Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF LATVIA	Assigned Ratings/Outlook: **A /stable**	Type: Monitoring, Unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	26-08-2016 11-06-2021 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 11 June 2021

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "A" for the Republic of Latvia. Creditreform Rating has also affirmed Latvia's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A". The outlook is stable.

Key Rating Drivers

1. Track record of dynamic economic growth over the last few years prior to the outbreak of Covid-19, although slightly less vivid than Baltic euro area peers, and slowing down in 2019; Latvian economy generally subject to elevated macro-financial volatility
2. Despite some resilience to the global recession caused by the coronavirus, weak start into 2021 due to more adverse situation in the second wave, although milder than in 2020; medium-term growth outlook remains dampened by unfavorable demographics, while well-targeted use of ample EU funding should help to future-proof the economic base and accelerate the income convergence process; possible adverse effects on competitiveness from strong wage growth will be monitored
3. Institutional set-up of generally high quality, including advantages from EU/euro area and NATO membership; continued progress in terms of AML/CFT framework, enhancing the quality and efficiency of its judicial system and combating and preventing corruption; despite increased political fragmentation and related challenges to government stability as witnessed very recently, we ultimately perceive policy-making as sound and responsive
4. Deterioration of fiscal metrics as a consequence of the pandemic likely transitory and occurring at a relatively low level, in our view not compromising fiscal sustainability against the backdrop of very high debt affordability, a demonstrated emphasis on fiscal prudence, and ongoing political commitment to fiscal soundness; EU-level funding to continue to act as a supportive pillar in this regard
5. Improving external position over the last years, but remaining vulnerabilities to external shocks as a small open economy and amid a relatively high share of non-resident holdings in government debt; recent current account surplus, distorted by pandemic, likely to turn into a slight deficit again

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Reasons for the Rating Decision and Latest Developments

Macroeconomic Performance

Latvia continues to display a balanced macro performance profile in which strong growth and a welcoming business environment are set against relatively moderate, though increasing, per capita incomes, generally elevated volatility in macroeconomic and financial variables, and structural bottlenecks related to unfavorable demographics. Last year's Covid-19-induced recession turned out to be relatively mild, partly due to Latvia's economic structure and idiosyncratic factors. A more adverse epidemiological situation amid the second infection wave and a respective weak start of the economy into the current year, in addition to a relatively cumbersome vaccination campaign, somewhat weigh on the Latvian near-term growth outlook. However, in view of significant fiscal backing and substantial EU funding via NextGenerationEU (NGEU) and the Multiannual Financial Framework (MFF) 2021-27, economic output is set to rebound strongly in the second half of this year, as well as next year, likely accelerating its convergence process towards EU level income. Determined economic adjustment as seen following the global financial crisis gives confidence that Latvia can overcome the detrimental economic effects of the epidemiological crisis in a timely fashion. If implemented effectively, EU means could help to tackle risks to the medium-term growth outlook associated with relatively low R&D investment, structural changes in the transport sector, as well as from demographic challenges.

Having displayed dynamic economic growth over the five years prior to the pandemic (average 2015-19: 3.1%), although less dynamic than Baltic peers Estonia (4.0%) and Lithuania (3.4%) over this period (euro area: 1.9%), Latvia's GDP fell by 3.6% in 2020. This decline was significantly smaller than we had estimated in our last review and constituted a comparatively mild fall compared to the euro area (EA) as a whole (-6.6%), partly aided by relatively small economic contractions in the country's most important European trading partners, including Estonia and Lithuania (EE: -2.9%, LT: -0.9%). A favorable performance of wood and paper manufacturing as well as computer and electronic products on the one hand, and its limited exposure to tourism and consumer-facing services on the other, also proved helpful in this respect.

Moreover, as suggested by the stringency index of the Blavatnik School of Government, Latvia's restrictions to public life during this crisis overall appear to have been somewhat less strict than in many other European countries, in line with the less severe first infection wave in Latvia. Crucially, the government took swift and sizeable action to cushion the negative effects on businesses and the labor market as well as on vulnerable parts of society.

As in most countries, collapsing household consumption exerted the most negative effect on GDP growth in 2020, falling by 10.0% and taking 5.9 p.p. off growth. The other main expenditure components ultimately contributed slightly positively, with net exports adding 0.5 p.p., as exports shrank by a rather tame 2.7%, whereas imports dropped by 3.3%. Gross fixed capital formation stagnated by and large (0.2%), with non-residential construction investment even accelerating against the previous year (2.4%, 2019: 1.8%). In contrast, investment in machinery and equipment saw a 2.2% decline. Government consumption meanwhile delivered a positive 0.5 p.p. to the overall negative 2020 GDP growth outturn.

Goods exports showed remarkable resilience last year, expanding by 4.3% (BoP data), in line with the average annual growth rate over 2015-19 (4.4%), and backed by rising exports of electrical equipment and supplies (20.0%, CSB data), machinery and mechanical appliances (8.8%), but also by a large increase in exports of cereals (19.3%). Services exports, on the other hand,

fell sharply by 21.2%, owing to the transport sector, which accounted for almost a third (31.9%) of all services exports last year, and in which exports plunged by 34.2%.

The pandemic-related distortions partly mask underlying structural changes in the transport sector. As a major transit center for East-West cargo flows, Latvia has been affected by lower volumes of cargo loading in ports and cargo transportation by rail, especially concerning coal. This reflects, inter alia, changes in energy policies in terms of a green transition and the development of renewable energy sources, as well as Russia's stronger emphasis on transit through its domestic ports, highlighting Latvia's susceptibility to negative consequences of EU-Russian and EU-Belarus tensions (see below).

Amid fast-accelerating infection rates, which according to ECDC data peaked in the first week of 2021 (14-day rate of 694 per 100 thousand persons), a state of emergency was re-declared in November 2020. Owing to containment measures to suppress the spread of the virus, total economic output decreased by 1.7% q-o-q in Q1-21 following an increase of 1.1% in Q4-20 (EA: Q1-21: -0.6%, Q4-20: -0.7%), although this was markedly less than the initially estimated decline by 2.6%. Contraction in private consumption and gross fixed capital investment were main drivers behind the negative outcome. Economic output was thus still 3.5% below its pre-pandemic level (Q4-19) in Q1-21 (EA Q1-21 vs. Q4-19: -5.5%).

As the14-day incidence rate dwindled to 366 in week 20, a gradual wind-down of restrictions is underway. The second state of emergency ended on 6 April, when gradual easing started. From 3 June shopping malls and cultural establishments are allowed to open, subject to conditions. In addition, rules pertaining to gatherings of people have been slightly relaxed. Looking at recent vaccination data, we observe that Latvia is lagging behind the EU and its Baltic peers, with 31.2% having received a first inoculation dose and 21.1% being fully vaccinated as of 11 June 2021 (EU: 51.1% and 26.7%). Against this backdrop, reaching the planned rate of 70% by summer would seem to require some acceleration, potentially hinting at a tamed pace for economic recovery over the next few months.

On the other hand, industrial data relating to March and April signal strong growth impulses, with industrial production rising by 20.5% y-o-y in April, backed by manufacturing, mining and quarrying as well as electricity and gas supply. Improving economic sentiment (European Commission data) echoes this positive impression, with the business climate in the industrial sector moving above pre-crisis levels in May. The current quarter should thus see some rebound of economic output, not least because the unemployment assistance benefit, which along with furlough benefits and wage subsidies was extended until the end of June 2021, might have provided some buffer.

Going forward, we expect a more substantial recovery to take hold in the second half of the year. Domestic demand, and in particular private consumption, should lead the recovery, also supported by strong wage growth (2020: 6.2%, CSB), both in the public and private sectors. Average monthly gross wages and salaries for full-time employees increased by 9.5% y-o-y in Q1-21, although somewhat biased by a 26.5% increase of wages in the health and social care sector. There were, however, also comparatively large increases in high value-added areas such as ICT (7.1%) and business services (6.7%). In addition, the minimum wage was raised from EUR 430 to 500 (+16.3%) from January 2021. Furthermore, the Latvian labor market should be aided by loans via the EU employment facility SURE (EUR 305mn).

Displaying some tightness before the corona crisis hit, Latvia saw its unemployment rate rise from 6.3% in 2019 to 8.1% last year (LFS-adj. Eurostat), thus slightly exceeding the unemployment rate in the euro area overall (2020: 7.8%) for the first time since 2012. Compared to its Baltic peers, it remained somewhat below the level registered in Lithuania (8.5%) and above that in Estonia (6.8%). Total employment fell by 2.3% in 2020 (National Accounts, Domestic Concept), a more pronounced decrease than registered for the euro area as a whole (-1.6%), and - strictly speaking - a second consecutive decline (2019: -0.1%). The monthly unemployment rate has been dwindling since Aug-20, stabilizing around 7.8% in Apr-21 (EA: 8.0%, LFS-adj.). Labor market conditions might deteriorate again, i.e. in case of a less benign growth scenario, possibly entailing a higher number of bankruptcies and job losses. Still, we consider it more likely that labor supply shortages will become a more demanding issue again and add to wage pressure if, as is our main scenario, Latvia's recovery gains traction and continues beyond this year.

Against the backdrop of favorable financing conditions, also driven by accommodative monetary policy, we expect gross fixed capital formation to also contribute markedly to improving economic activity. In particular, public investment will likely be boosted by the important infrastructure project Rail Baltica and the EU's Recovery and Resilience Facility (RRF), although the main impact should be felt from 2022 rather than the current year (see below).

Meanwhile, the export outlook is brightening, as the Covid-induced recession has tended to be relatively tame in main European trading partners. Amid a progressing inoculation campaign, prospects of a more stable recovery are improving, bolstering the outlook for foreign demand. For the reasons mentioned above, export activities in the transport sector may remain somewhat dampened. However, we note that until 2018 (latest available data) Latvia had advanced with regard to high-tech exports, with the share of these products climbing by 3.2 p.p. to 11.2% since 2013 (Eurostat), pushing the country into the group of those euro area members displaying a share above the median (9.6%).

Overall, we currently forecast a GDP rebound by 3.6% this year, with growth accelerating to about 5.3% in 2022. Continuing a long-running streak of good progress in terms of income convergence towards the EU-27 level of GDP per capita (2020: 71.3%, IMF data, PPP), the convergence process should thus pick up some speed. At USD 31,509 (2020), however, per capita income is still moving well below Estonia and Lithuania in this respect (EE: 37,475, LT: 38,824). Downside risks surrounding the near-term outlook remain largely linked to the evolution of the vaccination process, and to the success of containing the virus and associated mutations.

Deeper scarring effects from the health crisis cannot be ruled out at this stage, although past experience - in particular following the global financial crisis - suggests a high degree of flexibility and adaptability of the economy. Low private debt levels hint at existing risk-bearing capacities in the event of a less benign macroeconomic scenario than we currently envisage. Household debt to disposable income had fallen further to 32.4% as of Q4-20 (2019: 33.3%, ECB data), while indebtedness of non-financial corporations (NFC) had edged down to 45.7% of GDP by Q4-20 (Q4-19: 46.9%, ECB), both ratios corresponding to some of the lowest in the euro area.

In terms of competitiveness, we observe that real unit labor costs have continued to develop less favorably than those of the main European trading partners, both over a short horizon (2020: 6.7 y-o-y, EA: 2.6%) and considering a longer-term horizon (2020 vs. 2011: 35.1%, EA: 1.9%). Compensation per employee has risen significantly, exceeding growth of real labor productivity per person for many years, which at some point will likely affect competitiveness.

We have to highlight, however, that competitive wages should be conducive to attracting and maintaining skilled labor.

For the time being, it has to be stated that, notwithstanding rising labor costs, Latvia's global export market share increased slightly to 0.09% (+0.01 p.p.) in 2020, after having been stable over the two preceding years, thus so far not pointing to competitive losses. The increase was driven by goods, whereas the export market share regarding services remained stable. While we are still awaiting the World Bank's updated Doing Business Report, Latvia has continued to perform strongly in terms of non-price competitiveness as of the latest edition.

With regard to the medium-term growth prospects, we think that, if implemented effectively, support via the RRF along with other EU funding (see below) should provide a meaningful lever to strengthen economic resilience further by enhancing key skills and establishing and maintaining key infrastructure on the way to a more digitalized and greener economy. Although having improved until 2019 (latest available data, Eurostat), Latvia continues to trail Estonia and Lithuania when it comes to nominal productivity per hour worked and per person. Potential growth is currently estimated to be around 2.9% this year and 3.2% in 2022 (AMECO), below Lithuania's and roughly in line with Estonia's projected potential growth, aided by an assumed TFP expansion by 2.5% and 3.4% (average 2015-19: 3.4%) respectively, which would likely exceed that of the Baltic peers over this period.

Above-EU-average ESIF fund absorption in the recent past acts as an encouraging backdrop regarding the public administration's capacities to implement RRF-related projects. Drawing on data from the European Commission (EC), Latvia has spent about 61% of allocated means under the ESIF 2014-2020 umbrella (EU: 56%), although absorption flattened somewhat towards the end of this cycle. According to the Latvian authorities, the cumulative effect of the RRF plan on GDP growth in 2022-29 could be between 1.3 and 1.5 p.p. and the cumulative effect on employment about 0.7 p.p.

The funds could thus help to tackle challenges to potential growth arising from the disadvantageous demographic outlook and from low levels of R&D spending. Latest data show that Latvia's business expenditure on R&D is the lowest among all EU member states (2019: 0.17% of GDP, EU: 1.42%), and gross domestic expenditure on R&D is low as well (2019: 0.64% of GDP, EU-27: 2.2%, EE: 1.6%, LT: 1.0%). Private investment may also be deemed as relatively low for a catching-up economy, averaging 16.6% of GDP in 2016-20, below the EU average and behind its Baltic peers.

Further to risks to the medium-to-longer-term growth outlook, we stress Latvia's unfavorable demographic outlook, given the country's relatively low and shrinking working-age population (2020: 63.5% of the total population, 15-64y). Diminishing by 2.1 p.p. between 2015 and 2020, the ratio exhibited one of the strongest declines among the EU members (EU-27: -1.3 p.p.), and, looking ahead, is projected to shrink further to a sizeable degree by comparison (-3.1 p.p. by 2030), which emphasizes pressure to increase productivity and ultimately potential growth. Migration simulations based on EUROPOP 2019 add to our concern here, as they suggest a rather adverse development over the next two decades.

As for the transport sector, we will monitor developments around parts of the so-called EU Mobility Package I, against which there have been complaints by a number of European countries including Latvia. Objections particularly relate to the obligatory return of a vehicle to the Member State of establishment of the haulier every eight weeks, and the application of cabotage

quotas on the international combined transport operations. On 19 February 2021, the EC published results of two studies focusing on possible detrimental effects on the environment and suggesting existing conflict with aims formulated in the European Green Deal. Against this backdrop, the current specification might undergo some changes, possibly removing some disadvantages as seen on the part of Latvia, while political tensions and related sanctions between Russia and the EU, as well as between Belarus and the EU, will remain in place for the time being, not least posing challenges to the transit business.

Institutional Structure

The Republic of Latvia's generally high institutional quality continues to buttress our sovereign credit assessment, as does its membership in the European Union/European Monetary Union and in other pivotal international organizations such as NATO. While the former implies substantial benefits stemming from Latvia's access to broader and deeper capital markets, trade integration, and the adoption of common standards and codes, NATO membership proves viable in a geopolitical context, as the sovereign shares borders with the Russian Federation and Belarus. Political tensions between the EU and Belarus have flared up more recently, adding to challenges related to the strained relationship with Russia, entailing geopolitical tail risks. The domestic political context has also become more volatile over the last twelve months, and the governing coalition broke up in a fragmented political landscape. However, we still view the sovereign's policy-making as sound, given our perception of a broad consensus on key policy goals such as fostering inclusive growth and fiscal sustainability, and a strong commitment to the EU and pro-market polices.

Political volatility has increased significantly since our last review. The governing coalition, which was formed by five out of the seven parties represented in the Saeima (excluding the Harmony party and the Greens and Farmer's Union), had remained effective until very recently. Against the backdrop of a second, significantly more severe Covid-19 infection wave and sluggish vaccination progress, however, the government's stability appears to have receded noticeably over the last months. Latvia's Health Minister was thus replaced after a motion of no confidence at the beginning of this year. In May, the Latvian Minister of Economy stepped down after deciding to change his party affiliation. The government reshuffled this June, as the KPV LV party left the government after several MPs departed. The remaining four parties, having signed a memorandum of understanding on 2 June, will form a minority government, holding 48 out of 100 Saeima seats. Whilst general elections are due in fall 2022, we note that current opinion polls indicate that no party would achieve a share of more than 15% of the popular vote.

That being said, we continue to view Latvian policy-making as sound and responsive to the structural challenges at hand, as underscored by the latest vintage of the World Bank's Worldwide Governance Indicators (WGI). The quality of the sovereign's policy formulation and implementation is attested to be relatively high, reflected by a good 35th rank out of 209 economies worldwide (WGI government effectiveness), up from relative rank 43 a year before and outperforming the euro area median (rank 41), as well as the median of CEE economies (rank 55). Latvia remained at rank 53/209 in terms of the freedom of media, expression, and association (EA median: rank 37), but climbed several notches with regard to the WGIs rule of law, from rank 44 to 41/209 (EA: rank 40), and control of corruption, from rank 75 to 67/209 (EA: rank 55).

We think that the multi-year improvement in the sovereign's rule of law ranking is particularly noteworthy (WGI rule of law, 2000: rank 86), mirroring the implementation of targeted reforms over the last two decades, by which policy-makers have markedly improved the independence,

quality, and efficiency of its judicial system. According to the Justice Scoreboard 2020, Latvia has significantly reduced the number of, and the estimated time needed to resolve pending civil, commercial, administrative, and other cases since 2012. In addition, Latvia may be deemed as a European ICT frontrunner in terms of submitting claims online and the use of electronic means for case management.

The gap between the sovereign and the respective euro area average on the WGI control of corruption indicates the need for further improvements in this respect. However, the recent GRECO reports published at the beginning of this year highlight steadfast reform efforts in enhancing Latvia's anti-corruption framework. Corruption prevention concerning MPs, judges, and prosecutors has made good progress: GRECO arrives at the conclusion that eleven of fourteen recommendations in its fourth evaluation report have been satisfactorily dealt with, e.g. by abolishing administrative immunities for judges and prosecutors, and strengthening the role of the Judicial Council. Headway has also been made when it comes to fighting corruption in central governments and law enforcement agencies, as wide-ranging reforms have been launched, although ten of the seventeen recommendations in the fifth round evaluation have only been partly implemented so far.

Meanwhile, work on the enhancement of Latvia's AML/CFT framework continues after the FATF deemed the financial crime prevention system compliant with all FATF recommendations. While AML/CFT requirements have been significantly tightened over recent years, authorities follow along the lines of their AML/CFT action plan 2020-2022. In particular, human resource capacities of the KNAB, Latvia's corruption watchdog, are to be strengthened significantly in 2021/22.

In the same vein, reforms in key thematic areas were further expedited. Firstly, social protection will be further bolstered, as the government has lifted the guaranteed minimum income level and the minimum income thresholds, raised old-age and disability pensions as well as unemployment benefits, increased the minimum wage, and decided on new active labor market policy measures. Secondly, to enhance the health sector's performance, further funding will be provided for additional staffing in healthcare and the development of an eHealth system.

Thirdly, in a bid to improve the effectiveness of its tax system, also with the aim to support inclusive growth, competitiveness, and the social safety net, Latvian authorities have adopted several tax policy changes. These include an increase of the threshold for the non-taxable minimum personal income tax, a reduction of the social security contribution rate, and the implementation of a minimum social security contribution.

Fourthly, with a view to the support of corporate liquidity and private investment activity, policymakers aim to improve access to finance and investment opportunities, digitalization, and sustainable finance via their Financial Sector Development Plan 2021-23 published in March. Moreover, in its budget 2021, the government envisaged several measures to facilitate investment in R&D.

As in other European economies, Latvia's Recovery and Resilience Plan, the RRP which was submitted to the EC at the end of April, will play an important role in supporting Latvia's structural policy targets, but also as regards a fifth key policy item, greening the economy and digital transition. The RRP rests on six components, namely climate, digital transformation, reducing disparities, health care, economic transformation, and rule of law. A fifth of the RRP funds will be allocated to a wide range of measures such as improving the digital infrastructure, digitizing

public administration, boosting the digital skills of its population, and enabling the digitalization of the corporate sectors.

The bulk of the grants under the EU's RRF (37%) will be structured around measures under the climate pillar, where Latvia aims to reduce greenhouse gas (GHG) emissions - inter alia by investing in sustainable transport solutions and improving energy efficiency in housing and business - and to implement disaster management measures. In particular, authorities plan to green the transport system in Riga's metropolitan area and reduce GHG emissions in the important transport sector. Indeed, Latvia displays a relatively low, though rising share of energy from renewable sources in transport. At 5.1% (2019), the share of the country's renewables in transport is one of the lowest in the EU (avg. 8.9%), albeit in line with its Baltic peers (LT: 4.0%, EE: 5.1%). On the other hand, Latvia displays one of the highest overall shares of energy from renewables, posting at a remarkable 41.0% (2019), well above the EU average of 19.7%. Also, Latvia features one of the lowest readings when it comes to per capita GHG emissions (2019: 6.1 tons p.c. – EU: 8.4).

Prior policy efforts devoted to climate change relate to the National Energy and Climate Plan of Latvia for 2021-30 (NECP), which was enacted in early 2020 and sketches the country's main policy routes for green transition, including binding energy targets for renewable electricity, heat and cooling, as well as transport energy. We note that Latvia is ranked 17th in the EU-28 Eco-innovation Index for 2019 (incl. the UK). While the EC's Eco-innovation report concludes that the sovereign lacks clear responsibilities for greening the economy on the policy level, this may change in tandem with the implementation of the RRP.

Fiscal Sustainability

The sovereign's favorable public finances remain a decisive factor backing our credit ratings. Latvia's fiscal metrics have deteriorated with the onset of the pandemic, but to a lesser degree than those of its EU peers. At the same time, we see significantly ramped up corona crisis support triggered by a more severe second Covid-19 infection wave, translating into a further rising deficit and a continued brisk increase in public debt this year. That said, the sovereign commands over ample fiscal headroom, and we expect that its public debt ratio will remain comparatively low from a European perspective. Moreover, our baseline scenario foresees a strong decline in next year's deficit, coupled with a stabilizing debt-to-GDP ratio. While we assume debt affordability to remain very high, also thanks to favorable funding conditions, the EU's RRF financing and the commencing Multiannual Financial Framework (MFF) 2021-27 will lend further substantial fiscal support. Finally, the sovereign's demonstrated track record of fiscal prudence after the global financial crisis adds to our benign view of its fiscal sustainability.

Prior to the Covid-19 pandemic, the sovereign showed a run of very moderate headline deficits. Mirroring Latvia's sound fiscal policy-making and the importance of fiscal sustainability as a key policy target, its budget balance averaged at -0.7% of GDP in 2015-19. Due to the corona crisis public finances weakened markedly, with the headline deficit widening from 0.6% of GDP in 2019 to 4.5% of GDP in 2020.

While this represents the worst outturn since 2011, it was less severe than we had expected in our last review. In addition, metrics have worsened significantly less than in most other EU member states – the budget deterioration of 3.9 p.p. of GDP was the second-lowest in the EU (avg.

6.4 p.p.). In Latvia, the spread of the virus in the first half of 2020 was relatively contained (see above), implying a less grave recession and a lower take-up of emergency measures.

According to Ministry of Finance (MOF) data, measures to mitigate the impact of the Covid-19 pandemic amounted to EUR 1.29bn, 4.4% of GDP in 2020. Sectoral support accounted for roughly half of the support package (2.1% of GDP), mainly explained by extensive aid for health care (0.5% of GDP) and the transport sector (1.4% of GDP), in particular for the aviation industry, as the Latvian state increased its share in the national airline Air Baltic (0.9% of GDP). Tax support measures (0.9% of GDP) and the disbursement of temporary benefits (0.8% of GDP) weighed less heavily. The budgetary impact of the Covid-19 measures is estimated at 3.7% of GDP, as per Stability Program 2021 (SP21).

Hence, the deficit was largely driven by the spending side, with expenditure soaring by 9.5% and posting at 43.6% of GDP (2019: 38.4% of GDP, Eurostat data). Due to notable government support, subsidies leapt by 28.2%, while public investment increased by 8.3%. Latvia's public wage bill rose by 0.9 p.p. o 11.8% of GDP, being inflated by the rising pay for public workers in health care, defense, and education.

On the revenue side, plunging household spending and contracting employment resulted in declining tax revenues. Taxes on income and wealth dropped by a relatively moderate 1.2%, mainly on the back of decreasing PIT revenues (-5.7%). The loss in revenue intake was tempered by a sharp increase in CIT receipts which, however, was due to the 2018 corporate income tax reform and concurrent base effects. A marked decline was observed in production and import taxes as well (-2.5%); the VAT intake edged down by 3.2%. By contrast, 2020 saw a marked increase in property income (+19.2%), and net social contributions increased by 1.1%. Accordingly, general government revenue dropped by only 0.4%.

Whilst last year's outturn was better than expected, mainly due to a less severe first wave of coronavirus cases and a strong rebound in H2-20, we expect that the sovereign's public finances will continue to deteriorate in 2021. Against the backdrop of a fierce second infection wave, the government has significantly expanded the respective support measures targeted towards the Latvian health system, households and businesses.

Although we think that this year's take-up of the Covid-19-related measures will be somewhat lower again, the significantly ramped-up volume will presumably cause the headline deficit to balloon to 7.8% of GDP in 2021. Concomitant with an increasingly broad vaccination coverage and a gradual wind-down of emergency measures by the end of this year, in tandem with a continued economic recovery, we expect Latvia's deficit to decline sharply to 2.4% of GDP in 2022. We have to highlight that any forecast remains subject to unusually high uncertainty, essentially in view of new strains of the virus such as the Delta variant, and is ultimately dependent on the epidemiological situation and vaccination progress.

As Latvia's infection rate may be still deemed as relatively high, accompanied by a slowly progressing vaccination campaign, support schemes have been extended to June or even into the second half of this year. This year's relief measures are estimated to total EUR 3.4bn, or 11.0% of estimated GDP as of 7 May, already higher than the EUR 2.9bn approved in March earlier this year. As in 2020, the largest part is planned to be allocated towards sectoral support, namely EUR 1.67bn (5.4% of GDP). In particular, the government plans to provide significant aid for health care, i.e. purchases and remuneration, but sizable funding is also to be channeled towards Latvia's transport industry and grants for current assets. While approx. 1.8% of GDP is

reserved for loans and guarantees, disbursements of benefits are slated to surge as compared to 2020, and support measures are to amount to roughly 3.2% of GDP, e.g. as families with children, pensioners, and disabled persons will receive one-off allowances (0.9% of GDP).

Permanent measures related to the reform actions mentioned above, e.g. higher wages for medical staff and teachers, related tax payments, the introduction of a minimum social contribution, and rising social benefits lead to increases on the revenue and expenditure side, but the budgetary impact should be broadly neutral. Additionally, excise duty rates on alcoholic beverages and tobacco have been increased. What is more, decision-makers envisaged to shell out 6.0% and 6.4% of GDP in 2021/22 for public investment spending, among others, for the Rail Baltica project.

Overall, we expect that the sovereign's public debt ratio will see another marked increase in 2021. General government debt jumped from 37.0% of GDP in 2019 to 43.5% of GDP in 2020. To be sure, last year's 6.5 p.p. increase corresponds to one of the lowest readings in the EU, and Latvia's debt level is still low from a European perspective; as a point of reference, the 2020 euro area average was almost twice as high (98.0% of GDP). Given our underlying assumption of a sharply decreasing deficit in 2022 on the heels of the expansionary fiscal stance this year, Latvia's debt-to-GDP should edge up to 47.0% of GDP in 2021 and stabilize on that level next year. We would emphasize here that this still leaves considerable fiscal resources.

Budget execution data corroborate our expectations, according to which expenditure in the consolidated general budget jumped by 22.8% y-o-y in Q1, driven by rising social expenditure (+60.6%) as well as by subsidies and grants (+12.5%). At the same time, revenues surprised on the upside, having risen at an annual rate of 0.7%, but were somewhat biased by foreign financial assistance. Still, revenue might indeed perform somewhat better than expected, also underscored by operative state revenue service data (via FDC), which hints at vivid tax collection in April and May.

Further upside risks are linked to EU financing, which we expect to cater for significant budgetary relief going forward. Latvia will receive sizable EU funds under the RRF, which includes grants in the amount of approx. EUR 1.82bn. Latvia's Fiscal Council reckons that the RRF might raise revenues by EUR 500mn in 2022-26. Public investment will be further facilitated by the new MFF 2021-27, under which Latvia is eligible for cohesion policy funds with a volume of EUR 4.61bn (ESF+, ERDF, CF, ETC). Further funding sources are available under new EU facilities such as the Just Transition Fund (EUR 192mn).

In general, we believe that fiscal sustainability risks are manageable, not only due to EU's vital financial support. We deem fiscal policy-making as prudent, and debt affordability remains very high as reflected by low and diminishing debt servicing costs and favorable financing conditions, which we expect to remain in place in the medium term. Interest outlays amounted to 1.7% of general government revenue in 2020 (EA: 3.3%), down from 1.8% a year before and 2.7% in 2016. Moreover, the sovereign is able to secure its liquidity at low refinancing costs, as witnessed in March when Latvia issued a 10y Eurobond in the amount of EUR 1.25bn at a yield of 0.105% - the lowest long-term bond yield on record.

As regards its debt portfolio, we note that the sovereign's average weighted maturity stood at 9.503y in April 2021 (ECB data), one of the highest readings in the EU and suggesting low refinancing risks. Debt due over the next twelve months accounted for a low 8% as of Apr-21 (ECB data). FX risks are virtually non-existent. The last USD-bond will mature on 16 June 2021.

Meanwhile, contingent liability risks remain low. Outstanding state-guaranteed debt totaled EUR 475mn, or 1.6% of GDP in the first quarter of 2021. The drawdown on Covid-19-related guarantees is modest (0.3% of GDP, SP21), and makes up for only a small fraction of the already low maximum amount of 2.1% of GDP. By the same token, we continue to see low fiscal risks emanating from the Latvian banking sector, which is one of the smallest in the EU (total assets 2020: 82.8% of GDP) and dominated by subsidiaries and branches of well-capitalized Nordic banks (54% of capital, Q4-20). Adverse effects in the wake of the pandemic have been largely deflected by the authorities' swift and targeted measures.

Thus, Latvian banks continue to exhibit comfortable capital buffers and high asset quality, as illustrated by EBA data. Latvia's CET1 ratio increased from 22.6% in Q4-19 to 26.3% at the end of 2020, well above the EU average of 15.9%. The NPL ratio ticked up to a still low 2.2% (EU avg. 2.6%) after standing at 1.9% in Q4-19. Judging by FCMC data which also covers banks not under the domain of EBA, the NPL ratio dwindled from 7.1% to 4.7% in the year up to Q4-20, though it has to be cautioned that roughly half of Latvia's NPLs are flagged as unlikely to be redeemed. While the share of stage 2 loans in total loans and advances is one of the lowest in the EU. Latvian banks feature an average sector-specific exposure to industries heavily hit by the Covid-19 pandemic as measured by tier 1 capital.

House price growth has levelled off in the wake of the pandemic, with the annual growth rate falling from 8.8% in the fourth quarter of 2019 to 3.1% in Q4-20. Against this background, we note that affordability has not been derailed so far, judging by the price-to-income ratio (OECD data), and mortgage lending dynamics are rather weak.

Foreign Exposure

Latvia remains vulnerable to external shocks due to its small, open economy, and displays a comparatively high share of non-resident holdings in its government debt. Having said this, we see that Latvia's external position has persistently improved over recent years, rendering its economy more resilient to shocks such as the recent Covid-19 pandemic, as reflected by its net international investment position (NIIP). While the Latvian current account swung into a large surplus position, we expect it to pare back this year and post a moderate deficit over the medium term.

In the wake of the pandemic, Latvia's current account moved from a deficit of 0.6% of GDP in 2019 to a marked surplus of 3.0% of GDP in 2020; the 10-year average posts at -0.8% of GDP. However, this improvement is mainly explained by idiosyncratic factors, with the goods balance being the major driver. As elaborated above, goods exports have been remarkably resilient, mirroring the geographical and sectoral composition of Latvian exports, whereas import growth was dragged down by contracting domestic demand. In the end, the goods deficit narrowed to 5.0% of GDP as compared to 8.8% of GDP in the prior year and to a 10-year average of 10.3% of GDP. Meanwhile, the negative impact on transport and tourism resulted in a declining services surplus, by 1.8 p.p. to 6.2% of GDP. The primary income account is now broadly balanced (2020: 0.1% of GDP), following a 1.5 p.p. increase which came on the back of higher EU financing and lower dividend payments for foreign investors.

We expect the Latvian current account to move back to balance this year, and display a moderate deficit going forward, with trade flows normalizing gradually. Thus, its NIIP should continue on its longer term upward trajectory and improve alongside moderate, though sustained, FDI inflows and EU financial support. The still elevated and negative NIIP narrowed from -41.7% of

GDP in 2019 to -36.6% of GDP last year, less than half of the proportion observed in 2012 (-68.0% of GDP). At the same time, the negative NIIP continues to be mainly due to negative and less crisis-prone net foreign direct investments, which amounted to -49.8% of GDP in 2020. The country's net external debt stood at 14.3% of GDP in 2020, its lowest level since 2001 – also hinting at the economy's improved external resilience.

Rating Outlook and Sensitivity

Our rating outlook on Latvia's long-term credit ratings is stable, as we perceive limited downside risks to fiscal sustainability due to the reasons discussed above, and building on our expectation of an economic recovery which is likely to take hold from the second half of this year. However, we have to emphasize that the assessment and interpretation of economic developments remains more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could consider a downgrade of the outlook or the rating if the sovereign's public finances continue to deteriorate over a prolonged period of time and the public debt ratio's upward trend becomes more entrenched. In the same vein, a negative rating action could be prompted by medium-term growth falling significantly short of our expectations, or structural factors resulting in deteriorating underlying growth. Downward pressure could also result from escalating geopolitical risks or fraying consensus on key policy targets such as fiscal sustainability, inclusive growth, and enhancing the economy's competitiveness.

By contrast, we could contemplate a positive rating action if we observe faster-than-expected economic growth without causing macroeconomic imbalances, translating into a steeper path of economic convergence towards Western European levels, if the sovereign's debt-to-GDP ratio returns to pre-pandemic levels earlier than we assume at this stage, and/or if geopolitical risks related to the Russian Federation and Belarus subside.

Analysts

Primary Analyst
Fabienne Riefer
Sovereign Credit Analyst
f.riefer@creditreform-rating.de
+49 2131 109 1462

Chairperson
Dr Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

Long-term sovereign rating	A /stable
Foreign currency senior unsecured long-term debt	A /stable
Local currency senior unsecured long-term debt	A /stable

*) Unsolicited

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook. For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

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ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	**Demographics**
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	Business Environment	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as significant since it has a bearing on the economy's potential growth.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2015	2016	2017	2018	2019	2020	2021e
Macroeconomic Performance							
Real GDP growth	4.0	2.4	3.3	4.0	2.0	-3.6	3.6
GDP per capita (PPP, USD)	24,860	26,580	28,548	30,657	32,076	31,509	33,394
Credit to the private sector/GDP	50.3	50.2	46.0	40.8	38.5	38.3	n/a
Unemployment rate	9.9	9.6	8.7	7.4	6.3	8.1	n/a
Real unit labor costs (index 2015=100)	100.0	103.6	104.8	106.3	110.7	118.1	n/a
Ease of doing business (score)	79.1	80.6	80.0	80.3	80.3	n/a	n/a
Life expectancy at birth (years)	74.8	74.9	74.9	75.1	75.7	75.7	n/a
Institutional Structure							
WGI Rule of Law (score)	0.8	1.0	0.9	1.0	1.0	n/a	n/a
WGI Control of Corruption (score)	0.5	0.4	0.5	0.3	0.5	n/a	n/a
WGI Voice and Accountability (score)	0.8	0.8	0.8	0.8	0.9	n/a	n/a
WGI Government Effectiveness (score)	1.1	1.0	0.9	1.0	1.1	n/a	n/a
HICP inflation rate, y-o-y change	0.2	0.1	2.9	2.6	2.7	0.1	1.6
GHG emissions (tons of CO2 equivalent p.c.)	5.6	5.7	5.8	6.1	6.1	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-1.4	0.2	-0.8	-0.8	-0.6	-4.5	-7.8
General government gross debt/GDP	37.1	40.4	39.0	37.1	37.0	43.5	47.0
Interest/revenue	3.2	2.7	2.5	1.9	1.8	1.7	n/a
Debt/revenue	99.6	107.6	102.8	96.2	97.7	111.2	n/a
Weighted average maturity of debt (years)	4.6	5.3	7.5	8.1	9.9	9.2	n/a
Foreign exposure							
Current account balance/GDP	-0.6	1.6	1.3	-0.3	-0.6	3.0	n/a
International reserves/imports	0.2	0.2	0.3	0.2	0.2	0.3	n/a
NIIP/GDP	-61.7	-55.8	-53.1	-46.5	-41.7	-36.6	n/a
External debt/GDP	142.4	147.4	141.5	123.3	117.3	124.2	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Central Statistical Bureau of Latvia, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	26.08.2016	A /stable
Monitoring	18.08.2017	A /stable
Monitoring	29.06.2018	A /stable
Monitoring	03.07.2019	A /stable
Monitoring	26.06.2020	A /stable
Monitoring	11.06.2021	A /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Treasury of the Republic of Latvia participated in the credit rating process as it provided additional information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of the Latvian Treasury during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, Central Statistical Bureau of Latvia, Central Bank of Latvia, Republic of Latvia - Ministry of Finance, Ministry of Economic, Fiscal Discipline Council, Financial and Capital Market Commission (FCMC), GRECO, Moneyval.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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Creditreform Rating AG

Creditreform Rating AG
Europadamm 2-6
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Dr. Hartmut Bechtold
HRB 10522, Amtsgericht Neuss