Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF LATVIA	Assigned Ratings/Outlook: **A /stable**	Type: Monitoring, unsolicited
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 03-07-2019 “Sovereign Ratings” “Rating Criteria and Definitions”

Contents

Rating Action 1
Key Rating Drivers 1
Reasons for the Rating Decision . 1
Macroeconomic Performance..........2
Institutional Structure 5
Fiscal Sustainability 6
Foreign Exposure..........................10
Rating Outlook and Sensitivity...10
Ratings*.....................................11
Economic Data 12
Appendix 12

Rating Action

Neuss, 03 July 2019

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. Brisk economic expansion in 2018 buttressed by strong ESI fund absorption; expectation of moderating but still robust GDP growth in 2019/20, underpinned by healthy consumption and investment activity; high degree of macroeconomic volatility
2. Per capita income convergence towards EU levels progressed in 2018 and this development should continue in the near term; considerable medium- to long-term challenges pertaining to adverse demographics, while rapid wage growth could put cost-competitiveness at risk in the event of slowing productivity growth
3. Generally high institutional quality, though institutional set-up needs to be enhanced to close gap towards EU levels; although the new government is composed of parties covering a wide political spectrum, we expect current fiscal and economic policies to be largely maintained
4. Widening fiscal deficit in 2018, mainly driven by capital expenditures and implementation of health care and tax reform measures; we expect the deficit to narrow again in view of less expansionary fiscal policy stance; strong debt affordability metrics and moderate government debt, which is set to decline further
5. Moderating but still elevated susceptibility to external shocks due to high degree of trade openness, significant share of external government debt; risks associated with improving but still negative NIIP somewhat mitigated by rising FDI-share in external liabilities

Reasons for the Rating Decision

Creditreform Rating has affirmed the Republic of Latvia’s ratings, which mainly reflect strong and improving fiscal metrics and a generally strong institutional framework, while

the solid macroeconomic performance profile is somewhat balanced by risk factors pertaining to its small open economy and demographic developments.

Macroeconomic Performance

Latvia's macroeconomic profile continues to be somewhat constrained by its small and open economy, which increases its susceptibility to external shocks and entails a high degree of macro-financial volatility. Although output has more than doubled since Latvia entered the EU in 2004, its economy remains among the smallest in the EU-28, with a nominal GDP of roughly EUR 29.5bn (2018). Concurrently, Latvia displays a high degree of trade-openness. While last year's trade-to-GDP ratio of 118.4 % of GDP compares moderate to most Central and Eastern European (CEE) peers, it still exceeds the EU-28 level (2018: 89.1% of GDP) by far. Apart from these issues, the high dependence of domestic investment activities on European Structural and Investment Funds (ESIF) creates additional volatility in Latvia's national accounts. Fund inflows, which are closely linked to the EU's multiannual budgetary cycle, are estimated to make up for roughly two-thirds of public investment in the programming period 2014-20.

Posting an annual average growth rate of 3.2% in 2015-17, Latvia enjoyed a robust economic expansion in recent years. Contrary to most euro area peers, the Latvian economy continued gained further steam in 2018. Following an already strong 2017, when total output rose by 4.6%, real GDP growth accelerated to 4.8% last year. Thus, growth not only hit a seven-year-high (2011: 6.4%), it was also among the highest in the euro area economies, only exceeded by Malta (6.7%) and Ireland (6.7%).

Faster output expansion came on the back of a booming domestic demand. In particular, GDP was boosted by stellar investment growth in 2018, which made a growth contribution of 3.4 p.p. (2017: 2.5 p.p.). After a 13.1% increase in 2017, investment soared by 16.4% in real terms, as ESI fund absorption gained further momentum. As illustrated by EU data on ESIF implementation progress, financial resources spent on investment projects rose from 1.2 (2017) to EUR 2.1bn up to Q4-18 (as of 19 June 2019). Higher fund inflows were mainly mirrored by extraordinarily strong construction investment. Total construction spending continued to grow in the double-digits for the second consecutive year and skyrocketed by 22.9% (2017: +15.6%). Gross fixed capital formation in machinery and equipment also performed strongly, surpassing the previous year's level by 10.9% (2017: +8.2%).

Strong investment activity was accompanied by brisk private consumption, which added 2.8 p.p. (2017: 2.6 p.p.) to last year's growth. Consumer spending shifted into a somewhat higher gear, edging up from 4.1 to 4.5% in 2017-18, due to sharp employment gains and the strongest increase in average monthly gross wages since 2008. Partly driven by a steep increase of the national minimum wage from EUR 380 to EUR 430 at the beginning of the year, nominal wages expanded by 8.4% y-o-y, outpacing HICP inflation of 2.6% by a wide margin. Thus, private households' enjoyed significant purchasing power gains.

Buoyant domestic demand led to healthy import growth of 5.1% (2017: 8.9%), which continued to outpace exports. Total export growth sharply decelerated from 6.2 (2017) to

1.8% in 2018, the lowest reading in five years. In particular, external demand from outside the EU eased considerably. While EU exports were even stronger than in 2017, increasing by 8.3% (2017: 7.2%), exports to third countries turned negative and fell by 1.1% y-o-y (2017: +16.3%). From a sectoral perspective, weakening transport and financial service exports (+2.7 and -15.0% respectively), partly explain the modest export performance observed in 2018. As a result, net exports detracted 2.2 p.p. from growth last year.

Vigorous GDP growth translated into significantly higher per capita income in 2018. In PPP terms, Latvian per capita income is estimated to have risen from USD 27,685 in 2017 to 29,901 last year (IMF data). Income convergence with EU-levels also progressed notably, as GDP per capita climbed to 69% of the EU-28, up from 67% a year before. Latvia also moved closer to the median per capita income of our A-rated sovereigns (USD 35,938). We note, however, Latvian GDP per capita continues to fall short of Baltic peers Estonia and Lithuania, which recorded a comparable pace of income convergence from higher income levels (Estonia: USD 34,096, 79% of EU-28; Lithuania: USD 34,826, 81% of EU-28).

Looking ahead, income convergence should be sustained, even in the event of the anticipated slowdown in GDP growth to 3.1 and 3.0% in 2019 and 2020, respectively. As highlighted by quarterly national accounts data, Latvia's economic expansion sharply decelerated at the beginning of the year. Real GDP growth fell to 3.2% y-o-y (s.a) in Q1-19, down from 5.1 (Q3) and 5.3% (Q4) in the second half 2018. Furthermore, early indicators continued to weaken more recently. After the Commission's Economic Sentiment Indicator had steadily risen throughout 2018, marking a ten-year-high in December (106.7 points), it entered a downward trajectory thereafter and decreased to 103.5 points in May 2019. Although hard and soft data suggest that domestic demand has passed its cyclical peak, it should remain the main driver of growth over the next two years. On the other hand, we expect no growth impetus from net exports, as import dynamics should be broadly aligned with exports.

Investment should continue to spur economic growth in 2019/20, although it should gradually return to more sustainable growth rates over the next two years. Unlike in 2017/18, we expect no further acceleration in ESI fund absorption. To be sure, the project pipeline will be further extended going forward. According to latest EU Cohesion data, financial funds allocated to selected projects increased from around EUR 4.05bn (2017) to EUR 5.25bn at the end of 2018 – corresponding to 59 and 76% of planned investment respectively. Latest survey data on order books, export expectations and capacity utilization is also consistent with a sustained expansion in investment. Capacity utilization in the Latvian industry sector has held up well at the beginning of 2019 and remains high. In Q2-19 it stood at 76.9%, broadly unchanged from last year's second quarter and well above the long-term average (1993-2018: 64.6%).

Meanwhile, private consumption is set to remain strong. Still upbeat consumer sentiment signals that household spending is likely to continue on its upward trajectory. A sustained expansion in private consumption should be fostered by Latvia's well-performing labor market and concurrent wage growth. Although wage dynamics are set to moderate somewhat in view of stable minimum wages in 2019, households' disposable income

should continue to be fueled by nominal wage growth well in excess of inflation. Regarding the latter, HICP inflation should remain at 2.6% in 2019, as higher gas and electricity tariffs and food price inflation should feed into consumer prices this year.

The Latvian labor market continues to tighten, although the pace of employment growth observed in 2018 is unlikely to be sustained this year. Supported by a further increase in the labor participation rate, which increased from 77.0 (2017) to a record-high 77.7% in 2018, job creation resumed after two years of stagnation (2016: -0.3%; 2017: 0.0%). Employment growth spiked to 1.6% in 2018 on the back of vividly increasing construction employment (+9.4% y-o-y), the highest rate in five years. However, drawing on Eurostat data, employment growth moderated towards the end of the year (Q4-18: +0.7%) and fell back to 0.2% in the first quarter of 2019. Notwithstanding softer data on job creation, unemployment continues to fall. Reflecting the still benign economic development and a declining working-age population, the monthly harmonized unemployment rate (s.a.) edged down from 7.7% (Apr-18) to 6.4% in April 2019, representing the lowest level since April 2008 and on par with the EU-28 average of 6.4%.

Latvia's medium-term growth potential remains challenged by a confluence of multiple factors. Firstly, unfavorable demographic trends, namely ageing and emigration, are likely to put a lid on future employment growth. According to the EU's Ageing Report 2018, Latvia's working-age population (15-64y) is projected to decline by 5.7 p.p. to 58.5% of the total population in 2018-30, the third largest decrease in the EU-28 (Malta: -6.8 p.p.; Lithuania: -7.5 p.p.). Even though emigration has significantly slowed more recently, net migration should stay negative over the coming years. As illustrated by annual migration statistics from the Central Statistical Bureau, 15,814 people left Latvia in 2018 resulting in a net migration balance of -4,905 people. This compares favorably to the previous years, when net migration posted at -12,229 (2016) and -7,808 (2017). Looking ahead, ageing is set to exert even more pressure on labor supply. Drawing on European Commission projections, the increase in Latvia's old-age dependency ratio will be among the steepest in the Europe. The Latvian old-age dependency ratio is forecast to rise sharply from 31.4% (2018) to 43.2% by 2030, significantly higher than in the EU-28 (39.1%).

In view of the projected decline in Latvia's labor supply, economic growth is likely to become more dependent on investment-driven productivity gains over the coming years. However, investment still appears relatively low as measured by GDP. Even though private investment picked up from 16.5 to 17.4% of GDP in 2017-18, Latvia's private investment-to-GDP ratio still fell short of the levels seen before the crisis (annual average 2000-07: 25.9% of GDP), and also remained lower than other CEE's such as Estonia (18.4% of GDP), Hungary (19.7%of GDP) and the Czech Republic (22.1% of GDP). Lifting private investment will become even more important in the event of a lower cohesion fund allocation in the EU's 2021-27 budget cycle. Reflecting Latvia's progress in income convergence and the prospective departure of a large net contributor to the EU budget (UK), Latvia could see a drop to EUR 4.26bn (in 2018 constant prices), corresponding to a 13% drop in its fund allocations compared with the 2014-20 funding period.

In the longer run, rapid wage growth could put Latvia's cost competitiveness at risk if productivity growth softened. Even though wages evolved broadly in line with labor

productivity more recently, real unit labor costs (ULC) have risen markedly since the financial crisis. Together with Lithuania, Latvia's real ULC growth of 10.2% was the fastest in the euro area over 2010-18. For comparison, the euro area as whole saw negative ULC growth of 1.5% over this period. Diverging ULC trends were in largely driven by strong wage growth in the Latvian economy. On average, real wages outpaced productivity by 1.3 p.p. in 2010-18. While Latvia is a catching-up economy and we view real wage growth as welcome from the perspective of enhancing the appeal of Latvia to foreign workers and returning migrants, wage growth in excess of productivity gains could potentially erode the economy's cost competitiveness if sustained over a longer period. Keeping ULC growth in check appears particularly important, as exports are still heavily biased towards low value-added industries. Although the ULC trajectory should be monitored carefully over the coming years, we observe no detrimental effects on Latvia's cost competitiveness so far. Since 2012, Latvia's share in global exports has remained stable at 0.08%.

Institutional Structure

The credit ratings also reflect the generally high quality of Latvia's institutional framework. In addition, the sovereign maintains a long-standing track record of a sound and predictable policy framework which is based on broad consensus across political parties.

In our opinion, the sizeable fiscal adjustment in the aftermath of the financial crisis, as well as the country's favorable business environment testify to the generally high quality of Latvia's institutional setup and forward-looking policy-making. According to the latest Doing Business report 2019, Latvia is among the most business-friendly countries in the euro area. Ranking at 19 out of 190 economies, only Finland (rank 17) and Latvia's Baltic peers (EE: 16; LT: 14) received higher scores.

In our view, the sovereign benefits extensively from EU/EMU membership, involving significant trade integration, financial support via EU funds, and the adoption of common standards and rules. Facilitated by the country's EU and EMU accession, Latvia displayed notable improvements along all dimensions of the World Bank's Worldwide Governance Indicators (WGIs) over the last decade. Nevertheless, the latest edition of WGIs suggests that the sovereign has still scope to improve as compared with A-rated peers. While Latvia's performance is broadly aligned with the median of our A-rated universe when it comes to the levels of perceived corruption (rank 64/209) and the extent to which public power is exercised for private gain (rank 42), Latvia lags similar rated peers on the WGI's 'government effectiveness' and 'voice and accountability'. As regards the quality of policy formulation and implementation, Latvia is ranked at 45 out of 209 economies, while it stands at rank 54 as regards the perception of freedom of expression and free media (A-median ranks 42 and 44, respectively).

On the other hand, we see Latvia exposed to elevated geopolitical risks. While we believe that a military conflict is unlikely, given Latvia's NATO membership and the presence international troops since 2017, a further deterioration of the relationship between Russia and the EU or growing tensions with Latvia's Russian-speaking minority, are risks to consider.

Regarding the latter, we note that Social Democratic Party Harmony (19.8%), which mainly represents the country's Russian-speaking electorate, emerged as the strongest party from the parliamentary elections held on 6 October 2018, but was left out of new government coalition. After nearly four months of negotiations, corresponding to the longest government formation process Latvia has experienced since 1990, a broad-based coalition made up of five of the seven parties represented in the parliament was formed. On 23 January, Krišjānis Kariņš of the center-right New Unity, the smallest of the seven parties in the current parliament (6.7%), was elected prime minister, his government is supported by the New Conservative Party JKP, the anti-establishment KPV, the liberal LA-LP! and the National Alliance. While the balancing of special interests in a five-party coalition may prove challenging, our view on Latvia's policy framework remains fundamentally unchanged, as the commitment to sound public finances and growth oriented economic polices appears to be widely shared across the political landscape. As set out in the coalition agreement, the combat against money laundering, the implementation of a territorial reform and further improvements to social cohesion and the effectiveness of the judiciary are among the new government's main priorities.

Fiscal Sustainability

We continue to view Latvia's sustainable fiscal policy and moderate levels of public debt accompanied by high affordability as the sovereign's key credit strengths.

After the Latvian government had made huge strides with regard to budget consolidation, turning a deficit of -4.3% of GDP (2011) into a surplus of 0.1% of GDP in 2016, the budget balance slipped into negative territory again. More recently, the deficit widened from 0.6% of GDP (2017) to a still moderate 1.0% of GDP last year, mirroring the EU funding cycle and the implementation of the 2018 tax reform, and being broadly in line with the target stipulated in the 2018 Stability Program (0.9% of GDP).

The deterioration was mainly due to vividly rising government spending. Growth in government expenditures remained in the double-digits and leaped from 10.4 (2017) to 11.2% in 2018, with all major expenditure items contributing to the increase except for interest expenses. In particular, public investment maintained on its growth trajectory and rose by 34.2% on the year (2017: 32.8%). Mirroring the ongoing implementation of ESI co-funded infrastructure investments, gross fixed capital formation on the general government level increased from 4.4 to 5.4% of GDP. Spending on intermediate consumption also grew more dynamically than GDP, as growth accelerated from 6.6 (2017) to 12.7% in 2018. Meanwhile, strong wage growth was observed not only in the private sector, but also in the public sector, where compensation for state employees rose by 8.9% on the year (2017: 8.4%).

Thus, expenditures slightly outstripped equally dynamic revenues, which expanded by 10.0% on the year (2017: +8.5%). Enduring wage growth and strong economic activity led to briskly rising VAT-receipts and social security contributions. While VAT collection, posted a y-o-y increase of 13.2% (2017: +6.5%), net social security contributions skyrocketed by 17.1%, up from 9.4% in the previous year, after the Latvian government had decided to raise the state social insurance compulsory contribution rate by 1% at the beginning of

2018 in order to improve healthcare funding. Contrarily, the tax reform adopted by parliament in July 2017 negatively affected income tax receipts. The main purpose of the reform, which will be gradually implemented over 2018-20, is to lower income inequality and improve the competitiveness of the corporate sector. As regards personal income taxation, the former flat rate of 23% was replaced by a more progressive regime with three tax brackets, and the tax-free allowance was raised. To stimulate corporate investment, advance payments were abolished and reinvested profits were exempted from taxation and under the revised tax code. As a result of these changes, revenues generated from personal and corporate income taxation declined by 4.1 and 7.7% y-o-y, respectively (Eurostat data).

Going forward, Latvia's fiscal policy stance is set to become somewhat less expansionary, and we expect the headline balance to narrow to 0.5% of GDP in 2019 and 2020, respectively. Most importantly, government investment has likely reached its peak in 2018 and should gradually lose steam over the coming two years. Moreover, the state budget will benefit from some discretionary measures in 2019, namely higher dividends of the state-owned forest management company and receipts from the sale of CO2 emission allowances. Together, these one-offs are estimated to yield an additional 0.3% of GDP in revenues. That being said, the 2019 budget also includes some permanent revenue-enhancing measures. At the beginning of the year, Latvian authorities raised excise duties on alcoholic beverages, further excise duty hikes for cigarettes and petrol will enter into effect in July 2019 and January 2020, respectively.

Regarding the expenditure side of the budget, we note that change in government has not altered the top spending priorities. Strengthening the weak social safety net continues to rank high on the new administration's agenda. Thus, the ongoing implementation of pension and healthcare reforms will continue to absorb significant funds in 2019/20. Authorities envisage further facilitating access to health care, improving public health indicators, as well as taking care of the work remuneration for medical persons. As regards 2019, medical staff will enjoy a 20% wage hike. Overall, healthcare expenditures are planned to reach 4.0% of GDP by 2020 (2017: 3.5% GDP). In addition, measures to address poor pension adequacy will come at the cost of higher pension expenditures in 2019/20. At the beginning of this year, a reform of survivor pensions took effect. Under the new legislation, the recipients of the old-age disability and special state pension will receive 50% of the pension granted to the deceased spouse for a period of twelve months. The inheritance of funded pension capital is planned to start from 2020. Under the new scheme, it will be possible to transfer the accrued funded pension capital to a designated person. Apart from higher spending on social benefits, the new government plans to allocate higher funds to Ministry of Defense. The 2019 budget foresees an increase in defense spending by some 10%, in order to ensure sustained compliance with the NATO's minimum defense spending target of 2% GDP.

Notwithstanding moderate debt levels and a track record of prudent budget execution in recent years, the state's relatively narrow and volatile revenue base carries elevated budgetary risks in the event of a sharp economic downturn. Although Latvia's revenue-to-GDP-ratio inched up from 37.2 to 37.5% of GDP last year, the ratio remained well below

EA-19 levels (46.3% of GDP). In particular, the Latvian government generates relatively low tax receipts by European standards, partly due to the presence of a large shadow economy. SSE Riga estimates that Latvia's shadow economy reached 24.2% of GDP last year, making it the largest informal sector among the Baltics (EE: 16.7%; LT: 18.7% of GDP). Against this background, we view the ongoing implementation of tax compliance measures as positive. To combat "envelope wages" and to improve VAT collection, the government plans to lower the cash use prohibition threshold, to introduce electronic working time accounts in the construction industry, and to push back the non-licensed gambling and lottery market this year. Improving tax collection and broadening the tax base would also enhance the sovereign's fiscal resilience and flexibility. Empirical evidence shows that government revenues were subject to elevated volatility in the past. As measured by the standard deviation of general government revenue in 2009-18, volatility in Latvia was approx. 2.3 times higher than the EU-28 average.

Despite our expectation of moderate headline deficits over the next two years, debt sustainability risks appear limited against the backdrop of low government debt and favorable refinancing conditions.

In 2018, we observed a notable decline in general government debt, with the debt-GDP-ratio dropping from 40.0 to 35.9% – the lowest level since 2008 (18.2% of GDP). Thus, Latvia's debt levels not only compare well to the euro area (85.1% of GDP), but also to similar rated peers (A-median: 49.8% of GDP). Last year's decline in government debt was mainly driven by strong GDP growth and favorable stock-flow adjustments stemming from deleveraging in Latvia's SOE sector. We assume that government debt will continue to follow a gradually downward path in the medium-term. In this context, it has to be emphasized, however, that the underlying trend in government debt could be masked by debt management operations. Latvia envisages to pre-finance upcoming maturities, which may lead to temporary spikes in the sovereign's debt-to-GDP ratio. Making use of the favorable interest rate environment, Latvia issued a 30y-bond in the amount EUR 700m with a coupon of 1.875% in February 2019, which was re-opened in May by issuing another EUR 300m. Proceeds from the issuance are partly earmarked to redeem a US-Dollar bond with a 2.75% coupon coming due at the beginning of 2020. In general, Latvian government bonds with all tenors displayed low and further falling yields during the first half of the year. While yields of maturities up to 2021 moved deeper into negative territory, the sovereign's 2028 bond yield dropped from 1.07% (end of 2018) to 0.32% (24-Jun-2019). Looking forward, extraordinarily favorable financing conditions should translate into further improving debt affordability metrics. We note that Latvia's gross debt has become increasingly affordable over the past years. Since the end of 2011, the government's interest-to-revenue ratio has steadily trended downwards, slipping from 5.0 to 1.9% in Q4-18.

Meanwhile, we regard contingent liability risks to the government's budget as rather limited, mainly due to the structure of Latvia's banking sector. The domestic banking market remains characterized by a large presence of foreign-owned, mainly Nordic banks, while so called non-resident deposit (NRD) banks primarily provide services to clients in the CIS countries. In general, the Latvian banking sector is well capitalized, while asset quality

remains high. As highlighted by EBA data, the CET1 ratio was reported at 21.2% (Q4-18), up from 20.9% a year before, the NPL ratio stood at a low 2.8% at the end of last year.

Having said this, we believe that some reputational damage to the financial system has been caused by the wind-up of ABLV, following allegations by U.S. authorities of large-scale money laundering, and the dismissal of the Bank of Latvia's governor Rimsevics on bribery allegations. Regarding the latter, we note that Rimsevics was reinstated to his post in February after the European Court of Justice had ruled that Latvia broke EU law by barring him from office, without evidence to prove bribery allegations. Furthermore, the European Central Bank took over the supervision of PNB Banka in April 2019. PNB's largest shareholder had accused the central bank governor of having demanded bribes after the bank itself was fined on money laundering in 2017.

Non-resident deposit (NRD) banks with a business focus on Russia and the CIS countries have come under increased scrutiny after ABLV's failure. Since our last review, Latvian authorities further intensified their efforts to tighten the AML/CFT framework and to ensure its effective implementation. In an immediate response to ABLV's failure, banks were obliged to terminate business relations with entities that show signs of being a shell arrangement (i.e. not economically active and registered in jurisdictions without requirements to disclose financial statements) by 8 July 2018 latest. More recently, a new Whistleblower law came into force and cross-border cooperation between financial supervisory authorities was further strengthened. On 8 May 2019, Nordic and Baltic financial supervisors agreed to establish a permanent working group with representatives from each country's to maintain regular contact and exchange information and best practice in money laundering prevention. On 13 June, parliament passed amendments to the Finance and Capital Market Commission Law and the Law on Prevention of Money Laundering and Terrorist Financing. The adopted legislation addresses shortcomings in the country's AML/CFT framework identified during last year's review of international money-laundering standards watchdog Moneyval. Prospects of tighter regulatory requirements and supervisory pressure imposed on NRDs triggered significant deposit outflows from non-residents, culminating in a 35.8% decline from 4.9 to EUR 3.1bn between June and July 2018. However, we note that NRD deposits appear to have stabilized over the following months, hovering around EUR 3bn since then.

Notwithstanding relatively buoyant economic growth, bank lending contracted throughout 2018. As highlighted by ECB data, loan growth to NFC and households (adjusted for sales and securitizations) averaged at -8.7% and -3.3%, respectively last year. To be sure, loan contraction was partly a result of negative base effects related to structural changes in Latvia's banking sector. The decision of DNB ASA and Nordea Bank AB to sell a 60% stake in their joint-venture Luminor Bank to private equity investor Blackstone in September 2018, led to a sharp decline in the volume of loans granted by domestic credit institutions. However, even taking into account Bank of Latvia data which adjusts loan growth for restructuring operations (excluding one-offs between 2016 and 2018), private sector credit has been anemic since 2017. Sluggish lending activity appears to be partly due to weak borrower collateral, a preference for internal-funding among corporates, and generally tight credit standards.

Foreign Exposure

Our ratings on Latvia remain somewhat constrained by the country's external position. Even though imbalances have decreased materially over the recent years, the country is still exposed to elevated risks stemming from a high degree of trade openness and sizeable external refinancing needs in the government sector.

Given the small size of the domestic capital market, the Latvian government remains highly reliant on foreign funds to refinance its debt. In 2018, 81.1% of the government's total debt stock was held externally – one of the highest figures in Europe. In our view, high reliance on external funds denotes a vulnerability in the event of suddenly shifting investor sentiment or more generally, in time of distress in global financial markets. We note, however, that the provision of investment options for domestic investors remains a strategic goal of Latvian authorities. According to the Latvian Treasury, its strategic target for the domestic market has been achieved over the last years, as regular auctions done in the domestic capital market covered ongoing redemptions, thus holding external debt as a share of general government debt broadly stable.

We also acknowledge that the economy's net international investment position (NIIP) has significantly strengthened over the last years. Aided by strong GDP growth and more recently, shrinking non-resident deposits in the banking sector, Latvia's NIIP improved from -82.9 of GDP (2010) via -56.3 of GDP (2017) to -49.1% of GDP in 2018. The ongoing improvement in Latvia's NIIP in the aftermath of the financial crisis was driven by external deleveraging. Net external debt still compares relatively high to other Baltics and also to most CEE peers, but at 22.7% of GDP it has more than halved since 2010 (55.7% of GDP). Concurrently, the share of FDI liabilities, which we regard as relatively stable funding source given that it is mostly made up of equity (2018: 74.5%), has steadily increased. Last year, FDI accounted for one-third (33.2%) of the Latvian economy's external liabilities, up from 31.3% in 2017 and 24.1% in 2010.

Persistent current account deficits, which contributed to the build-up of external imbalances in the run-up to the financial crisis, have moderated in recent years. Since 2015, the current account has been broadly balanced averaging at 0.2% of GDP (p.a.). Last year, Latvia ran a small current deficit. On the back of slowing exports, accelerating investment activities and a more expansionary fiscal stance, the current account balance weakened from 0.7 to -1.0% of GDP in 2017-18. While the trade in services surplus decreased from 8.6 to a still high 8.1% of GDP, the primary income deficit widened from -0.7 to -1.3% of GDP, due to higher income obtained by foreign investors on their Latvian assets. Going forward, we anticipate a slightly higher current account deficit, as exports dynamics should be muted, while domestic demand is set to remain strong.

Rating Outlook and Sensitivity

Our Rating outlook on the Latvia's ratings is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to remain fundamentally unchanged over the next twelve months.

Our rating could be lowered if we observed prolonged stagnation or a reversal in income convergence towards EU-28 levels, or if adverse developments lead to lower-than-expected medium-term growth. As a small open economy, decelerating economic activity in the euro area could adversely affect GDP growth given Latvia's strong trade linkages with its neighboring countries. Growth could also be hampered by escalating tensions with Russia, which could lead to a tightening of trade sanctions on the EU level. Apart from the materialization of external risks, accelerating net migration could result in a faster-than-anticipated decline in the Latvian workforce, thereby weakening the economy's growth potential. We could also consider a downgrade if, contrary to our expectations, a significant deterioration in public finances occurred, mirrored by significant budget deficits and a steep increase in government debt.

By contrast, upward pressure on our ratings could arise if the volatility of macro-financial variables was significantly reduced or if we observed higher-than-expected growth rates in the medium term, leading to accelerating income convergence. In the same vein, we could raise our ratings if we see sustained and credible fiscal consolidation complemented by a further reduction of debt at the general government level.

Primary Analyst
Johannes Kühner
Sovereign Credit Analyst
j.kuehner@creditreform-rating.de
+49 2131 109 1462

Chair Person
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

Economic Data

	2013	2014	2015	2016	2017	2018	2019e
Real GDP growth	2.4	1.9	3.0	2.1	4.6	4.8	3.1
GDP per capita (PPP, USD)	22,450	23,560	24,709	25,717	27,685	29,901	31,491
HICP inflation rate, y-o-y change	0.0	0.7	0.2	0.1	2.9	2.6	2.6
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	74.3	74.5	74.8	74.9	74.9	n.a.	n.a.
Fiscal balance/GDP	-1.2	-1.4	-1.4	0.1	-0.6	-1.0	-0.5
Current account balance/GDP	-2.7	-1.7	-0.5	1.6	0.7	-1.0	n.a.
External debt/GDP	133.9	144.1	143.7	148.9	140.5	121.0	n.a.

Source: International Monetary Fund, Eurostat, 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

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.

This sovereign rating is an unsolicited credit rating. The Ministry of Finance (MoF) participated in the credit rating process as the MoF 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 MoF during their review. However, the rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used 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, Central Statistical Bureau of Latvia, Central Bank of Latvia, Republic of Latvia - Ministry of Finance Latvia

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.

Disclaimer

Any rating issued by Creditreform Rating AG is subject to the Creditreform Rating AG Code of Conduct which has been published on the web pages of Creditreform Rating AG. In this Code of Conduct, Creditreform Rating AG commits itself – systematically and with due diligence – to establish its independent and objective opinion as to the sustainability, risks and opportunities concerning the entity or the issue under review.

When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and

national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

This report is protected by copyright. Any commercial use is prohibited without prior written permission from Creditreform Rating AG. Only the full report may be published in order to prevent distortion of the report's overall assessment. Excerpts may only be used with the express consent of Creditreform Rating AG. Publication of the report without the consent of Creditreform Rating AG is prohibited. Only ratings published on the Creditreform Rating AG web pages remain valid.

Creditreform Rating AG

Creditreform Rating AG
Hellersbergstrasse 11
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: Prof. Dr. Helmut Rödl
HRB 10522, Amtsgericht Neuss