COUNTRY REVIEW

Latvia

25 February 2011

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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Strengths

- Low risk of systemic political instability
- Good international relations, EU and NATO membership
- Fairly strong business environment

Weaknesses

- Small industrial base
- Unfavourable export structure
- A currency peg has largely neutralised monetary policy, leaving fiscal policy as the major tool to steer the economy
- Overly rapid unwinding of previously large macroeconomic imbalances has been socially painful
- Still high fiscal deficit and surging public debt
- High external debt burden
- Modest foreign exchange reserves in relation to annual external debt payments
- Banking sector highly vulnerable to external shocks and liquidity pressures
- The refinancing of maturing external debt will remain difficult for banks and companies amid still tight lending conditions

Country Risk Assessment

Ratings	**Latvia**		**Median**	**Median**	**Peers**	
	Latest	**Previous**	**Grade C**	**Grade D**	**Turkey**	**Macedonia**
Systemic Political Risk:	**P2+**	**P2+**	**P2-**	**P3+**	**P3+**	**P3+**
Systemic Economic Risk:	**E5**	**E6**	**E5**	**E6**	**E5**	**E6**
ME rating:	ME5	ME6	ME5	ME6	ME5	ME6
Structure	*4.0*	*4.0*	*5.9*	*6.0*	*4.0*	*4.0*
Policy	*5.6*	*5.6*	*5.2*	*5.6*	*5.8*	*4.6*
Solvency	*5.9*	*6.0*	*2.8*	*4.3*	*3.3*	*6.0*
External Liquidity	*3.8*	*6.0*	*4.2*	*4.8*	*6.0*	*6.0*
SBE rating:	SBE2	SBE2	SBE4	SBE5	SBE3	SBE4
COUNTRY GRADE:	**C**	**D**			**C**	**D**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Riga
Population:	2.261 mn (2009)
GDP:	USD 25652 mn (2009)
Currency:	Lat (LVL)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Valdis DOMBROVSKIS (since March 2009)
Next elections:	Presidential: June 2011 / Legislative: October 2014

Major Industries (% of GDP at market prices, 2009)	
Services	76.1%
Real estate, renting & business activities	20.0%
Industry	20.6%
Manufacturing	9.9%
Agriculture	3.3%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr)	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	80	110

* Major economies

Main Exports (% of total, 2009)	
Food and agricultural products	18.6%
Wood and articles of wood	16.5%
Machinery, mech. & electr. equipment	14.1%
Base metals and articles thereof	12.4%
Chemicals	8.5%

Main Imports (% of total, 2009)	
Food and agricultural products	18.3%
Chemicals	17.2%
Machinery, mech. & electr. equipmen	15.7%
Wood and articles of wood	11.8%
Base metals and articles thereof	8.1%

Lead Export Markets (% of total exports, 2009)	
EU-12 (new members since 2004)	36.9%
Lithuania	16.4%
Estonia	14.4%
EU-15	34.9%
Germany	8.7%
CIS	13.9%

Lead Import Markets (% of total imports, 2009)	
EU-12 (new members since 2004)	37.9%
Lithuania	17.0%
EU-15	37.3%
Germany	11.5%
CIS	15.9%
Russia	10.7%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	28,980	33,725	25,653	24,141	25,153
Population (mn)	2.28	2.27	2.26	2.25	2.25
GDP per capita (USD)	12,705	14,850	11,346	10,715	11,194
Real GDP growth (% yr/yr)	10.0	-4.2	-18.0	-0.3	3.0
Inflation (HICP; %, eop)	14.0	10.4	-1.4	2.4	2.5
Fiscal balance (ESA 95; % of GDP)	-0.3	-4.2	-10.2	-8.5	-6.0
Fiscal balance (incl. bank restructuring costs; % of GDP)	-0.3	-8.2	-10.9	-12.0	-7.7
Public debt / GDP (ESA 95; %)	9.0	19.7	36.7	46.0	52.0
Current account balance (% of GDP)	-22.2	-13.3	8.9	3.8	2.0
Gross external debt / GDP (%)	134.5	125.3	163.0	165.7	167.0
Net external debt / GDP (%)	52.1	55.0	61.2	58.0	63.6
Gross external debt / Exports of goods & services (%)	326.6	298.2	372.3	316.9	325.6
Debt-service ratio (%)	37.6	42.3	57.3	47.5	47.7
Foreign exchange reserves (EUR mn)	3,824	3,541	4,483	5,382	5,000
Import cover (months)	3.5	3.3	6.5	6.7	5.9
Exchange rate assumption, LVL:USD (av)	0.51	0.48	0.51	0.53	0.55
Exchange rate assumption, LVL:EUR (av)	0.70	0.70	0.71	0.71	0.71

f: CRU central forecast

Sources: National figures, IMF, Eurostat, ECB, IHS Global Insight, Euler Hermes Economic Studies

Political Stability

Latvia is a well-established democracy and a member of NATO and the EU. Some ethnic tensions still exist as around one third of Latvia's population is ethnic Russian. However, civil violence is unlikely as the problems have waned in recent years. The risk of systemic political instability is low even though the post-independence political environment has been beset by continued government instability, with frequent collapses in government. In the past, government changes have not resulted in abrupt policy changes, since a majority of parliamentarians are on the centre-right ideologically. Critically, however, government instability has often impeded efficient and decisive economic policies.

The latest government collapse took place in February 2009 when then PM Godmanis resigned, following massive popular protest against the impact of the deep global and domestic economic crises as well as the IMF- and EU-backed austerity programme launched in December 2008. A new five-party, centre-right coalition government—comprising New Era, Civic Union, People's Party, Union of Greens and Farmers (ZZS) and For Fatherland and Freedom-Latvian National Independence Movement (TB-LNNK)—under new PM Dombrovskis took office in March 2009. But the political turmoil and change in government was accompanied by a standstill in policymaking such that required fiscal targets and structural reforms were not met, causing a four-month delay of urgently needed funding from the IMF and the EU, which brought Latvia at the brink of financial collapse. But since mid-2009 or so, the Dombrovskis government gained ground and was able to implement tough austerity measures and to resume continued donor funding. The reduction of the government to a four-party minority administration in March 2010 owing to the withdrawal of the People's Party from the coalition did not end its relatively successful crisis management. And in the October 2010 legislative election, held on schedule, the electorate rewarded the ruling parties with an increased share of the votes, PM Dombrovskis was re-elected and formed a new two-party coalition government comprising the Unity bloc (recently formed, includes New Era, Civic Union and Society for Different Politics) and the ZSS, which has a majority of 55 out of 100 parliamentary seats. This should be sufficient to continue the austerity course.

Economic Stability

The World Bank classified Latvia as a high income country in a survey from July 2010, based on GNI per capita of USD12,390 in 2009. The economy appears quite advanced, with services accounting for about 76% of GDP, industry 21% and agriculture 3% in 2009. However, the manufacturing base (just 10% of GDP) is very small for an emerging market that probably needs continued strong external demand to achieve long-term, sustainable and high growth. Moreover, the export structure is also unfavourable: In 2009, Lithuania accounted for 16.4% of Latvia's merchandise exports, Estonia 14.4%, CIS economies 13.9% and all fellow members of the EU-27 together for 71.8%, making the economy vulnerable to the business cycles of these economies. Real GDP grew by an average annual 8.6% in 2000-2007, however, in large part this was due to an overheating of the economy, which was reflected in mounting macroeconomic imbalances such as an excessive credit boom that fuelled domestic demand and caused a housing bubble, elevated inflation and unsustainably high current account deficits. In the wake of the global financial and economic crisis, this growth model collapsed and the economy fell into deep recession, with a cumulative output decline of more than 21% in 2008-2009.

In 2010, real GDP continued to contract by 6% yr/yr in Q1 and by 2.1% in Q2, but returned to growth of 2.9% in Q3 (the first increase since Q1 2008) and 3.7% in Q4 (preliminary estimate). These figures suggest that full year 2010 GDP contracted by 0.3%. The turnaround in Q3 2010 was supported by a modest recovery in private consumption (+2.5% yr/yr) and inventory re-stocking which caused a 3.5% increase in gross capital formation, though net trade made the largest contribution to growth as exports expanded stronger than imports. Assuming that domestic demand will continue to recover only gradually and external demand may weaken, we forecast real GDP growth of about 3% in 2011.

Economic policy contains high risks. Monetary policy has been focused on maintaining the fixed (narrow-band) exchange rate regime. The lat (LVL), the local currency, is pegged closely to the euro within the EU's Exchange Rate Mechanism II (ERM-II, a 2-year waiting room prior to entry to the European Monetary Union—the euro zone), in a narrow ±1% band around its central parity rate of 0.7028 lats/euro (although ERM II officially allows a band of ±15%). As a consequence of the currency peg, however, monetary policy instruments of the Bank of Latvia (BoL; the central bank) have had a limited impact on curbing inflation (which peaked at 17.9% yr/yr in May 2008) and excessive credit growth (which remained above 50% yr/yr until mid-2007) and, ultimately, in moderating the once-overheating economy in 2004-2007. This left fiscal and structural policies as the major instruments to rein in demand pressures and cool the economy. However, Latvia's rapid economic growth in those years had disguised lax fiscal policy and large structural fiscal deficits as the actual fiscal accounts remained near-balanced despite an 80% increase of real expenditure between

2003 and 2007. Structural policies (e.g. public wages, health care, pensions) had also been neglected.

Several aspects raised serious concern about the stability of the currency peg in Q2 2009. The most important factors were a rapid 33% drop in foreign exchange (FX) reserves from February to May 2009 (suggesting sharply increased pressure on the exchange rate), a more than 20% real effective exchange rate overvaluation (indicating high vulnerability to a considerable depreciation at some point), the failure of a local LVL50mn (EUR70mn) government bond auction in June 2009 (signalling that locals had lost confidence in the currency peg), and ongoing delays of scheduled EU and IMF disbursement (increasing the risk of a deep financial crisis). However, thanks to decisive policy action by the government since mid-2009 that brought donor funding back on track, Latvia's currency peg has withstood the pressures from the domestic and the global financial crises. Meanwhile, official FX reserves of the central bank have roughly doubled from a low of EUR2.6bn in June 2009 and cover more than 200% of the monetary base. And the real effective exchange rate overvaluation (as compared to the previous 60 months) has decreased to a modest 3.3% in December 2010. Fears of a devaluation have largely dissipated as the overall economic situation has improved and the government again appears firmly committed to defend the currency peg. It takes the view that devaluation now would be more costly than maintaining the current system. However, this view could in principle change at some point, especially if the economic performance fails to improve further and popular resistance to fiscal austerity increases. Other downside risks to the central case scenario, that the currency peg holds, include a loss of domestic confidence in the banking system and contagion from other crises.

'Internal devaluation', i.e. massive real wage cuts and sharp fiscal tightening, helped to reduce inflation gradually from a peak of 17.7% yr/yr (on the EU's HICP) in May 2008 and, combined with the sharp decline in domestic demand, shifted it to a prolonged period of deflation from October 2009 to August 2010. Since then, inflation has accelerated again, partly owing to base effects, and stood at 3.5% yr/yr in January 2011. We forecast annual average inflation of about 3.2% in 2011.

Private-sector credit growth was excessive for a long time, peaking at 63% yr/yr in early 2006, and remained unsustainable until at least Q1 2008, when it still stood at 25%. Then, as a result of the sharp global liquidity tightening, credit growth slowed rapidly and annual private sector credit has been contracting since Q3 2009, a necessary adjustment which, however, has affected economic recovery.

In the wake of the economic downturn in 2008-2009, as sharply lower growth led to lower fiscal revenues, the fiscal deficit rose rapidly to 4.2% of GDP in 2008 and 10.2% in 2009 (in ESA95 terms and excluding bank restructuring costs). But the ratio would have been even higher, had the IMF/EU loan programme not required unprecedented fiscal adjustments that have been largely met since mid-2009. In February 2010, the IMF extended its Stand-By Arrangement by nine months to December 2011. The fiscal deficit to GDP ratio targets for 2010 and 2011 are 8.5% and 6%, respectively. Preliminary data suggest that the 2010 deficit came in close to target and we forecast the same for 2011 as the government has planned further austerity measures. Meanwhile, total public debt has surged from just 9% of GDP in 2007 to about 46% in 2010.

The current account swung from a deficit of 13.3% of GDP in 2008 to an 8.9% surplus in 2009, as imports (in line with domestic demand) contracted even sharper than exports. In 2010 the current account surplus narrowed to about 3.8% of GDP; and December 2010 saw the first monthly deficit since two years. We forecast the annual current account surplus to decline to about 2% of GDP.

FX reserves reached a peak of EUR4.2bn in September 2008 but dropped sharply by 37% to EUR2.6bn in June 2009. Supported by disbursements under the IMF/EU loan programme, reserves have recovered since then and stood at EUR5.4bn at end-2010, sufficient to cover more than six months of imports.

Gross external debt reached a peak of EUR29.8bn in Q4 2008 but has since remained slightly below that level, standing at EUR28.9 bn in Q3 2010. However, the significant fall in nominal GDP and exports during the crisis means that the external debt burden continued to rise as a share of GDP (from 125% at end-2008 to about 165% in Q3 2010) and export earnings (from 298% to 315%). Even taking into account the considerable assets held abroad by Latvian institutions, the debt position is critical: Net external debt rose from a manageable 25% of GDP in 2003 to a worrisome 61% in 2009 and has fallen only slightly to an estimated 58% in 2010.

As of Q3 2010, the public sector accounted for 20% of gross external debt (5% in Q3 2008), direct investment 11% (9%), banks 48% (65%) and private companies 21% (the same as in Q3 2008).

External debt-servicing has been difficult for many years and will remain so, estimated at close to 50% of export earnings in 2011. Total external debt payments (ST debt and principal repayments on

MT/LT debt) due in 2011 are estimated to be more than twice the level of current FX reserves. As a result, there is still significant roll-over risk as the refinancing of maturing external debt will remain difficult amid still tight lending conditions. Disruptions in the banking and corporate sectors cannot be ruled out yet.

Structural Business Environment

The Structural Business Environment is generally strong. Latvia is ranked 49th out of 212 economies in our assessment overall, just behind Lithuania (44th) but ahead of Hungary (52nd).

However, the global financial crisis illustrated that the banking sector is highly vulnerable to external shocks and liquidity pressures. About 60% of banking assets is controlled by subsidiaries of Nordic banks that played a leading role in funding the credit and housing boom until 2007. The banking sector's foreign liabilities increased to 86% of GDP and accounted for over 80% of total liabilities. Bank's over-exposure to real estate materialised rapidly after the property bubble burst in 2007-2008 (real estate prices are estimated to have fallen by over 60%), calling into question the value of bank assets. The parent banks of the foreign-owned institutions maintained credit lines to their subsidiaries as they had committed under the IMF/EU-led financial rescue package. However, 60% foreign bank ownership in Latvia is much lower than in Estonia (96%) and Lithuania (85%). The other 40% of banking assets in Latvia is mainly controlled by domestic banks (though there are also some small Russian-owned banks). These banks rely on more fragile forms of foreign financing, mainly short-term loans and non-resident deposits, which faced considerable redemption pressures amid the worsened global liquidity conditions in late 2008. In November 2008, the government was forced to take over the largest domestic bank (and second largest overall), Parex, as it suffered large withdrawals of deposits. Parex was reportedly having problems rolling over foreign debt in the context of the intensified global financial crisis. Meanwhile, the Latvian authorities have strengthened financial supervision and improved their crisis management capacity, but the impact of the crisis continues to have an effect. In March 2010, banks were still making large losses and the ratio of nonperforming loans in total loans had increased to 18%. The banking sector's foreign liabilities still account for more than 80% of total liabilities and the foreign-currency exposure of Latvian private borrowers is very high at about 86% of total loans. As the number of household and corporate insolvencies is likely to remain high, further disruptions in the banking sector are possible.

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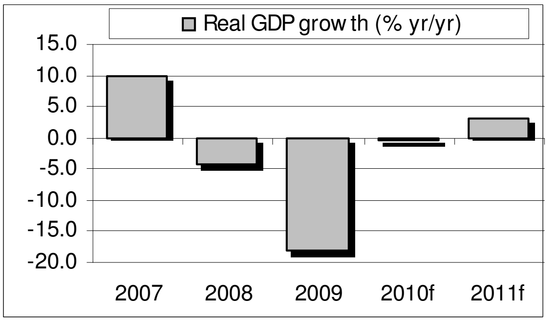
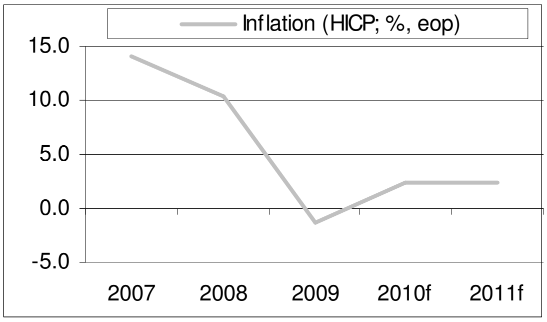
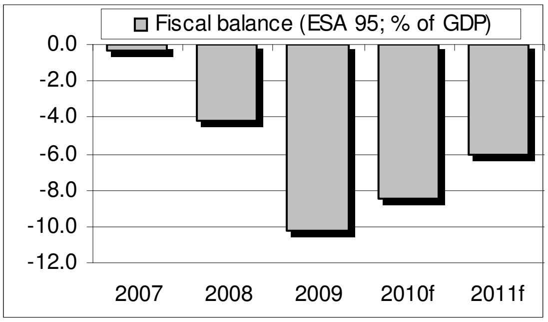
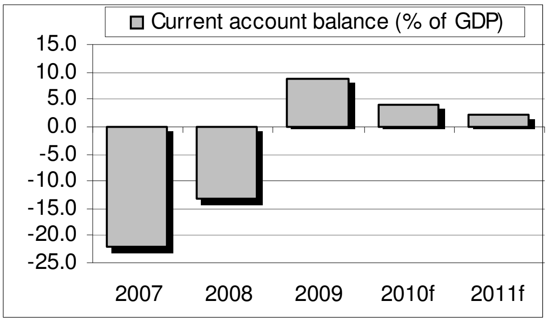
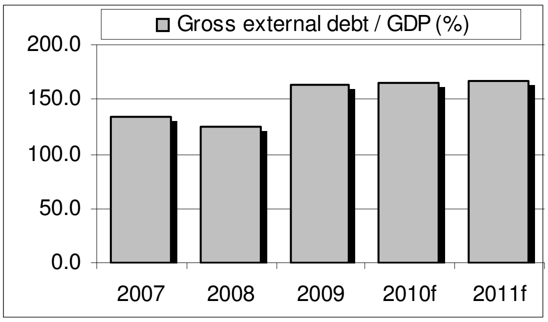
Charts

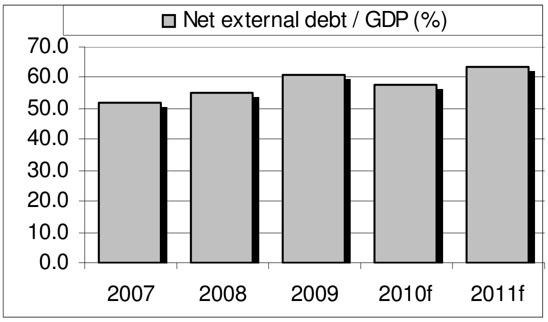

Real GDP growth (% yr/yr)
15.0
10.0
5.0
0.0
-5.0
-10.0
-15.0
-20.0
2007
2008
2009
2010f
2011f

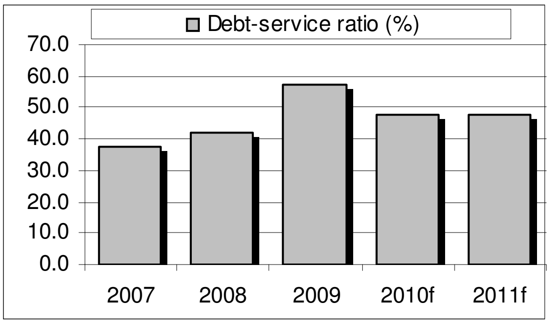

Inflation (HICP; %, eop)
15.0
10.0
5.0
0.0
-5.0
2007
2008
2009
2010f
2011f

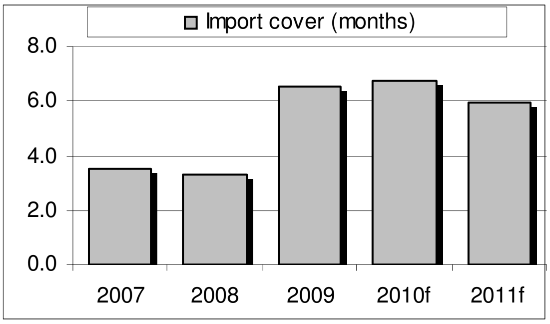

Fiscal balance (ESA 95; % of GDP)
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
15.0
10.0
5.0
0.0
-5.0
-10.0
-15.0
-20.0
-25.0
2007
2008
2009
2010f
2011f


Gross external debt / GDP (%)
200.0
150.0
100.0
50.0
0.0
2007
2008
2009
2010f
2011f


Net external debt / GDP (%)
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


Debt-service ratio (%)
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


Import cover (months)
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f