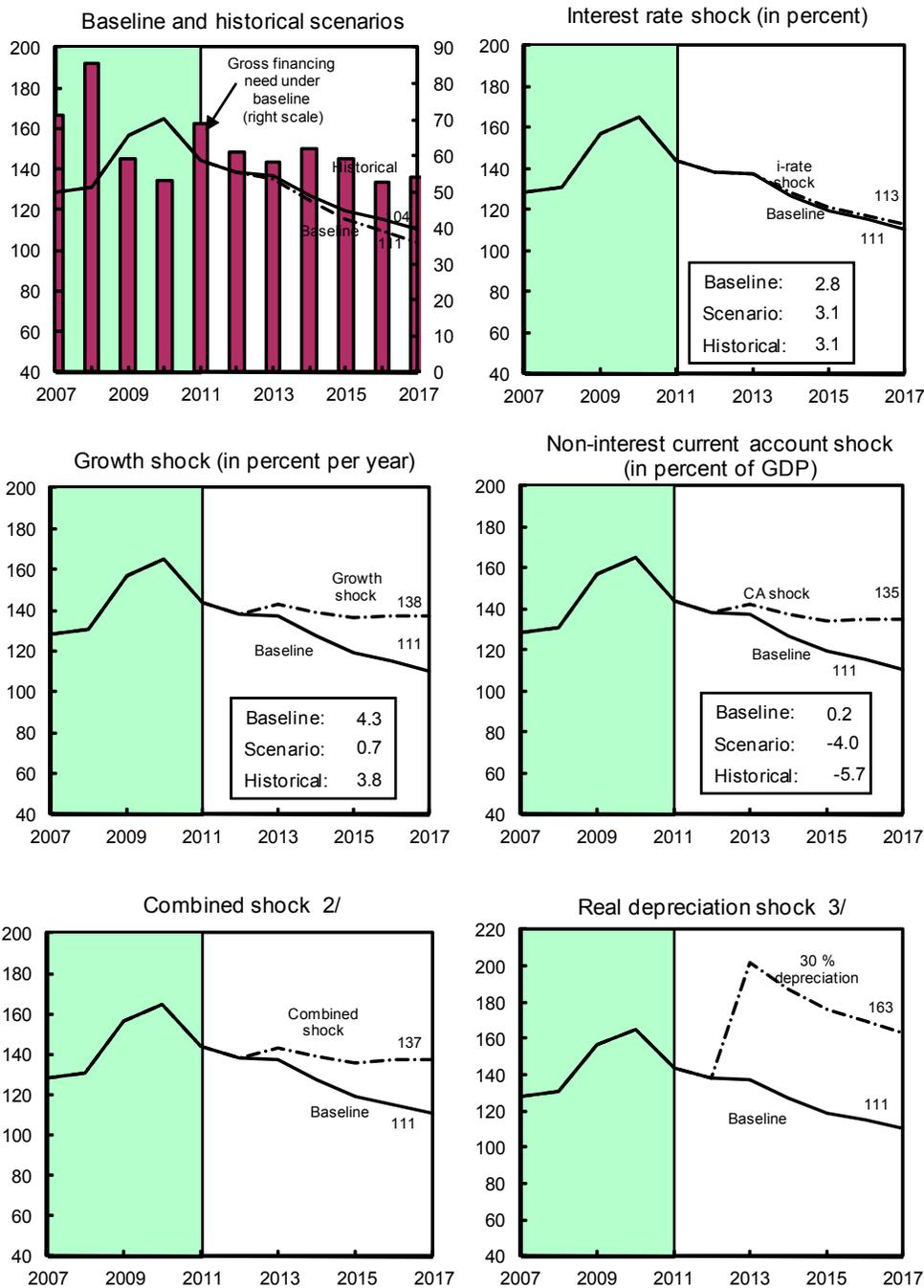
3/ For projection, line includes the impact of price and exchange rate changes.

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.

**Figure 10. Latvia: External Debt Sustainability: Bound Tests**  
(External debt in percent of GDP)



Sources: IMF 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.  
3/ One-time real depreciation of 30 percent occurs in 2012.

**Table 10. Latvia: Bank of Latvia Balance Sheet, 2008–13**

	2008	2009	2010	2011	2012	2013
	Actual			Projections		
	(billions of Lats, current exchange rate)					
Reserve money	2.1	1.9	2.6	2.4	2.5	2.6
Currency issued	1.0	0.8	0.9	1.2	1.2	1.3
Reserves at the BoL	1.1	1.1	1.7	1.2	1.3	1.3
Required reserves	1.1	0.9	0.8	1.0	1.1	1.1
Deposit facility	0.0	0.3	0.9	0.2	0.2	0.2
Net foreign assets 1/	2.3	3.3	4.0	3.4	3.8	4.7
Foreign assets	2.7	3.4	4.1	3.5	3.8	4.8
Foreign liabilities	0.4	0.1	0.0	0.1	0.0	0.0
Net domestic assets	-0.2	-1.4	-1.4	-1.1	-1.3	-2.1
Net credit to government	-0.6	-1.3	-1.1	-0.7	-0.9	-1.7
Net credit to banks (excluding deposit facility)	0.6	0.1	0.0	0.0	0.0	0.0
Net credit to other sectors	0.0	0.0	-0.1	0.0	-0.1	-0.1
Other items, net	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Memorandum items:						
Base money 2/	2.1	1.6	1.8	2.2	2.4	2.5
Net foreign assets (percent of base money)	110.5	201.3	222.7	158.2	159.8	191.4
Net foreign assets (percent of reserve money)	110.4	174.3	153.6	145.8	150.9	182.4
Net foreign assets (percent of M2)	67.3	112.2	112.6	93.7	103.8	121.4
Net foreign assets (percent of broad money)	39.3	56.9	63.1	53.0	57.3	66.9
Broad money multiplier	2.8	3.1	2.4	2.8	2.6	2.7

Sources: Bank of Latvia; and IMF staff estimates.

1/ Includes Treasury foreign assets deposited at the BoL.

2/ Excludes banks' deposits at deposit facility.

Table 11. Monetary Survey, 2008–13

	2008	2009	2010	2011	2012	2013
	Actual				Projections	
	(billions of Lats)					
Broad money	5.9	5.8	6.4	6.5	6.6	7.1
Lats broad money (M2)	3.5	3.0	3.6	3.7	3.7	3.9
Currency in circulation	0.9	0.7	0.8	1.0	1.1	1.2
Lats deposits	2.6	2.3	2.8	2.6	2.6	2.7
Resident foreign exchange deposits	2.5	2.9	2.8	2.8	3.0	3.2
Net foreign assets	-5.9	-3.0	-1.2	-0.2	0.3	1.4
Bank of Latvia	2.3	3.3	4.0	3.4	3.8	4.7
Domestic money banks	-8.2	-6.3	-5.3	-3.7	-3.5	-3.4
Net domestic assets	11.8	8.8	7.6	6.7	6.4	5.7
Domestic credit	14.3	12.2	11.2	11.0	9.9	9.2
Credit to government, net	-0.4	-1.5	-1.4	-0.7	-0.9	-1.7
Credit to public corporations	0.4	0.4	0.5	0.4	0.5	0.5
Credit to private sector	14.3	13.3	12.2	11.3	10.3	10.4
Other items, net	-2.4	-3.4	-3.6	-4.3	-3.5	-3.5
Sources of funds of deposit money banks	18.2	16.3	16.4	15.2	15.4	15.8
Resident deposits	5.1	5.2	5.6	5.4	5.5	5.9
Non-resident deposits	3.5	3.3	4.2	4.9	5.8	6.0
Liabilities to foreign financial institutions	9.3	7.4	6.5	4.7	3.9	3.7
Other foreign liabilities	0.4	0.6	0.1	0.1	0.2	0.2
Uses of funds of deposit money banks	18.2	16.3	16.4	15.2	15.4	15.8
Reserves	1.2	1.2	1.8	1.3	1.4	1.4
Cash in vault	0.2	0.1	0.1	0.1	0.1	0.1
Required reserves	1.1	0.9	0.8	1.0	1.1	1.1
Deposit facility	0.0	0.3	0.9	0.2	0.2	0.2
Domestic credit	14.3	13.4	12.3	11.8	10.7	11.0
Foreign assets	4.9	4.9	5.6	6.1	6.3	6.5
Other items, net	-2.2	-3.1	-3.3	-4.0	-3.1	-3.1
<i>Memorandum: private credit net of provisions</i>	12.9	11.0	9.8	8.9	8.6	8.9
	(annual percentage change)					
Broad money	-3.9	-1.9	9.8	1.5	2.5	6.6
Net foreign assets	...	48.9	59.6	81.6	229.2	368.0
Bank of Latvia	...	42.1	21.7	-14.8	10.9	24.5
Domestic money banks	...	23.2	17.1	30.3	3.9	3.9
Net domestic assets	11.2	-25.4	-13.9	-11.8	-5.2	-10.0
Domestic credit	9.7	-14.5	-8.1	-1.5	-10.8	-6.4
Credit to government, net	-323.3	-298.5	2.9	53.6	-36.7	-83.3
Credit to public corporations	52.5	3.8	19.9	-8.3	15.2	0.0
Credit to private sector	11.0	-6.9	-8.4	-7.4	-9.0	1.2
Private credit net of provisions	8.9	-14.6	-11.0	-9.3	-3.3	3.5
	(percent of GDP, unless otherwise indicated)					
Memorandum items:						
Lats broad money (M2)	21.6	22.6	28.0	25.7	23.9	24.0
Broad money	36.9	44.5	50.0	45.4	43.3	43.6
Currency in circulation	5.4	5.1	6.3	7.3	7.2	7.2
Residents' FX deposits (percent of total deposits)	48.6	55.6	50.3	51.7	53.8	53.8
Domestic credit	88.8	93.4	87.7	77.4	64.2	56.7
Private sector credit	88.7	101.6	95.2	79.0	66.9	63.8

Sources: Bank of Latvia; and IMF staff estimates.

**Table 12. Latvia: Financial Soundness Indicators, 2007–12**

(In percent, unless otherwise indicated)

	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Sep-12
<b>Commercial banks</b>						
<i>Capital Adequacy</i>						
Regulatory capital to risk-weighted assets	11.1	11.8	14.6	14.6	17.4**	17.7
Regulatory Tier I capital to risk-weighted assets 1/	9.8	10.5	11.5	11.5	14.2**	15.23
Capital and reserves to assets	7.9	7.3	7.4	7.3	7.5	9.4**
<i>Asset Quality</i>						
Annual growth of bank loans	37.2	11.2	-7.0	-7.1	-8.1	-3.2**
Loans past due over 30 days		7.8	20.3	21.5	19.9	14.4**
Loans past due over 90 days	0.8	3.6	16.4	19.0	17.5	12.5**
Loans past due over 90 days net of loan loss provisions to capital		13.6	67.6	65.3	40.4	18.5**
Loan loss provisions to loans past due over 90 days		61.3	57.4	61.6	72.3	76.0**
Loan loss provisions to total loans		2.2	9.4	11.7	12.6	9.1**
Share of loans in total assets, banks dealing with residents 2/	80.4	82.5	76.4	74.7	76.2	78.3**
Share of loans in total assets, banks dealing with non-residents 2/	48.9	51.7	52.4	46.4	40.1	37.3**
<i>Earnings and Profitability</i>						
ROA (after tax)	2.0	0.3	-3.5	-1.6	-0.9	0.8**
ROE (after tax)	24.3	4.6	-41.6	-20.4	-11.2	7.6**
Net interest income to total income	32.5	30.1	23.3	19.0	20.9	25.4**
Noninterest expenses to total income	32.3	47.5	114.5	93.5	86.7	65.8**
Trading income to total income	7.8	5.6	8.6	5.4	6.5	8.1**
Personnel expenses to noninterest expenses	31.5	21.3	8.5	11.9	11.9	17.4**
<i>Income from operations with non-residents to total income</i>						
Banks dealing with residents 2/	13.0	13.7	21.0	25.7	18.8	12.4**
Banks dealing with non-residents 2/	49.2	48.0	44.8	46.6	52.3	53.6**
<i>Liquidity</i>						
Liquid assets to total assets	25.0	21.6	21.1	27.3	27.4	29.7**
Liquid assets to short term liabilities	55.7	52.8	62.8	67.9	63.9**	59.3
Customers deposits to (non-interbank) loans	68.2	58.8	61.9	77.5	84.1	99.5**
<i>Sensitivity to Market Risk</i>						
Net open positions in FX to capital 3/	5.4	6.3	4.1*	4.2	3.2**	4.7
Net open positions in EUR to capital	3.2	3.7	3.0*	2.8	1.8**	3.8
FX assets to total assets	79.7	80.5	82.7	80.6	81.1	80.8**
FX deposits to total deposits	70.7	69.4	74.5	72.6	73.5	76.5**
FX liabilities to total liabilities 3/	81.7	81.1	83.8	81.6	79.1	81.2**
FX loans to total loans 3/	81.8	85.0	87.1	88.9	86.3	85.6**
<b>Nonfinancial Enterprises 4/</b>						
Total debt to equity	202.0	217.6	281.2	264.5	238.7	207.5
Return on equity	31.1	14.4	1.7	-0.1	2.0	2.8
Earnings to interest expenses	496.7	225.9	24.1	169.6	655.6	493.5
<b>Households</b>						
Household debt to GDP	42.4	41.1	48.1	46.3	38.6	33.3
Household debt service to GDP 5/	2.48	2.72	2.52	1.97	1.60	1.45
<b>Real Estate Markets</b>						
Real estate prices annual growth rate 6/	-7.3	-37.1	-39.6	7.6	-1.0	1.0
Residential real estate loans to total loans 7/	31.6	30.5	31.3	32.1	31.9	31.9**
Commercial real estate loans to total loans 7/	17.8	19.5	19.9	18.0	16.8	16.2
<b>Memorandum Items</b>						
Number of banks dealing with residents 2/	9	14	15	15	17	12**
Number of banks dealing with non-residents 2/	14	13	12	14	13	16**
Assets of banks dealing with residents/Total banking system assets 2/	60.8	63.9	78.4	66.6	63.3	56.6**
Assets of banks dealing with non-residents/Total banking system assets 2/	39.2	36.1	21.6	33.4	36.7	43.4**

Sources: Latvian Central Statistical Bureau; BoL; FCMC; Latvian Leasing Association; and IMF staff calculations.

\*Excluding Parex Bank hereinafter (Parex Bank was bailed-out in November 2008; it was excluded from the calculation of net open currency position as of March 2009 as they didn't comply with the limits on net open currency position set by Minimum Capital Requirements regulation after they have received the state support and several restrictions on their operations were introduced; as of July 2011 banking regulator (FCMC) allowed Parex Bank not to comply with capital adequacy regulation and excluded it from calculation of other regulatory ratios; banking licence of Parex Bank was cancelled as of March 2012 as it was converted to asset management company "Reverta").

\*\*Excluding Parex Bank and Latvijas Krājbanka hereinafter (operations of Latvijas Krājbanka were suspended as of November 2011 and its banking licence was cancelled as of May 2012).

1/ Regulatory Tier 1 capital to risk weighted assets as from Dec\_2009 is calculated as Tier 1 capital (including deduction)/risk-weighted assets.

2/ Banks dealing with residents (non-residents) are defined as banks in which non-resident non-MFI deposits are below (above) 20 percent of their assets.

3/ Including euro-denominated positions.

4/ Data is not annualized and not comparable to yearly figures due to different sample (for 3, 6, 9 and 12 months respectively). Starting from Q2 2010 data used in calculations is adjusted to full coverage of the nonfinancial enterprises. Last observation in 2011 is from September and in 2012 is from June.

5/ Interest payments only.

6/ Prices of typical standard apartments in Riga. Source: Real estate company Latio.

7/ Loans to residents only to total loans (including loans to non-residents). Last observation on commercial real estate loans is from June 2012.

**Table 13. Latvia: Indicators of Fund Credit, 2009–16 1/**

(millions of SDRs)

	2009	2010	2011	2012	2013	2014	2015	2016
Stock, existing	713.8	982.2	982.2	0.0	0.0	0.0	0.0	0.0
Obligations, existing	11.2	21.8	26.9	1003.0	1.6	0.0	0.0	0.0
Repurchase	0.0	0.0	0.0	982.2	0.0	0.0	0.0	0.0
Charges	11.2	21.8	26.9	20.8	1.6	0.0	0.0	0.0
Stock of existing Fund credit								
In percent of quota	502.3	691.2	691.2	0.0	0.0	0.0	0.0	0.0
In percent of GDP	4.3	6.2	5.4	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and services	9.8	11.7	9.4	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	16.1	19.7	23.3	0.0	0.0	0.0	0.0	0.0
Obligations to the Fund from existing Fund drawings								
In percent of quota	7.8	15.3	18.9	705.9	1.1	0.0	0.0	0.0
In percent of GDP	0.1	0.1	0.1	5.5	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.2	0.3	0.3	9.2	0.0	0.0	0.0	0.0
In percent of gross reserves	0.3	0.4	0.6	22.6	0.0	0.0	0.0	0.0

Source: IMF staff estimates.

1/ Assumes full repayment of outstanding Fund obligations in December 2012.

## Appendix I. The Non-Resident Banking Sector in Latvia

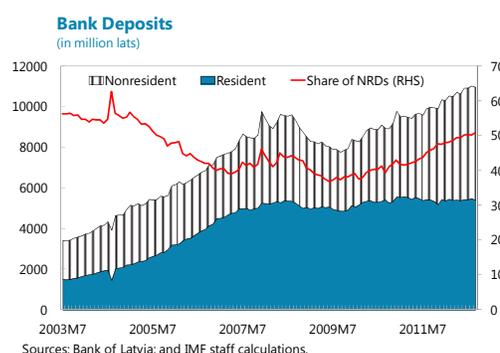
**The financial sector in Latvia is dominated by commercial banks, with a strong foreign presence.** Commercial banks' assets accounted for almost 90 percent of total assets in the financial sector and 150 percent of GDP at end-2001. There are 20 commercial banks—including 8 subsidiaries of foreign banks from Sweden, Norway, Austria, Russia and Ukraine—and 8 foreign bank branches in Latvia.

**The banking sector is segmented between banks dealing with domestic clients and banks dealing with non-resident clients (NR banks).** This split in business models is to a large extent correlated with bank ownership. In broad terms, the subsidiaries of Nordic banks and the branches of foreign banks deal with resident clients while the other banks focus on non-resident clients. NRDs account for: more than 70 percent of deposits for 2/3 of local banks; more than 60 percent of deposits for all non-Nordic subsidiaries; and less than 10 percent of deposits for all but one branch of foreign banks and for all Nordic subsidiaries.

**A large fraction of foreign depositors are from CIS countries.** As of end-September 2012, about 1/3 of NRDs were from EU countries, 12 percent from CIS countries (70 percent of them from Russia) and 55 percent from other non-EU jurisdictions. The latter, however, corresponds largely to offshore companies from jurisdictions such as the British Virgin Islands and Belize, whose ultimate beneficial owners are mostly CIS residents. Also, 58 and 25 percent of EU deposits are from the U.K. and Cyprus respectively, but the ultimate owners are mainly CIS residents. Overall, 80 to 90 percent of NRDs are estimated to come from CIS countries. CIS depositors have historically found Latvia attractive as a provider of banking services for a number of reasons: (i) its geographical location; (ii) widespread fluency in Russian; and (iii) efficient and competitively priced banking services.

### **Banks specialized in non-resident clients constitute a large and increasing fraction of the banking sector.**

NRDs across the banking system are about L5.5 billion or 51 percent of total deposits. Almost 60 percent of banks in Latvia, accounting for 43 percent of the banking system in terms of assets and 58 percent in terms of total deposits, specialize in non-resident customers according to the FCMC's classification rule—which considers a bank



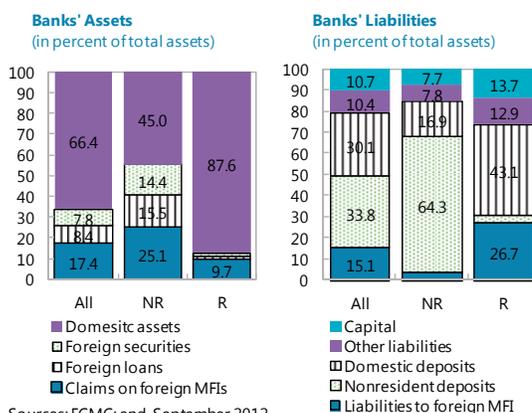
as specialized in non-resident clients if NRDs represent more than 20 percent of its assets. While the size of the non-resident segment in Latvia has always been large, it is expanding at a rapid pace. In the 12 months to end-September 2012 NRDs increased by 19.7 percent (15.7 percent if exchange rate effects are excluded). The recent acceleration is believed to be mainly due to CIS depositors relocating their funds from countries with banks under stress in the euro area, mainly Cyprus. Another potential driver of recent NRD flows is the fact that since mid-2010 Latvia grants EU residency permits to foreigners investing at least L200,000 in the form of subordinated debt of a credit institution (other eligibility criteria include investment in real estate or in nonfinancial companies). But this factor seems to have played a minor role, as only about L50 million in investment (out of L290 million) claimed for obtaining EU residency permits were made in the banking sector.

**A large share of NR banks' assets is invested abroad.** The share of foreign assets in NR banks' total assets is about 55 percent, while it is only 12 percent for banks dealing with residents. More than 90 percent of these assets are issued by counterparts in the European Economic Area (EEA, 62 percent), CIS countries (18 percent) and the U.S. and Canada (13 percent).

- Almost half of total foreign assets held by NR banks are **claims on foreign MFIs**, 80 percent of which are from EEA countries (of which banks from Germany, Austria, the U.K. and Switzerland account for 77 percent).

- **Foreign loans** account for about 1/4 of NR banks' foreign assets. About 70 percent of these are granted to clients from CIS countries, either directly (40 percent of total foreign loans) or indirectly through jurisdictions such as the U.K., Cyprus, British Virgin Islands and Belize.

- **Foreign securities** account for 1/4 of the foreign assets of NR banks, almost half of which correspond to *government securities*. Among the latter, 93 percent is issued by the U.S., Canada or EEA countries. These countries also account for 57 percent of *non-government securities*, while 28 percent is issued by corporates from CIS countries.



Latvia: Structure of the Banking Sector (end-September 2012)

	Loans		Claims on MFIs		Gov. Securities		Other Securities		Total assets		Liab. to Foreign MFIs	Deposits		Capital	Other Liabilities
	Total	Foreign	Total	Foreign	Total	Foreign	Total	Foreign	(mln. Lats) (% of GDP)		Total	NR			
<b>System</b>	60.5	7.6	16.7	15.7	5.2	3.0	5.1	3.8	19,809	130.2	20.3	60.2	29.8	9.4	10.0
<b>Banks</b>	56.9	8.4	18.4	17.4	5.9	3.4	5.8	4.4	17,256	113.4	15.1	63.8	33.8	10.7	10.4
Of which, by activity:															
dealing with NR depositors	37.2	15.5	26.8	25.1	9.7	6.3	10.5	8.0	8,569	56.3	3.3	81.1	64.3	7.7	7.8
dealing with resident depositors	76.3	1.3	10.2	9.7	2.2	0.5	1.2	0.8	8,687	57.1	26.7	46.7	3.7	13.7	12.9
Of which, by ownership:															
Domestic banks	38.4	12.4	22.5	20.9	10.9	6.8	11.8	8.8	7,580	49.8	1.2	82.6	62.0	7.8	8.3
Subsidiaries of foreign banks	71.3	5.3	15.3	14.6	2.0	0.8	1.1	0.9	9,676	63.6	26.0	49.1	11.6	13.0	12.0
Of which: Nordic parents	77.4	1.3	10.4	10.3	1.7	0.5	1.1	0.8	7,954	52.3	28.8	44.9	2.9	13.6	12.7
Of which: CIS parents	28.5	9.7	45.7	44.1	3.6	2.2	0.4	0.4	908	6.0	0.9	85.8	63.4	7.4	5.9
<b>Branches of foreign banks</b>	85.1	2.3	5.1	4.5	0.2	0.0	0.0	0.0	2,553	16.8	55.7	35.9	3.0	0.6	7.8

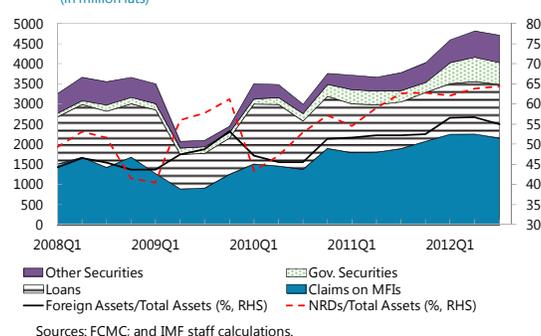
Source: FCMC.

**The rather rapid increase in NRDs in NR banks has been associated with an accumulation of liquid foreign assets.** While NRDs in banks dealing with non-resident clients increased by almost L1.4 billion between 2008 and 2012, their portfolio of foreign assets expanded by L1.2 billion, most of which is invested in liquid assets. Claims on foreign MFIs (with maturity up to 30 days) and government securities account for more than 90 percent of the foreign assets accumulated over the last 4 years. Foreign loans, instead, are at essentially the same level as in 2008.

**Consequently, NR banks have become more detached from the domestic economy.** Domestic assets held by NR banks have decreased by L0.5 billion between 2008 and 2012 (while total assets increased by 0.7 billion). Loans to residents granted by NR banks decreased by almost L1 billion over the same period.

**NR banks have smaller capital buffers than the rest, but are subject to higher minimums.**

While the average capital adequacy ratio of banks dealing with residents has increased from about 10 percent in 2007 to close to 20 percent in 2011, it has increased from slightly above 10 percent to about 15 percent for banks dealing with non-residents. NR banks face higher minimum levels, though: since mid-2011 the FCMC requires these banks to hold extra capital (from 0.5 to 9 percent of risk weighted assets) depending on the exposure of each bank to the non-resident business, and the growth rate of this exposure.

NR Banks' Assets: Foreign Assets  
(in million lats)

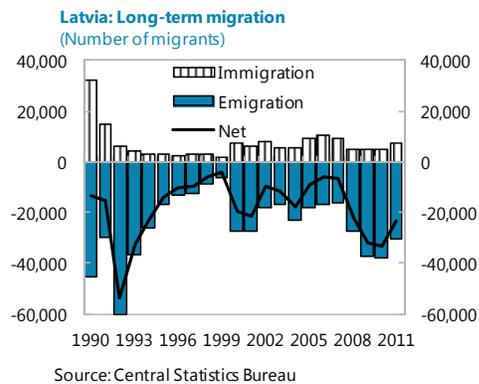
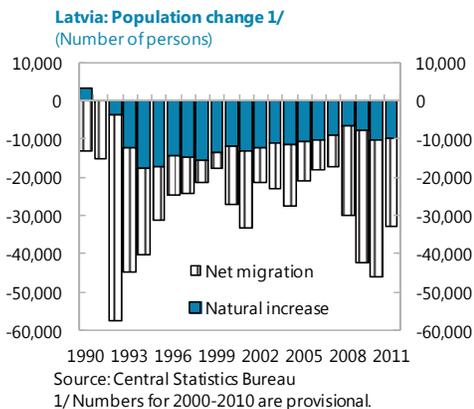
Sources: FCMC, and IMF staff calculations.

## Appendix II. Latvia's Demographic Challenge

**Latvia's population is shrinking rapidly.** During 2000–11, the population declined by about 14 percent (340 thousand people). Emigration was responsible for about  $\frac{2}{3}$  of this decline while natural change due to low fertility accounted for the remainder:

- *Emigration:* an estimated 200–215 thousand people, mainly young people—roughly 9 percent of the population—have left Latvia during 2000–11 (Hazans, 2011<sup>1</sup>; and Central Statistics Bureau); and
- *Low fertility:* the decline of the population for natural reasons was about 125–140 thousand people (5 percent of the population). The number of births has halved since the early 1990s—from around 40,000 annual births to around 20,000—falling below replacement levels.

**Demographic decline is not merely an economic issue, but is more broadly perceived as an important national concern.** On economic grounds alone, emigration may enhance welfare (in expectation) in the short-term as it is an alternative to unemployment, reduces unemployment insurance costs, and may increase the inflow of remittances. However, in the long term, emigration and demographic decline have negative economic consequences for the country, including to human capital, public finances, and pension schemes. For a small country like Latvia (about 2 million inhabitants), excessive emigration is unsustainable. The authorities are engaged in the difficult task of seeking to reverse incentives to emigrate and encourage the return of expatriates.



**Emigration tends to slow down substantially with economic recovery.** The largest episodes of emigration in the past decade occurred during the Russian crisis in the early 2000's and the global financial crisis in 2008–10 (see chart). In this latter period net emigration was about four times larger than it was during the boom in 2005–07. The contraction in labor demand during the crisis and consequent layoffs led unemployed workers to seek job opportunities abroad (the preferred destinations in 2011 for

<sup>1</sup> Sources: Mihails Hazans, 2011, "Who lives in Latvia today? A snapshot of real demographic situation", presentation: <http://www.lu.lv/zinas/t/7594/>

over ⅔ of emigrants were countries inside the European Union, notably Germany, the UK, and Ireland). Net emigration declined sharply in 2011, and is likely to fall further as the economy continues to rebound. It is less clear whether it will turn negative; inference is difficult based on the short and shock-filled empirical record. The authorities are optimistic that net emigration can be curbed, and surveys indicate that 20 percent of emigrants plan to return within 5 years (Hazans, 2011). On the other hand, given the large income gap between Latvia and preferred emigration destinations, some component of net emigration is likely to be structural and thus less amenable to reversal.

**The policies with the most traction to discourage emigration are pro-growth policies**, those favoring income convergence and factor price equalization over time, which are desirable in their own right. Measures such as facilitating immigration by other nationalities have less political support. Ministers have publicly encouraged expatriate Latvians to return home, but recognize that labor is mobile within the EU.

**Given the general nature of remedies for emigration, the more specific policy focus has been on increasing birth rates.** The draft *National Development Plan 2014–20* (NDP) sets “a stable basis for demographic growth” as a strategic objective. The *2013 budget* includes a variety of family-related measures:

- *Health care* – compensation for prescription medicines for mothers and children, extended access to medical services, and compensation for treatment of reproductive health.
- *Tax policy* – extended income tax allowance for dependents.
- *Social support* – extended cash transfers for children aged 0–1.5 years, higher floor and ceiling for parental benefits, and new cash transfer to families to facilitate access to kindergarten services.

**Available evidence on the drivers of fertility rates, although scant, favors supporting formal child care.** In principle, fiscal policy can help families to reduce the costs of children while also influencing preferences on the size of family. But this can occur only when the policy support is sufficiently large, consistent, and appropriately designed. Political pressure for universal rather than means-tested transfers could increase the risk of poorly targeted, fiscally costly measures that fall short of achieving their objective. More specifically, the available evidence indicates that:

- *Availability of formal childcare has an unambiguously positive effect on fertility rates, whether through childcare subsidies and enrollment, part-time employment or control over working time.*
- *Duration and payment of parental leave has an ambiguous effect on fertility, conditional on employment. Home- or childcare leave benefits that are not earnings related can have positive effect on fertility, especially among low-income families (e.g. Finland).*
- *Financial transfers can have a small and positive but usually temporary effect on fertility rates: they may induce earlier decisions to have children without significantly affecting overall fertility. Transfers*

*typically do not affect opportunity costs and cover only a small part of the direct costs, but can affect the fertility of low-income households.*

**Demographic policies must navigate a delicate balance between boosting fertility, containing disincentives for labor force participation, and reducing inequalities among beneficiaries.** Personal income tax allowances for children can be regressive, as unemployed and low-income families may not have enough income to benefit from the allowance. Similar support could more effectively be provided through child benefits. At the same time family oriented support in Latvia (both contributory and non-contributory) has been found to be poorly targeted. Therefore, priority should be given to means-testing all child allowances. Empirical evidence suggests that high levels and durations of parental benefits can disincentivize work: long paid leaves in particular can result in deteriorating skills. The best options for reconciling family and work incentives lie in policies promoting child care; the OECD countries with the highest female employment rates today are also the ones with high fertility rates. The recent literature has documented a significant negative elasticity of female labor supply with respect to the cost of child care of around -0.13 to -0.2. This implies that policies to reduce the cost of child care for families could achieve the dual goal of increasing fertility and promoting work incentives. In-work tax credits—desirable in their own right as conducive to greater low-skilled employment—could also help mitigate fertility decline if conditioned on the presence of children in the household.



# REPUBLIC OF LATVIA

December 19, 2012

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By

European Department

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## FUND RELATIONS

(As of November 30, 2012)<sup>1</sup>

I. **Membership Status:** Joined May 19, 1992; Article VIII

II. **General Resources Account:**

	SDR Million	Percent of Quota
Quota	142.10	100.00
Fund holdings of currency (Exchange Rate)	745.10	524.35
Reserve Tranche Position	0.06	0.04

III. **SDR Department:**

	SDR Million	Percent of Allocation
Net cumulative allocation	120.82	100.00
Holdings	94.73	78.41

IV. **Outstanding Purchases and Loans:**

	SDR Million	Percent of Quota
Stand-By Arrangements	603.04	424.38

V. **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

<sup>1</sup> Data and projections in this section do not reflect the authorities' subsequent announcement that they will make early repayment of all outstanding Fund credit in December 2012.

**VI. Projected Payments to Fund<sup>2</sup>:**

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

	<b>Forthcoming</b>				
	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
Principal	66.92	345.84	134.22	56.06	
Charges/Interest		7.42	1.71	0.30	0.02
Total	66.92	353.26	135.93	56.36	0.02

**VII. Exchange Rate Arrangement:**

The currency of Latvia is the lats, 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  $\pm 1$  percent band. On January 1, 2005, the lats was repegged to the euro at the rate  $\text{€}1=0.702804$  lats, and on April 29, 2005, Latvia entered ERM II, maintaining the previous band width. Exchange restrictions maintained for security reasons have been notified to the Fund for approval most recently in March 2011 (see EBD/11/11, March 11, 2011).

**VIII. Previous Article IV Consultation:**

The 2010 Article IV staff report was published on December 9, 2010 (IMF Country Report No. 10/356). The previous Article IV Board discussion took place on July 21, 2010. The Public Information Notice No. 10/104 was released on August 12, 2010.

**IX. 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.

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<sup>2</sup> Original schedule (does not reflect the authorities' subsequent announcement that they will make early repayment of all outstanding Fund credit in December 2012).

## X. 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.

### 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

**XI. Technical Assistance: Technical Assistance (2007–12):**

<b>Dept.</b>	<b>Project</b>	<b>Action</b>	<b>Timing</b>	<b>Counterpart</b>
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/L EG	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

**XII. Resident Representative Post:** Mr. David Moore was appointed Resident Representative effective from June 11, 2009.

## STATISTICAL ISSUES

### Assessment of Data Adequacy for Surveillance

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

2. **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 classification, 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.

3. **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.

4. **Monetary statistics:** Monetary statistics could provide more detail in the liabilities of depository corporations by subsectors of the general government in line with international standards.

5. **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.

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

7. **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 November 30, 2012

	Date of latest observation	Date received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of publication <sup>7</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>8</sup>	Data Quality – Accuracy and reliability <sup>9</sup>
Exchange Rates	11/29/2012	11/30/2012	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	11/29/2012	11/30/2012	D	D	D		
Reserve/Base Money	10/31/2012	11/15/2012	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	10/31/2012	11/15/2012	M	M	M		
Central Bank Balance Sheet	11/29/2012	11/30/2012	D	D	D		
Consolidated Balance Sheet of the Banking System	10/31/2012	11/15/2012	M	M	M		
Interest Rates <sup>2</sup>	10/31/2012	11/15/2012	M	M	M		
Consumer Price Index	10/31/2012	11/10/2012	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	9/30/2012	11/29/2012	M	Q	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	9/30/2012	11/29/2012	M	Q	M		
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	9/30/2012	11/29/2012	M	Q	M		
External Current Account Balance	9/30/2012	12/4/2012	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	9/30/2012	12/4/2012	M	M	M		
GDP/GNP	Q3 2012	11/9/2012	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q3 2012	12/4/2012	Q	Q	Q		
International Investment Position <sup>6</sup>	Q3 2012	12/4/2012	Q	Q	Q		

<sup>1</sup> Any reserve assets that are pledged or 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

<sup>2</sup> Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Includes external gross financial asset and liability position vis-à-vis nonresidents.

<sup>7</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

<sup>8</sup> 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).

<sup>9</sup> 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.

## RELATIONS WITH THE WORLD BANK

(As of December 7, 2012)

Title	Products	Provisional Timing of Missions	Expected Delivery Date
<b>1. Bank Work Program</b>	Evaluation of the employment and social protection situation in Latvia coming out of the crisis: "Who is Unemployed, Inactive or Needy? Assessment of Post-Crisis Policy Options"	October 2012	March 2013
	Competitiveness Report: Peer Review of Industrial Policy	March 2012	June 2013
	Ports: Competitiveness and Governance Review	January 2013	November 2013
<b>2. Fund Work Program</b>	Staff Visit	May 2013	May 2013
	2013 Article IV Consultation	October 2013	November 2013



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 13/11  
FOR IMMEDIATE RELEASE  
January 28, 2013

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

**IMF Executive Board Concludes 2012 Article IV Consultation and Second Post-Program Monitoring Discussions, and Ex-Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement with the Republic of Latvia**

On January 23, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV consultation<sup>1</sup> and the Second Post-Program Monitoring Discussions<sup>2</sup>, and the Ex-Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement<sup>3</sup> with the Republic of Latvia.

**Background**

Latvia continues to rebound vigorously from the deep downturn in 2008–09, despite recession in the euro area. Real GDP growth of 5.5 percent in 2011 and 5.7 percent in the first three quarters of 2012 was underpinned by both external and domestic demand. Strong job creation has resulted in falling unemployment, but the unemployment rate remains high at about

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<sup>1</sup> 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. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

<sup>2</sup> Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

<sup>3</sup> The requirement for ex post evaluations (EPEs) was agreed by the IMF Executive Board in September 2002 for members using exceptional access in capital account crises, and extended to any use of exceptional access in February 2003. The purpose of the EPE is to provide a critical and frank discussion of whether justifications presented at the outset of the arrangement—including the justification for exceptional access—were consistent with Fund policies and to review performance under the Fund-supported program.

15 percent, and half of the unemployed have been out of work for more than a year. Consumer price inflation has declined sharply from its peak, averaging [2.4] percent in 2012. Robust export growth is expected to keep the current account deficit at about 2 percent despite recovering import demand. Latvia has successfully returned to international markets.

As a result of fiscal consolidation measures over the last 4 years, Latvia reduced its general government deficit from nearly 10 percent of GDP in 2009 (ESA 95 definition) to 3.4 percent of GDP in 2011. Despite a 1 percentage point mid-year reduction in the statutory VAT rate and a supplementary budget containing additional expenditures, revenue over performance helped reduce the deficit to below 2 percent of GDP in 2012. The 2013 budget further cements past fiscal gains and should be consistent with both the Maastricht deficit criterion and the Stability and Growth Pact.

The banking system returned to profitability in 2011 and is well capitalized. Credit to residents has contracted substantially since the onset of the crisis, but the rate of contraction has been declining and is likely to level off soon. Non-resident deposits (NRDs) in the banking system—a potential source of vulnerability to international reserves—have been expanding rapidly, but to a large extent this process has been matched by an accumulation of liquid foreign assets.

The government aims at euro adoption in 2014. The country is well-positioned to meet all the Maastricht criteria in 2013. Joining the euro would remove residual currency risk, adding stability to the Latvian economy.

### **Executive Board Assessment**

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Latvia's early repayment of all outstanding obligations to the Fund following the successful international bond issuance, which reflects renewed confidence in the economy and the authorities' policies. The economy continues to recover strongly, inflation has fallen sharply, and the current account deficit is modest. While the medium-term economic outlook is favorable, risks are tilted to the downside because of the uncertain external environment. Directors emphasized the need for continued strong policies to safeguard financial stability, tackle persistently high structural unemployment, and strengthen potential growth.

Directors commended the authorities' remarkable fiscal adjustment and welcomed that the 2013 budget appropriately consolidates the fiscal gains, holding the budget deficit well below the Maastricht criterion. They called for sustaining measures to build fiscal space and avoid the resurgence of imbalances. Directors urged the authorities to keep the lowering of the Guaranteed Minimum Benefit and the decentralization of its financing under close review to ensure that the system continues to provide adequate support to the most vulnerable and avoids deepening regional disparities. They welcomed the authorities' readiness to reconsider the issue in light of the upcoming World Bank report. While some Directors saw merit in the planned cuts to the personal income tax in order to improve work incentives, others urged caution given concerns

about equity and fiscal space, and highlighted the need for compensatory measures. Directors agreed that structural fiscal reforms, including timely passage and effective implementation of the Fiscal Discipline Law, will be crucial to strengthening fiscal sustainability.

Directors noted that the banking system continues to recover. However, the rapid increase of non-resident deposits (NRDs) warrants vigilance, given that it represents a source of vulnerability to international reserves and a contingent fiscal liability. Directors welcomed higher minimum capital requirements for NRD-specialized banks, and recommended continued intensive and frequent supervision. Directors looked forward to completion of the banking sector restructuring, and noted that a new FSAP would be useful to take stock of the transformation since the crisis.

Directors welcomed the authorities' strong commitment to euro adoption and commended the progress towards meeting the Maastricht criteria. They noted however that continued strong implementation of structural reforms will be necessary to address high structural unemployment and enhance competitiveness. Priorities for action are reforms to the judicial system, the governance structure and transparency of state-owned enterprises, and the quality of higher and vocational education.

Directors agreed with the conclusions of the ex post evaluation. They concurred that the immediate program objectives were achieved and that important progress was made in meeting longer-term objectives. Key supporting elements included strong ownership by the authorities, significant support by the international community, including a large financing package, effective engagement by the private sector, an explicit and credible exit strategy, and a flexible program design. Directors also agreed that the case of Latvia shows the importance of adequately accounting for real-financial linkages in estimating the impact of financial stress on real activity and in program design.

### **Ex-Post Evaluation**

The economic boom in Latvia that began in 2000 and accelerated following accession to the European Union in 2004 proved unsustainable. Large private sector inflows fueled rapid economic growth driven mainly by domestic demand in the nontradeable sector. Inflation accelerated, a real estate bubble developed, and a large current account deficit opened. The accompanying increase in foreign indebtedness, which financed domestic credit expansion, led to the buildup of vulnerabilities particularly in the banking sector and heightened financial account risks.

By early 2008, the fast growth was leveling off but severe vulnerabilities turned the slowdown into a crisis. Capital flows came to a sudden stop as global liquidity tightened. Uncertainty regarding the financial condition of the largest domestically-owned bank led to a run on its deposits and a severe system-wide liquidity shortage. These pressures were compounded by concerns over the sustainability of the currency peg. In November, the authorities turned to the IMF and the European Commission for financial support to avert a systemic bank failure, prevent further decline in international reserves that could threaten the sustainability of the peg, and address the

deterioration in the fiscal position in the face of the decline in economic activity. The Stand-By Arrangement (SBA) was approved in December 2008 with an exceptional access of SDR 1.52 billion, equivalent to 1,200 percent of quota—one of the largest in Fund history at the time, with significant co-financing from other partners including the European Union and regional partners.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2012 Article IV consultation and Second Post-Program Monitoring Discussions with the Republic of Latvia.

**Latvia: Selected Economic Indicators, 2009–13**

	2009	2010	2011	2012	2013
				Projections	
<b>Real Economy</b>					
Real GDP (percentage change)	-17.7	-0.9	5.5	5.2	3.7
HICP inflation (percentage change, period average)	3.3	-1.2	4.2	2.4	2.2
Unemployment rate (period average, percent) 1/	18.2	18.7	16.2	15.0	13.7
Nominal GDP (billions of lats)	13.1	12.8	14.3	15.3	16.3
<b>Public Finance 2/</b> (percent of GDP, unless otherwise indicated)					
Total Revenue	36.2	36.0	35.6	38.0	35.4
Total Expenditure	43.3	42.4	38.7	38.7	36.6
Basic fiscal balance	-7.1	-6.4	-3.1	-0.7	-1.2
ESA balance	-9.7	-8.2	-3.4	-1.8	-1.7
General government gross debt	32.9	39.7	37.5	37.6	42.2
<b>Balance of payments</b>					
Trade balance	-7.1	-7.0	-10.7	-11.9	-12.3
Current account balance	8.7	3.0	-2.1	-2.2	-3.4
Gross official reserves (billions of euros)	4.8	5.8	4.9	5.4	6.7
Gross external debt	156.8	165.1	143.9	138.3	137.2
Net external debt 3/	58.8	54.2	46.0	39.5	35.1
<b>Exchange rates</b>					
Lats per U.S. dollar (average)	0.506	0.530	0.501	...	...
Lats per euro (average)	0.704	0.704	0.697	...	...
REER (period average; CPI based, 2000=100)	110.2	103.6	103.8	...	...
(percent change, + denotes appreciation)	5.5	-6.0	0.2	...	...
<b>Money and Credit</b>					
Broad money (percentage change)	-1.9	9.8	1.5	2.5	6.6
Credit to private sector (percentage change)	-6.9	-8.4	-7.4	-9.0	1.2
Treasury Bill rate (365 days, eop, percent)	10.2	1.8	1.7	...	...
Money market rate (one month, eop, percent, annualized)	2.7	0.6	1.1	...	...

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

1/ LFS statistics were revised in 2011 in compliance with population census; data before 2011 have not been revised yet.

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

3/ Gross external debt minus gross external debt assets.

**Statement by the Staff Representative on the Republic of Latvia**  
**January 23, 2013**

1. **This statement summarizes developments in Latvia since the issuance of the staff report** (EBS/12/167). The additional information does not change the thrust of the staff appraisal.
  
2. **Latvia repaid all outstanding obligations to the Fund on December 20, 2012.** The repurchase amounted to SDR 603.038 million (about €714.3 million) and covered obligations under the 2008-11 SBA program. This development was prefigured in the staff report. All tables and charts in the staff report already incorporate the repayment, unless otherwise specified.

**Statement by Mr. Benny Andersen, Executive Director,  
and Mr. Gundars Davidsons, Senior Advisor to the Executive Director  
on the Republic of Latvia  
January 23, 2013**

On behalf of the Latvian authorities, we thank staff for the excellent analysis provided in the reports and the selected issues papers. The Latvian authorities have always given careful consideration to policy recommendations coming from the Fund. Also this time, the authorities and staff had fruitful discussions and staff provided a valuable insight on the economy's risks and challenges. Though the views differed on some minor points, the Latvian authorities broadly agree with the views outlined in the Article IV/PPM and Ex-Post Evaluation reports. In the following few paragraphs we will try to convey the authorities' views on various subjects discussed during the staff visits.

*Economic outlook*

**Still riding the wave generated by the Latvian authorities' decisive actions of 2009/2010 the economy continued to surprise on the upside.** Despite the headwinds from the sovereign debt crisis and the still-ongoing deleveraging, the slowdown we had been expecting all through 2012 has not materialized. The exports sector performed better than expected, and the 3rd quarter GDP figure, at 5.2 percent (y-o-y), added yet another quarter of Latvia heading the list of the EU's best growth performers. The recent data indicate this rapid growth trend, though gradually decelerating, was continuing also in the 4th quarter. Recognizing that this growth is largely a rebound from the excessive drop during the crisis and has its roots in the hysteria of 2009, the authorities project a gradual slowdown in 2013, in line with staff views.

*End of Latvia's 2008 SBA*

**The repayment of the remaining debt to the Fund closes the chapter on Latvia's 2008 Stand-By Arrangement.** The economy has indeed experienced a profound change: the exchange rate is now broadly in line with fundamentals, and the current account and public deficits are at comfortable levels. The fact that the repayment to the Fund was financed by a US dollar bond issuance at a yield of 2.9 percent illustrates that this revival has also been recognized by markets. The most significant cost of the crisis is the increase in emigration. While the problem is not new, Latvia was an emigration country even during the boom years, finding a way to curb emigration and make the country a more attractive place to live will be one of the toughest challenges the authorities will face in the coming decades. In this context, we found the discussion in Appendix II on demographic challenges particularly interesting. **More information on the authorities' views on the program and the Ex-Post Evaluation can be found in the Annex to Latvia's "Ex-Post Evaluation of Exceptional Assess Under the 2008 Stand-By Arrangement" paper.**

### *Article IV consultation and PPM discussions*

**On most key Article IV consultation issues, the authorities and staff were on the same page.** On the fiscal policy, monetary policy stance, exchange rate assessment, structural reforms, and the challenges in the financial sector the views did not differ substantially. Three issues were discussed more thoroughly, and therefore, warrant a closer look: the changes in the guaranteed minimum income (GMI) benefit provision, the envisaged PIT reductions, and the increase of non-resident deposits (NRDs).

- **The discussion on the GMI benefit was probably the closest to what can be called contentious, though from the authorities' perspective, the differences are not as significant as they may seem.** The Latvian authorities have always considered the centralization of the GMI benefit as a temporary crisis measure to be unwound as the crisis ends. They also believe that there is a strong rationale for a decentralized GMI benefit system, since municipalities are better placed to assess the needs and incentives of particular individuals. That said, the Latvian authorities do believe that the current degree of inequality is unacceptable and the high level of poverty, tracing back to the collapse of the Soviet Union, should be reduced. The GMI benefit changes, however, should be a part of a more comprehensive reform effort addressing the challenges faced not only by social assistance clients but also low-income households in general. The upcoming World Bank report "*Latvia: Who is Unemployed, Inactive or Needy? Assessing Post-Crisis Policy Options*" will serve as guidance for further work. If strong arguments are put forward, the Latvian authorities do not exclude re-introduction of some elements of a centralized GMI. For 2013, the government is confident that municipalities will be able to provide the benefit in full. It should be noted that in line with the agreement between Cabinet of Ministers and Association of Local Governments, the 2013 budget law includes transfers to the poorest municipalities. Besides, the government has also committed to support municipalities should their personal income tax revenues fall below planned targets.
- **The authorities are determined to implement the PIT cuts as planned.** The aim of the rate reductions is to reduce labor costs, with the broader goals of unemployment reduction and improvement in competitiveness in sight. The agreement on the PIT cuts was a difficult compromise decision and is currently supported by the business community and other stakeholders.
- **The Latvian authorities are taking steps to mitigate the risks associated with the recent increase of NRDs.** While the authorities' thinking is very much in line with that of staff, it should be noted that against the backdrop of the past experience, the current level of the deposits is high, but not extraordinarily high. That said, the Latvian authorities agree that particular vigilance is warranted and, as outlined in the

report, are taking measures to reduce the risks. The FCMC has set higher capital requirements for banks specialized in non-resident clients and has taken other steps to strengthen liquidity risk management in those banks. The supervision of activities related to non-resident clients has also been significantly strengthened. The Latvian authorities stand ready to introduce additional measures if the NRD-associated risks increase.

### *The road ahead*

**The authorities' commitment to euro adoption remains unwavering.** The Latvian authorities are committed to meet the Maastricht criteria in a sustainable way and are comforted by the ECB and EC assurances that the criteria will be applied in an economically meaningful manner.

**Efforts to reduce the unacceptably high rate of unemployment will continue.** The unemployment rate has declined considerably, from the peak of over 20 percent to 13.5 percent in the 3rd quarter of 2012 (seasonally adjusted 14.1 percent). Since we agree with staff that most of the remaining unemployment is structural in nature, achieving a further reduction will be increasingly difficult. Nevertheless, the authorities intend to take additional steps to decrease unemployment. A new targeted grant scheme for companies expanding employment in selected sectors was launched in the last quarter of 2012 and measures to facilitate regional mobility are in the pipeline. The authorities have also continued to refine the existing active labor market measures gearing employment incentives and training programs more towards the skills demanded by employers. The above-mentioned World Bank study is progressing and the first results are expected in a few months. This study is expected to provide a clearer picture of the extent of long term and structural unemployment, poverty and inequality and serve as guidance for future policy changes.

**The crisis has triggered a broad range of potentially growth-enhancing reforms in key sectors.** Significant changes are envisaged in higher and vocational education, the judicial system, the management of state-owned enterprises, and in competition policy. The Selected Issues paper covers those issues in great detail, properly reflecting the challenges the Latvian authorities face and the authorities' future plans. We place a high value on staff's interest and assessment on such subjects. Staff rightly points out that the reforms in the higher education sector are already meeting strong insider resistance. Sustaining the reform momentum in a more benign environment will be the authorities' main domestic challenge in the years to come.