Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF LATVIA Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Assigned Ratings/Outlook: **A /stable**	Type: Monitoring, Unsolicited with participation
	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	26-08-2016 10-06-2022 "Sovereign Ratings" "Rating Criteria and Definitions"

Contents

Rating Action 1
Key Rating Drivers 1
Reasons for the Rating Decision and Latest Developments 2
Macroeconomic Performance 2
Institutional Structure 6
Fiscal Sustainability 7
Foreign Exposure 7
Rating Outlook and Sensitivity ...11
Analysts 11
Ratings* 11
Economic Data 13
ESG Factors 12
Appendix 13

Rating Action

Neuss, 10 June 2022

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. We expect Latvia's economy to expand this year and next, mainly on the back of recovering household spending; Russia's invasion in Ukraine and the related economic fallout is set to dampen economic expansion significantly in the near term; main channels hampering growth performance should be the now pressing need to divert former trading business with Russia and Belarus, as well as higher commodity prices and shortages in raw materials
2. Medium-term growth outlook remains largely positive, backed by the initiatives and investment financed by the EU's Recovery and Resilience Facility (RRF), which should contribute to re-/upskilling Latvia's labor force and to lifting innovation potential, thereby strengthening productivity amid unfavorable demographic prospects, which we view as the main risk to Latvia's convergence process; whilst setting incentives to attract and maintain talent amid shortages of skilled labor, upward pressure on wages may at some point start to eat into the wider economy's cost competitiveness
3. Generally strong institutional framework including advantages associated with EU/EMU and NATO membership; progress in strengthening the AML/CFT framework has continued, flanked by further advancements in enhancing the judicial system; current polls point to an ongoing high degree of fragmentation in parliament after the October election, possibly posing challenges to cohesive and swift policy formulation
4. Despite a likely repeated high deficit this year, we deem fiscal risks as contained, mirroring still low debt levels and low debt servicing costs; we assume Latvia's public debt ratio to increase this year, but gradually decline over the medium term; the sovereign displays some fiscal room to cushion the adverse effects from the fallout of the Russian war, whilst further pursuing a path of reinforcing inclusive growth along with the twin transformation (green and digital)

5. Ongoing improving trend regarding the external position over recent years, with the negative net international investment position (NIIP) continuing to shrink; the share of non-resident holdings of government debt has decreased further; still prevalent vulnerability to external shocks is highlighted by the current geopolitical events

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Latvia's macroeconomic profile is characterized by a good degree of economic diversification and a relatively business-friendly environment. A period of robust GDP growth prior to the pandemic and the demonstrated ability to adapt to challenging circumstances have ensured some resilience enabling a relatively strong economic recovery despite headwinds from Covid-19-related containment measures. Balancing these factors, there are vulnerabilities and macro-financial volatility linked to the economy's small size and high degree of openness. Moreover, low innovation performance, lackluster overall credit growth, as well as a rapidly aging and declining population, constitute constraints to underlying growth. Whether marked downside risks from current geopolitical and economic circumstances linked to Russia's war in Ukraine can be limited will have to be monitored vigilantly. Resources to cushion adverse effects will be available via significant EU funding in the form of NextGenerationEU (NGEU) and the Multiannual Financial Framework 2021-27 (MFF 21-27), which will presumably facilitate reforms and initiatives conducive to enhancing social inclusion and lifting productivity, backing expectations of continued convergence towards EU levels in the medium term.

A phase of strong economic growth over recent years fostering Latvia's convergence towards EU levels was only temporarily interrupted by the outbreak of the corona crisis. After a comparatively mild real GDP contraction in 2020 by European comparison (-3.8%, euro area (EA): -6.4%), Latvia's real GDP expanded by 4.5% in 2021 (EA: 5.4%). With that, total economic output exceeded its pre-crisis level already last year, contrary to developments in the euro area as a whole, and despite ending the year on a weaker note due to re-introduced restrictions owing to soaring Covid-19 infection cases. Latvia's GDP per capita continued its solid long-term upward trend. However, at an estimated USD 34,707 in 2021 (IMF data, PPP terms), Latvia's GDP per head represents the lowest among our A-rated sovereigns. In addition, we have to highlight that the income convergence process towards EU levels has slowed more recently, as Latvia's GDP p.c. remained unchanged at 71% of the weighted EU average last year (IMF, PPP terms).

Last year's recovery in domestic demand was mainly driven by rebounding private consumption (growth contribution +2.7 p.p.) and to a lesser extent by government consumption. Posing some drag on the increase in gross fixed capital formation, construction investment declined strongly, burdened by issues around postponed investment projects, labor supply, and rising costs. By contrast, investment in machinery and equipment, as well as in intellectual property, was expanded. Since imports rose considerably more strongly than recovering exports, net exports exerted a heavily negative effect on GDP growth (-5.3 p.p.). Inventories ultimately made the strongest contribution to growth last year.

---

[1] This rating update takes into account information available until 03 June 2022.

More recently, quarterly real GDP rebounded by 3.6% q-o-q (sa, ca) in Q1-22, amid falling infection numbers and eased restrictions. Accordingly, private consumption experienced a forceful recovery (+7.2% q-o-q), while challenges in the construction sector continued to persist, exacerbated by unfavorable weather conditions.

The near-term growth outlook is significantly clouded by Russia's war in Eastern Europe, as also mirrored in substantial drops in industrial, services, and consumer confidence following the Russian invasion in Ukraine. On the back of soaring energy and food prices, Latvian inflation is skyrocketing, at 16.4% in May-22 (HICP) posting one of the highest rates in the EU. At the same time, the extent to which shortages of materials and equipment represent a factor limiting industrial production is at its highest level since Latvia's EU accession in 2004 (European Commission (EC) survey data), albeit at a lower level than on average in the EU (Q2-22: 26% vs. EU 51%).

Along with the other Baltic and CEE countries, Latvia is perceived to be among the most vulnerable EU members with regard to the fallout from the war in Eastern Europe, on account of the high energy intensity of its economy and the importance of Russia as a source for commodities, especially gas imports (EC). In a bid to end the dependency on certain products and raw materials and to find alternative export destinations, companies are now faced with having to reorient parts of their business and trade flows, and the government intends to cease natural gas imports from Russia from January 2023. To this end, the cabinet supports the implementation of a floating LNG terminal project in cooperation with Finland and Estonia as well as the construction of a LNG terminal in Latvia.

Looking ahead, we expect private consumption to see a further, albeit more moderate, increase this year, as the burden placed on consumers — in particular through higher energy prices — will be partly mitigated by support measures provided by the government (see below). While wages are set to rise further, albeit at a slower pace due to base level effects and more moderate public wage growth, and while employment in parts of the service sector affected by previous containment measures should recover, there are downside risks to the labor market associated with the current geopolitical context and related economic consequences (see below).

The outlook for gross fixed capital investment has thus become markedly more uncertain, too, with the downside risk of companies becoming hesitant to invest under the current circumstances and the challenges related to having to cut remaining links to Russia. Also, investment activity is likely to suffer from supply shortages, i.e. labor and raw materials. This said, financing conditions should still remain constructive, albeit prospectively less so than in the recent past, given the changing tide as regards monetary policy. While private indebtedness remains comparatively low, generally pointing to the presence of shock-absorbing capacities, ongoing negative credit growth to NFCs partly reflects challenges regarding access to finance, ultimately representing a hindrance to economic growth. EU funding — among others via the RRF — will act as a stabilizing pillar. The government will submit the payment claim for disbursement of a EUR 231mn tranche linked to the completion of nine reform measures to the EC this June (Ministry of Finance, MoF).

As suggested above, the external environment is subject to considerable challenges as a result of Russia's aggression and related reactions on the part of the international community. While trade links to Russia have become weaker in the wake of its annexation of Crimea, exposure is still significant. Russia was the fifth-largest export destination for Latvia in 2021, receiving 7% of Latvian goods exports last year (CSB data). Somewhat mitigating the blow of having to find new

markets, exports to Russia and Belarus are to a large extent re-exports with limited domestic value added, as also the EC points out.

On the import side, Russia was the origin of 9% of total goods imports to Latvia, making Russia the fourth-largest supplier to Latvia. More than a third (35%) of the import value could be attributed to mineral oil, with iron and steel being further key import materials. Apart from goods trade, key services trade areas such as transport and travel look set to remain negatively affected as well. Also worth noting, in light of Latvia's relatively high gross value added share of agriculture, accounting for 4.7% of total GVA in Q4-21 (EA: 1.7%), supply disruptions in this area could additionally weigh on economic growth performance, while fueling mounting price pressure on these commodities. Net trade is thus likely to exert a negative effect on GDP growth this year and next, with export growth presumably rather subdued, while imports should see a stronger rise by comparison, fostered by domestic demand.

Overall, we expect real GDP to rise by 2.5% this year, acknowledging substantial uncertainty around this forecast. Depending on any relaxation of the geopolitical tensions caused by the events in Eastern Europe, we currently assume total economic output to gain some traction in 2023, growing by 2.8%, as businesses may be able to adapt and consumer prices may have peaked in the meantime.

Latvia's labor market saw strong performance prior to the pandemic. In tandem with a comparatively mild decline in economic output during the crisis and on the back of furlough schemes supporting employment, negative effects remained limited. In 2021, amid rebounding economic growth, the annual unemployment rate dropped to 7.6% on the heels of an increase by 1.8 p.p. to 8.1% in 2020 (Eurostat, LFS-adj.). With that, the rate was roughly in line with average unemployment in the euro area (2021: 7.7%). More recently, judging by monthly data (sa), unemployment declined to 6.6% in Apr-22, matching levels registered shortly prior to the outbreak of Covid-19.

Employment, on the other hand, has developed less favorably, posting a third consecutive decline in 2021 (National Accounts data, domestic concept), as opposed to increases seen in the other Baltic peers and the euro area overall. Latvia's underperformance in this respect is partly linked to a delayed recovery in the service sector amid Covid-19 containment measures. In this context, we reiterate an initially sluggish vaccination campaign by European comparison. Going forward, the lifting of restrictions should thus be mirrored to some extent in a more positive employment situation in the service sector.

While the expected ongoing economic expansion should generally bode well for the labor market, we see downside risks for jobs in some areas. Transport and travel services are likely to remain impaired by the geopolitical context and the concomitant need to divert some business, as well as by remaining uncertainty over epidemiological developments. In addition, there remain uncertainties over the EU's mobility package, which will likely negatively affect the transport sector and against which a number of European countries, including Latvia, have lodged complaints. Against this backdrop, unemployment could see a temporary increase in 2022, at least in the affected sectors. Meanwhile, shortages of skilled labor in various sectors may continue to exert upward pressure on wages.

The annual increase in gross monthly wages and salaries averaged 8.6% between 2017 and 2021 in the private sector (7.9% in the public sector). In 2021, the monthly minimum wage was lifted by 16.3% to EUR 500. Notwithstanding strong wage growth over recent years, the sovereign's

global export market share has been stable over a longer phase and even ticked up from 0.08% to 0.09% in 2019-20, thanks to a rising share in goods trade (2020: 0.09%), while the global market share regarding services exports was stable (2020: 0.10%). This suggests that adverse effects on Latvia's cost competitiveness from misaligned productivity and wage growth have hitherto been rather limited.

However, given that increases in compensation per employee have persistently outpaced real productivity growth for a prolonged period of time, the unfavorable development of real unit labor costs may at some point start to undermine the sovereign's competitive stance vis-à-vis its trading partners. We note that in terms of nominal productivity per hour worked and per person (PPS, 2021: 64.1% and 73.3% of the EU level, respectively) Latvia is gradually progressing, but continues to trail its Baltic peers. At the same time, the rising wage level reflects progressing convergence towards the EU level, and in order to attract and retain the talent needed to address reported shortages of skilled labor, competitive wages appear vital. We will continue to monitor developments in this regard, including for any effects from a possible integration of Ukrainian refugees into the labor market.

As is also foreseen in the national Recovery and Resilience Plan (RRP), stepping up gross domestic expenditure on R&D, which has remained well below the other Baltic member states and the euro area overall (2020: 0.7% of GDP, EA: 2.4%), should prove conducive to lifting the country's innovation potential and productivity, ultimately fostering potential growth. Drawing on the EC's Innovation Scoreboard, Latvia has made noticeable progress with regard to its innovation performance relative to the EU up until the pandemic broke out. More generally, investment in terms of gross fixed capital formation as a percentage of GDP has trended upwards over the last few years, climbing to 24.5% in 2020 and thereby exceeding levels observed in Lithuania and the EU overall, as well as prospectively contributing to a more favorable basis for underlying growth.

The EC estimates that potential growth will moderate to 2.1% for 2022 and 2023 (AMECO), from an estimated average of 2.6% since 2015, continuing to fall short of the projected potential growth rates of its Baltic neighbors. Recalling that this estimate does not include the assumed positive impact of the RRP reforms, there may be room for positive surprises despite the current difficult geopolitical context, especially as total factor productivity is expected to be the main driver for potential growth over this period. We note that the government estimates potential growth to be at 3.0% this year and 3.2% in 2023 (Stability Report April 2022, SP22).

From a demographic perspective, less gloomy migration data may lend some support to a more optimistic scenario, as the downward trend in net emigration has continued. Latest data referring to 2021 showed that net emigration had slowed to about 286 persons. Whether more than 11,200 refugees from Ukraine with the right to employment (SP22) will make use of this right and for how long is highly speculative at this stage.

As to the degree of digitalization, the EC's Digital Economy and Society Index ranks Latvia 17th among the EU countries in 2021, corresponding to an improvement by one rank compared to 2020 and displaying room to catch up, especially in terms of the basic digital skills of the population. As expressed in its RRP, the government targets a share of 54% of the population with at least basic digital skills by Q3-26, which would match the EU level in 2021 by then. Of the roughly EUR 1.8bn in RRF grants to fund the RRP, 20% are dedicated to the digital transition, while 37% are allocated for projects related to climate protection. Thus, the bulk of the funds will go towards strengthening health and social security, education and social inclusion, addressing

pressing challenges otherwise weighing on medium-to-longer-term growth prospects. According to the EC, the RRP could increase Latvian economic output by approx. 2% by 2026, not including any positive effects from structural reforms.

Further EU funding allocated to Latvia includes EUR 4.8bn via the 2021-27 EU cohesion policy funds. Latvia has shown average performance regarding fund absorption, as 65% of the 2014-2020 European Structural and Investment Funds (ESIF) was reported as spent as of end Dec-21, almost in line with the EU average (63%). There is EUR 2.67bn left to be spent by the end of 2023 from this facility. While the substantial EU funds thus continue to support a constructive medium-term outlook, we would nevertheless flag the need to closely monitor continued timely implementation, given the abovementioned headwinds in connection with the war in Ukraine, while political fragmentation could also slow down reform progress to some degree (see below).

Institutional Structure

Latvia's credit rating is underpinned by a favorable institutional framework that includes the benefits associated with its integration into the EU/EMU and NATO membership, advantages of which have to be set against elevated geopolitical risks stemming from the sovereign's borders with Russia and Belarus. We also assess further headway made in combating corruption and in reinforcing the AML/CFT framework as positive. Against the backdrop of a more volatile domestic political context over the last few years and of opinion polls suggesting another fragmented parliament, we would flag potential issues around formation of a stable government after the parliamentary election in October 2022. While we overall expect policy-making to remain focused on major goals as elaborated in the RRP and National Reform Program (NRP), challenges around timely implementation may arise in the event of weakening government cohesion.

The latest set of the World Bank's Worldwide Governance Indicators (WGI) supports the assessment of a generally strong institutional set-up. This said, the perception of government effectiveness deteriorated markedly in the reference year 2020, with the sovereign dropping from relative rank 35th to 49th out of 209 economies considered, now underperforming against the euro area median (rank 35). While rank 56 in terms of voice and accountability (EA median: 33) and rank 40 when it comes to rule of law (EA median: 32) were little changed from the preceding year, we emphasize a significant improvement with regard to control of corruption. While still trailing the euro area median in this respect (rank 43), Latvia has made a leap from rank 67 to 52 out of 209 sovereigns considered.

Similarly, there has been further progress in terms of strengthening the AML/CFT framework. October 2021 saw authorities adopt a new software for suspicious transactions and threshold declarations, and parliament passed a new law strengthening protection for whistleblowers (Jan-21), with the latter transposing an EU directive into national law. Moreover, the Cabinet approved measures (Feb-22), including providing for the establishment of an AML/CFT Competence Centre, as well as a training center for judges, prosecutors and court employees.

The government's decision to abolish the scheme granting temporary residence permits to foreign citizens in exchange for real estate investments (Mar-22) seems to go in a similar direction. Partly tying in with this, there are also further efforts to reduce the extent of the shadow economy in a broader-based approach coordinated by the Shadow Economy Council, involving public administration and non-governmental organizations, which remains work in progress.

We note that the EC's Jul-21 Rule of Law report pays testament to further advancements concerning the enhancement of the justice system's quality and efficiency. Among other things, the strategy for 2021-2025 aims to foster judicial independence, and with the Economic Court opened in Mar-21, efficiency in dealing with complex cases in the economic/financial realm should be increased. Some room for improvement remains with regard to limited human resources as regards the Judicial Council.

As to other structural reforms, we would highlight an ongoing reform of Latvia's insolvency framework, which could be ultimately conducive to boosting lending activity to corporates. Latest developments involve a strategy for the supervision of administrators of insolvency proceedings for 2022-23, presented by the Insolvency Control Service (Jan-22).

While in our view the abovementioned developments point to an ongoing high degree of responsiveness to EU policies and recommendations from international institutions, we note that in April the EC decided to refer Latvia to the Court of Justice of the European Union along with nine other EU member states. These ten member states, in the view of the EC, had failed to fully transpose and communicate how national measures transpose the EU Electronic Communications Code.

Turning to developments related to pursuing the green agenda, Latvia remains committed to its ambitious goal of reducing greenhouse gas (GHG) emissions by 65% compared to 1990 by 2030, and achieving carbon neutrality by 2050. With regard to the EC's Eco Innovation Index 2021, Latvia occupies rank 18 among the EU countries, suggesting some potential to catch up. Looking at the overall share of energy from renewable sources, Latvia is in fact one of the European frontrunners, exhibiting a share of 42.1% in 2020 (EU: 22.1%), only exceeded by Sweden and Finland among the EU member states. While the share of renewables used in gross electricity consumption and heating/cooling amounts to 53% and 57%, respectively, there is scope to further increase the respective share in the transport sector, which in 2020 came to 6.7% (EU: 10.2%).

Fiscal Sustainability

Still capitalizing on rigorous fiscal prudence demonstrated after the global financial crisis, Latvia's credit rating remains supported by low public debt and very low debt servicing costs. The sovereign has some fiscal space to tackle the current epidemiological and geopolitical challenges, notwithstanding the pandemic-related deterioration of its public finances. The deficit is likely to remain elevated this year due to the need to cushion the impact from the war in Ukraine, to reorient parts of the external trade, and to the stepping-up of defense measures. Despite less favorable near-term growth and fiscal prospects, the debt ratio should reverse beyond 2022, although this will essentially depend on the further development of the geopolitical situation as well as on the new government and related fiscal priorities after the October election. We assume debt-to-GDP will remain at a low level over the medium term. In any case, public debt should remain very affordable, even though financial market funding conditions are becoming less favorable given envisaged steps towards monetary policy normalization. EU-financing made available under RRF and MFF 21-27 will remain an important supportive pillar. We will continue to monitor any progress made on reducing the shadow economy, as is envisaged in the RRP.

The sovereign entered the corona crisis on a solid footing in terms of its public finances, having recorded moderate headline deficits averaging 0.7% in 2015-19. Following a widening of the

negative general government balance to 4.5% of GDP in the first year of the pandemic, Latvia was one of few EU member states whose deficit increased in 2021, to 7.3% of GDP, as measures to support households and businesses remained largely in place. The impact from the supportive measures on the general government budget totaled about EUR 2.1bn, or 6.4% of GDP. Even at this elevated level, the deficit remained well below the DBP22 estimate last October, ultimately reflecting a better-than-expected tax revenue outcome.

Along with rebounding net social contributions, the economic recovery lifted government revenue by 8.2% in 2021 (2020: -0.9%), whereas total government expenditure soared by a considerably stronger 16.0% (2020: +8.9%), boosted by a 16.2% increase in transfers and further rising social benefits (+9.8%), as well as by a vividly increasing public wage bill (+11.8%).

As regards the current year, Covid-19 support for 2022 is envisaged to reach EUR 1.4bn (SP22), conditional on the absence of any more aggressive virus variants that might require renewed containment measures. Public finances were on a favorable course until Mar-22, with tax revenue up by 19.8% in the first three months of 2022 compared to the same period last year (cash basis), pushing total revenue up by 17.4% y-o-y. Total expenditure meanwhile increased by 2.9%. However, given the upward pressure on energy and other commodity prices and the worsening outlook for the European and the global economy on account of Russia's military aggression in Ukraine, the near-term fiscal prospects have deteriorated.

In order to soften the blow, roughly EUR 0.34bn in support to Latvian businesses and consumers is so far foreseen for 2022 (SP22), a sum which may rise depending on the duration of the conflict and any potential further escalation, thus illustrating considerable uncertainty over fiscal outcomes this year. Also, the government shells out some financial support for refugees from Ukraine (approx. EUR 21mn, SP22). As for other discretionary measures planned for 2022, authorities inter alia envisaged an increase in non-taxable minimum income. On the expenditure side, further increases of public sector wages in healthcare and education and enhancing healthcare services count among those initiatives with a deficit-increasing effect (DBP22).

Acknowledging substantial uncertainty around near-term forecasts, we expect the headline balance to amount to about 7.0% of GDP this year. Against the backdrop that most support measures to attenuate high energy costs are supposed to be temporary, and given the expectation of ongoing economic growth, the deficit in the general government balance should narrow to about 2.8% of GDP in 2023. We see remaining uncertainty over epidemiological developments, energy costs and costs related to accommodating refugees as main risks to this forecast. Over the medium term, the government envisages the headline balance to continue to display a deficit, which is to shrink to -1.7% of GDP by 2025, with the primary balance likewise remaining negative. Defense investments will be driven up over the coming few years, as the government aims to lift defense spending to 2.5% of GDP by 2025.

Having dropped by slightly over 10 p.p. of GDP to 36.7% of GDP between 2010 and 2019, the pandemic lifted Latvia's public debt ratio to 43.3% of GDP in 2020. Last year, given the mounting deficit, general government debt climbed to 44.8% of GDP, still comparing favorably against most of our A-rated sovereigns (median: 56.0% of GDP), the euro area as whole (95.6% of GDP), and remaining below our expectation in our last review. In view of the likely still elevated headline deficit this year and the slower GDP growth, the debt ratio should edge up to approximately 46.2% of GDP in 2022 before starting to reverse amid an ongoing economic expansion and a markedly lower deficit from next year.

Contingent liability risks continue to remain relatively low, with state and local government guarantees totaling 2.0% of GDP in 2021. Paid-out, but not repaid, state-guaranteed loans came to EUR 411.1mn at the end of last year (1.3% of GDP), corresponding to a decrease of EUR 130mn compared to 2020. Covid-19-related guarantees amounted to a maximum of 0.30% of GDP, with the take-up at 0.26% in 2021.

The banking sector with total assets of 79.1% of GDP as of Q3-21 (Q3-16: 119.7%, ECB data), one of the smallest in the EU, continues to give a sound impression, having shown resilience over the course of the pandemic. While its dominance by foreign-owned entities could be considered a potential structural vulnerability given the concomitant dependence on the respective macro-financial developments, major parent institutions generally appear in solid shape.

According to EBA data, the NPL ratio in Latvia's banking sector dropped further from an already low 1.6% as of Q4-20 to 0.6% in Q4-21. Drawing on FCMC data, also covering banks not under the domain of the EBA, the NPL ratio decreased from 4.7% in 2020 to 3.6% in 2021. We observe that the share of stage 2 loans in loans and advances at amortized cost increased somewhat, to 10.9% in the second half of 2021 (EU: 8.9% as of Q4-21, EBA data). This said, risks continue to seem manageable, given a high CET1 capitalization level (Q4-21: 30.4%, EU: 15.7%, EBA). The wider financial system has remained largely resilient during the corona crisis.

Contrary to outstanding loans to NFCs, which have continued to trend down over the pandemic, loans to private households have been expanding of late, driven by mortgage lending, with the annual growth rate of outstanding loans for house purchases rising to 8.3% as of Mar-22 (Mar-21: -0.4%). Having levelled off in the initial stages of the pandemic, house prices have accelerated markedly since Q2-21, displaying a y-o-y rate of 16.5% as of Q4-21 (Q4-20: 2.2%, Eurostat data). After some moderation, the 3-year growth rate was close to 30% at the end of last year (Q4-21: 29.6%), thus close to the highs seen in 2018. However, affordability measures such as the price-to-income ratio (OECD data) do not hint at any misalignments so far.

Turning to more structural developments, we would highlight as positive a significant improvement in lowering the VAT gap, referring to the pre-crisis year 2019. From an estimated 10.2% in 2018, Latvia's VAT gap as a percentage of VAT total tax liability dwindled to 8.3%, corresponding to the most pronounced decrease among the EU members and falling below the EU median. More generally, while remaining considerable, the gap between Latvia and the euro area as a whole in terms of total tax receipts (and social security contributions) to GDP has gradually narrowed over recent years, having fallen to 9.7 p.p. in 2020. On a less positive note, Latvia's relatively large informal economy is estimated to have reached 26.6% of GDP in 2021, which would represent an increase from the estimated level for 2020 (25.5% of GDP), according to a recent study by Stockholm School of Economics. Having said this, a number of initiatives to strengthen tax administration should contribute to improvements going forward.

Overall, we continue to view fiscal sustainability risks as relatively low, with the sovereign continuing to benefit from substantial EU funding, and bearing in mind a benign debt portfolio structure exhibiting an average weighted maturity of 9.501y in Mar-2022, corresponding to one of the higher readings in the EU and suggesting low refinancing risks. Interest rate payments fell by another 17.0% in 2021, leaving them at 0.5% in terms of GDP (2020: 0.7% of GDP) and 1.3% of total revenue.

In the context of tapping the capital market, we also note that Latvia very successfully placed its first (8-year) sustainability bond on 6 December 2021, with a volume of EUR 600mn and a coupon of 0.25%, achieving an order book over EUR 2.5mn, underscoring smooth market access and still benign refinancing conditions. Debt affordability should remain high, notwithstanding likely further steps towards ECB monetary policy normalization partly anticipated by financial markets. The yield on Latvian 10y government bonds has risen to 1.59% as of Apr-22 (ECB data, monthly quote), representing the highest level since Dec-14.

As announced, the PEPP was terminated at the end of Mar-22. Despite stepping up its communication suggesting the possibility of two interest rate hikes for Q3-22, we still expect the ECB to take a cautious approach in tightening monetary policy in light of the significantly heightened uncertainty due to the war in Ukraine, and to maintain a high degree of flexibility.

Foreign Exposure

Latvia's credit rating remains somewhat constrained by its external position. Downside risks from a likely marked slowdown in European and global GDP growth, and the emerging necessity to redirect a portion of its trade away from Russia and Belarus in a timely manner, emphasize some vulnerabilities linked to being a small, open economy. Adding to these, a relatively high share of government debt is held by non-residents, although the share continues to gradually decrease, thus contributing to improving the external stance over recent years as suggested by a further narrowing of its negative NIIP. Having experienced large swings in its current account balance since the outbreak of the pandemic, we expect some distortions to continue in the near future as fallout from Russia's aggression in Ukraine, related countersanctions and lingering shortages of materials. Over the medium term, we assume a return to a moderate current account deficit.

Having displayed an average deficit of a mere 0.8% of GDP over the years 2010-19, Latvia's current account balance, which in light of the exceptional circumstances of the pandemic had recorded a surplus to the tune of 2.9% of GDP in 2020, swung back into deficit last year, totaling -2.9% of GDP. Following a pronounced narrowing in the first year of the pandemic, the goods deficit in terms of GDP expanded by 2.3 p.p. to -7.4% amid strongly recovering imports in 2021. Adding to the negative effect on the current account balance, the primary income balance returned to its pre-crisis deficit and the surplus in the services balances decreased further to 5.3% of GDP as transport and tourism exports remained below pre-crisis levels. With that, the surplus in services trade reached its lowest level since 2007.

Given the developments around Russia's war in Ukraine and the expected negative effects on Latvian net trade, we assume a further widening of the deficit this year. In case of some relaxation of the geopolitical situation in 2023 and concomitant redirection of trade flows for certain materials, the current account deficit should narrow to some degree, though remaining above levels seen before Russia's invasion and subject to some uncertainty relating to the impact of the EU mobility package.

Latvia's negative NIIP meanwhile shrank to -28.1% of GDP last year, with the large and dominating net negative position in direct investment increasingly offset by a larger net positive balance in portfolio investment of late. Prospectively, EU and sustained FDI inflows should contribute to further improvements in the NIIP over the medium term, while in the short-term the fallout from the Russian aggression could cause some volatility.

Rating Outlook and Sensitivity

Our rating outlook on Latvia's long-term credit ratings is stable. Currently more pronounced downside risks to macroeconomic performance, the external position, and the near-term fiscal outlook are largely balanced by some fiscal room for maneuver, the track record of fiscal prudence, and ongoing progress in reducing dependency on Russia, while being firmly anchored in the European/Western institutional and defense structures. We emphasize that the assessment and interpretation of economic developments remains subject to considerable uncertainty in light of the recent accumulation of crises.

We could consider a negative rating action if medium-term growth prospects worsen materially, slowing down the convergence process and also affecting the fiscal outlook negatively to a considerable degree. Part of such a scenario could be further escalation of the war in Ukraine or if the situation becomes increasingly entrenched going forward, possibly exacerbated by shifting priorities in terms of fiscal policies and/or failure to implement the RRP as envisaged, with negative repercussions on productivity and potential growth. This could also bear down on the convergence progress.

Conversely, a positive rating action could be triggered if negative reverberations from the war in Ukraine remain limited, with robust GDP growth rates and ongoing implementation of the RRP, thus improving prospects for underlying growth and further tangible progress in terms of income convergence. A markedly more pronounced decline of the public debt ratio could also prompt a positive rating action.

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.

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

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]	2016	2017	2018	2019	2020	2021e	2022e
Macroeconomic Performance							
Real GDP growth	2.4	3.3	4.0	2.5	-3.8	4.5	2.5
GDP per capita (PPP, USD)	26,591	28,571	30,669	32,233	31,594	34,707	37,330
Credit to the private sector/GDP	50.2	46.0	40.7	38.2	38.1	37.9	n/a
Unemployment rate	9.7	8.7	7.4	6.3	8.1	7.6	n/a
Real unit labor costs (index 2015=100)	103.6	104.7	106.3	108.9	116.7	113.1	n/a
World Competitiveness Ranking (rank)	37	40	40	40	41	38	n/a
Life expectancy at birth (years)	74.9	74.9	75.1	75.7	75.5	73.4	n/a
Institutional Structure							
WGI Rule of Law (score)	1.0	0.9	1.0	1.0	1.0	n/a	n/a
WGI Control of Corruption (score)	0.4	0.5	0.3	0.5	0.7	n/a	n/a
WGI Voice and Accountability (score)	0.8	0.8	0.8	0.9	0.9	n/a	n/a
WGI Government Effectiveness (score)	1.0	0.9	1.0	1.1	0.9	n/a	n/a
HICP inflation rate, y-o-y change	0.1	2.9	2.6	2.7	0.1	3.2	9.2
GHG emissions (tons of CO2 equivalent p.c.)	5.7	5.8	6.1	6.1	n/a	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	0.0	-0.8	-0.8	-0.6	-4.5	-7.3	-7.0
General government gross debt/GDP	40.4	39.0	37.1	36.7	43.3	44.8	46.2
Interest/revenue	2.7	2.5	1.9	1.8	1.7	1.3	n/a
Debt/revenue	107.6	102.8	96.2	97.5	111.6	119.2	n/a
Total residual maturity of debt securities (years)	5.3	7.5	8.1	9.9	9.2	9.4	n/a
Foreign exposure							
Current account balance/GDP	1.6	1.3	-0.2	-0.7	2.9	-2.9	n/a
International reserves/imports	0.2	0.3	0.2	0.2	0.3	0.2	n/a
NIIP/GDP	-54.2	-51.4	-45.2	-40.1	-34.7	-28.1	n/a
External debt/GDP	147.3	141.4	123.3	116.8	124.8	112.0	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

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 and the Central Bank of Latvia participated in the credit rating process as they 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 and the Central Bank 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, 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, 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 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
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: Michael Bruns
HRB 10522, Amtsgericht Neuss