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 12-05-2023 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 12 May 2023

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.

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Key Rating Drivers

1. Despite persisting vulnerabilities with regard to high energy dependency and challenges in cutting previous ties to Russia, real GDP proved comparatively robust around the turn of the year; nevertheless, we expect economic growth to decrease markedly this year as a result of ongoing headwinds linked to the war in Ukraine, followed by some acceleration in 2024 as inflation rates recede, while the tighter monetary policy will exert dampening effects on the Latvian economy
2. With regard to the medium term, further roll-out of measures related to the Recovery and Resilience Plan (RRP) generally supports a constructive outlook, with low private indebtedness lending shock-absorbing capacity, whereas net emigration and related shortages of skilled labor, as well as scope to improve capital spending, present constraints to growth prospects; cost competitiveness and envisaged improvement of EU fund absorption remain to be monitored, as are any signs of resuming income convergence
3. Generally strong institutional framework including benefits associated with being a member of the EU/EMU as well as NATO; ongoing progress regarding reforms further enhancing the institutional quality, e.g., concerning the judiciary; despite the higher degree of fragmentation in parliament relatively swift formation of a government coalition led by the previous prime minister and backed by a small majority, fostering expectations of coherent policymaking amid expressed commitment to further reform implementation
4. Risks to fiscal sustainability are largely contained, given scope to navigate the challenges of the successive crises amid a moderate debt ratio and still high debt affordability, while EU funding remains a supportive pillar in this regard; having come in lower than assumed last year, we expect the general government deficit to decrease in 2023 and 2024 and debt-to-GDP to trend down gradually
5. Persisting vulnerabilities linked to being a small open and energy-dependent economy; expected ongoing inflow of EU funds and foreign direct investment (FDI) should be conducive

to balancing such risks, with the recent reduction of government debt held by non-residents contributing to a somewhat strengthening underlying profile; we expect Latvia's current account deficit to shrink in light of the assumed moderation of energy prices and export resilience going forward

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

We regard Latvia's macroeconomic profile as underpinned by an increasing degree of diversification strengthening the economy's underlying resilience, partly visible in higher gross valued-added shares of ICT and business services. Macro-financial volatility linked to the economy's high extent of openness and small size balance this to some degree. While Latvia experienced some backlash in terms of income convergence towards the EU level due to the recent succession of crises, similar to its Baltic peers, we expect it to resume its convergence progress on the back of this improved resilience and by its marked progress in reducing dependency on Russian fossil fuels, as well as ongoing efforts to improve absorption of EU funds alongside implementation of reforms and initiatives set out in the RRP. Downside risks in the short term continue to relate to adverse economic effects associated with the war in Ukraine, especially via high - albeit partly receding - energy and food prices. With regard to the medium-to-longer term, skill shortages, exacerbated by detrimental demographic developments including net emigration, and potential challenges to lifting labor productivity more generally could pose constraints to growth prospects.

Following a technical recession in the course of 2022, the Latvian economy ultimately posted GDP growth of 2.8% for the full year (euro area, EA: 3.5%), on the heels of a comparatively mild pandemic downturn in 2020 and a strong recovery in 2021. The expansion of real GDP in 2022 was led by private consumption, in turn aided by the lifting of pandemic restrictions and the government's energy support measures, contributing 4.6 percentage points (p.p.) to last year's growth outcome. Government consumption and gross fixed capital formation added to a considerably smaller extent, with construction investment recording a third consecutive pronounced decline amid higher costs and shortages of materials. Despite another increase in exports, net exports posed a drag to GDP growth last year.

On the back of receding energy prices, real GDP saw a rebound in Q4-22, expanding by 1.2% quarter-on-quarter. According to the flash estimate for Q1-23, Latvian economic output continued to rise in the first three months of the year (0.5% q-o-q), firming the impression that the shock presented by Russia's military attack on Ukraine has been weathered relatively well so far. Provisional estimates also suggest that GDP growth in Q1-23 was driven by the service sector, while activity in the producing sector dropped.

Looking ahead, economic sentiment indicators compiled by the European Commission (EC) worsened in April, following a broad-based improvement in this year's first quarter from a very low level as far as consumer sentiment is concerned, and from comparatively subdued levels as

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[1] This rating update takes into account information available until 05 May 2023.

regards the construction sector and industry. Export expectations and new orders continued to improve in April, likewise from somewhat muted levels.

With Latvia's inflation rate remaining one of the highest in the EU, posting at 15.0% in Apr-23 (preliminary, Eurostat), disposable income of private households remains squeezed, likely constraining private consumption despite still largely favorable labor market developments and persistent wage growth. Salaries increased by 8.0% y-o-y in the private sector and by 6.2% in the public sector in 2022 (Stability Program 2023, SP23). As of 1 January 2023, the minimum wage was raised from EUR 500 to 620.

At an annual average of 6.9% as of 2022 (LFS-adj., 2021: 7.6%), Latvia's unemployment rate remains above its pre-pandemic level (2019: 6.3%), but continues to decline and is roughly in line with the rate recorded for the euro area as a whole (6.7%). Contrary to the euro area and its Baltic peers, Latvia's total employment is not yet back to the level registered in 2019, when it had been on the decline already. That said, 2022 saw employment increase by 2.7% (2021: -2.6%, NA data, domestic concept), but we note that there was a q-o-q decrease in last year's final quarter.

Regarding structural aspects of the labor market, we observe that labor participation remains below that of Baltic peers, at 76.6% of the total population in Q4-22, although comparing favorably against the euro area (Q4-22: 74.6%). Judging by the EC's social scoreboard, there is some scope to improve when it comes to equal opportunities and in terms of social protection.

The outlook for investment is dampened by sharply increased interest rates and higher costs for materials and energy, which should continue to weigh on construction projects in particular. However, RRP-related investment should remain a supportive pillar, as well as the implementation of the multi-year cross-country project Rail Baltica. Concerning the RRP, a first disbursement of EUR 201mn was made in October 2022. The need to enhance Latvia's defense infrastructure alongside changes to energy suppliers will also require further investment. In this context, we note that Latvia ceased to import natural gas from Russia as of 2023. While an own LNG terminal might be an option that would likely take several years, Latvia has secured access to gas via LNG terminals in Lithuania and Finland as well as the Lithuania-Poland pipeline.

Last year's increase in exports was boosted by an ongoing rise in service exports (2022: +34.8%, BoP data), with the export of 'other business services' as well as telecom services mounting by 40.2% and 28.6%, respectively, pointing to a higher degree of diversification and increasing resilience of exports on the back of a broader base. Assuming that receding energy prices will allow for some acceleration of economic activity among Latvia's main trading partners, we expect a positive trend for exports over the coming quarters. Net exports could exert a small positive growth contribution this year and next.

On the whole, we expect real GDP to grow by about 1.2% in 2023, followed by an acceleration to 2.2% in 2024, partly due to an ultimately positive surprise as regards quarter-on-quarter growth over the winter half 2022/2023, and despite an increasingly dampening effect on domestic demand from tighter monetary policy and fading government support. In terms of GDP per capita, Latvia's convergence process towards EU levels has stalled more recently (2022: 71% of EU, IMF data), but is estimated to have remained above its 2019 level (69% of EU), and we expect convergence to continue in the medium term.

The government plans to step up the somewhat sluggish absorption of EU funds beyond the Research and Recovery Facility (RRF) in the course of the year, which would support investment.

After two years of expansion, general government gross fixed capital formation fell sharply in 2022, declining by 14.4%. As of the end of 2022, roughly 78% of the European Structural and Investment Funds (ESIF) 2014-2020 had been spent, leaving Latvia in the lower third among the EU members in this respect and well behind Lithuania and Estonia.

We think that a somewhat faster and effective absorption of the funds should be conducive to strengthening Latvia's productivity, which, measured as nominal productivity per hour worked and per person (2022: 65% and 76% of EU level, respectively) remains below the levels of its Baltic peers, but has continued to increase over recent years.

Potential growth trailed that of Estonia and Lithuania over recent years as well. Estimated to reach 1.6% in 2023 and 1.8% in 2024, with total factor productivity expected to be the main driver, it would remain below the average over the ten years to 2022 (2.3%, AMECO data). Beyond 2025, productivity and, to a smaller extent, capital growth could propel potential growth, whereas the contribution from labor may turn negative, given unfavorable demographics. In this context, we would highlight ongoing net emigration and a shortage of skilled labor as potentially severe burdens to medium-to-longer-term growth, underscoring the importance of the authorities' efforts to foster reskilling/upskilling of the population in order to strengthen productivity.

Moreover, public gross domestic expenditure on research and development measured against GDP was on a slight downward trend in the ten years to 2021. While this does not hold for business investment on R&D over the same period, the gap to Baltic peers regarding this measure remains considerable (LV 2021: 0.23% vs. EE: 0.98% and LT: 0.54% of GDP, Eurostat). In addition, access to finance in particular for SMEs, which account for more than three-quarters of employed persons (77.5%, EC intelligence) and more than two thirds of value added (69.7%), remains challenging, potentially slowing down progress regarding the digital and green transition. This issue is to be specifically addressed by several RRP measures envisaged to be implemented by the end of the current year (National Reform Program, NRP, 2023).

Non-financial corporate (NFC) debt remains relatively low and has decreased further as of Q4-22 (34.6% of GDP, ECB data), with ongoing weak lending to NFCs partly reflecting deficiencies in financial intermediation, as also the Bank of Latvia (BoL) points out. Furthermore, as mentioned above, sharply increasing interest rates additionally weigh on the loan demand of enterprises in the current phase (ECB Bank Lending Survey). Tying in with this, the current loan demand of private households remains rather subdued, and according to latest ECB data (Q4-21), their indebtedness set against disposable income was among the lowest in the EU. Put positively, the comparatively low private indebtedness offers shock-absorbing capacity at this stage, adding to underlying resilience.

From a cost perspective, Latvia's competitive stance continues to compare somewhat unfavorable against its main European trading partners and the euro area overall, largely driven by the comparatively strong wage growth over recent years, also taking into account the phase preceding the pandemic. While awaiting an update on global export market shares, we note that Latvia's respective share remained stable in 2021 (Eurostat data). We will continue to monitor the balance of cost competitiveness on the one hand and having to offer competitive wages in order to retain and attract skilled labor on the other.

Whether, and to what extent, refugees from Ukraine might be able to help fill gaps in the labor market in the medium-to-longer term remains unclear at this point in time. We flag as potentially positive that net emigration slowed down markedly over recent years, already prior to the pandemic, although developments in the years since 2020 may be distorted by the pandemic shock and incoming refugees from Ukraine. As regards the OECD's 2023 assessment of talent attractiveness, Latvia moves in the lower third among OECD members.

Focusing on Latvia's competitiveness regarding non-cost factors, we observe that the country moved up to 35th place out of 63 in the 2022 IMD Global Competitiveness index, improving from rank 40 in 2019. With that, Latvia occupies a middle-range position among the EU countries. When it comes to innovation, the Global Innovation Index (GII) provided by the World Intellectual Property Organization (WIPO) suggests there remains ample scope to improve, given that Latvia slipped to rank 41 out of 132 economies in 2022, down 7 places compared to 2019, making it one of the lower-ranking EU members in this respect. Room to catch up also remains in terms of digital transformation, with the EC's Digital Economy and Society Index putting Latvia in 17th place among the 27 EU countries.

Institutional Structure

The sovereign's credit rating also rests on its favorable institutional framework, including significant benefits linked to EU/EMU as well as NATO membership, with the latter representing a counterweight to more pronounced geopolitical risks associated with Latvia's borders with Russia and Belarus. We deem further progress in terms of enhancing transparency of lobbyism and regarding the prevention of corruption to be positive. Notwithstanding a more volatile political context over recent years, and despite another fragmented parliament following the October 2022 election, we expect coherent policymaking and a focus on timely implementation of RRP-related measures.

The Worldwide Governance Indicators (WGIs) compiled by the World Bank underscore our favorable assessment of the sovereign's institutional quality, and it is worth stressing that the four pillars on which we put the highest emphasis in this regard have on trend improved over the ten years to 2021, the most recent reference year. Latvia remains broadly in line with our A-rated sovereigns when it comes to respective rankings concerning government effectiveness (LV rank 48 out of 209 countries, 'A' median rank: 47), rule of law (LV rank 37, 'A' median: 45) and control of corruption (LV rank 49 vs. 'A' median of 50). In terms of voice and accountability, Latvia's relative rank of 52 displays is slightly more off the median rank of our A-rated universe (42) either.

That said, the improving trend until 2015 concerning the WGI government effectiveness did not continue. Rather, the indicator of the quality of policy formulation and implementation moved more or less sideways since then. This would tie in with the impression of a more volatile domestic political context and a more fragmented parliament over the last few years.

In this vein, no party obtained more than 20% of the votes following the parliamentary election held on 1 October 2022. With 26 seats, gaining 18 seats compared to 2018, New Unity became the strongest party and formed a three-way coalition headed by previous prime minister Karins with the National Alliance (13 seats) and the United List (15 seats), thus commanding over a small majority of the 100-seat Saeima. Although fading government cohesion cannot be ruled out entirely against the somewhat volatile political backdrop over the last few years, and bearing in mind that the United List was formed of several smaller parties, we assess the government's

expressed commitment to further implementing reforms as positive, with a tangible expression thereof consisting in the creation of a new ministry for climate and energy.

Apart from advancements of Latvia's AML/CFT framework, progress on a broad range of initiatives in our view emphasize the sovereign's responsiveness to recommendations by relevant institutions. Measures recently rolled out and aiming to further enhance the quality of the institutional framework include a law in force from January 2023 to increase transparency of lobbying interests. The register of interest representation and the declaration system is to launch on 1 September 2025. Furthermore, the EC's Rule of Law report (Jul-22) attested to progress made to further advance the overall efficient justice system. In a second GRECO compliance report concerning the fifth evaluation round on preventing corruption on top governing levels, published in January 2023, Latvia is considered fully compliant with 12 out of 17 recommendations, with the remaining five deemed as having been partly implemented.

In a step to increase the efficiency of financial market supervision and financial sector resolution, the Financial and Capital Market Commission was integrated into the Bank of Latvia as of 2023. We are also aware of a new action plan by the Ministry of Justice in a bid to provide guidance to businesses and consumers in managing financial distress, among others building on innovative digital means.

In terms of greening the economy, the Cabinet had approved a new program to modernize the infrastructure of the electricity grid as part of the RRP (Nov-22), among other things to increase network connectivity in populated areas and to build charging stations for electric vehicles. Picking up on the abovementioned ESIF 2014-2020, part of the remaining funds are to be used for updating the public transport fleet and infrastructure by the end of the year, fostering the transition towards green energy. In addition, as part of the RRP and the EU cohesion policy program 2021-2027 for Latvia, 2023 will see support of pollution-reducing equipment in households and projects aiming to lower greenhouse gas emissions in the transport sector, among others.

Focusing on eco-innovation capabilities, Latvia was seen as moving in the middle range of the EC's respective index in 2022. Latvia's overall share of energy from renewable sources stagnated in 2021 compared to the preceding year, at 42.1%, corroborating its stance as one of the front-runners among the EU members. More than half of its gross electricity consumption, as well as of its energy sources used for heating/cooling, stemmed from renewable sources, as opposed to under 40% and less than a quarter, respectively, recorded for the EU as a whole in that year. Latvia's transport sector remains laggard, however, with the renewable share of 6.4% moving below the EU average in 2021 (9.1%).

Fiscal Sustainability

Latvia's credit rating is backed by relatively low risks to fiscal sustainability in light of a moderate public debt ratio, its strong track record of fiscal prudence, and credible commitment to fiscal consolidation. Despite challenges presented by adverse economic effects due to the geopolitical tensions, including the need to alleviate the burden of higher energy and food prices on the economy, reorient parts of its external trade flows and increase defense measures, we view fiscal risks as contained at this stage. We expect the debt-to-GDP to remain at a moderate level over the medium term, aided by a benign debt portfolio structure and high debt affordability, notwithstanding less favorable financing conditions on financial markets as monetary policy tightening continues. Access to considerable EU

funds continues to provide vital support over the medium term, while we will monitor any progress on reducing the informal economy.

Latvia's general government deficit for 2022 came in markedly lower than estimated in our last review (Jun-22: -7.0% of GDP), amounting to -4.4% of GDP, narrowing significantly compared to the deficit recorded for 2021 (-7.1% of GDP). We recall that during the years from 2012 until prior to the outbreak of the corona pandemic, Latvia had recorded only moderate deficits (balance in 2016).

The marked reduction in the sovereign's headline deficit came on the back of substantially rising revenue (12.4%, 2021: 8.4%), in turn driven by double-digit percentage increases in tax receipts and net social contributions. Total general government expenditure rose as well, but at a slower rate than in 2021 (2022: 5.8%, 2021: 16.0%). While social benefits other than social transfers recorded a decline, compensation of employees saw another increase. Expenditure was also driven by the purchase of gas reserves, which rose by 34%. Total support measures to cushion adverse effects from the pandemic were down to approximately EUR 966mn in 2022, while about EUR 604mn were dedicated to mitigating the energy price shock. Including support measures to refugees from Ukraine, the combined estimated effect of crisis measures on the 2022 budget balance came to about 3.8% of GDP (Ministry of Finance, MoF).

Mitigating measures to alleviate adverse effects related to the war in Ukraine are set to continue to weigh on public finances in the current year. As of Mar-23, the combined budgetary impact of crisis measures was estimated to amount to about EUR 307mn (MoF). In the SP23, authorities envisage a total impact of roughly EUR 856mn (roughly 1.9% of our estimated GDP 2023) for the full year 2023. Uncertainty around these estimates remains high, given the unpredictable nature of the war in Ukraine, the related geopolitical tensions, and ongoing shifts in energy markets that affect price levels. A likely stronger dampening effect on the economy from tightening monetary policy adds to uncertainty.

Drawing on the Draft Budgetary Plan 2023 for envisaged discretionary measures regarding the current year, these are dominated by deficit-increasing expenditure measures reflecting government priorities of security, education, energy, competitiveness and quality of life including health. Apart from planned spending on an air defense system, larger expenditure positions include rising outlays for healthcare services, increases in wages in public administration and for medical staff, and increased spending on education and research.

On the revenue side, envisaged dividend revenue from state joint-stock companies in the energy sector is assumed to yield some offsetting effects to the deficit-increasing expenditure measures. By contrast, making the abolition of VAT advance payments a permanent feature is expected to exert a deficit-increasing impact going forward. Acknowledging a continued elevated level of uncertainty, not least as support measures might be extended after all, we expect the deficit to dwindle to about -3.5% of GDP in 2023, and further to -2.4% of GDP in 2024.

We note that the role of the Stability Program is to be strengthened by intensified political discussion on the legislative level, following amendments to the Law on Budget and Financial Management entering into force in November 2022. Apart from this, Latvia's Fiscal Discipline Law was fully restored for 2023, to our mind further underscoring commitment to fiscal prudence. With regard to the medium term, the government aims to lower the headline deficit to -0.7% of GDP in 2026. With a view to tax system efficiency, authorities intend to develop tax policy priorities for the years 2024-2027 in 2023.

Against the backdrop of the smaller deficit and strongly expanding nominal GDP, Latvia's general government debt-to-GDP decreased by 2.9 p.p. to 40.8% in 2022, less than half the level recorded for the euro area as whole (2022: 93.0% of GDP) and constituting one of the lowest ratios among the euro area members. We expect the public debt ratio to moderate further to about 38.9% of GDP this year and to remain at a similar level in 2024 (39.2% of GDP), partly due to an expected markedly lower nominal GDP growth next year. With that, the pre-pandemic level (2019: 36.5% of GDP) would not yet be reached.

Contingent liabilities in the form of public guarantees stood at a comparatively low 1.9% of GDP in 2022 (SP23). Looking at the banking sector, which is dominated by Nordic banking groups, we highlight some statistical effects related to the transfer of shares of Swedbank Group banks in the Baltic countries to the larger holding group registered in Latvia, Swedbank Baltics AS, which consolidates the data, partly complicating interpretation of some statistics, as also BoL stresses in its Financial Stability Report (2022). We note that, e.g., total assets of Latvia's rose as a consequence thereof, roughly doubling to 154.5% of GDP in the year to Q3-22 (Q3-21: 77.4% of GDP) and lifting the sector into the lower middle-range among EU members in terms of size. Other statistics, such as the CET1 ratio and return on assets data provided by EBA, on which we usually draw for our assessment of the sector, were affected by these statistical effects as well.

Irrespective of some distortions, Latvia's banking sector continues to give a sound impression regarding capitalization, asset quality and profitability. Exposure to Russia, Belarus and Ukraine is limited. As of Q4-22, the sector's CET1 ratio stood at 24.0%, representing the highest level among the EU countries. A stronger statistical effect from the abovementioned developments is visible in a significantly lower NPL ratio, which as of Q4-22 stood at just 0.5%, down from an already relatively low 1.6% in Q3-21. While we would tend to consider foreign Nordic banking groups dominating Latvia's banking sector as sound, one would have to point to some concentration risks. Direct exposure to Russia, Belarus and Ukraine came to 1.5% of total assets in terms of liabilities and 0.8% of total assets in terms of assets as of Dec-22 (MoF intelligence).

Banks' outstanding credit to NFCs in absolute terms remains below pre-pandemic levels. Following some acceleration in lending activities, the annual increase has moderated to 7.7% in Feb-23 (ECB data). While, by contrast, outstanding credit to private households for house purchases had climbed above 2019 levels, dynamics have slowed more recently, with the annual increase dropping to 3.7% y-o-y (Feb-23, ECB data). Tighter monetary policy, also affecting demand for loans, and more restrictive bank lending standards are likely to continue to curb credit dynamics as regards the private sector in the near term. In this environment, real house prices started to drop in a y-o-y comparison (OECD, Q4-22: -7.1%). Eurostat house price data suggest a markedly slowing increase, with the annual rate down to 9.1% in Q4-22 (Q4-21: 16.1%).

With regard to more structural developments, we would highlight further significant progress when it comes to lowering the VAT gap, although the reference year 2020, for which a fall in the VAT gap by 3.6 p.p. to a low 3.6% is suggested, may be distorted by pandemic-related factors (2021e: 3.4%). This does, nevertheless, continue an improving trend following tax audit reforms, and we will continue to monitor more recent estimates in this regard. At the same time, while awaiting updated numbers, this positive development is balanced to some extent by estimates which hint at a relatively pronounced share of the informal economy and an increasing path thereof over the years to 2020 (2021: 26.6% of GDP, Stockholm School of Economics). That said, we are aware that a multiannual plan (2023-2025) to curb the shadow economy is to be developed.

Overall, we assess fiscal sustainability risks for the sovereign as relatively low. Barring potential challenges to absorption, Latvia draws significant advantages from EU funding. Moreover, prospects for fiscal sustainability benefit from the benign debt portfolio structure, among other featuring no foreign exchange-denominated debt. While the average weighted maturity of government debt decreased to about 7.3 years as of Feb-23 (Feb-22: 8.8y, ECB data), it continues to suggest low refinancing risks. For the first time since 2012, interest payments increased, mounting by 12.5% in 2022. However, at 0.5% of GDP, or 1.3% of total revenue in that year, they remained at a relatively low level, corroborating high debt affordability despite less favorable financing conditions.

As of Mar-23, the yield on 10y Latvia government bonds has risen to 3.91% (ECB data, monthly quote), representing the highest level since Jan-12. We expect two more interest rate hikes by the ECB this year following the decision in May-23, presumably by 25bp each, while we consider a first lowering unlikely to occur before 2024. For the time being, the ECB will continue to reinvest the principal payments from maturing securities purchased under the Pandemic Emergency Purchase Program (PEPP) until at least the end of 2024, whereas a gradual winding down of the Asset Purchase Program (APP) portfolio began in March 2023, with an initial monthly portfolio reduction of EUR 15bn until June 2023. The ECB expects to discontinue the reinvestments under the APP as of July 2023, corresponding to an acceleration of shrinking its balance sheet.

Foreign Exposure

Risks related to Latvia's external position continue to constrain the sovereign's credit rating to some extent. As a small, open economy, Latvia remains subject to downside risks from the economic slowdown, especially in Europe, as well as any disruptions to trade flows, in addition to the challenges entailed by cutting remaining ties with Russia and Belarus and the ongoing shifts in energy markets. The share of government debt held by non-residents has continued to decrease, contributing to improving the external stance over recent years. Following large pandemic-induced movements in its current account balance, soaring energy prices and the need to replace Russia as an energy supplier have pushed the balance deep into deficit via the goods account.

Latvia's current account deficit increased to -6.4% of GDP in 2022, reaching its highest level since 2008 (-12.3% of GDP), driven by a swelling negative balance in goods trade amid higher energy prices and efforts to reorient fossil fuel trade away from Russia. The positive service trade balance, on the other hand, increased last year, but at 5.6% of GDP remains below levels recorded prior to the outbreak of SARS-CoV-2, despite further recovery in net export of transport and tourism services.

We expect the current account deficit to moderate over the medium term, assuming a stabilization of energy prices on lower levels amid an expected sustainable set-up in terms of alternative energy suppliers. Against the backdrop of progress in finding alternative fossil energy suppliers and declining energy prices, we project the current account deficit to narrow over the coming quarters, acknowledging a still high level of uncertainty around the war in Ukraine and ongoing reorganization of energy markets.

Latvia's negative net international investment position (NIIP) remained roughly stable set against GDP in 2022 (-27.0% of GDP, 2021: -27.5% of GDP), with no excessive movements in its main components. Over recent years, the negative position exhibited an improving trend. With liabilities dominated by government bonds and FDI, the NIIP excluding non-defaultable instruments

(NENDI) exhibits a positive balance, standing at 16.3% of GDP in 2022. We continue to expect a positive impact on Latvia's external risk profile from prospective EU and sustained FDI inflows over the medium term.

Rating Outlook and Sensitivity

Our rating outlook for the Republic of Latvia's long-term credit ratings is stable. We view downside risks regarding the macroeconomic profile and the external position as broadly balanced by significant fiscal scope to address the challenges linked to the war in Ukraine, acknowledging ongoing high levels of uncertainty in the context of successive global economic shocks.

A negative rating action could be prompted by a significant worsening of the medium-term growth outlook, which would likely slow Latvia's convergence process and have adverse effects on the course of public finances. A further escalation of the war in Ukraine and/or disruptions to new energy routes, causing high energy prices, could be part of such a scenario, as could failure to implement RRP measures, to sufficiently absorb EU funds and reach higher productivity levels, with negative consequences for potential growth.

Conversely, we could consider raising the rating or outlook if spillover effects from the war in Ukraine remain manageable, and robust GDP growth continues amid timely roll-out of further RRP initiatives and improved EU fund absorption, thereby fostering Latvia's income convergence towards EU levels. A firm downward trend in the public debt ratio would also be conducive to a positive rating action.

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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

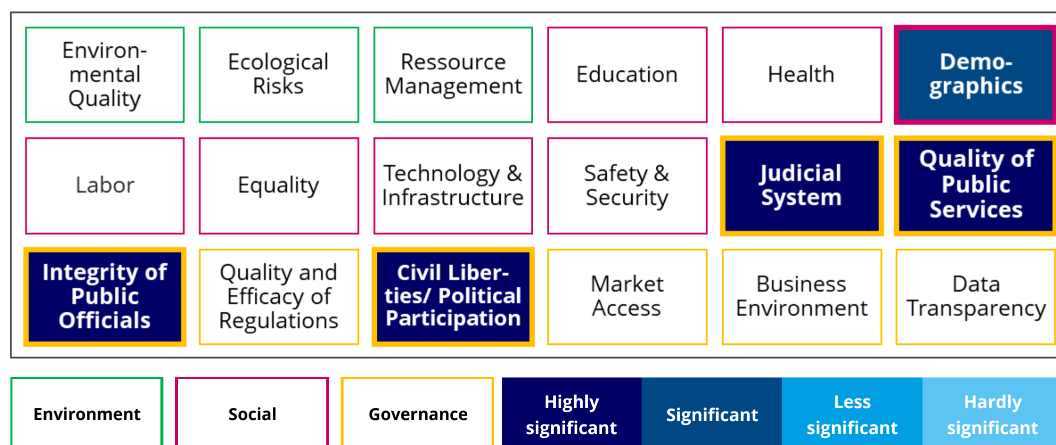
ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

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.

ESG Factor Box



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 exert 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 on public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	3.3	4.0	2.6	-2.3	4.3	2.8	1.2
GDP per capita (PPP, USD)	28,571	30,674	32,267	32,174	35,252	38,545	40,256
Credit to the private sector/GDP	46.0	40.7	38.1	37.1	37.0	34.3	n/a
Unemployment rate	8.7	7.4	6.3	8.1	7.6	6.9	n/a
Real unit labor costs (index 2015=100)	104.7	106.3	108.8	113.0	109.9	111.2	112.5
World Competitiveness Ranking (rank)	40	40	40	41	38	35	n/a
Life expectancy at birth (years)	74.9	75.1	75.7	75.5	73.1	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.9	0.9	1.0	0.9	1.0	n/a	n/a
WGI Control of Corruption (score)	0.5	0.3	0.5	0.7	0.7	n/a	n/a
WGI Voice and Accountability (score)	0.8	0.8	0.9	0.9	0.9	n/a	n/a
WGI Government Effectiveness (score)	0.9	1.0	1.1	0.9	0.9	n/a	n/a
HICP inflation rate, y-o-y change	2.9	2.6	2.7	0.1	3.2	17.2	9.8
GHG emissions (tons of CO2 equivalent p.c.)	5.8	6.1	6.1	5.6	5.8	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	-0.8	-0.8	-0.6	-4.4	-7.1	-4.4	-3.5
General government gross debt/GDP	38.9	37.0	36.5	42.0	43.7	40.8	38.9
Interest/revenue	2.5	1.9	1.8	1.7	1.3	1.3	n/a
Debt/revenue	102.6	96.0	97.0	110.7	118.0	114.0	n/a
Total residual maturity of debt securities (years)	7.5	8.1	9.9	9.2	9.4	8.3	n/a
Foreign exposure							
Current account balance/GDP	1.3	-0.1	-0.6	2.6	-4.2	-6.4	n/a
International reserves/imports	27.1	22.2	23.6	28.7	22.5	15.1	n/a
NIIP/GDP	-51.5	-45.4	-40.3	-34.1	-27.5	-27.0	n/a
External debt/GDP	141.4	123.3	116.7	121.4	109.6	100.6	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
Monitoring	10.06.2022	A/ stable
Monitoring	12.05.2023	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 Ministry of Finance 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 Ministry 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, IMD Business School, Central Statistical Bureau of Latvia, Central Bank of Latvia, Republic of Latvia - Ministry of Finance, Ministry of Economic, Fiscal Discipline Council, GRECO, Moneyval, Stockholm School of Economics.

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 the event 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”.

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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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