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REPUBLIC OF LATVIA

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2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LATVIA

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 2014 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 2, 2014, following discussions that ended on March 10, 2014, with the officials of the Republic of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 8, 2014.
- **Informational Annex** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board as expressed during its May 2, 2014 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for the Republic of Latvia.

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 2014 ARTICLE IV CONSULTATION

April 8, 2014

KEY ISSUES

Context: Latvia's economy continues to recover strongly as it joins the euro area. The output gap is now largely closed, and labor market conditions are tightening despite still high unemployment. The current account is close to balance, while inflation has fallen to near zero due mainly to declining energy prices. Bank balance sheets are improving but credit continues to contract. The growth of non-resident deposits (NRDs) in the banking system decelerated in 2013.

Challenges: Latvia's broadly favorable medium-term outlook faces several external risks. Prolonged weakness in euro area trade partners, or a new episode of global financial volatility could set back the recovery. Ongoing events in Ukraine and Russia could affect the economy through both trade and financial channels, especially if there are broader regional spillovers. Maintaining competitiveness within the euro area will require sustained reform efforts across a number of areas, such as infrastructure, education, labor markets and the judicial system.

Staff views: The 2014 budget appropriately continues fiscal consolidation at a gradual pace, and introduces some welcome measures to strengthen the social safety net, but recent changes to the Guaranteed Minimum Income (GMI) benefit should be reconsidered. Medium-term fiscal sustainability has been underpinned by the adoption of the Fiscal Discipline Law (FDL). Efforts to revive bank credit should focus on reducing the private sector's debt overhang, by improving the efficiency and speed of resolution procedures. The large size of NRDs in the banking system is a source of vulnerability and warrants continued vigilant supervision.

Authorities' views: The authorities largely concurred with staff's assessment, notwithstanding some differences on tax and benefit policies. They agreed on the importance of structural reforms to preserve competitiveness within the single currency and on the need to maintain higher prudential standards and close supervision of NRD-specialized banks.

Approved By
Mahmood Pradhan (EUR) and Mark Flanagan (SPR)

Discussions were held in Riga during February 26–March 10, 2014. The team comprised Messrs. Aiyar (head), Srour and Lian (all EUR) and Ms. Diouf (SPR). Mr. Rutkaste (OED) joined the discussions. A conference was held in Riga during the mission to discuss the forthcoming Baltic Cluster Report.

CONTENTS

ANNEXES

ANNEX FIGURES

ANNEX TABLE

APPENDICES

CONTEXT

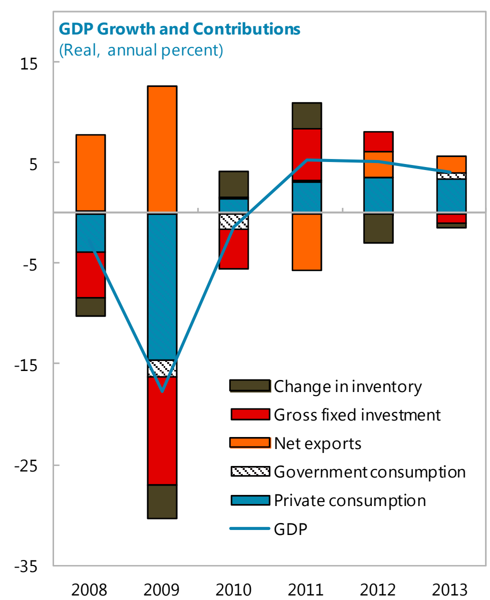
1. **Latvia adopted the euro on January 1, 2014, fulfilling a long-desired policy goal.** The country has taken rapid strides since the crisis, undertaking a large internal devaluation and addressing severe macroeconomic imbalances. Over the last three years Latvia has achieved strong economic growth and a substantial fall in unemployment. Market confidence has soared; a 1 billion euro seven year government bond issued in January was heavily oversubscribed.

2. **The 2012 Article IV consultation supported euro adoption and broadly commended macroeconomic policies.** The staff appraisal recommended continued fiscal consolidation at a gradual pace; adoption of a medium-term framework to anchor the budgetary process; strengthening the social safety net; and close supervision of non-resident deposits (NRDs) in the banking system. Policy making has been in line with these recommendations to a considerable extent. The 2014 budget cements past fiscal gains while introducing some measures to protect vulnerable sections of society. The Fiscal Discipline Law (FDL) has been adopted and monitoring and supervision of NRD-specialized banks further strengthened.

RECENT ECONOMIC DEVELOPMENTS

3. **Latvia enters the euro area with the fastest rate of growth in Europe, despite some leveling-off in the pace of expansion.** Growth has moderated from an average of 5.3 percent in 2011–12 to 4.1 percent in 2013. The output gap is now largely closed and remaining unemployment is largely structural.

4. **In 2013 robust consumption growth partly compensated for an investment slowdown and unexpected supply shocks in the metal industry.** Consumption grew at 5.0 percent y-on-y, buoyed by rising real wages as labor market conditions tightened. On the other hand gross fixed investment declined by 4.3 percent, partly driven by negative developments in the metal industry, but also possibly reflecting increasingly binding credit constraints, and a wait-and-see attitude by investors in the run-up to euro adoption. In the middle of the year the steelmaker Liepajas Metalurgs—accounting for about 2 percent of GDP and 4 percent of exports—ceased production, following a debt default that triggered a government guarantee (Appendix I). Anemic growth in trade partners and the shuttering of Liepajas Metalurgs contributed to the weakness of exports. However, import growth was even slower—consistent with the investment slowdown—resulting in an improvement of the trade balance.



5. Inflation fell sharply. Headline inflation in 2013 was zero, compared with 2.3 percent the previous year, continuing a sustained decline since the peak of early-2011. The main cause for the decline was a 1.7 percent fall in energy prices, which has a large weight in the Latvian economy, partly due to the importance of the transportation sector. Excluding energy, food and non-alcoholic beverage components, CPI inflation was about 0.6 percent in 2013. Inflation has picked up in the early months of 2014, with y-on-y CPI rising to 0.6 percent in February, and core CPI to 1.2 percent.

6. Unemployment, while still high, is falling rapidly. By end-2013, the unemployment rate had declined to 11.3 percent, relative to 13.9 percent at end-2012, continuing the steep fall from a crisis peak of about 20 percent in 2010**.** The improvement is underpinned by strong job creation: over the same period, employment increased by 2.1 percent, while the participation rate held steady. Tightening labor market conditions are reflected in rising wages: real wages increased by about 4.2 percent in 2013, a significant acceleration from the muted pace of earlier wage growth (1.3 percent in 2012). This is in line with staff analysis suggesting that the cyclical component of unemployment has largely been eliminated at this juncture; remaining unemployment is mainly structural in nature.[1]

7. Bank balance sheets are improving, but net credit growth has yet to resume. Banks' return on equity improved to 9.7 percent in 2013 from 8.8 percent the previous year. With the pace of write-offs accelerating, the NPL ratio for non-financial corporate loans declined to 7.9 percent in September 2013 from 10.9 percent a year previously, while that of household loans declined from 15.9 percent to 13.4 percent. But the amortization of existing loans continued to exceed the issuance of new loans, and domestic credit contracted by 5.7 percent in 2013.

8. Nordic parent banks continue to deleverage from their Latvian subsidiaries. Liabilities to parent banks declined to 4.2 billion euros by end-2013 from 5.2 billion euros a year ago, bringing loan-to-deposit ratios to 134 percent from 160 percent a year earlier. Banks report that they are now generally comfortable with the level of loan-to-deposit ratios, and stand ready to expand their balance sheets, but that credit growth is restrained by a combination of weak demand and tighter lending standards. Meanwhile non-resident deposits (NRDs) in the banking system continued to grow, albeit at a slower pace.[2] NRDs grew by 11.1 percent in 2013 compared to 17.1 percent in 2012, belying concerns of a surge of deposit inflows in the wake of the Cyprus banking crisis.

9. The 2013 budget target was met despite a large unanticipated government payment on behalf of the steel firm. The general government deficit outturn of 1.3 percent of GDP was slightly below the target of 1.4 percent.[3] Improved tax administration and reforms to tackle

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[1] High structural unemployment characterizes not just Latvia's economy but that of all the Baltic countries, as described in the Baltic Cluster Report.

[2] In Latvia the Nordic subsidiaries are responsible for the vast majority of domestic lending, funded by a mix of parent bank loans and domestic deposits; while a different segment of banks with much weaker links to the domestic economy specializes in non-resident deposit liabilities (which are mainly channeled into foreign assets). See Appendix 1 of the 2012 Article IV Staff Report for a detailed description of the institutional features of Latvia's banking system.

[3] Under the European System of Accounts (ESA) definition.

underreporting yielded substantial revenue gains. This more than compensated for higher than planned expenditures caused by the guarantee call on Liepajas Metalurgs (about 0.3 percent of GDP), and the indexation of small pensions (below 285 euros) from September onwards. Adjusting for revenue transfers from the government to the privately managed pension pillar (the second pillar), the 2013 outturn implied a fiscal consolidation of about 0.8 percent of GDP. Separately, the passage of the Fiscal Discipline Law (FDL)— which constrains the structurally adjusted fiscal deficit to 0.5 percent of GDP or less—ensures that future budgets will be grounded in a medium-term framework that seeks to avoid pro-cyclicality.

10. Since the crisis external stability has improved notably, but there are lingering concerns (Appendix II). From a substantially overvalued pre-crisis starting point, staff estimate that the real effective exchange rate is now broadly in line with fundamentals. External debt has fallen substantially but remains high at about 131 percent of GDP at end-2013. While external debt is projected to decrease by a further 10 percentage points of GDP over the medium term in the baseline, large shocks to growth and the non-interest current account could impede the adjustment. Moreover, NRDs are subject to sudden stops in the face of a sufficiently large financial shock, although the risk is mitigated by the accumulation of liquid foreign assets by and higher prudential requirements for NRD-specialized banks.

OUTLOOK AND RISKS

11. Under staff's baseline scenario, economic growth will ease slightly in 2014. Consumption is expected to level off from the rapid pace of last year, but should remain robust, supported by the continuing tightness of labor markets and a rise in the minimum wage from 280 to 325 euros per month. A rebound in investment and imports is predicated on improved business sentiment and the release of pent-up investment demand in the wake of euro adoption. Stronger growth in the euro area and other trade partners should enable more rapid export growth. However, the downward revision of baseline growth in Russia will have a moderating impact on the rebound in investment and exports. Inflation should pick up as the downward pressure from commodity prices recedes and wages continue to rise. The forecast is rather sensitive to the extent of the investment recovery, which in turn is tied to the prospects of resuscitating credit. Looking further ahead, with continuing reform efforts and prudent macroeconomic management, growth of about 4 percent per annum—well above the euro area average—should be attainable during the convergence process.[4]

12. There are risks to this broadly favorable outlook (RAM). A prolonged slowdown in European partner countries would dampen Latvia's recovery and increase its current account deficit, while a surge in global financial volatility could affect bank funding. Ongoing events in Ukraine

[4] A growth rate close to or greater than 4 percent per annum was achieved by several Central European emerging markets in the decade before the crisis, as they expanded trade links with West European economies and integrated into supply chains. Latvia's own GDP growth rate between 1997–2006 averaged 7.5 percent.

could generate real and external spillovers. While trade links with Ukraine are minor, Russia accounts for about 11 percent of exports. A deeper slowdown in Russia would adversely affect trade prospects, especially if there were broader regional spillovers. As noted by the authorities, ruble depreciation could depress export margins even if trade volumes held steady. Moreover, the flow of non-resident deposits (NRDs) to the Latvian banking system from CIS countries could be subject to volatility. On the domestic front, slow progress on important structural reforms could cause an erosion of hard-won gains in competitiveness, a resurfacing of imbalances and upward pressure on external debt ratios. That said, Latvia does have upside potential if it can generate higher levels of investment, including through additional foreign direct investment, and rapidly implement reforms aimed at enhancing productivity and improving the business environment.

POLICY DISCUSSIONS

13. Discussions centered on maintaining competitiveness in the euro area; reviving bank credit to support investment; ensuring fiscal sustainability over the medium term while strengthening the social safety net; and the need for vigilant financial sector supervision. Taken together, this set of policies would promote external stability going forward, while preserving internal balance and laying the foundations for robust growth.

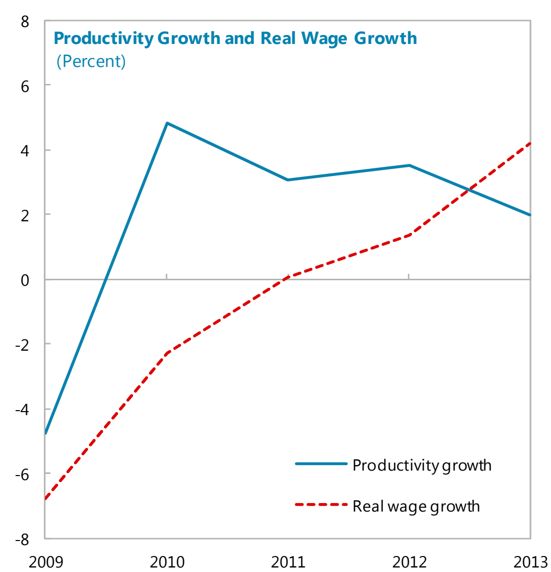
A. Maintaining Competitiveness in the Euro Area

14. Latvia's medium-term macroeconomic challenge—maintaining competitiveness under a fixed exchange rate regime—remains unaltered by euro accession. The chief source of past competitiveness gains was a combination of productivity growth and wage restraint. The resulting turnaround in the real effective exchange rate enabled an export-driven recovery. But with the output gap near zero and the labor market tightening correspondingly, wages are inevitably on the rise. Productivity gains should therefore be the chief driver of competitiveness gains going forward. The authorities agreed on the importance of structural reforms across a broad range of areas, aimed at improving productivity, lowering structural unemployment and enhancing competitiveness.

15. Upgrading public infrastructure could provide an important spur to competitiveness. As noted in the Baltic Cluster Report (BCR), infrastructure improvements would enhance productivity, while helping to attract FDI and associated technological knowhow. Staff urged implementation of the recommendations of the World Bank's recent comprehensive assessment of Latvian ports: enhancing connectivity to land transport, and improving governance and accountability. Reforms to liberalize the electricity sector and deregulate tariffs would encourage new suppliers to enter the market, over time increasing supply and reducing prices. On a different front, centralizing SOE management while divesting non-core activities—in line with long-planned reforms—would improve efficiency and accountability, contributing to an improvement in the business environment. The authorities agreed with the thrust of recommended reforms in each of these areas. The World Bank recommendations were being studied with a view to develop an actionable plan. Tariff liberalization in the electricity sector—initially planned for April—had been postponed in order to develop better safeguards for low-income households, who would be negatively affected by a rise in tariffs. Legal amendments establishing centralized management of SOEs are pending in parliament.

16. Progress on education and training reforms could help Latvia reduce structural unemployment and move up the product value chain. As highlighted in the Cluster Report, reforms to higher education—including an independent quality-based accreditation of study fields, better targeting of public funding to universities, consolidation of higher education institutions and promoting the use of EU foreign languages in teaching—would build a more skilled workforce. Reforms to vocational training—including apprenticeship programs and better alignment of training with employers' needs—could help reduce skills mismatches and hence alleviate structural unemployment in the medium-term. The authorities agreed with the need for wide-ranging reforms, and pointed to progress in a number of areas. A project has been launched with the World Bank to study a new financing model for higher education. Institutes of higher education are being encouraged to shift resources from the social sciences towards STEM fields, and to collaborate with municipalities and the private sector in anticipating the skills demanded by the market. A pilot project has been launched with technical assistance from Germany under which students from 6 vocational education and training (VET) institutions apprentice at firms with international links. The program will be studied and potentially expanded.

17. The Latvian labor market is very flexible, as documented in the BCR, but work incentives could be further improved. In particular, a more gradual phasing-out of the guaranteed minimum income (GMI) benefit—which currently phases out one-for-one with income—would reduce the tax wedge for GMI recipients entering employment. More generally, the BCR finds that labor taxation is high across the Baltics relative to comparator countries, so measures to reduce the tax wedge could yield high dividends in reducing structural unemployment. In Latvia, a system of in-work tax credits and benefits should be considered; empirical evidence suggests that these have proven particularly effective in increasing employment of lower skilled workers. The authorities agreed that reducing taxes on labor could help improve work incentives and reduce structural unemployment – and pointed to the lowering of social contributions by 1 percentage point in the 2014 budget. Moreover, the Ministry of Welfare noted that it is working on a proposal to allow GMI recipients to continue to collect the GMI benefit for a period of four months after entering employment.



B. Reviving Bank Credit

18. The continuing contraction of credit is a concern, especially when coupled with the investment downturn. For several years following the trough of the crisis, productivity growth remained well above wage growth, allowing firms to finance investment using retained profits. But the sharp contraction in gross fixed investment in 2013 suggests that the limits to internal financing of investment may have been reached; with the tightening of the labor market, real wages are now rising more quickly and profit margins are being squeezed.

19. Latvia's creditless recovery is in line with historical experience, but its lengthy duration makes it an outlier. The Baltic Cluster report finds that sharp boom-bust cycles are often followed by creditless recoveries, especially if the cycle is accompanied by a banking crisis, as in Latvia's case. However, even among the sample of emerging economies that experienced creditless recoveries in the past, positive credit growth has usually resumed by this stage in the cycle. Staff analysis suggests that a combination of demand and supply factors is likely responsible for weak credit: private agents remain burdened with legacy debts, while banks have significantly tightened lending standards since the crisis. The authorities broadly concurred with the assessment, pointing to the need to ensure that credit supply to firms is not restricted to only large corporations.

20. Measures to further reduce the private sector's debt overhang could help resuscitate the demand for credit, lower perceptions of credit risk, and underpin a rebound in investment. While earlier legal amendments have already strengthened the insolvency regime, its administration and implementation could be strengthened.[5] Staff recommended reforms to the judicial system to speed up the often cumbersome process of debt resolution. A recent measure allowing the presiding officer of a court to transfer cases to less burdened jurisdictions is helping to better distribute the backlog of cases, and the number of courts has been increased. The authorities noted that legal amendments are in train to provide more efficient alternatives to the regular court system. The system of arbitration courts—which is currently unwieldy and of uneven quality—will be consolidated and standardized, to increase public confidence in arbitration and encourage its use. The Law of Mediation is being amended to allow courts to order parties to seek mediation (replacing the current purely voluntary nature of mediation). Separately, amendments to the Civil Procedure Law aim at strengthening the role of administrators in authenticating liabilities.

21. Staff warned against the hasty passage of recent legislative proposals that could act as a drag on new lending. Proposed amendments to the Personal Insolvency Law—currently with Parliament—would limit the liability of mortgage borrowers and their guarantors to the value of collateral.[6] The authorities confirmed that they will not support the measure, which is likely to drive down the supply and raise the cost of new mortgage lending if enacted. They are confident that in any case the amendment will not be retroactive (which could lead to large-scale write-downs of banks' mortgage books).

[5] See "Republic of Latvia: Selected Issues", January 2013, IMF Country Report No. 13/29.

[6] The current personal insolvency framework provides for eligible debtors to be discharged after successful implementation of a payment plan over a maximum period of 3.5 years.

22. Over the medium-term, encouraging non-bank sources of finance may help reduce vulnerability to bank-led credit crunches. As detailed in the Baltic Cluster Report, the small scale of Latvia's domestic market constrains development of its own capital market. Staff encouraged the authorities to pursue integration into regional markets in order to access a larger investment pool. Latvia's stock market—like those of the other Baltic countries—is already fully integrated with the Nordic exchanges (within the Nasdaq OMX group), sharing a common trading platform and supervisory standards. But smaller companies could be encouraged to list on alternative exchanges such as First North, while regional ratings agencies or credit guarantee schemes—subject to strict supervision and risk management standards—could be explored to alleviate financing constraints for SMEs. The authorities pointed to the formation of the Single Development Institute (Appendix I) as a vehicle for encouraging alternative sources of financing for SMEs. But they noted that government schemes need to be very carefully designed to avoid moral hazard and market distortions.

C. Maintaining a Prudent Fiscal Policy

23. The 2014 budget continues with fiscal consolidation at a measured pace, appropriate to the economy's cyclical position and moderate government debt. It targets a general government deficit of 0.9 percent of GDP, a gradual narrowing from the 1.3 percent deficit in 2013. The budget is the first to be governed by the new Fiscal Discipline Law (FDL), whose adoption is in line with Fund advice. After adjusting for transfers from government revenue to the privately managed pension pillar (the second pillar), the budget is compatible with the FDL's medium-term objective of a structural deficit no greater than 0.5 percent.

24. The budget appropriately "unfreezes" some expenditure areas that have been under tight control since the crisis, while rearranging some revenue streams. Small pensions were indexed in September 2013, and the minimum wage has been increased from 285 euros to 320 euros per month. The authorities noted that these measures should be viewed in the context of substantial wage cuts in 2009–10 and only limited increases in 2011–13. On the revenue side, the earlier schedule of reductions in the personal income tax rate has been delayed, in line with staff advice, and replaced instead by a 1 percentage point reduction in social security contributions. To reduce the tax burden on low-income workers and families, the non-taxable threshold for workers and dependents has been increased.

25. While the budget goes some distance to address high levels of inequality, more is needed. In particular, staff urged reversal of the 2013 cuts to Latvia's Guaranteed Minimum Income (GMI) benefit, and a re-centralization of the scheme's financing, in line with the recommendations of a comprehensive World Bank study on employment. Social exclusion benefits in Latvia are among the lowest in Europe (Appendix III), while regional disparities mean that some income-constrained local governments may be unable to provide even the reduced benefit levels in full. The authorities argued, however, that higher GMI benefits and centralized financing were only introduced as a crisis measure, and have been appropriately reversed now that the economy is recovering. They also pointed out that local governments had not faced any constraints in financing the benefit scheme in 2013.

26. Budgetary planning will need to contend with several potential fiscal headwinds over the medium-term. Future planned declines in the PIT rate and in SOEs' payout ratios will act as a drag on revenue, reducing revenue as a percentage of GDP by about 4 percentage points between 2013 and 2016, and thus requiring corresponding reductions in spending to meet medium-term deficit targets.[7] Staff argued that such large reductions could impede adequate public expenditure on investment, especially in priority areas like infrastructure. Several options could be considered to ensure that the fiscal envelope remains adequate. First, the PIT cut should be reconsidered. While the authorities view this as a measure to improve work incentives, untargeted cuts in the PIT rate are not first-best from an efficiency or equity perspective.[8] Second, revenues from property taxes could be expanded, in conjunction with cadastre reform. Property taxes are generally non-distortionary compared with other forms of taxation, and currently amount to only about 0.7 percent in Latvia, low by international standards.[9] The authorities agreed that this could be a promising source of revenue, but suggested that political consensus—likely to develop only after the October election—would be required to move forward. Third, measures to broaden the tax base by combating the grey economy should continue to be pursued vigorously. The authorities pointed to significant progress in this area as a result of improved tax administration, a crackdown on fictitious companies and more frequent audits. Various indicators suggest that there has been a reduction in the number of unregistered businesses and "envelope salaries", an increase in the number of taxpayers, and an increase in the rate of recovered tax arrears.

D. Financial Supervision

27. The level of non-resident deposits in Latvia's banking system represents a key vulnerability to the economy, albeit one that is mitigated by some factors. At end-2013, NRDs accounted for almost half of the banking sector's total deposits. A sudden stop or reversal in NRDs could put pressure on the country's balance of payments, while constituting a significant contingent fiscal liability (via sovereign backing for the deposit insurance system). However, risks to the domestic economy are mitigated by the fact that about 82 percent of such deposits are invested abroad, mostly in liquid instruments.[10]

28. Despite widespread concerns about a substitution of NRDs from Cyprus to Latvia in early 2013, there is little evidence to date of such an effect. If anything, there has been a recent deceleration in the growth rate of NRDs. But developments so far have occurred against the

[7] The PIT rate is scheduled to be lowered by one percentage point in 2015 and again in 2016, while SOE payout ratios are to be cut from the current 90 percent level to 80 percent in 2015 and to 27 percent in 2016.

[8] Better options would include a two-tier PIT system or further increases in the minimum non-taxable allowance.

[9] The OECD average is close to 2 percent of GDP.

[10] About 14 percent of NRD banks' assets are held as reserves at the central bank.

backdrop of deposit withdrawal restrictions and capital controls in Cyprus. Regulators must remain vigilant to the possibility of large inflows from Cypriot depositors when controls are eased. The evolving situation in Ukraine and Russia could lead to capital flight from those countries and a surge in deposit inflows to Latvia. On the other hand, sanctions targeted against individuals and businesses in the CIS could cause outflows from the Latvian banking system to jurisdictions outside the ambit of sanctions. Some smaller Latvian banks also have considerable asset exposure to Ukraine.

29. The authorities are keenly aware of the need for vigilant supervision of the NRD banking sector. They agreed with staff that spillovers from events in Ukraine will need to be closely monitored, although they did not view as likely any systemic impact. The financial regulator (FCMC) already imposes higher minimum capital and liquidity requirements on NRD-specialized banks, in line with staff advice.[11] These differential requirements will be continued under the Basel III framework. The authorities also pointed to several steps that have been taken to strengthen the AML/CFT regime, including more intensive on-site and off-site checks, larger sanctions levied against banks for regulatory infractions, and a further strengthening of customer due diligence rules. The Financial Intelligence Unit (FIU)—responsible for fighting money laundering, tax evasion and other financial crimes—has been strengthened with additional staff and comprehensive training programmes.

30. Bank supervision responsibilities will evolve as the euro area moves towards a banking union. By the end of 2014, the ECB will undertake direct supervision of systemic cross-border banks, including the large Nordic subsidiaries resident in Latvia. But supervision of these banks at a consolidated level would quite likely be separated from the ECB; with Sweden unlikely to "opt-in" to the banking union, and Norway not part of the European Union. Existing colleges of supervisors for large cross-border banks comprise both home and host representation. When the Single Supervisory Mechanism (SSM) comes into effect, modalities should be in place for close consultation between the Latvian host authorities, ECB regulators and the Nordic regulators of the parent banks, both on supervision and on setting regulatory requirements (e.g. capital and liquidity requirements). The authorities concurred with the need for close tripartite communication, noting that agreement had already been reached on expanding the supervisory colleges to include representation from all three parties.

STAFF APPRAISAL

31. As Latvia joins the euro area, its economy continues to recover strongly. Growth in 2013 is estimated at 4.1 percent, and the output gap has largely closed. Unemployment, while still high,

[11] Since mid-2011 the FCMC has required NRD-specialized banks to hold an additional capital buffer. As of end-June 2013, the buffer requirement ranges from 0.4 to 9.7 percent of risk-weighted assets, and depends on both the level and growth rate of the exposure to non-resident business.

has been declining rapidly and is now mainly structural in nature. A slowdown in investment and exports was partly compensated by robust consumption demand, supported by rising real wages.

32. The outlook for 2014 is broadly favorable. Growth is projected at around 3.8 percent, underpinned by an investment recovery due to the positive sentiment associated with euro adoption. Exports should be bolstered by higher growth in key European trade partners. The main risks to this outlook are external. Export prospects could be adversely affected by the impact on the Russian economy of the ongoing events in Ukraine, especially if there were broader regional spillovers. Sustained weakness in European partner countries would dampen Latvia's recovery and increase its current account deficit, while a surge in global financial volatility could affect bank funding.

33. The 2014 budget consolidates past fiscal gains at a measured pace. It contains some commendable measures to strengthen the social safety net, including a rise in the minimum wage, indexation of small pensions and a rise in the minimum income tax threshold. However, more should be done to strengthen Latvia's Guaranteed Minimum Income (GMI) benefit.

34. Over the medium-term fiscal policy will need to contend with several potential headwinds. The passage of the FDL is welcome, and should ensure that budgeting is anchored in a framework designed to avoid pro-cyclicality. It will be important to maintain investment expenditures in crucial areas such as infrastructure, despite planned reductions in the income tax rate. Continuing efforts to reduce the scale of the grey economy—which have already yielded results—could increase the revenue envelope. Reductions in the PIT rate should be reconsidered. Property tax revenues should be expanded in conjunction with cadastral reform.

35. Latvia's basic medium-term macroeconomic challenge—maintaining competitiveness under a fixed exchange rate regime—remains unaltered by euro accession. With internal devaluation having run its course and labor markets tightening, the focus must shift from wage restraint to productivity gains. Progress on a broad range of structural reforms will be needed to improve the business climate and yield the desired productivity improvements**.**

36. Priority reforms include measures to upgrade Latvia's infrastructure, improve the system of higher and vocational education, and improve SOE management. The recommendations of a recent World Bank study of Latvian ports should be implemented as soon as possible. Plans to liberalize tariffs and introduce greater competition in the electricity sector should be expedited. Reforms to align higher education more closely with market demand, and to expand vocational education, would help reduce skills mismatches and hence alleviate structural unemployment in the medium-term. Centralizing the management of state-owned enterprises while divesting non-core activities—in line with long-planned reforms—would improve efficiency and accountability.

37. Labor market reforms to improve work incentives and lower structural unemployment should be implemented. In particular, a more gradual phasing-out of the guaranteed minimum income (GMI) benefit—which currently phases out one-for-one with income—would reduce the tax wedge for GMI recipients entering employment. A system of in-work tax credits and benefits could also be considered to increase employment of lower skilled workers.

38. Bank credit continues to contract well into the recovery in Latvia, and in the other Baltic countries, and could constrain investment going forward. A combination of supply and demand factors are likely holding back credit. Measures to tackle the private sector's debt overhang could help resuscitate both credit demand and supply, and underpin an investment rebound. Proposed reforms to unclog the backlog of insolvency cases—including legislative amendments to encourage speedier alternatives to the traditional court system, such as arbitration and mediation—are commendable.

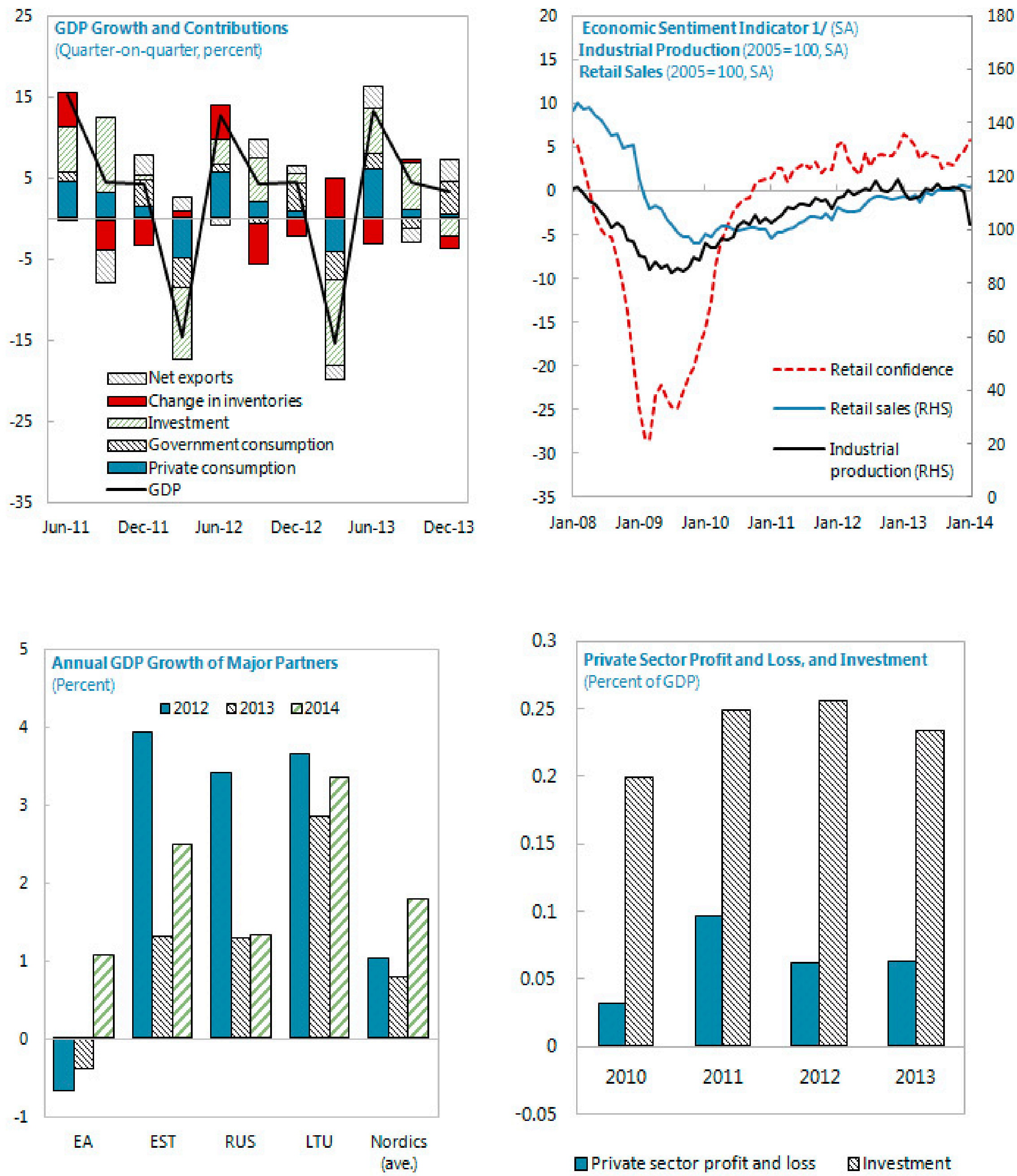
39. The growth of non-resident deposits (NRDs) has decelerated in recent months, but NRDs comprise nearly half of all deposits in the banking system. While the expansion of NRDs is associated with an accumulation of liquid foreign assets (which decreases the risks of domestic spillovers), the increasing size of the sector represents a source of vulnerability to external shocks. The supervision of NRD-specialized banks should continue to be sufficiently intensive and frequent, including with regard to AML/CFT, given their relatively higher risks and susceptibility to sudden surges and stops. This is particularly important in the context of elevated risks arising from events in Ukraine. Appropriately, minimum capital requirements and liquidity ratios on NRD-specialized banks are already higher than for others.

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

Latvia: Risk Assessment Matrix

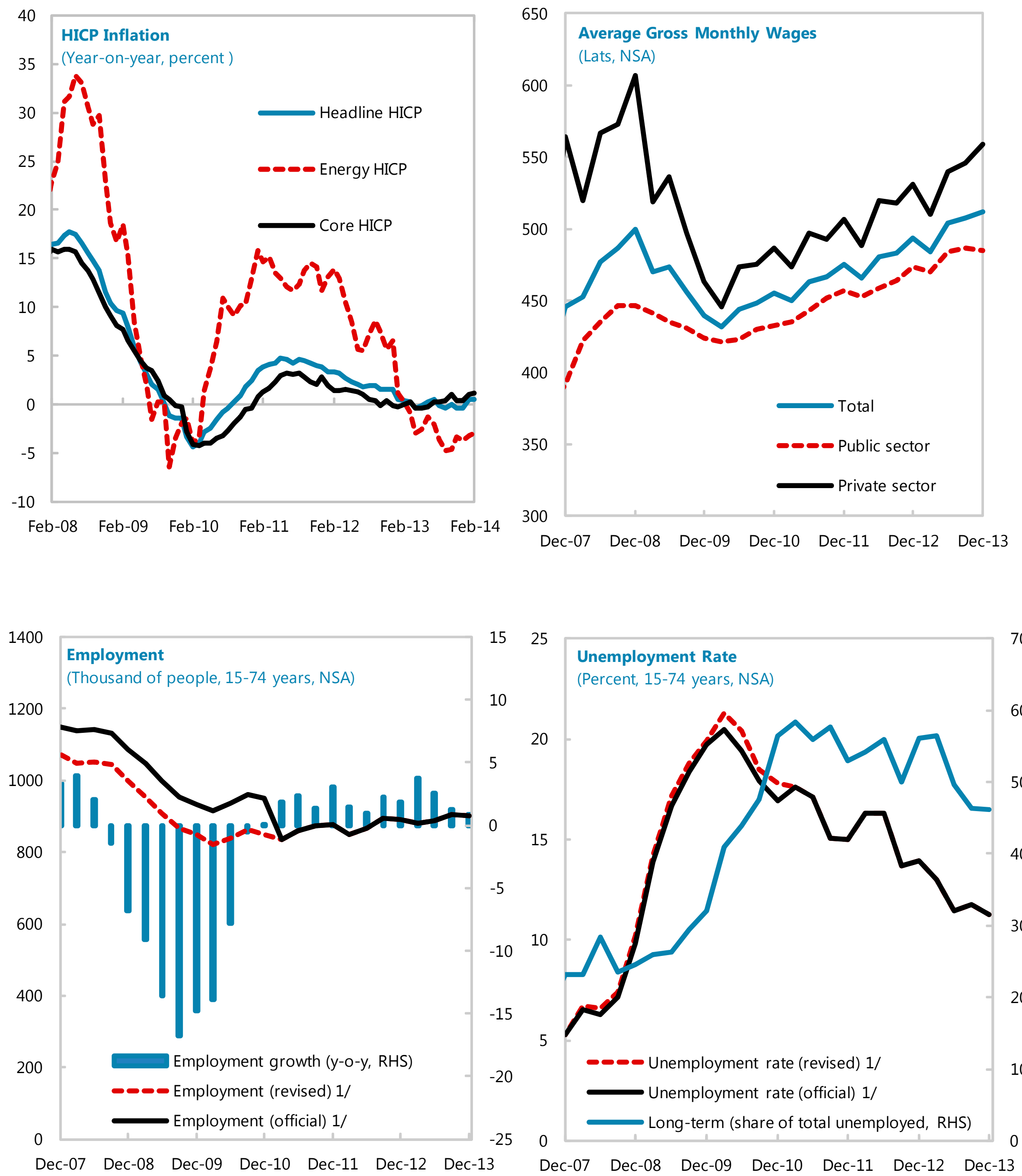
Risk	Relative Likelihood	Impact if Realized
1. Surges in global financial market volatility (related to UMP exit)**,** leading to economic and fiscal stress, and constraints on country policy settings.	**High**	**Medium** Could affect funding from Nordic parent banks reliant on international wholesale funding. Quicker deleveraging by Nordic parents would hinder a credit recovery.
2. Protracted period of slower growth in advanced economies in Europe (larger than expected deleveraging or negative surprises on potential growth) **or emerging economies** (incomplete structural reforms)**.**	**High**	**Medium / High** The Euro Area remains Latvia's single largest trade partner. But demand spillovers may be mitigated if Russia and Nordic countries are less affected.
3. Financial stress in the Euro Area re-emerges triggered by stalled or incomplete delivery of national and euro area policy commitments.	**Medium**	**Medium** Non-resident deposits are susceptible to quick reversals in the face of a sufficiently large shock.
4. Increasing geopolitical tensions surrounding Ukraine lead to disruptions in financial, trade and commodity markets.	**Medium**	**High** Russia is an important export market. The NRD-banking sector has large liabilities to CIS countries.
5. Fiscal slippages or failure to advance on structural reforms.	**Medium** Latvia's new Fiscal Discipline Law should limit the room for fiscal slippages.	**Medium** In the absence of structural reforms productivity growth and the business environment would suffer, harming competitiveness and employment.
6. Prolonged work stoppage at Leipajas Mettalurgs.	**Medium** Some investors have shown interest in acquiring the company.	**Medium** The firm is expected to resume production sometime in the second half of 2014. Lingering problems would slightly alter output and employment relative to baseline.

Figure 1. Latvia: Real Sector, 2007–13



Sources: Latvian Central Statistical Bureau; Haver Analytics; and IMF staff calculations.
1/ Difference with long-term average.

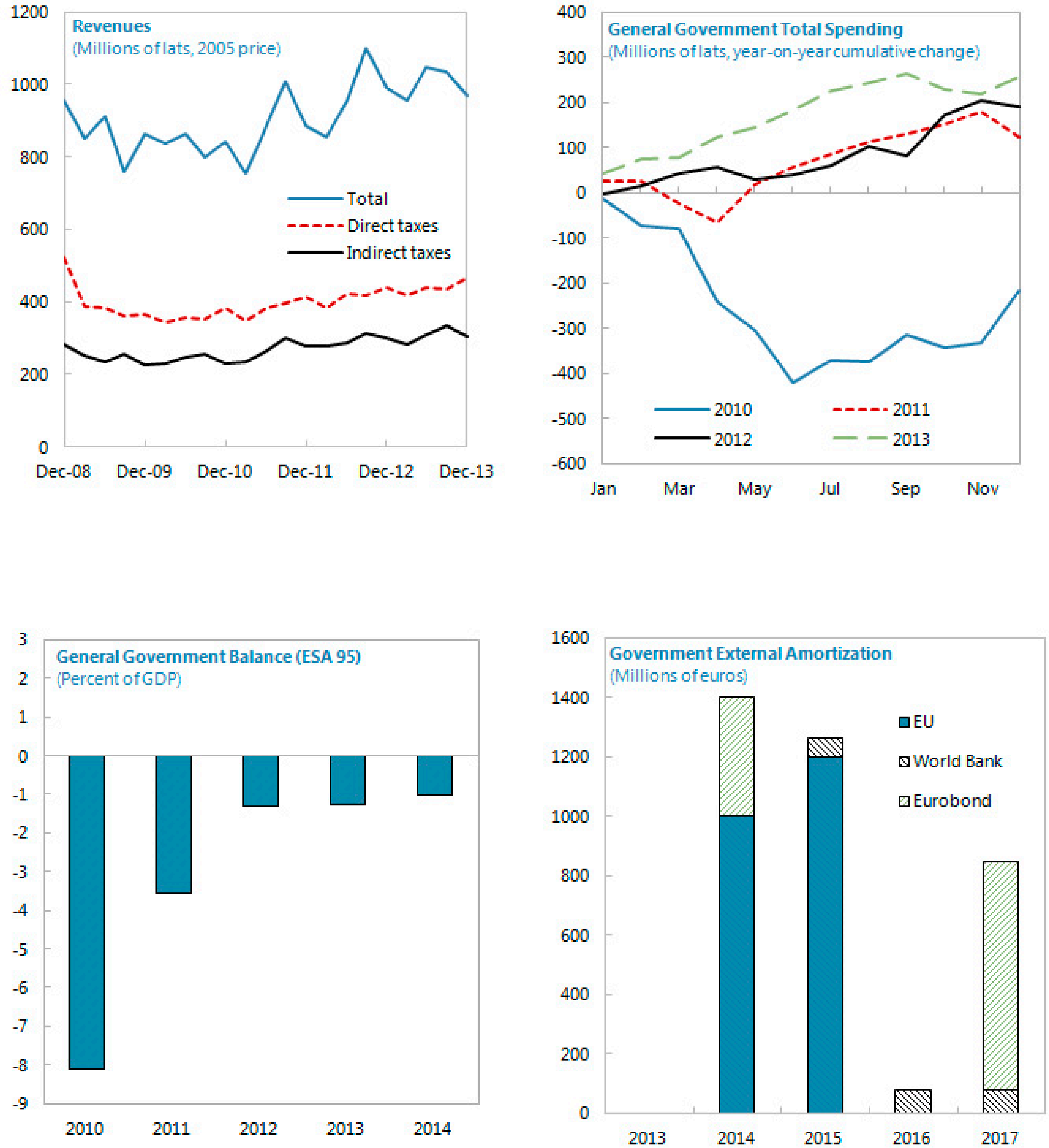
Figure 2. Latvia: Inflation and the Labor Market, 2007–13



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

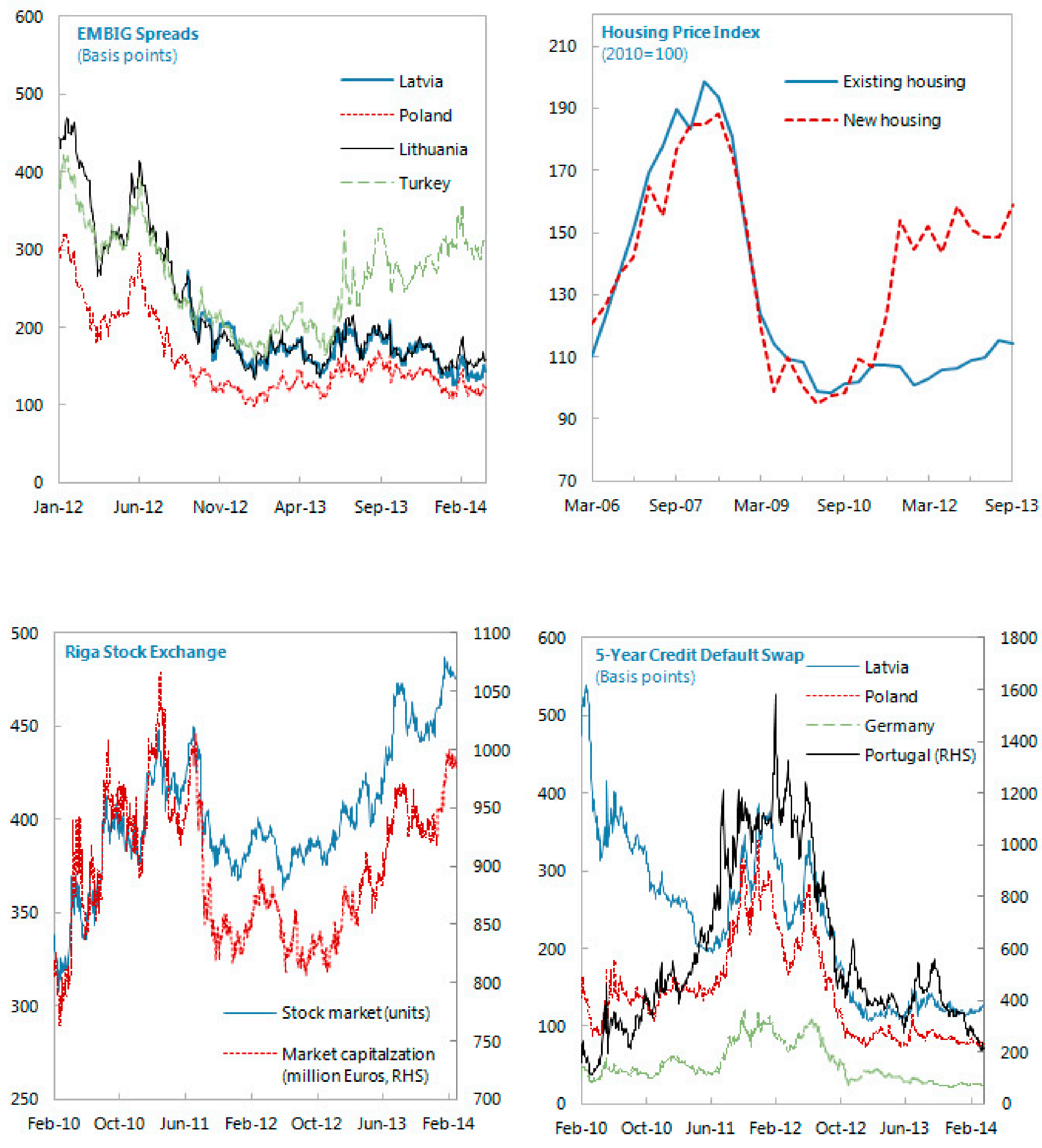
1/ Labor Force Survey. Unemployment data for 2011 was revised in compliance with the population census; official data before 2011 has not yet been revised; revised data is staff estimate based on 2011 correction.

Figure 3. Latvia: Fiscal Developments, 2008–14



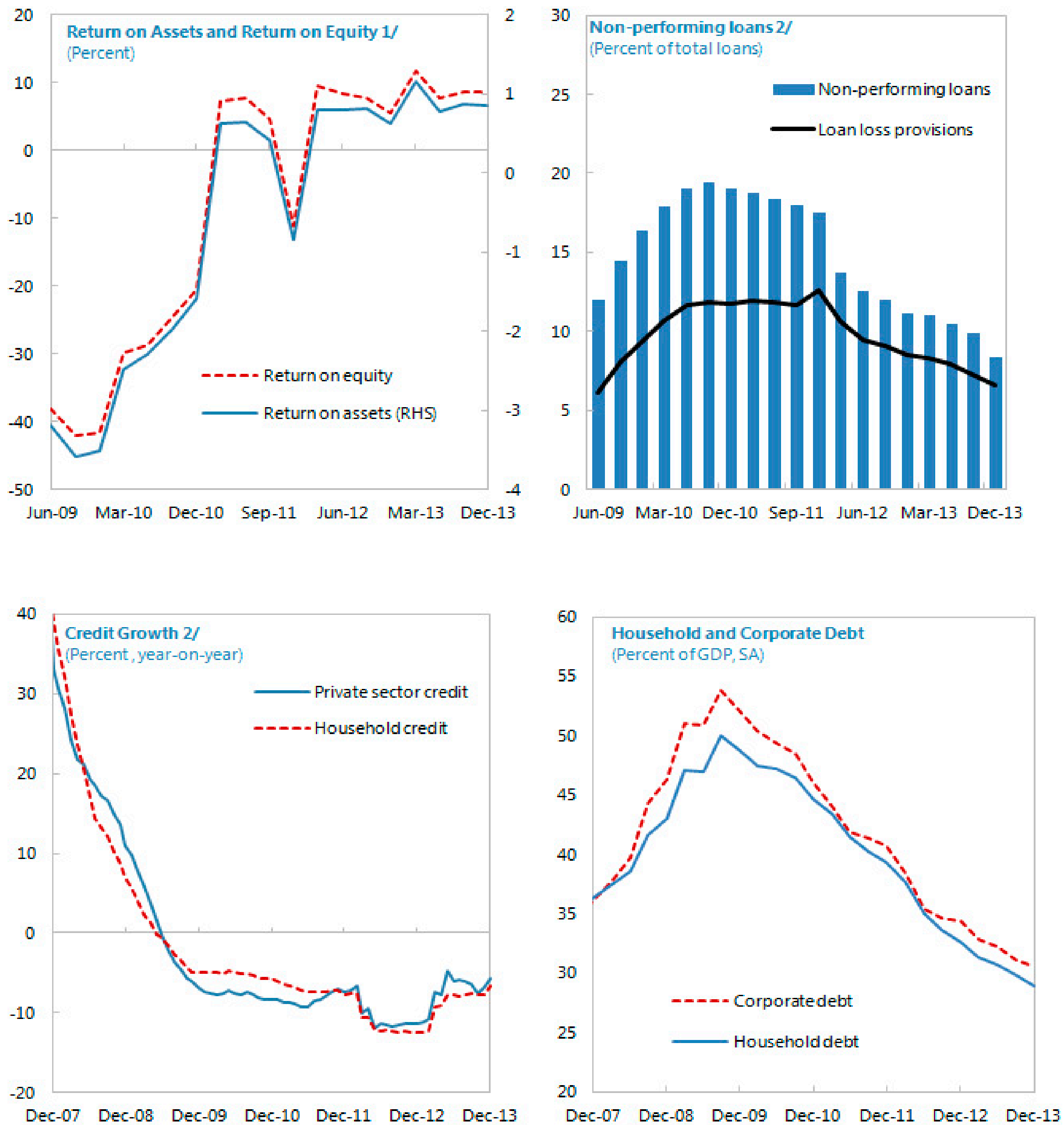
Sources: Latvian authorities; and IMF staff estimates.

Figure 4. Latvia: Financial Markets Developments, 2006–13



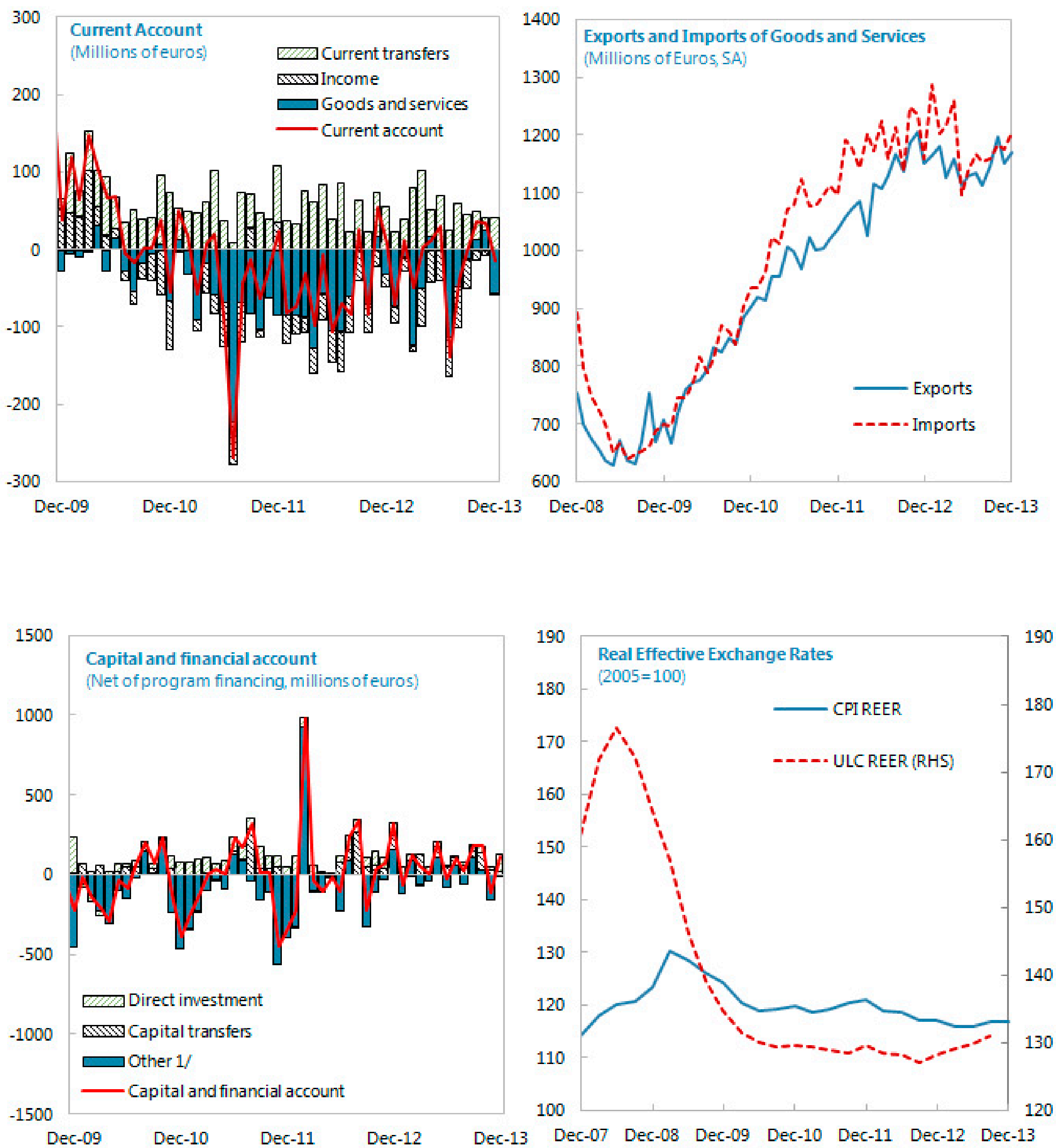
Sources: Bank of Latvia; Bank for International Settlements; Bloomberg; and IMF staff calculations.

Figure 5. Latvia: Banking Sector Developments, 2007–13



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.

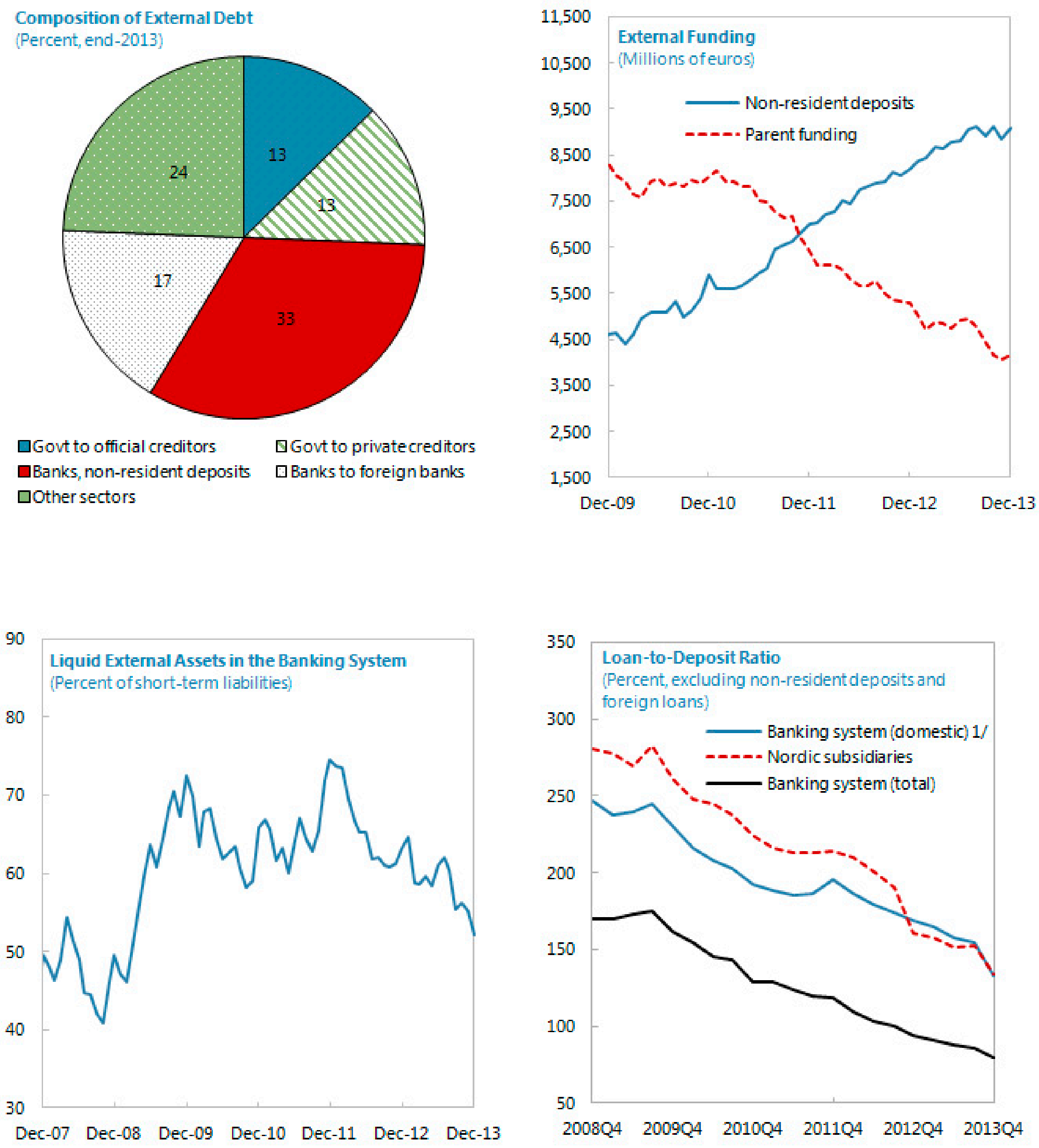
Figure 6. Latvia: Balance of Payments, 2007–13



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. Latvia: External Debt and Vulnerabilities in the Banking System



Sources: Bank of Latvia; FCMC; and IMF staff calculations.
1/ exclude foreign loans and non-resident deposits.

Table 1. Latvia: Selected Economic Indicators, 2008–14

	2008	2009	2010	2011	2012	2013	2014
							Proj.
National accounts	(Percentage change, unless otherwise indicated)						
Real GDP	-2.8	-17.7	-1.3	5.3	5.2	4.1	3.8
Private consumption	-5.8	-22.6	2.3	4.8	5.8	5.4	5.2
Gross fixed capital formation	-13.8	-37.4	-18.1	27.9	8.7	-4.3	5.9
Exports of goods and services	2.4	-13.1	12.5	12.4	9.4	1.0	3.1
Imports of goods and services	-10.2	-31.7	11.8	22.3	4.5	-1.7	4.4
Nominal GDP (billions of lats)	16.1	13.1	12.8	14.3	15.5	16.4	17.2
Nominal GDP (billions of euros)	22.7	18.6	18.2	20.5	22.1	23.3	24.5
GDP per capita (thousands of euros)	10.4	8.6	8.6	9.9	10.8	11.4	12.1
Savings and Investment							
Gross national saving (percent of GDP)	18.0	29.2	22.7	22.7	23.0	22.0	21.5
Gross capital formation (percent of GDP)	31.2	20.5	19.8	24.9	25.5	22.9	23.1
Private (percent of GDP)	26.6	17.2	16.8	20.8	21.8	19.2	20.0
CPI Inflation							
Period average	15.4	3.5	-1.1	4.4	2.3	0.0	1.5
End-period	10.5	-1.2	2.5	4.1	1.6	-0.3	2.4
Labor market							
Unemployment rate (LFS definition; period average, percent) 1/	7.5	16.9	18.7	16.2	15.0	11.9	10.7
Real gross wages	4.4	-6.8	-2.3	0.0	1.3	4.3	2.9
	(Percent of GDP, unless otherwise indicated)						
Consolidated general government 2/							
Total revenue	35.6	36.2	36.0	35.6	37.0	35.9	35.3
Total expenditure	39.0	43.3	42.4	38.7	36.9	36.7	36.4
ESA balance	-4.2	-9.7	-8.1	-3.6	-1.3	-1.3	-1.0
General government gross debt	17.2	32.9	39.7	37.5	36.4	35.1	35.1
Money and credit							
Credit to private sector (annual percentage change)	11.0	-6.9	-8.4	-7.4	-11.4	-5.7	-2.0
Broad money (annual percentage change)	-3.9	-1.9	9.8	1.5	4.5	2.2	5.3
EMBIG (Percent)	...	...	...	...	1.60	1.39	...
Money market rate (one month, eop, percent)	13.3	2.7	0.6	1.1	0.3	0.3	...
Balance of payments							
Gross official reserves (billions of euros)	3.7	4.8	5.8	4.9	5.7	5.8	...
Current account balance	-13.2	8.7	2.9	-2.1	-2.5	-0.8	-1.6
Trade balance	-17.9	-7.1	-7.0	-10.7	-10.4	-9.0	-9.4
Gross external debt	130.9	156.8	165.1	143.9	136.4	130.6	130.5
Net external debt 3/	57.5	58.8	54.2	46.0	38.9	35.3	33.1
Exchange rates							
Lats per euro (period average) /4	0.71	0.70	0.70	0.70	0.70	0.70	...
Euro per U.S. dollar (period average)	0.68	0.72	0.75	0.72	0.78	0.75	...
REER (period average; CPI based, 2000=100)	104.5	110.2	103.6	103.8	102.1	100.8	...

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 was pegged to the euro at 1 EUR = 0.702804 LVL rate, with ±1 percent band.

Table 2. Latvia: Macroeconomic Framework, 2010–19

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
	(Percentage change, unless otherwise indicated)									
National accounts										
Real GDP	-1.3	5.3	5.2	4.1	3.8	4.4	4.2	4.1	4.0	4.0
Consumption	-0.2	4.0	4.5	5.0	4.5	4.1	4.0	3.8	3.8	3.7
Private consumption	2.3	4.8	5.8	5.4	5.2	4.8	4.6	4.4	4.3	4.2
Public consumption	-7.9	1.1	-0.2	3.6	2.1	1.4	1.5	1.5	1.5	1.5
Gross capital formation	-6.3	38.6	-3.9	-6.2	5.0	9.1	5.5	5.5	5.5	5.5
Gross fixed capital formation	-18.1	27.9	8.7	-4.3	5.9	8.9	5.5	5.5	5.5	5.5
Stockbuilding	2.7	2.6	-3.0	-0.5	-0.2	0.1	0.0	0.0	0.0	0.0
Exports of goods and services	12.5	12.4	9.4	1.0	3.1	5.4	5.5	5.4	5.2	5.2
Imports of goods and services	11.8	22.3	4.5	-1.7	4.4	6.6	5.6	5.5	5.4	5.3
Contributions to growth										
Domestic demand	-1.5	10.9	2.6	2.5	4.7	5.3	4.5	4.4	4.3	4.3
Net exports	0.1	-5.6	2.5	1.7	-0.9	-0.9	-0.3	-0.3	-0.3	-0.3
CPI inflation										
Period average	-1.1	4.4	2.3	0.0	1.5	2.5	2.3	2.3	2.3	2.3
End-period	2.5	4.1	1.6	-0.3	2.4	2.5	2.3	2.3	2.3	2.3
Labor market										
Unemployment rate (LFS definition; period average, percent) 1/	18.7	16.2	15.0	11.9	10.7	10.1	9.6	9.3	9.1	8.9
Employment (period average, percent change)	-5.8	2.2	1.6	2.1	1.1	0.5	0.3	0.0	0.1	0.0
Real gross wages	-2.3	0.0	1.3	4.3	2.9	2.9	3.2	3.4	3.4	3.4
	(Percent of GDP)									
Consolidated general government 2/										
Total revenue	36.0	35.6	37.0	35.9	35.3	35.1	31.7	31.5	30.7	30.7
Total expenditure	42.4	38.7	36.9	36.7	36.4	33.9	33.4	31.8	31.2	31.3
ESA balance	-8.1	-3.6	-1.3	-1.3	-1.0	-0.9	-0.8	-0.5	-0.5	-0.5
ESA structural balance	-2.7	-1.6	-0.1	-1.1	-0.8	-0.8	-0.8	-0.5	-0.5	-0.5
General government gross debt	39.7	37.5	36.4	35.1	35.1	33.9	32.4	31.5	29.7	28.4
Saving and investment										
Gross national saving	22.7	22.7	23.0	22.0	21.5	22.0	22.2	22.4	22.7	23.1
Private	25.5	21.1	18.7	18.2	18.5	16.6	19.2	18.1	18.5	19.0
Public 3/	-2.8	1.6	4.3	3.8	3.0	5.4	3.0	4.3	4.2	4.1
Foreign saving 4/	-2.9	2.1	2.5	0.8	1.6	1.9	2.0	2.0	2.0	2.0
Gross capital formation	19.8	24.9	25.5	22.9	23.1	24.0	24.2	24.4	24.7	25.0
Private	16.8	20.8	21.8	19.2	20.0	20.9	21.0	21.3	21.6	21.9
Public	3.0	4.1	3.8	3.7	3.1	3.0	3.2	3.2	3.2	3.2
External sector										
Current account balance	2.9	-2.1	-2.5	-0.8	-1.6	-1.9	-2.0	-2.0	-2.0	-2.0
Net IIP	-80.4	-72.8	-66.6	-65.0	-61.1	-56.4	-53.5	-50.8	-48.7	-46.8
Gross external debt	165.1	143.9	136.4	130.6	130.5	121.0	122.3	121.2	121.1	120.6
Net external debt 5/	54.2	46.0	38.9	35.3	33.1	30.6	28.3	26.4	24.4	21.9
Memorandum items:										
Gross official reserves (billions of euros)	5.8	4.9	5.7	5.8	...	...	...	...	...	...
Nominal GDP (billions of euros)	18.2	20.5	22.1	23.3	24.5	26.3	28.0	29.9	31.8	33.8

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. Latvia: General Government Operations, 2010–19 1/

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
	(percent of GDP)									
Total revenue and grants	36.0	35.6	37.0	35.9	35.3	35.1	31.7	31.5	30.7	30.7
Tax revenue	26.6	27.2	27.6	27.6	27.3	26.9	26.1	25.8	25.7	25.5
Direct Taxes	16.2	16.3	16.5	16.5	16.1	15.7	15.0	14.8	14.8	14.7
Corporate Income Tax	0.9	1.4	1.6	1.6	1.6	1.7	1.6	1.7	1.7	1.7
Personal Income Tax	6.1	5.5	5.6	5.7	5.7	5.6	5.2	5.2	5.2	5.2
Social Security Contributions	8.6	8.6	8.5	8.5	8.0	7.8	7.4	7.3	7.3	7.2
Real Estate and Property Taxes	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.6	0.6	0.6
Indirect Taxes	10.4	10.9	11.2	11.1	11.2	11.3	11.1	11.0	10.9	10.9
VAT	6.5	6.7	7.2	7.1	7.3	7.5	7.4	7.4	7.4	7.4
Excises	3.6	3.4	3.2	3.1	3.1	3.0	3.0	2.9	2.8	2.8
Other indirect taxes	0.4	0.8	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7
Non Tax, self-earned and other revenue	4.7	3.8	3.9	3.6	3.4	3.1	2.7	2.8	2.6	3.1
EU and miscellaneous funds	4.7	4.6	5.5	4.8	4.6	5.0	2.9	2.8	2.4	2.0
Total expenditure 2/	42.4	38.7	36.9	36.7	36.4	33.9	33.4	31.8	31.2	31.3
Current expenditure	39.4	34.6	33.1	33.0	33.3	31.4	31.1	29.9	29.5	29.4
Remuneration	8.5	7.9	7.4	7.5	7.5	7.4	7.1	7.2	7.2	7.3
Goods and Services	5.4	5.1	4.7	4.8	4.7	4.5	4.4	4.2	4.1	4.0
Subsidies and Transfers	23.0	19.2	18.4	17.8	18.0	17.1	17.1	16.1	15.8	15.7
Subsidies to companies and institutions	9.2	7.8	7.8	7.3	8.0	7.2	7.5	6.6	6.4	6.2
Social Support	13.6	11.3	10.4	10.3	9.9	9.7	9.5	9.3	9.3	9.3
Pensions	9.8	8.5	8.0	7.8	7.4	7.0	6.8	6.6	6.6	6.6
Other	3.9	2.8	2.4	2.5	2.5	2.6	2.7	2.7	2.7	2.7
International cooperation	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	0.9	0.9	1.0	1.2	1.0	1.0	1.0	1.0	1.0	1.0
Oher	0.1	0.0	0.1	0.2	0.3	0.3	0.3	0.2	0.2	0.2
Interest	1.4	1.4	1.5	1.4	1.7	1.1	1.1	1.1	1.1	1.2
Capital expenditure	3.0	4.1	3.8	3.7	3.1	3.0	3.2	3.2	3.2	3.2
Measures to be identified	0.0	0.0	0.0	0.0	0.0	0.5	0.9	1.2	1.5	1.3
Restructuring costs	0.9	0.1	-0.1	0.6	-0.1	-0.1	-0.1	0.0	0.0	0.0
Fiscal balance	-7.3	-3.2	0.1	-1.3	-1.1	1.3	-1.6	-0.3	-0.5	-0.6
Financing (net)	7.1	3.2	-0.1	1.3	1.1	-1.3	1.6	0.3	0.5	0.6
Domestic financing	1.1	0.6	-2.7	1.3	-1.5	3.5	-1.7	-0.2	-0.6	-1.6
External financing	5.9	2.0	2.6	0.0	2.5	-4.8	3.3	0.5	1.1	2.2
Errors and omissions	0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items										
ESA balance	-8.1	-3.6	-1.3	-1.3	-1.0	-0.9	-0.8	-0.5	-0.5	-0.5
ESA structural balance 3/	-2.7	-1.6	-0.1	-1.1	-0.8	-0.8	-0.8	-0.5	-0.5	-0.5
Nominal GDP (billions of euros)	18.2	20.5	22.1	23.3	24.5	26.3	28.0	29.9	31.8	33.8

Sources: Latvian authorities; and IMF staff estimates.

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

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

3/ Excludes one-off and unsustainable measures and a (negative) ESA correction buffer for unforeseen events.

Table 4. Latvia: Medium-Term Balance of Payments, 2010–19

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
	(Percent of GDP, unless otherwise indicated)									
Current account	2.9	-2.1	-2.5	-0.8	-1.6	-1.9	-2.0	-2.0	-2.0	-2.0
Goods and services	-1.0	-4.3	-3.6	-1.9	-2.7	-3.3	-3.3	-3.3	-3.4	-3.4
Goods (fob)	-7.0	-10.7	-10.4	-9.0	-9.4	-9.8	-9.8	-9.9	-10.0	-10.1
Exports	37.8	42.1	45.0	43.3	42.9	42.6	43.0	43.3	43.7	44.0
Imports	44.9	52.9	55.4	52.2	52.3	52.4	52.8	53.2	53.7	54.1
Services	6.1	6.4	6.8	7.1	6.6	6.5	6.6	6.6	6.7	6.7
Credit	15.3	15.6	16.0	15.9	15.4	15.3	15.5	15.6	15.7	15.8
Debit	9.2	9.2	9.2	8.7	8.8	8.8	8.9	9.0	9.1	9.1
Income	0.2	-0.9	-1.8	-1.4	-1.6	-1.7	-1.6	-1.6	-1.6	-1.5
Compensation of employees	2.4	2.3	2.3	2.2	2.2	2.2	2.2	2.1	2.1	2.1
Investment income	-2.1	-3.2	-4.1	-3.7	-3.9	-3.9	-3.8	-3.7	-3.6	-3.6
Current transfers	3.6	3.0	2.9	2.5	2.8	3.1	2.9	2.9	2.9	3.0
Capital and financial account	-6.2	-2.4	11.2	3.3	5.7	6.7	2.3	2.3	2.3	3.7
Capital account	1.9	2.1	3.0	2.5	2.3	2.6	1.3	1.5	1.1	0.9
Financial account	-8.1	-4.5	8.2	0.9	3.4	4.1	1.0	0.8	1.2	2.8
Direct investment	1.5	4.9	3.2	1.5	3.0	3.1	3.4	3.9	4.4	5.0
Portfolio investment and financial derivatives	-2.8	-1.8	4.7	0.1	4.5	-2.4	2.4	-1.3	-0.1	1.1
Other investment	-6.8	-7.6	0.2	-0.7	-4.1	3.3	-4.9	-1.8	-3.2	-3.3
Financing	2.1	4.9	-8.9	-1.7	-4.1	-4.8	-0.3	-0.3	-0.3	-1.7
	(Percent change, unless otherwise indicated)									
Current account	-67.4	-183.6	25.3	-65.2	103.5	29.4	12.1	6.0	8.3	3.0
Goods and services	20.3	22.3	13.9	2.3	3.8	6.4	7.6	7.5	7.3	7.3
Goods (fob)	-3.4	71.7	4.1	-8.5	9.8	11.6	7.4	7.2	7.8	7.5
Exports	30.3	25.4	15.3	1.4	4.3	6.4	7.6	7.5	7.3	7.3
Imports	23.5	32.7	13.0	-0.4	5.2	7.4	7.5	7.4	7.4	7.3
Services	-1.6	19.2	13.3	10.9	-2.0	5.2	7.6	7.5	7.1	7.2
Credit	1.1	14.7	10.3	4.8	2.4	6.4	7.6	7.5	7.3	7.3
Debit	3.0	11.7	8.2	0.3	6.0	7.4	7.5	7.4	7.4	7.3
Income	-96.4	-525.6	115.6	-15.3	20.1	14.0	-1.5	6.7	3.9	5.6
Current transfers	3.6	-4.7	2.3	-9.5	18.5	18.2	-1.1	7.1	6.9	10.3
Capital and financial account	-64.3	-56.6	-606.2	-68.5	79.2	26.8	-63.5	5.3	7.3	71.3
Capital account	-22.0	21.7	52.2	-12.2	-1.9	21.6	-46.2	17.7	-19.0	-10.1
Financial account	-58.9	-37.9	-298.0	-88.8	308.4	30.4	-74.4	-11.2	53.7	147.2
Direct investment	142.2	268.0	-28.7	-51.1	108.1	13.7	16.9	20.0	21.7	19.5
Memorandum items										
Export volume (goods and services, percent change)	12.5	12.4	9.4	1.0	3.1	5.4	5.5	5.4	5.2	5.2
Import volume (goods and services, percent change)	11.8	22.3	4.5	-1.7	4.4	6.6	5.6	5.5	5.4	5.3
Gross reserves (billions of euros)	5.8	4.9	5.7	5.8	...	...	...	...	...	...
Gross external debt	165.1	143.9	136.4	130.6	130.5	121.0	122.3	121.2	121.1	120.6
Medium- and long-term	112.2	98.9	86.5	76.8	76.3	67.8	69.6	68.9	69.3	69.2
Short-term	52.8	45.0	49.9	53.8	54.2	53.2	52.7	52.3	51.8	51.3
Net external debt 1/	54.2	46.0	38.9	35.3	33.1	30.6	28.3	26.4	24.4	21.9
Nominal GDP (billions of euros)	18.2	20.5	22.1	23.3	24.5	26.3	28.0	29.9	31.8	33.8
U.S. dollar per euro (period average)	1.33	1.39	1.29	1.33	...	...	...	...	...	...
Lats per euro (period average)	0.70	0.70	0.70	0.70	...	...	...	...	...	...

Sources: Latvian authorities; and IMF staff estimates.

1/ Gross external debt minus gross external assets.

Table 5. Latvia: Financial Soundness Indicators, 2008–13
(in percent unless otherwise indicated)

	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Commercial banks						
Capital Adequacy						
Regulatory capital to risk-weighted assets	11.8	14.6	14.6	17.4	17.6	18.9
Regulatory Tier I capital to risk-weighted assets 1/	10.5	11.5	11.5	14.2	15.2	17.3
Capital and reserves to assets	7.3	7.4	7.3	7.5	9.4	9.9
Asset Quality						
Annual growth of bank loans	11.2	-7.0	-7.1	-8.1	-10.9	-6.5
Sectoral distribution of loans (in % of total loans, stock)	100.0	100.0	100.0	100.0	100.0	100
Agriculture, hunting and related service activities	1.7	1.6	1.6	2.0	2.4	3.2
Construction and real estate activities	19.6	20.8	20.4	20.0	18.6	18.1
Industry and trade	23.1	22.3	22.0	22.0	24.3	24.2
Financial intermediation	6.0	4.5	3.2	2.8	2.7	3.6
Households	38.4	39.3	39.8	40.0	39.1	38.4
Non-residents	11.2	11.4	13.1	13.2	12.9	12.6
Loans past due over 90 days	3.6	16.4	19.0	17.5	11.1	8.3
Earnings and Profitability						
ROA (after tax)	0.3	-3.5	-1.6	-0.9	0.6	0.86
ROE (after tax)	4.6	-41.6	-20.4	-11.2	5.6	8.65
Liquidity						
Liquid assets to total assets	21.6	21.1	27.3	27.4	32.3	34.5
Liquid assets to short term liabilities	52.8	62.8	67.9	63.9	59.8	64.4
Customers deposits to (non-interbank) loans	58.8	61.9	77.5	84.1	106.3	126.2
Sensitivity to Market Risk						
Net open positions in USD to capital	1.4	0.7*	0.9	0.6**	0.6	…
Net open positions in equities to capital	0.1	0.03	0.03	0.03	0.1	…
FX assets to total assets 3/	80.5	82.7	80.6	81.1	80.0	…
FX deposits to total deposits 3/	69.4	74.5	72.6	73.5	76.2	37.6
FX liabilities to total liabilities 3/	81.1	83.8	81.6	79.1	80.6	…
FX loans to total loans 3/	85.0	87.1	88.9	86.3	84.5	12.2
Nonfinancial Enterprises 4/						
Total debt to equity	217.6	281.2	264.5	238.7	204.1	…
Return on equity	14.4	1.7	-0.1	2.0	0.8	…
Earnings to interest expenses	225.9	24.1	169.6	655.6	245.0	…
Households						
Household debt to GDP	41.1	48.1	46.3	38.6	30.6	…
Household debt service to GDP 5/	2.72	2.52	1.97	1.60	1.23	…
Memorandum Items						
Number of banks dealing with residents 2/	14	15	15	17	13	13
Number of banks dealing with non-residents 2/	13	12	14	13	16	15
Assets of banks dealing with residents/Total banking system assets 2/	63.9	78.4	66.6	63.3	54.5	54.8
Assets of banks dealing with non-residents/Total banking system assets 2/	36.1	21.6	33.4	36.7	45.5	45.2

Source: CSB, BoL, FCMC, Latvian Leasing Association, 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 calculaton 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/ Euro-denominated positions are included in and before 2012, but not in 2013.

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 calculatons is adjusted to full coverage of the nonfinancial enterprises.

5/ Interest payments only.

Table 6. Latvia: Indicators of Fund Credit, 2009–16

(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	5.4	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.2	0.3	0.3	8.9	0.0	0.0	0.0	0.0
In percent of gross reserves	0.3	0.4	0.6	20.7	0.0	0.0	0.0	0.0

Source: IMF staff estimates.

Annex I. Public Debt Sustainability Analysis (DSA)

Latvia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

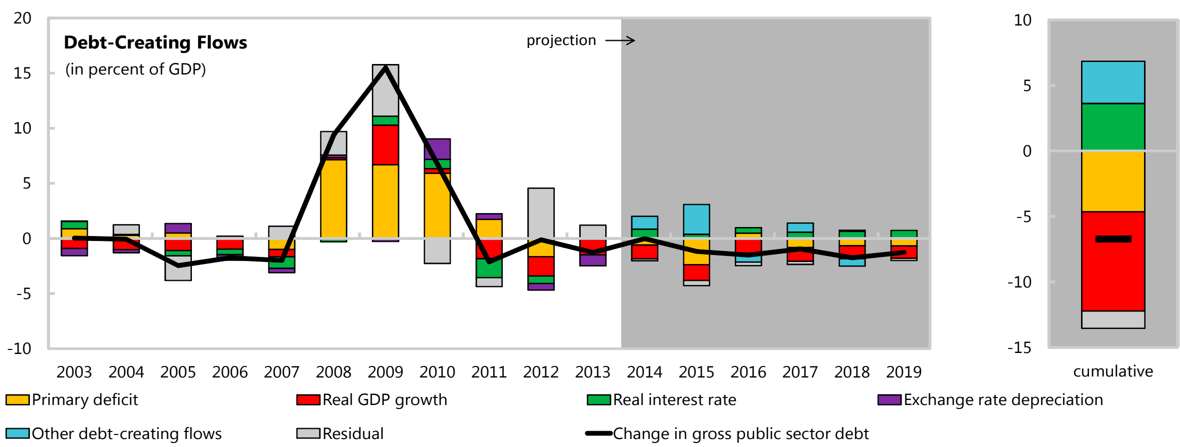
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of January 31, 2014		
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019	Sovereign Spreads		
Nominal gross public debt	19.6	36.4	35.1	35.1	33.9	32.4	31.5	29.7	28.4	EMBIG (bp) 3/		58
Public gross financing needs	6.2	1.1	2.5	8.1	5.8	9.0	7.6	8.4	8.5	5Y CDS (bp)		122
Real GDP growth (in percent)	3.5	5.2	4.1	3.8	4.4	4.2	4.1	4.0	4.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	7.7	3.3	1.4	1.3	2.6	2.4	2.4	2.4	2.4	Moody's	Baa2	Baa2
Nominal GDP growth (in percent)	11.7	8.7	5.6	5.2	7.1	6.7	6.6	6.4	6.4	S&Ps	BBB+	BBB+
Effective interest rate (in percent) [4/]	5.6	4.5	4.1	3.9	3.9	4.0	4.3	4.6	5.0	Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.6	-0.1	-1.3	0.0	-1.2	-1.5	-1.0	-1.8	-1.3	-6.7	
Identified debt-creating flows	2.2	-4.7	-2.5	0.1	-0.7	-1.2	-0.7	-1.9	-1.1	-5.4	
Primary deficit	2.5	-1.6	-0.1	-0.6	-2.4	0.5	-0.8	-0.7	-0.7	-4.7	-0.4
Primary (noninterest) revenue and grants	35.4	37.0	35.9	35.3	35.1	31.7	31.5	30.7	30.7	195.1	
Primary (noninterest) expenditure	37.9	35.4	35.9	34.7	32.7	32.2	30.6	30.1	30.0	190.4	
Automatic debt dynamics [5/]	-0.3	-3.0	-2.4	-0.4	-1.1	-0.9	-0.7	-0.5	-0.4	-4.0	
Interest rate/growth differential [6/]	-0.4	-2.4	-1.4	-0.4	-1.1	-0.9	-0.7	-0.5	-0.4	-4.0	
Of which: real interest rate	-0.2	-0.7	0.0	0.8	0.4	0.5	0.6	0.6	0.7	3.6	
Of which: real GDP growth	-0.3	-1.8	-1.4	-1.3	-1.4	-1.3	-1.3	-1.2	-1.1	-7.6	
Exchange rate depreciation [7/]	0.2	-0.6	-1.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	1.2	2.7	-0.8	0.8	-0.7	0.0	3.2	
Privatization/Drawdown of Deposits (+ r	0.0	0.0	0.0	1.2	2.7	-0.8	0.8	-0.7	0.0	3.2	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroare	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.4	4.6	1.2	-0.2	-0.5	-0.3	-0.3	0.1	-0.2	-1.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

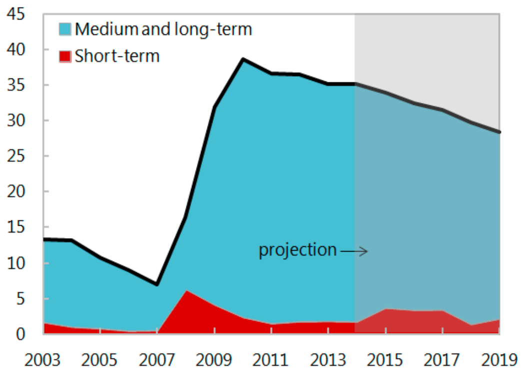
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

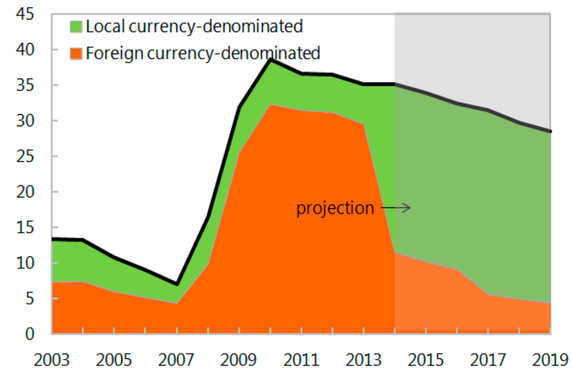
Figure AI.1. Latvia: Public DSA–Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



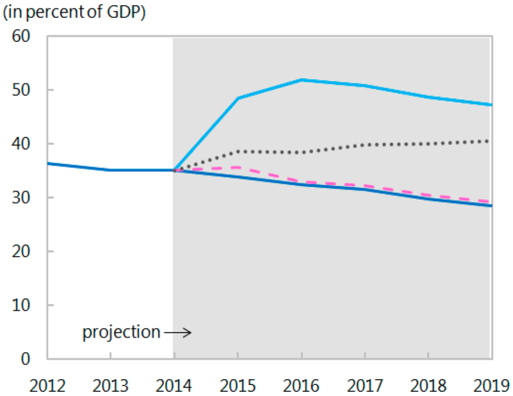
By Currency
(in percent of GDP)



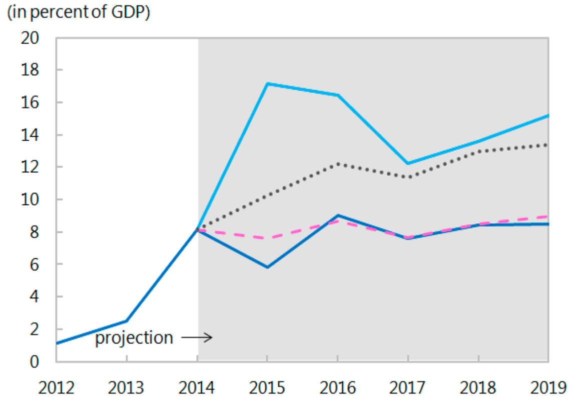
Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	3.8	4.4	4.2	4.1	4.0	4.0
Inflation	1.3	2.6	2.4	2.4	2.4	2.4
Primary Balance	0.6	2.4	-0.5	0.8	0.7	0.7
Effective interest rate	3.9	3.9	4.0	4.3	4.6	5.0
Constant Primary Balance Scenario						
Real GDP growth	3.8	4.4	4.2	4.1	4.0	4.0
Inflation	1.3	2.6	2.4	2.4	2.4	2.4
Primary Balance	0.6	0.6	0.6	0.6	0.6	0.6
Effective interest rate	3.9	3.9	3.9	4.3	4.6	5.0

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	3.8	3.3	3.3	3.3	3.3	3.3
Inflation	1.3	2.6	2.4	2.4	2.4	2.4
Primary Balance	0.6	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	3.9	3.9	2.9	2.7	2.3	2.2
Contingent Liability Shock						
Real GDP growth	3.8	-4.4	-4.5	4.1	4.0	4.0
Inflation	1.3	0.4	0.2	2.4	2.4	2.4
Primary Balance	0.6	-7.8	-0.5	0.8	0.7	0.7
Effective interest rate	3.9	4.4	4.3	4.5	4.8	5.1

Source: IMF staff.

Table 1. Latvia: External Debt Sustainability Framework, 2009–19

(in percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2009	2010	2011	2012	2013			2014	2015	2016	2017	2018	2019	**Debt-stabilizing non-interest current account 6/**
1 **Baseline: External debt**	156.8	165.1	143.9	136.4	130.6			**130.5**	**121.0**	**122.3**	**121.2**	**121.1**	**120.6**	**-4.8**
2 Change in external debt	25.8	8.3	-21.1	-7.5	-5.8			-0.1	-9.5	1.3	-1.2	-0.1	-0.5	
3 Identified external debt-creating flows (4+8+9)	44.2	14.2	-22.7	0.9	-8.2			-2.3	-2.6	-3.4	-3.3	-3.5	-3.7	
4 Current account deficit, excluding interest payments	-16.9	-9.0	-3.3	-2.2	-2.6			-2.2	-1.9	-1.6	-2.8	-2.8	-2.9	
5 Deficit in balance of goods and services	1.1	1.0	4.3	3.6	1.9			2.8	3.3	3.3	3.3	3.4	3.4	
6 Exports	43.4	53.6	58.5	60.5	59.0			58.8	58.0	58.4	58.9	59.4	59.9	
7 Imports	44.5	54.6	62.8	64.1	60.8			61.6	61.2	61.7	62.2	62.7	63.3	
8 Net non-debt creating capital inflows (negative)	13.6	5.0	-0.1	0.9	1.6			0.7	0.7	-0.7	-0.7	-1.1	-1.2	
9 Automatic debt dynamics 1/	47.6	18.3	-19.3	2.1	-7.2			-0.8	-1.3	-1.0	0.1	0.4	0.4	
10 Contribution from nominal interest rate	8.3	6.1	5.5	4.6	3.4			3.8	3.9	3.7	4.8	4.8	4.9	
11 Contribution from real GDP growth	30.1	2.2	-7.4	-7.4	-5.2			-4.6	-5.2	-4.7	-4.6	-4.5	-4.5	
12 Contribution from price and exchange rate changes 2/	9.2	10.0	-17.3	4.9	-5.5			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-18.4	-5.9	1.6	-8.4	2.4			2.1	-6.9	4.7	2.2	3.4	3.2	
External debt-to-exports ratio (in percent)	360.8	307.7	246.1	225.5	221.5			221.8	208.7	209.4	205.7	203.9	201.4	
Gross external financing need (in billions of US dollars) 4/	15.0	13.7	18.9	17.5	17.6			21.8	23.1	23.0	26.0	27.4	29.5	
in percent of GDP	58.2	57.5	67.3	61.1	56.6	10-Year	10-Year	65.3	63.0	57.8	60.1	58.6	58.5	
Scenario with key variables at their historical averages 5/								**130.5**	**118.4**	**116.7**	**112.6**	**109.1**	**105.1**	**-12.3**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	-17.7	-1.3	5.3	5.2	4.1	3.3	8.7	3.8	4.4	4.2	4.1	4.0	4.0	
GDP deflator in US dollars (change in percent)	-6.5	-6.0	11.7	-3.3	4.2	8.2	11.8	3.9	5.2	4.2	4.2	3.9	3.5	
Nominal external interest rate (in percent)	4.9	3.6	3.9	3.3	2.7	5.0	2.0	3.1	3.3	3.3	4.2	4.3	4.3	
Growth of exports (US dollar terms, in percent)	-20.9	14.6	28.3	5.3	5.7	15.8	16.3	7.5	8.2	9.5	9.4	8.9	8.5	
Growth of imports (US dollar terms, in percent)	-39.0	13.8	35.4	3.8	3.0	14.6	23.1	9.1	9.1	9.5	9.4	9.0	8.5	
Current account balance, excluding interest payments	16.9	9.0	3.3	2.2	2.6	-2.2	11.0	2.2	1.9	1.6	2.8	2.8	2.9	
Net non-debt creating capital inflows	-13.6	-5.0	0.1	-0.9	-1.6	5.9	11.6	-0.7	-0.7	0.7	0.7	1.1	1.2	

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

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

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

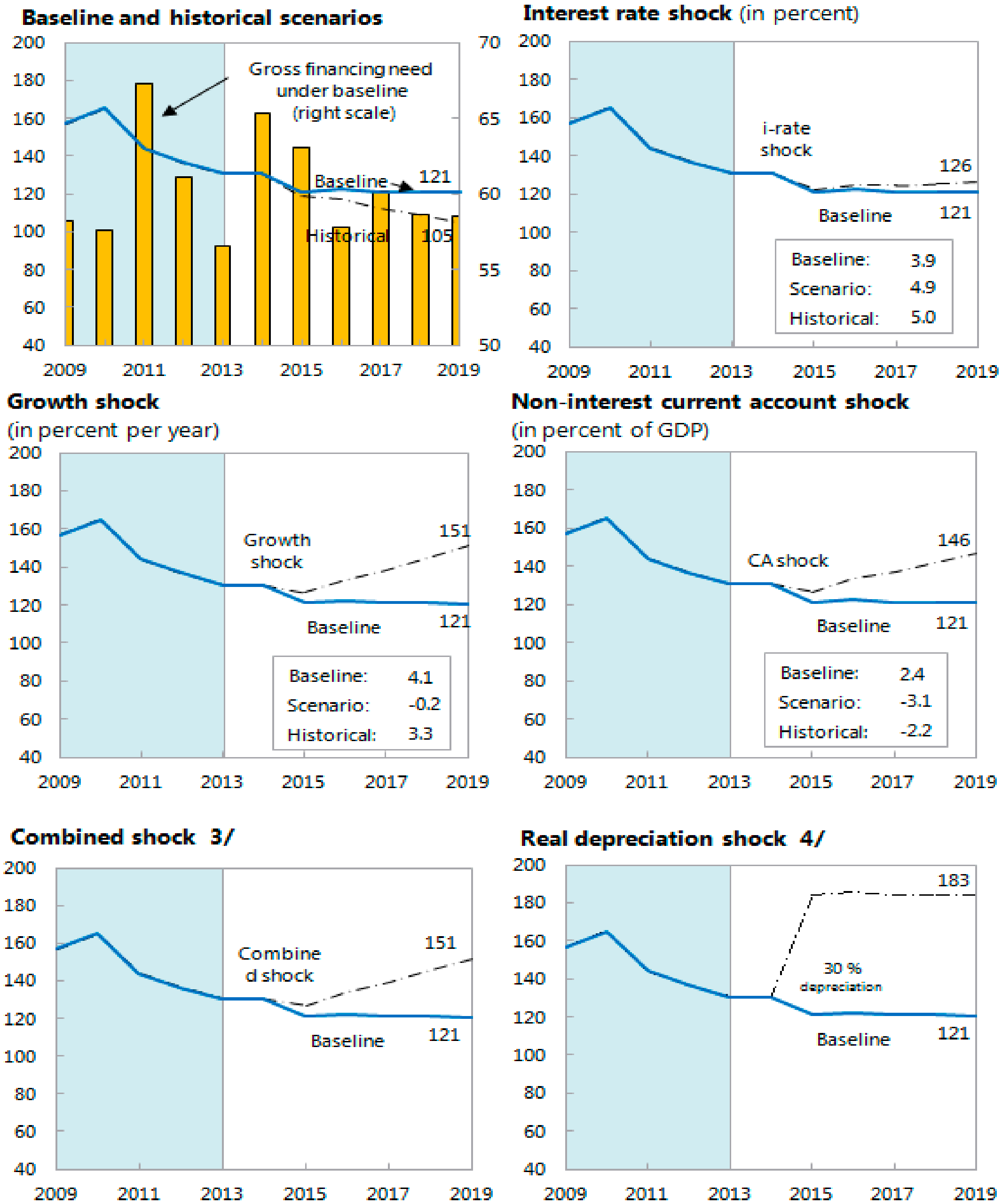
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Figure 1. Latvia: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

Appendix I. Progress on Restructuring

This appendix describes the state of play on several important corporate restructurings, encompassing both public and private firms. In the case of Liepajas Metalurgs, the bankruptcy of the company is relatively recent, while in other cases the ongoing restructuring has a longer history. See the 2013 Article IV Staff Report for further context.

1. **Latvia' s biggest steelmaker, Liepajas Metalurgs (LM), ceased operations in May 2013 after several quarters of deteriorating performance, and was later declared insolvent.** LM was a major player in Latvia's economy, with a net turnover of about 2 percent of GDP and 4.4 percent of exports in 2012, employing some 2,300 workers (0.3 percent of the labor force). The government assumed liability for a loan to LM that was guaranteed in 2009 to support the firm's expansion, resulting in a fiscal expenditure of about 0.3 percent of GDP.

2. **LM's assets have been pledged to the government and the company's three other main creditors.** A sales plan for the company's assets was approved by the government in January, and contains two options: an auction or an international tender. The latter is the preferred option as it would increase the chances of bundling the assets (which have more value in combination than piecemeal), maximizing the recovery value and facilitating a speedy reopening. The authorities are keen to ensure that the sale occurs before the end of the year, when costs to maintain the equipment will soar again owing to elevated winter heating charges. It is expected that any new owner would choose a smaller operation size utilizing only the newest equipment of the deceased company. The authorities are optimistic about eventually recovering the full amount of their claims on LM—except the costs linked to maintenance and the insolvency process—but this is not certain.

3. **The sale of the commercial part of Mortgage and Land Bank (MLB) has been successfully completed.** Four bundles of assets accounting for about 60 percent of book values were sold into the market. The remaining assets—valued at 100 million Latvian lats—were transferred to a newly formed company called Hiponia, owned by the Latvian Privatization Agency (LPA) and supported by a loan from the Ministry of Finance.

4. **A Single Development Institution (SDI) was established by the end of 2013.** This institution will merge the non-commercial part of MLB with two other entities: the Latvian Guarantee Agency (LGA) and Rural Development Fund (RDF). The transfer of MLB, RDF, LGA shares to the new SDI will be completed in 2014. The SDI will run state support programs mainly to provide guarantees and intermediation for priority support areas (such as industrial production, exports and services), and in some cases to provide direct lending to projects that are credit rationed because of their small size, high riskiness, or lack of related expertise in Latvian commercial banks to bear the risk.

5. **The sale of Citadele is expected this year.** The bank continues to be profitable following restructuring, under its new management. It is yet to be decided whether the sale will occur through an IPO or through an auction to large investors; this will be reassessed after a preliminary road show and the solicitation of non-binding bids. The wealth management arm of Citadele will be sold together with the rest of the bank to maximize the entity's market value.

Appendix II. Latvia: External Stability Assessment

1. **Staff estimates that the real effective exchange rate (REER) is broadly in line with fundamentals.** CGER's External Sustainability and Macroeconomic Balance Approaches both suggest a small undervaluation of the REER whereas the Equilibrium Real Exchange Rate (ERER) approach concludes that in 2013, the exchange rate was about 10 percent above its equilibrium level. In the case of Latvia, the former two estimates are likely more reliable, producing results close to one another, and consistent with external sector developments. By contrast, the ERER method is known for its weakness when applied to countries that experienced profound structural economic changes, and thus breaks in time series trends.

Latvia: 2014 Real Exchange Rate Assessment Using CGER Methodology

	Current Account Balance		REER (in logs)		
Approach	Norm	Underlying	Equilibrium	Actual	Misalignment [1]
External Sustainability	-3.4	-2.0	...	...	-3.8
Macroeconomic Balance	-2.9	-2.0	...	...	-2.4
Equilibrium Real Exchange Rate	...	...	4.9	5.0	10.3
Memo item					
Average					1.3

Source: IMF staff estimates.

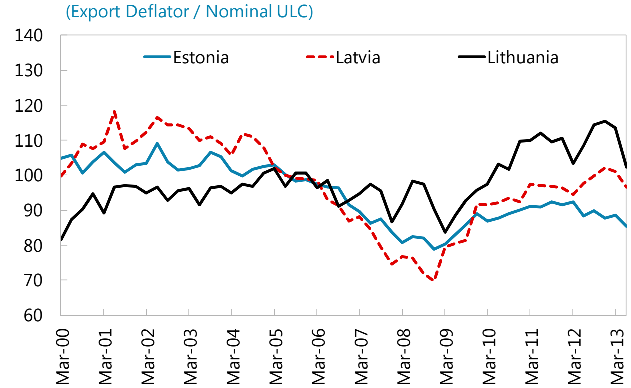
[1] A positive number indicates overvaluation.

2. **There has been a slowdown in the rate of competitiveness gains.** The CPI-based REER remained broadly stable on average in 2013, reflecting a drop in Latvian prices relative to its main trading partners that compensated for an appreciation in the NEER of 2.1 percent. The ULC-based REER appreciated by 2.2 percent during January-July 2013 compared to 2012 (Panel 6).

3. **A simple measure of export profitability—the ratio between the export deflator and nominal ULC—indicates that recently margins are being squeezed, after a long period of gains.** Similar patterns hold for Estonia and Lithuania, suggesting that this is a regional trend.

Latvia and Other Baltics: Export Profitability Compared to Euro Area, 2000–12

(Export Deflator / Nominal ULC)

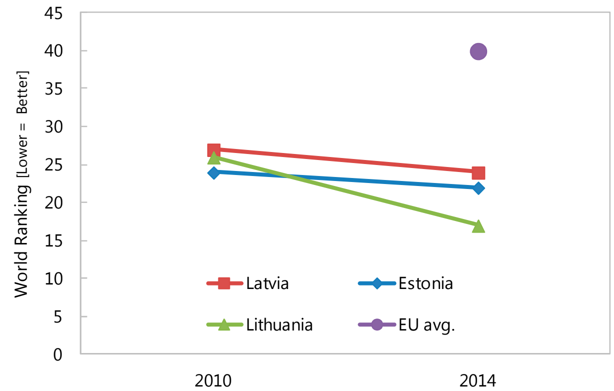


Sources : Eurostat and IMF staff calculations.

4. **Latvia's rapid export growth since the recession has been aided by increasing diversification, both in terms of products and markets.** Heavy reliance on Nordic and some advanced West European markets has been balanced with increasing export shares to other Baltic countries, CIS countries and the CESEE, while the technological sophistication of the product mix has been increasing. However, the impetus to exports from a correction of

macroeconomic imbalances—from a pre-crisis position of large overvaluation—is now largely dissipated. Given the limited room for future competitiveness gains through REER depreciation, non price competitiveness gains through structural reforms should be a priority.

Doing Business Ranking: Latvia vs. Baltics
(Out of 189 countries)

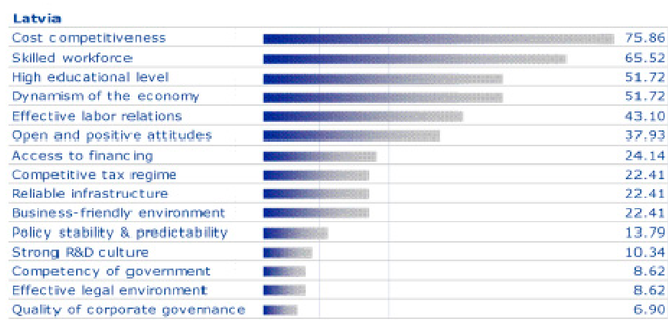


Source: The World Bank.

5. The World Bank's Doing Business indicator shows that Latvia has become relatively more business friendly in recent years and fares better than most European Union countries (although it continues to lag behind Estonia and Lithuania). But other indicators (IMD's World Competitiveness, 2013) suggest that there is considerable room to facilitate trade, including through improvements in infrastructure, and the efficiency of the legal system.

6. External debt has fallen substantially since the crisis but remains high at about 130.6 percent of GDP at end 2013. The rapid decline in the debt-to-GDP ratio is accounted for mostly by the repayment of liabilities to parent banks by Nordic subsidiaries. Going forward, this deleveraging is expected to level off, but at the same time, the rate of growth of NRD inflows is expected to continue to moderate. FDI was exceptionally low in 2013, as one component of the general investment slump, but is expected to rebound over the medium-term now that the uncertainty regarding euro accession has been resolved.

Latvia: IMD's World Competitiveness, 2013[1]



Source: IMD.

[1] A survey asked to select choose out of 15 indicators, the top five perceived as the key attractiveness factors for Latvia. The figure shows the percentage of responses per indicator.

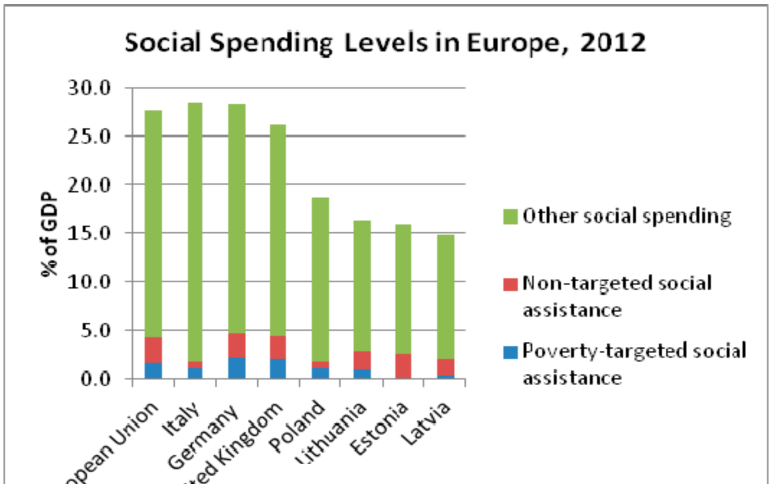
7. External debt is projected to decrease by a further 10 percentage points of GDP over the medium term, although the debt sustainability assessment shows that growth and non-interest current account shocks could derail this adjustment. Moreover, NRDs are subject to sudden stops in the face of a sufficiently large financial shock, as occurred during the global financial crisis. There are mitigating factors—such as the accumulation by NRD banks of sizeable liquid foreign assets, and higher prudential requirements for NRD banks—but supervision will need to remain vigilant.

Appendix III. Inequality and Social Assistance in Latvia

1. **As detailed in a recent World Bank study[1] Latvia suffers from high levels of poverty and inequality, while social assistance benefits are relatively low.** Policy action is therefore needed to strengthen the social safety net.

2. **Latvia has one of the most unequal income distributions in EU.** In 2012 Latvia had the highest at-risk-of-poverty rate, third highest 75/25 quintile ratio and third highest severe material deprivation rate in the EU. Nearly two-thirds of the poor live in households with low work intensity, who are either unemployed, inactive or retired.

3. **Social spending in Latvia remains relatively low**—amounting to about 15 percent of GDP compared to an EU average of about 28 percent of GDP in 2011—and is primarily driven by social insurance programs. Spending on social assistance in Latvia is particularly low, and poverty-targeted programs represent a relatively small percentage of social assistance. Moreover, the distribution of social assistance benefits in Latvia is rather regressive. Less than 20 percent of all social benefits accrue to the poorest quintile with the richest quintile receiving almost 27.5 percent, strikingly different from the 40–10 percent split seen in the EU on average.



Source: Eurostat and staff calculations

4. **The Guaranteed Minimum Income (GMI) benefit—the main poverty-targeted program in Latvia—is well targeted albeit overly restrictive, and does not provide adequate income support.** The GMI program has virtually no leakage to the upper quintiles with 91.3 percent accruing to the poorest quintile. However, despite increased coverage during the crisis, in 2010 it still reached only 13.7 percent of the poor. Further, the GMI contributes very little—only around 10 percent—to the incomes of those in the poorest quintile, leaving most beneficiaries (75 percent in 2010) at risk of poverty. Low coverage follows from low-income thresholds, other restrictive eligibility criteria, and limited financing due to decentralization to municipalities.

[1] *Latvia: Who is Unemployed, Inactive or Needy? An Assessment of Post-Crisis Policy Options,* The World Bank, Washington, D.C., May 2013

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

April 8, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of April 8, 2014)

Membership Status: Joined May 19, 1992; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	142.10	100.00
Fund holdings of currency (Exchange Rate)	142.06	99.97
Reserve Tranche Position	0.06	0.04

SDR Department:

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

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

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

Projected Payments to Fund:

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

	Forthcoming				
	2014	**2015**	**2016**	**2017**	**2018**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Exchange Rate Arrangement:

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

Previous Article IV Consultation:

Latvia is on the 12-month consultation cycle. The last Article IV consultation was concluded on January 23, 2013 (IMF Country Report No. 13/28). The Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2013/pn1311.htm.

Safeguards Assessment:

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

FSAP Participation and ROSCs:

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

ROSC Modules

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

Technical Assistance: Technical Assistance (2007–12):

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

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

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund for surveillance purposes is classified as adequate (A). 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).

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

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

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

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

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

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

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

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

As of November 30, 2012

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	02/28/2014	03/01/2014	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	02/28/2014	03/01/2014	M	M	M		
Reserve/Base Money	02/28/2014	03/15/2014	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	02/28/2014	03/15/2014	M	M	M		
Central Bank Balance Sheet	02/28/2014	03/01/2014	M	M	M		
Consolidated Balance Sheet of the Banking System	02/28/2014	03/15/2014	M	M	M		
Interest Rates[2]	02/28/2014	03/15/2014	M	M	M		
Consumer Price Index	02/28/2014	03/15/2014	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	12/31/2013	02/28/2014	M	Q	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	12/31/2013	02/28/2014	M	Q	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/31/2013	02/28/2014	M	Q	M		
External Current Account Balance	9/30/2013	12/4/2013	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	9/30/2013	12/4/2013	M	M	M		

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

As of November 30, 2012

GDP/GNP	Q4 2013	03/15/2014	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q3 2013	12/4/2013	Q	Q	Q		
International Investment Position[6]	Q3 2013	12/4/2013	Q	Q	Q		

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

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

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

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

[5] Including currency and maturity composition.

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

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

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

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

Press Release No. 14/205
FOR IMMEDIATE RELEASE
May 8, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Latvia

On May 2, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Latvia.

Latvia entered the euro area in January 2014 with the fastest rate of growth in Europe. A slowdown in investment and exports was partly compensated by robust consumption demand, supported by rising real wages, bringing GDP growth in 2013 to 4.1 percent.

Strong job creation reduced the unemployment rate to 11.3 percent by end-2013, close to its structural level. Consumer price inflation fell to an average of about zero in 2013, mainly due to weakening energy prices. A successful sovereign bond issue in January demonstrated that the country retains market access at favorable rates.

The 2013 general government deficit outturn of 1.0 percent of GDP was below the target of 1.4 percent.[2] Improved tax administration yielded substantial revenue gains which more than compensated for a large unanticipated loan repayment on behalf of a bankrupt steel company, and indexation of small pensions from September onwards. Separately, the passage of the Fiscal Discipline Law ensures that future budgets will be grounded in a prudent medium-term framework that seeks to avoid pro-cyclicality.

Bank balance sheets continued to strengthen. Profitability increased and the ratio of non-performing loans declined for both the household and corporate sector. But credit continued to contract, and parent funding of Nordic subsidiary banks declined further. Non-resident deposits (NRDs) in the banking system—which now account for almost half of all deposits and are subject to stricter prudential requirements—continued to grow but at a slower pace.

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

[2] The 2013 general government deficit was revised from 1.3 percent of GDP to 1 percent of GDP after the issuance of the staff report.

Executive Board Assessment[3]

Executive Directors congratulated the Latvian authorities on fulfilling their goal of joining the euro area. Directors observed that the economic recovery continues to be strong, unemployment has declined rapidly, and the current account position is near balance. However, risks to the broadly favorable medium-term outlook are tilted to the downside, given an uncertain external environment. Directors emphasized the importance of continued fiscal prudence, accelerated reforms to reduce structural unemployment and boost productivity, sustained resumption of bank credit, and vigilant supervision of the financial sector.

Directors agreed with the broad contours of the 2014 budget, which allows fiscal consolidation to continue at a measured pace while strengthening the social safety net. They welcomed the passage of the Fiscal Discipline Law and the authorities' commitment to the structural deficit targets over the medium term. To this end, Directors encouraged the authorities to reconsider the planned reductions in the personal income tax rate, improve revenue administration, and broaden the tax base by increasing property taxes and reducing the grey economy. Addressing high levels of income inequality and safeguarding investment expenditures in crucial areas remain important objectives.

Directors underscored that progress on a broad range of structural reforms will be needed to maintain competitiveness within the euro area and to reduce structural unemployment. Key priorities include upgrading infrastructure, particularly in the area of ports, liberalizing the electricity sector, and centralizing the management of state-owned enterprises while divesting non-core activities. Directors also recommended aligning higher education and vocational training with market demand to reduce skills mismatches. Broader labor market reforms are also needed to improve work incentives. In this regard, they saw merit in a more gradual phasing-out of the guaranteed minimum income (GMI) benefit to reduce the tax wedge for GMI recipients entering employment.

Directors highlighted the urgency of reviving bank credit to support investment and growth. They welcomed the planned reforms to expedite the resolution of insolvency cases, and urged further efforts to reduce the private sector's debt overhang and develop non-bank sources of financing, including through further integration with regional markets. Directors noted that the large size of non-resident deposits (NRD) and associated risks warrant continued vigilant supervision. They supported the stricter prudential requirements for NRD-specialized banks, close consultation with home and European supervisors and regulators, and ongoing initiatives to strengthen the framework for anti-money laundering.

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[3] 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.

Republic of Latvia: Selected Economic Indicators, 2008–14

	2008	2009	2010	2011	2012	2013	2014
							Proj.
National accounts	(Percentage change, unless otherwise indicated)						
Real GDP	-2.8	-17.7	-1.3	5.3	5.2	4.1	3.8
Private consumption	-5.8	-22.6	2.3	4.8	5.8	5.4	5.2
Gross fixed capital formation	-13.8	-37.4	-18.1	27.9	8.7	-4.3	5.9
Exports of goods and services	2.4	-13.1	12.5	12.4	9.4	1.0	3.1
Imports of goods and services	-10.2	-31.7	11.8	22.3	4.5	-1.7	4.4
Nominal GDP (billions of lats)	16.1	13.1	12.8	14.3	15.5	16.4	17.2
Nominal GDP (billions of euros)	22.7	18.6	18.2	20.5	22.1	23.3	24.5
GDP per capita (thousands of euros)	10.4	8.6	8.6	9.9	10.8	11.4	12.1
Savings and Investment							
Gross national saving (percent of GDP)	18.0	29.2	22.7	22.7	23.0	22.0	21.5
Gross capital formation (percent of GDP)	31.2	20.5	19.8	24.9	25.5	22.9	23.1
Private (percent of GDP)	26.6	17.2	16.8	20.8	21.8	19.2	20.0
CPI Inflation							
Period average	15.4	3.5	-1.1	4.4	2.3	0.0	1.5
End-period	10.5	-1.2	2.5	4.1	1.6	-0.3	2.4
Labor market							
Unemployment rate (LFS definition; period average, percent) 1/	7.5	16.9	18.7	16.2	15.0	11.9	10.7
Real gross wages	4.4	-6.8	-2.3	0.0	1.3	4.3	2.9
	(Percent of GDP, unless otherwise indicated)						
Consolidated general government 2/							
Total revenue	35.6	36.2	36.0	35.6	37.0	35.9	35.3
Total expenditure	39.0	43.3	42.4	38.7	36.9	36.7	36.4
ESA balance	-4.2	-9.7	-8.1	-3.6	-1.3	-1.3	-1.0
General government gross debt	17.2	32.9	39.7	37.5	36.4	35.1	35.1
Money and credit							
Credit to private sector (annual percentage change)	11.0	-6.9	-8.4	-7.4	-11.4	-5.7	-2.0
Broad money (annual percentage change)	-3.9	-1.9	9.8	1.5	4.5	2.2	5.3
EMBIG (Percent)	...	...	...	...	1.60	1.39	...
Money market rate (one month, eop, percent)	13.3	2.7	0.6	1.1	0.3	0.3	...
Balance of payments							
Gross official reserves (billions of euros)	3.7	4.8	5.8	4.9	5.7	5.8	...
Current account balance	-13.2	8.7	2.9	-2.1	-2.5	-0.8	-1.6
Trade balance	-17.9	-7.1	-7.0	-10.7	-10.4	-9.0	-9.4
Gross external debt	130.9	156.8	165.1	143.9	136.4	130.6	130.5
Net external debt 3/	57.5	58.8	54.2	46.0	38.9	35.3	33.1
Exchange rates							
Lats per euro (period average) /4	0.71	0.70	0.70	0.70	0.70	0.70	...
Euro per U.S. dollar (period average)	0.68	0.72	0.75	0.72	0.78	0.75	...
REER (period average; CPI based, 2000=100)	104.5	110.2	103.6	103.8	102.1	100.8	...

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 was pegged to the euro at 1 EUR = 0.702804 LVL rate, with ±1 percent band.

Statement by Mr. Audun Groenn, Executive Director for the Republic of Latvia and by Mr. Uldis Rutkaste, Senior Advisor to the Executive Director
May 2, 2014

On behalf of our Latvian authorities, we thank staff for the analysis provided in the staff report for the 2014 Article IV Consultation with the Republic of Latvia, the first since the euro adoption. The report properly reflects the fruitful discussions with the authorities on different policy options in the context of both the Article IV and Baltic Cluster Report missions, and the challenges that the Latvian economy is facing. The Latvian authorities have always given careful consideration to policy recommendations coming from the Fund. In our recent experience, policy discussions and Fund advice have provided meaningful input to shaping the authorities' strategy for a prudent fiscal policy and ambitious structural reforms, which implemented in a frontloaded fashion, routed the economy out of the recession and on a sustainable growth path.

After the years of the crisis, the report describes a largely calm period of an economy in equilibrium. While GDP growth remains among the fastest in Europe, the output gap is largely closed, the current account stays close to balance, and the fiscal position is credibly anchored within the recently enacted medium-term fiscal framework. The real exchange rate is broadly in line with fundamentals and the inflation rate, that had been temporarily pushed into a very low territory by easing commodity and energy prices, is gradually picking up to more normal levels.

In this overall heartening outlook characterized by harmony between staff and the authorities on most issues, our authorities would like to provide more detailed remarks on the following subjects: first, on the outlook for 2014 and 2015 in light of the events in Ukraine; second, on fiscal and tax policies, in particular, with regards to addressing the high level of inequality; and third, on the risks associated with non-resident deposits (NRDs).

Outlook for 2014 and 2015

The recent events in Ukraine and Russia have obviously introduced new downward risks and increased the uncertainty surrounding the projections. For the time being, the effect is difficult to gauge, but the authorities' calculations suggest that no severe downturn could be expected even in case of material disruptions of economic ties. Both the Ukrainian hryvnia and the Russian ruble have depreciated significantly, but monthly exports data do not show any effect yet; February figures still post robust annual and monthly growth.

However, a growth slowdown may not be ruled out against weaker external demand and if a further escalation leads to trade restrictions and heightened uncertainty. Anecdotal evidence points to a profound impact on businesses working in Ukraine (in particular, fish processing seems to have been harmed the most). A more diverse, but equally uncertain picture is observable in the case of exports to Russia with some enterprises even planning expansion, but most worried about the possible effect of a future escalation of tensions. Significant effects on business confidence and businesses postponing investment or expansion decisions in Latvia cannot be excluded, though very little of this is currently evident. On the upside, should the situation in Ukraine remain contained, a stronger-than-expected euro area recovery may very well provide an additional impetus to the Latvian economy.

Fiscal policy and measures addressing high level of inequality

Despite the unanticipated loan repayment on behalf of Liepajas Metalurgs[1], the 2013 fiscal deficit outturn was better than expected, at 1.0 percent of GDP. Staff rightly points to the challenges related to the planned cut in PIT in the coming years. The authorities are fully aware that, if implemented without compensatory measures, it may excessively constrain much-needed public expenditure in priority areas. While it is obvious that an adequate response to this prospect will be necessary, most likely along the lines suggested by staff, it is doubtful that details of possible measures averting the revenue squeeze will be clearer before the October elections. Building on the past success, the authorities are also fully committed to continued efforts to reduce the grey economy that would further increase revenue envelope.

In line with the authorities' priorities, the 2014 budget included several measures addressing the high level of inequality, such as indexation of small pensions and an increase in the minimum income tax threshold. After a careful analysis of the potential impact on employment, a decision was taken to increase the minimum wage. Job search requirements for unemployed have already been strengthened in 2013. An increase in the minimum income levels used to calculate last resort benefits (GMI), the introduction of gradual phasing out of this benefit with an aim to encourage return to the labor market, as well as a possible return to co-financing and a review of eligibility criteria, are being considered and discussed with municipalities and other stakeholders.

Mitigating the risks pertaining to NRDs

While recognizing the risks related to the NRDs, the authorities do not agree that "the level of non-resident deposits in Latvia's banking system represents a key vulnerability to the economy". The authorities closely monitor banks focused on NRDs. Those banks are subject to additional, much stricter, prudential capital and liquidity requirements (within Pillar II)—based on pre-defined quantitative criteria, taking into account both the share of non-resident deposits and loans to non-residents in bank's balance sheet, as well as their growth rate. Currently, NRD banks' capital adequacy ratio exceeds the minimum regulatory requirement on average about two times (reaching 17.7 percent at the end of 2013), whereas their average liquidity ratio was 78.3 percent in February 2014 (minimum regulatory requirement is 30percent). Liquidity stress test results show that each Latvian bank would be able to withstand an outflow of up to 60 percent of its non-resident deposits without recourse to other sources of financing to replenish the outflows.

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[1] Since the issue of the guarantee on Liepajas Metalurgs an array of enhancements to the sovereign guarantee system of Latvia has been introduced, the most intrinsic of them being improvement of guarantee planning procedure, strengthening involvement of line ministries into the planning and monitoring process and straitening the target applicant scope. These reforms render relevant grounds to avoid similar cases and fiscal impact in the future.

The financial regulator (FCMC) will continue to enhance the risk-oriented approach to supervision and maintain Pillar II tools to adequately capture the risks inherent in banking activities, especially those of the NRD-specialized banks. Capital add-on and individual liquidity ratios for NRD-specialized banks are re-assessed annually or can be re-set more frequently, in case of material changes in banks' strategy or risk profile. The supervisory toolkit is supplemented by macroprudential instruments that can be activated to address system-wide risks and increase resilience of banks, if mandated by external or internal developments. The new Law on Resolution and Recovery (tentatively by end 2014 or Q1 2015) will, inter alia, introduce a bail-in provision for banks' creditors, thus effectively alleviating the potential burden of resolution costs on tax-payers.

Latvia continues to strengthen the AML framework. Significant progress has been made in the implementation of the Moneyval recommended action plan. Supervision of AML risks and bank compliance practices remains intense, recently broadening the focus, so as to also encompass non-bank payment services providers given the notable development of this segment.

On a different but related issue, the report leaves the impression that external debt, at 130.6 percent of GDP, is a significant source of concern. This concern is a long-lasting feature of Latvia's Article IV reports. Nonetheless, it should be noted that this high level of external debt is linked to high level of NRDs, 82 percent of which, as noted in the report, are invested abroad in liquid assets, mitigating the risks of an outflow. Therefore, gross external debt is expected to remain high so long as there is a well-supervised non-resident element in the banking system. In our authorities' view, the net debt, firmly on a declining trend (expected at 33.1 percent in 2014), would probably be more informative when it comes to the associated risks to the domestic economy.