

| Rating Object | Rating Information | |
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| REPUBLIC OF LATVIA | Assigned Ratings/Outlook: A /stable | Type: Follow-up Rating, 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: | 26-08-2016 18-08-2017 |
| | Rating Methodologies: | "Sovereign Ratings" |

Rating Action

Neuss, 18 August 2017

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. Latvian GDP set to expand at robust rates in 2017-18 on the back of strengthening domestic demand, after growth fell short of expectations due to a sharp decline in investment last year
2. Latvia's macroeconomic performance is subject to a high degree of volatility, as the economy features a small domestic market, high degree of trade openness and high dependence on EU funds
3. Generally high quality of institutional set-up which continues to improve, but further efforts needed to catch up with EA-19 levels; growth-friendly business environment
4. Track record of prudent budget execution and forward-looking debt management strategy resulting in low levels of public debt, modest deficits and a moderate share of foreign currency debt; tax reform not likely to put the sustainability of public finances at risk
5. External risks pertaining to large external liabilities, in particular in the banking sector, balanced against moderate current account deficits and a stabilization of the net international investment position in the recent past

Reasons for the Rating Decision

We assess that the sovereign's creditworthiness continues to be mainly supported by sound fiscal policy-making which is reflected by moderate budget deficits and low levels of general government debt over the recent years. Since Latvia left the Excessive Deficit Procedure in 2013, headline deficits have averaged at a moderate 1.0% of GDP (2013-16). After net borrowing stood at -1.3% of GDP in 2015, the government achieved a balanced budget last year (0.0% of GDP). Thus, the actual budgetary outcome was significantly better than forecasted by the government in its 2016 stability program (-1.0% of GDP). The better-than-expected fiscal performance can be mainly attributed to favorable

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developments affecting both the revenue and expenditure side of the budget. Despite the fact that economic growth fell somewhat short of our expectations, general government revenue grew by a solid 4.3% to EUR 9.1bn. Driven by vivid wage growth and buoyant domestic demand, VAT receipts (+8.3%) and taxes on income and wealth (+9.7%) experienced strong increases. Also, the state revenue benefited from some discretionary income last year. In the course of investigations on money laundering, funds worth 0.2% of GDP, which were deposited in Latvian banks, were declared illegal and confiscated by the state. Turning to the expenditure side of the budget, higher spending on social benefits and employee compensation was partly offset by a lower-than-anticipated absorption of ESI funds and a further decline in interest spending.

Given the initial budgetary position, which was more favorable than expected, Latvia's 2017 budget is slightly expansionary, as the increase of certain taxes (higher micro enterprise tax rates) and savings identified in last year's spending review should not be sufficient to counter-finance additional government outlays. With the aim of honoring commitments of Latvia as a NATO member, the government intends to ramp up spending on internal security and defense. Moreover, the authorities have budgeted higher healthcare expenditure for 2017. Latvia's public spending on healthcare was among the lowest in the EU-28 (3.8% of GDP) – with adverse consequences for the Latvian population. Although some progress has been achieved in recent years, Eurostat data indicates that unmet healthcare needs are still more common than in most other EU-28 member states, as access to healthcare is restricted by waiting lists and high out-of-pocket payments. Taking into account that income inequality in Latvia is among the highest in the EU-28, low-income earners are facing problems accessing health care services. To improve both access to and quality of medical treatment, the Latvian health system is currently undergoing a major reform. Starting in 2017, additional funds will be provided to improve the treatment of oncological patients, reimburse medicine for Hepatitis C and reduce waiting queues to medical specialists.

We expect Latvia's headline deficit to be at 0.7% of GDP this year. Going into 2018, the deficit should continue to widen as the tax reform recently approved by the Saeima (28 July 2017) will come at the cost of lower revenues. The reform is aiming to lower income inequality and improve the competitiveness of the corporate sector. As regards personal income taxation, the current personal income tax regime with a unified tax rate of 23% will be replaced by a more progressive regime with three tax brackets. Moreover, the tax-free allowance as well as the minimum wage will be raised, which should benefit low- and middle-income earners. To incentivize higher corporate investment, reinvested earnings will be exempted from taxation. Although the reform package also includes some revenue-enhancing measures (higher corporate income tax rate, increase in excise duties and social security contributions), we assume that additional net borrowing will be needed to finance the tax reform.

In our view, the aforementioned measures are not likely to put the sustainability of public finances at risk, given Latvia's low levels of general government debt. Although the government's debt-to-GDP ratio increased from 36.5 (2015) to 40.1% (2016), this was the third-lowest reading in EA-19 (behind Estonia and Luxembourg) and is the lowest level of

general government debt among our A-rated sovereigns. Last year's increase in government debt was mainly a result of debt management operations, namely the prefunding of a USD 1bn bond which matured in Feb-17. Looking forward, debt-to-GDP should gradually decrease, largely driven by strong growth. Furthermore, we expect the sovereign to draw on its cash buffers. As of Q1-17, Latvia's cash position amounted to 6.4% of GDP (Q1-16: 3.2% of GDP). What is more, outstanding government debt continues to be structured favorably in terms of currency composition and maturity. According to treasury data, short-term and foreign currency debt accounted for only 11.4 and 12% of the government's total debt stock in Q2-17, respectively.

Meanwhile, we regard contingent liability risks for the government's budget as rather limited, mainly due to the structure of Latvia's banking sector. Currently, the domestic banking market is characterized by a large presence of foreign-owned, mainly Nordic banks. In general, the Latvian banking sector is well capitalized and asset quality further improved in 2016. While the CET1 ratio was reported at 18.6% (Q1-17), up from 17.3% a year before, the NPL ratio for the resident portfolio dropped from 4.6% to a low 3.3% between Q2-16 and Q2-17 (FCMC data). Meanwhile, non-resident deposit (NRD) banks with a business focus on Russia and the CIS countries are facing a tighter regulatory environment, after some of these banks had been involved in illegal transactions and money laundering in the past. In September and November 2016, the Financial and Capital Market Commission (FCMC) issued amendments to Latvia's existing AML/CFT framework. The new regulations aim to ensure minimum requirements for the risk management of money laundering and terrorist financing, and for a transparent compilation of information about customers and their transactions. Ongoing deposit outflows on behalf of non-residents can at least partly be attributed to higher regulatory requirements imposed on NRDs. After NRDs in Latvian banks fell by 14.4% in the second half of 2016, a further drop of 8.1% was observed between January and June 2017. At the same time, the share of NRDs decreased from 48.5 to 41.8% of total deposits raised by MFIs. However, as NRD banks play no significant role in lending to the domestic economy, we believe that the withdrawal of funds should have only a minor impact on credit supply.

Latvia's macroeconomic performance continues to be subject of elevated volatility, making forecasts somewhat challenging. Sharp swings in economic activity are mainly due to the small size of the domestic economy (2016 GDP: EUR 25.0bn), coupled with its high degree of openness (trade-to-GDP ratio: 115.4%). Hence, growth is comparatively sensitive to external economic developments. Moreover, the country exhibits a large dependence on EU funds when it comes to investment. Over the programming period 2007-13, Latvia received EU-funds worth EUR 5.2bn and EUR 5.6bn over the period 2014-20, accounting for about a half of total public investment.

The importance of EU funds to the Latvian economy also explains modest growth in 2016, which came in at 2.0% last year, significantly slower than in 2015 (2.7%). Due to a lower-than-expected absorption of EU funds and delays in fund implementation related to the reorganization of the national contracting framework, gross fixed capital formation sharply contracted by 11.7%. In the same vein, net trade curtailed GDP expansion, as imports experienced stronger growth than exports. Thus, Latvian GDP growth was entire-

ly driven by strong domestic consumption in 2016. Both public and private consumption expenditures continued to increase at robust rates contributing 2.1 and 0.5 p.p. to total growth. While public consumption was up 2.7% on the back of higher spending on employee compensation and social benefits, private household spending was boosted by rising real disposable income.

As regards Latvia's economic prospects, we expect GDP growth to accelerate, fueled by robust growth of private consumption and a recovery in investment. Thus, the composition of growth should become more balanced this year, with private consumption and investment contributing equally to the economic expansion. Underpinned by sustained wage growth, we forecast private consumption to expand at similar rates as in 2016, but purchasing power gains should be limited by rising inflation rates (2017e: 2.7%, 2016: 0.1%). Against the background of high and rising capacity utilization in the manufacturing sector, a higher absorption of EU funds, and returning credit growth, investment activities should see a turnaround this year. Firstly, capacity utilization stands at 74.5% (Q3-17), close to its historical peak of 75.3% in Q3-05. Secondly, ESIF implementation has accelerated over the recent year and we expect a higher rate of project selection going forward. Recent data on the implementation progress shows that financial resources allocated to selected projects increased from EUR 0.61bn at the end of 2015 to EUR 2.21bn by end-2016 (32.0% of planned investment). And thirdly, loan growth is gradually recovering, as credit to non-financial corporations rose by 0.9% y-o-y in Jun-17 (May-17: 0.6%, Apr-17: 4.1%), after turning the corner at the end of last year. On the external side, exports should benefit from improving growth prospects in Latvia's main trading partners. In this regard, exports to Russia and CIS countries have seen a strong rebound since Q4-16 and are set to lift export growth going forward. However, as we expect a pick-up of investment which should boost import demand, we believe that net exports will continue to drag on GDP growth. As a result, we expect GDP to increase by 3.4% in 2017 and 3.6% next year. Our forecast is supported by quarterly data, indicating strong economic activity in the first half of the year. Growth in Q1-17 came in at 4.1% y-o-y (seasonally and calendar adjusted), the highest rate in four years, with investment rebounding strongly. According to a flash estimate published by CSB Latvia, growth gained further momentum in Q2, expanding at rate of 4.8%.

Notwithstanding that the Latvian economy should experience relatively strong growth this year, medium-term growth prospects are challenged by comparably low levels of investment and a shrinking labor force. As of 2016, Latvia's investment-to-GDP ratio of 18.3% was the lowest among the Baltics (LT: 18.6; EE: 22.0%; EA-19: 20.1% of GDP) and has been rapidly declining since 2012 (25.4% of GDP). At the same time, emigration shows no sign of abating yet, with 12.229 inhabitants leaving the country on a net base – most of them at working age. Since Latvia joined the EU in 2004, net outward migration in the age group 15-64y totaled at about 184.000. In view of this, the substantial decrease in unemployment since 2010 (19.5%) should be interpreted with caution. Down from 9.9% in 2015, the unemployment rate dropped for the sixth consecutive year and posted at a still high 9.6% in 2016, as the working age population decreased at a faster pace than employment.

Going forward, an ageing population will put further pressure on labor supply and in turn impede employment growth. The EU Commission estimates that the share of the elderly population (>65y) will increase from currently 19.9% (2017) to 25.5% by 2030. To some extent, labor supply may be raised by higher spending on active labor market policies, which posted at a low 0.1% of GDP in 2015 (OECD average: 0.5% of GDP), as well as by the implementation of measures to reduce skill mismatches. While unemployment among workers with less than lower secondary education remains well above the 20%-mark, the unemployment rate of workers with tertiary education posted at a low 4.4% in 2016 and employers are facing skill shortages in some industries (e.g. IT and engineering). However, given that Latvia already exhibits high and rising activity rates (2016: 76.3% vs. EU-28: 72.9%), policies to foster labor supply should only have a limited effect on employment.

A shrinking workforce, together with rapidly rising wages, could also have negative repercussions on Latvia's external cost competitiveness. In 2016, real unit labor costs (ULC) remained on an upward trajectory, increasing at a rate of 4.0% y-o-y, while the euro area as a whole reported ULC growth of 0.0%. Thus, Latvia and the euro area continue to show diverging trends in real ULC. Last year's increase in ULC was largely driven by vividly growing wages. Although growth of real compensation per employee somewhat slowed to 6.1% (2015: 6.5%), this was more than sufficient to outpace real labor productivity, which expanded by 2.0% in 2016. The further trajectory of ULC has to be monitored closely. The same holds for HICP inflation, which has risen sharply since the turn of the year. The HICP 12-month moving average climbed from 0.1% in Dec-16 to 1.9% in Jun-17, standing well above the EA-19 and EU-28 average of 1.1%, respectively. Preserving cost competitiveness appears to be essential in order to support further convergence towards average EU income levels. At an estimated USD 25,710 (PPP terms), Latvian per capita income stood about 35% below EU-28 levels in 2016 and was the lowest among our A-rated sovereigns (median: USD 31,339).

Latvia's credit profile continues to be backed by the generally high quality of its institutional framework, which benefits from the country's integration in the European Monetary Union and the European Union. Although the sovereign receives lower rankings compared to the euro area median on all of the World Bank's World Governance Indicators (WGI), Latvia's current rankings reflect improvements with regard to the quality of public services and the prevalence of corruption. Latvia ranks 67th and 34th out of 209 countries on the WGI indices control of corruption and government effectiveness, up from rank 71 and 47 in the previous year's assessment. Notwithstanding the headway that has been made in the past, persisting inefficiencies in the public sector, as well as a procurement system which is prone to corruption, leave Latvia with ample room for further improvement. As measured by the shadow economy index compiled by the Centre for Sustainable Business, Latvia still features a large shadow economy, estimated at 20.3% of GDP in 2016, down from 21.3%, but higher than in Lithuania (16.5%) or Estonia (15.4%). To be sure, Latvia displays a relatively business-friendly environment. The World Bank's Doing Business report 2016-17 ranks Latvia's business environment 3rd within the euro area, mainly due to low corporate taxation and favorable conditions for start-ups.

Our ratings on Latvia remain constrained by the country's external position. In our view, the country is still exposed to elevated external risks resulting from a high degree of trade openness and sizeable external liabilities concentrated in the banking sector, in particular in the form of foreign deposits. Although Latvia's net international investment position (NIIP) has shown signs of stabilization over the last two years, net external liabilities still amounted to a high 58.2% of GDP in 2016 (2015: 62.5% of GDP). Admittedly, risks related to external indebtedness are somewhat mitigated by the composition of the NIIP. The largest part of net external liabilities can be attributed to FDI capital flows which we regard as less volatile than portfolio investment and other investment. As of 2016, net FDI accounted for approx. 80% of the economy's net external liability position. Furthermore, 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. In 2016, Latvia's current account turned positive for the first time in six years. On the back of improving terms of trade, subdued investment, and a stronger-than-expected budget outturn, the current account recorded a surplus of 1.5% of GDP (2015: -0.8% of GDP). However, we expect Latvia to run a small deficit again as accelerating investment activities and a more expansionary fiscal stance should drag on the current account balance in 2017.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of A 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 – will remain fundamentally unchanged in the near term.

We could consider a downgrade of our credit ratings if Latvia's medium-term growth should fall substantially short of our current expectations. Given its high degree of openness, Latvia is in particular sensitive to a slowdown of growth in the euro area Russia. Should the euro area experience a period of subdued growth, this would likely have a negative impact on Latvian exports and FDI inflows.

In the same vein, growth could be dented by increasing geopolitical tensions with Russia, which could result in a tightening of trade sanctions on the EU level. Domestic risks to our growth outlook mainly pertain to a faster-than-anticipated decline of the Latvian workforce. Alongside a materialization of growth risks, we could lower our ratings if we observed a significant deterioration of government finances – contrary to our current expectations.

Our rating could be raised if Latvia were to make faster-than-expected progress in debt reduction or improvements in its external metrics. The implementation of comprehensive reforms, which are suited to boost potential growth and income convergence, could also translate into a higher rating.

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Ratings*

Long-term sovereign rating A /stable

Foreign currency senior unsecured long-term debt A /stable

Local currency senior unsecured long-term debt A /stable

*) Unsolicited

Economic Data

| [in %, otherwise indicated] | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017e |
|---------------------------------------|--------|--------|--------|--------|--------|--------|--------|
| Real GDP growth | 6.4 | 4.0 | 2.6 | 2.1 | 2.7 | 2.0 | 3.4 |
| GDP per capita (PPP, USD) | 19,817 | 21,296 | 22,439 | 23,585 | 24,675 | 25,710 | 27,190 |
| Inflation rate, y-o-y change | 4.2 | 2.3 | 0.0 | 0.7 | 0.2 | 0.1 | 2.7 |
| Default history (years since default) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Life expectancy at birth (years) | 73.6 | 73.8 | 74.0 | 74.1 | 74.1 | n.a. | n.a. |
| Fiscal balance/GDP | -3.3 | -1.0 | -1.0 | -1.6 | -1.3 | 0.0 | -0.7 |
| Current account balance/GDP | -3.2 | -3.6 | -2.7 | -2.0 | -0.8 | 1.5 | n.a. |
| External debt/GDP | 133.8 | 141.2 | 139.0 | 130.7 | 138.9 | 140.3 | n.a. |

Appendix

Regulatory Requirements

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

The rating was conducted on the basis of Creditreform Rating's "Sovereign Ratings" methodology. Creditreform Rating AG 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 Creditreform Rating's rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality 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 and that the rating action was and is free of any existing or potential conflicts of interest. 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 Creditreform Rating's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

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