INTERNATIONAL GROUP OF RATING AGENCIES
RAEX EXPERT RA RATING AGENTUR EUROPE
Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

Research Report on Latvia

24th of July, 2015

Author:

Gustavo Angel
Expert of Rating-Agentur Expert RA GmbH

For further information contact:

Rating-Agentur Expert RA GmbH
Office 601a, Mainzer Landstrasse 49,
60329 Frankfurt am Main, Germany
+49 (69) 3085-54-85
E-mail: info@raexpert.eu
www.raexpert.eu

Introduction

Latvia's main macroeconomic indicators have shown a remarkable improvement since the aftermath of the 2008 crisis. The country's accession to the Eurozone at the beginning of 2014 contributed significantly to price stabilization and reduction of inflation rate. Current levels of government debt and fiscal deficit remain well below the Maastricht limit and pose no significant risk to the Latvian economy. The banking sector was profitable during 2014, but the declining level of private credit remains the main drawback of the industry. High dependence of foreign banks on parent banks as well as the country's exposure to and dependence on foreign shocks (mainly from Russia and other Eurozone members) stand as the main risks for the Latvian economy.

Main Economic Indicators of Latvia

Macro indicators	2012	2013	2014
Gross pub. debt, bill EUR	8,0	8,2	9,6
Nominal GDP, bill EUR	22,0	23,2	24,1
Real GDP growth, %	4,8	4,2	2,4
Gross gov. debt/GDP, %	36,5	35,2	40,0
Deficit (surplus)/GDP, %	0,1	-1,1	-1,4
Inflation rate, %	1,6	-0,4	0,7
Curr. Account balance/GDP, %	-	-3,3	-2,9

Development indicators	2014
Inequality adj. HDI	0,72
GDP per capita (Thou. of USD)	23,7

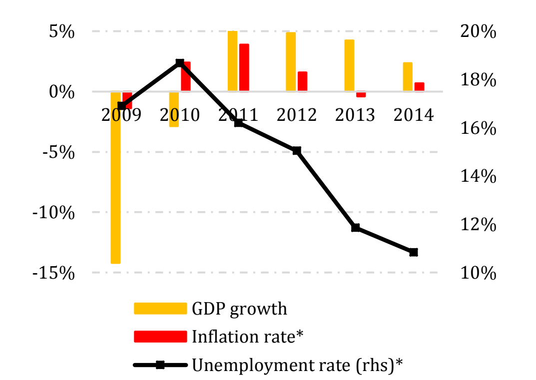
Default indicator	As of 24.07.15
5-Year CDS spread (Bp)	88,0
10Y Gov Bond Yield, %	1,35

Sources: RAEX (Europe) calculations based on data from IMF, Eurostat, Deutsche Bank, Trading Economics.

Economic recovery is still in place with a robust outlook. Latvia has made significant economic progress since the 2008 crisis (see graph 1). While slower than in 2013, real GDP grew by 2,4% during 2014. Additionally, the unemployment rate continued to decline, ending the year 2014 at 10,8%, the lowest unemployment rate registered since 2008. The accession of Latvia to the Eurozone at the beginning of 2014 contributed significantly to price stabilization and reduction of inflation rate in the country. The main driver of Latvia's economic recovery was household consumption, which boosted as a result of an increase in the minimum monthly wage from 320 to 360 EUR, as well as a reduction in the income tax rate from 24% to 23% by the beginning of 2015. We expect consumption to increase further by the end of 2016 if an additional decline of 1% in the income tax rate, as announced by the Latvian Ministry of finance, materializes. Even though the economy has recently slowed in the face of a deteriorating external environment, the economic outlook is encouraging on the basis of a pick-up in the economic activity in the Euro area as well as sustained consumption levels and low commodities prices.

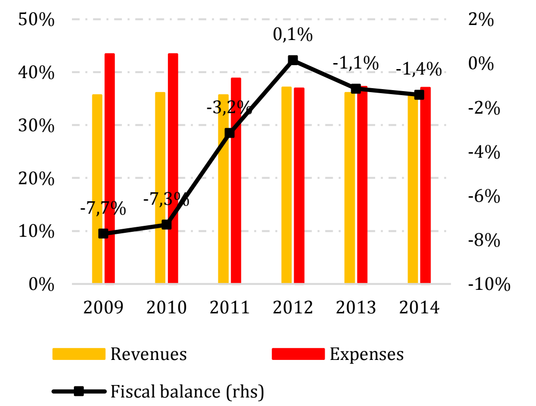
Fiscal balance deteriorated but stands at tolerable levels. As a result of expenditure cuts and tax raises, the Latvian Government managed to bring down the fiscal deficit to GDP ratio from 7,7% in 2009 to 1,4% in 2014 (see graph 2). Even though it widened compared to 2013 figure (1,1%), the 2014 value still remains well below the 3% GDP limit stated in

Graph 1: Latvia's macroeconomic soundness



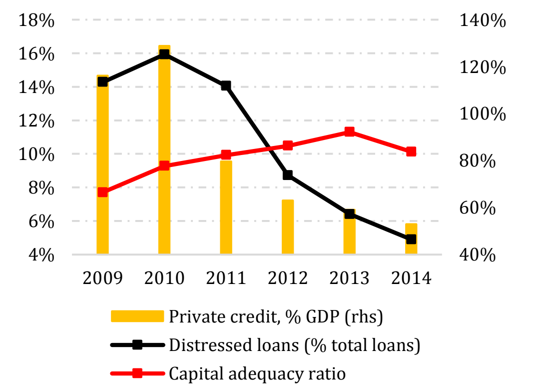
Source: RAEX (Europe) calculations based on data from IMF and Eurostat.
*2014 forecast

Graph 2: Fiscal position of Latvia (% GDP)



Source: RAEX (Europe) calculations based on data from IMF

Graph 3: Banking sector position



Source: RAEX (Europe) calculations based on data from World Bank

the Maastricht treaty. The loss in revenues which followed the 1 percentage point cut in personal income tax was offset by growth of the tax base, as enforcement of tax payment improved and nominal wages increased. We expect that in the following years the recently elected center-right government coalition will keep deficit around the 2014 figure, since the Latvian Government has proved remarkable effort in complying with the Fiscal Discipline Law (FDL)[1].

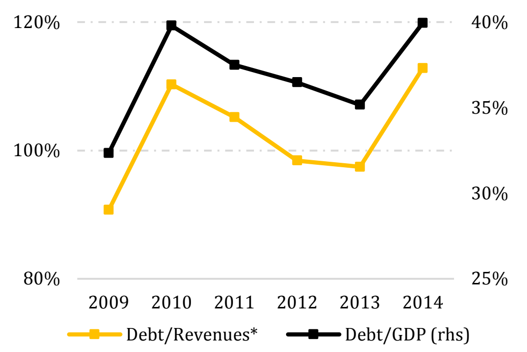
Banking sector is profitable and still highly dependent on external funding. The Latvian banking sector ended the year 2014 with a positive ROA and an average capital adequacy ratio of 10%. While the share of distressed loans stood at its lowest value since 2009 (5%), the share of private credit to GDP continued its negative trend totaling 53% by the end of 2014 (see graph 3). As detailed in our previous research report[2], Latvia's banking sector is so dependent on foreign banks (mainly Scandinavian), that assets of the five largest foreign banks represent 50% of total assets while 69% of total loans are granted by four foreign banks. In view of this dependence, the ECB quantitative easing programme is likely to have little impact on bank lending in Latvia, since foreign subsidiaries depend on parent banks for funding rather than on the local wholesale market, and the parent banks do not show signs of liquidity constrain. Because of this, the main roots for such a low level of lending lays on the demand rather than on the supply side.

The Latvian government debt load remains bearable but with up-ward trend. Gross government debt indicators remain at tolerable levels with debt/GDP and debt/fiscal revenues ratios amounting to 40% and 112,8% by the end of 2014 respectively. Debt indicators showed a downward trend during the period 2010-2013 but this trend changed since ever with an increase of 5pp and 13pp in the former and latter indicator between 2013-2014 respectively (see graph 4). The country still shows little short-run exposure as short-term debt accounted for 4,3% of GDP and 12,1% of fiscal revenues by the end of 2014. Additionally, long-term risks assessment of the market is low as the yield on government long-term bonds remain below 2% (one of the lowest in the Eurozone).

Latvia's dependence and exposure to Russia and Eurozone still significant. Despite its sound macroeconomic and financial indicators, Latvia's small and opened economy is highly exposed to external risks, mainly coming from Russia and western Europe. The recent accession of Latvia to the Eurozone contributed significantly to the reduction of the

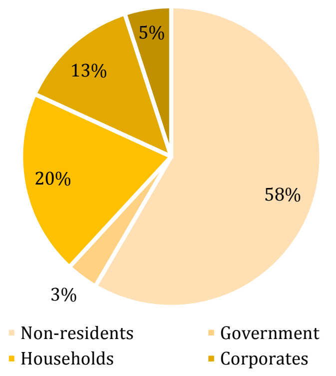
[1] The FDL sets a medium-term objective (MTO) for the deficit of 0,5% of GDP, but allows for deviations from this target for revenue transfers to the privately managed "Pilar II" pension fund.
[2] Research report on Latvia from 30th of January, 2015 (http://raexpert.eu/reports/Research_report_Latvia_30.01.2015.pdf)

Graph 4: Latvian gross government debt



Source: RAEX (Europe) calculations based on data from IMF. *2014 Forecast

Graph 5: Distribution of banks' deposits (May 2015)



Source: RAEX (Europe) calculations based on data from Central Bank of Latvia

inflation rate, but at the same time it introduced negative exposure such as a possible contagion of the current Greek crisis as well as loss of competitiveness in key industries. Latvia's dependence on Russia is not only stronger than on Europe, but also clearer. Latvia is exposed to external shocks from Russia (and the Russian-Ukrainian crisis), as 11% of Latvian exports were directed to Russia in 2013 and a vast majority of oil and gas supplies of Latvia were imported from Russia. Even though Russian counter-sanctions on Latvia's food exports remain in place, Russian FDI to Latvia accelerated in the first half of 2014. An additional source of external exposure for Latvia is the share of non-resident deposit (mainly from Russian and Scandinavian citizens), which amounted to 58% of total bank deposits in 2014 (see graph 5).

Conclusion

Latvia is still showing signs of economic recovery since its crisis in 2008 with positive GDP growth rates, higher household consumption and low inflation rate. The country's creditworthiness remains sound as fiscal and government debt position stood at tolerable levels with low short- and long-term exposure. The banking sector is healthy and profitable but can be potentially harmed if the current negative trend in credit volume remains in place. Latvia's high exposure to external risks (especially from Russia and Euro-zone countries) have not harmed the country's overall trade and competitiveness.