Euler Hermes
Economic
Research

Country Report

Latvia

Growth is weakening but economy remains resilient

General Information

GDP	USD28.374bn (World ranking 92, World Bank 2012)
Population	2.03 million (World ranking 146, World Bank 2012)
Form of state	Parliamentary democracy
Head of government	Laimdota STRAUJUMA
Next elections	2015, presidential

Strengths

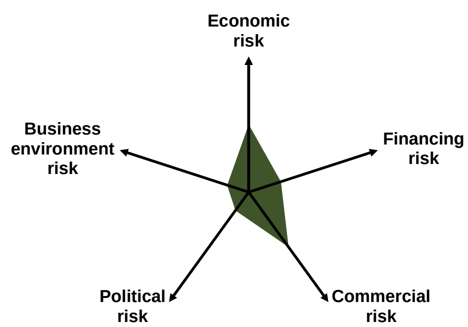
- Low systemic political risk
- Good international relations, with accession to the Eurozone in January 2014
- Sustained economic growth after the deep economic crisis in 2008-2010
- Low inflation
- Solid public finances and access to international capital markets
- Strong business environment

Weaknesses

- Very high external debt burden
- Domestic credit continuously contracting since the crisis
- Small industrial base
- Unfavourable export structure, largely dependent on Russia and other Baltic States.
- Banking sector vulnerability

Country Rating

BB1



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Lithuania	15%	1	30%	Russia
Estonia	12%	2	12%	Lithuania
Russia	11%	3	11%	Belarus
Germany	6%	4	6%	Germany
Netherlands	5%	5	5%	Estonia

By product (% of total)

Exports		Rank		Imports
Refined Petroleum Products	17%	1	34%	Refined Petroleum Products
Non-Edible Agricultural Prod.	8%	2	5%	Paints
Iron Steel	5%	3	2%	Natural Gas
Beverages	5%	4	2%	Miscellaneous Hardware
Wood Articles	4%	5	2%	N.E.S. Products

Source: Chelem (2012)

Economic Overview

Having largely recovered from the global crisis, the economy is now suffering from low prospects in the EU and Russia

After several years of overheating and rising macroeconomic imbalances until 2007, the economy experienced a hard landing and fell into a severe, protracted recession (-17.7% in 2009). A sound recovery began in H2 2010, resulting in real GDP growth of +5.3% in 2011, +5% in 2012 and +4.2% in 2013, making Latvia the fastest growing economy in the EU over the past years.

The recovery was driven by robust private consumption, soaring investment (until mid-2012) and solid external demand. However, growth is forecast to decelerate to +2.3% in 2014 on the back of the weaker-than-expected economic recovery in the Eurozone (Euler Hermes expects an average growth of +0.7% in 2014), coupled with the impact of the crisis in Russia which accounts for 11% of Lithuanian exports (rank 3 among export destinations) and 30% of imports (rank 1 among import origin countries). In the first nine months of 2014, nominal exports of goods to Russia declined by -2.7% y/y. In 2013 exports to Russia had increased by +3.3% to EUR1.2 bn.

As a result of weaker export expansion, combined with a robust increase in imports, net exports should contribute negatively to GDP growth in 2014 while domestic demand will be the main driver. In 2015, external demand is likely to recover gradually and growth is forecast to pick up slightly to +2.6%. Downside risks to this forecast include a potential serious escalation of the conflict between the EU and Russia over Ukraine, while lower energy prices in 2015 are an upside risk.

Insolvencies are slightly going up but still below pre-crisis levels

Insolvencies are forecast to slightly pick up from 820 cases in 2013 to around 880 cases in 2014 (+7.3%) before falling to approximately 850 cases in 2015. This will still be about -16% below the pre-crisis level (average annual 1,014 cases in 2000-2007).

The banking sector is gradually improving but remains reluctant to lend

Credit to the private sector has continued to decline (-6.4% y/y in August 2014) since the credit bubble burst in 2009 and currently accounts for about 56% of GDP (89% in 2007, prior to the financial crisis). Private agents remain burdened with legacy debts, while banks have significantly tightened lending standards since the crisis, making the recovery slower. According to the IMF, the banking sector as a whole has returned to profibility in 2012 and capital and liquidity ratios are adequate. Non-performing loans to total loans have declined from a peak of 19% in 2010 to 8.3% in 2013, however, that ratio for households has remained higher at 13.4% in 2013 (slightly down from 15.9% in 2012).

Inflation is low

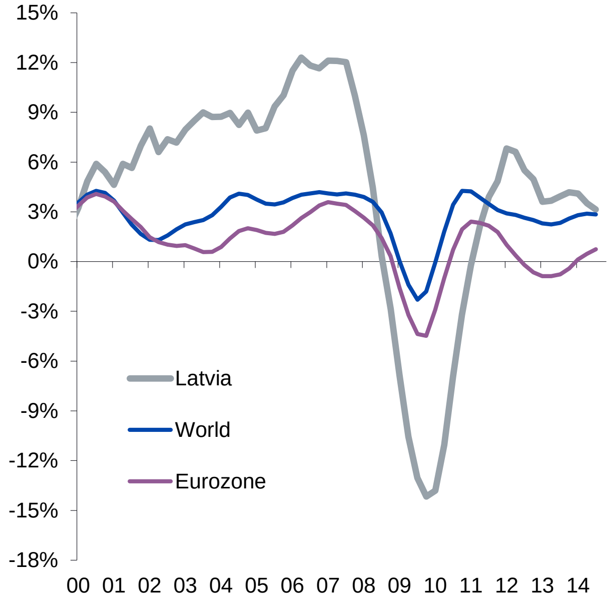
Inflation measured by the EU's Harmonised Index of Consumer Prices (HICP) has been subdued since early 2012 and even swung briefly into deflationary territory in 2013 (-0.5% y/y in December 2013). Inflation is forecast to pick up slightly to an average +0.7% in 2014, notably given strong job creation (unemployment rate down to 10.8% in June 2014 from 11.8% a year earlier). It is expected to further increase to +1.8% y/y by end-2015.

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	5.0	4.2	2.3	2.6
Inflation (%, end-year)	1.6	-0.5	0.8	1.8
Fiscal balance (% of GDP)	-0.8	-0.9	-1.2	-1.3
Public debt (% of GDP)	40.9	38.2	40.5	39.0
Current account (% of GDP)	-3.5	-2.2	-2.3	-2.5
External debt (% of GDP)	136.4	129.0	130.0	131.0

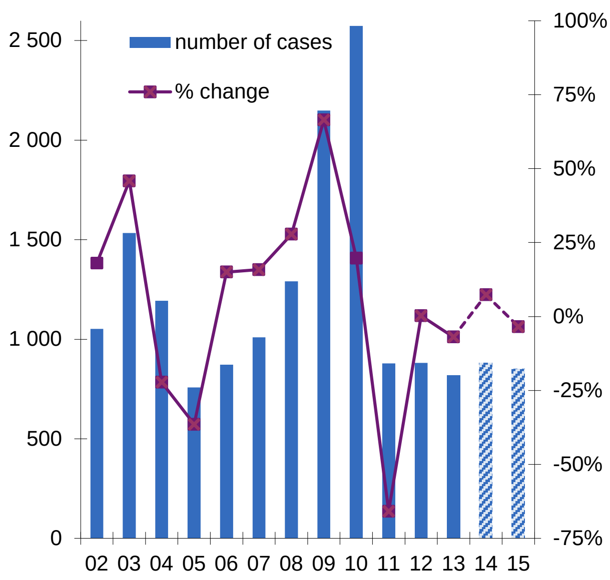
Sources: National sources, IHS, Euler Hermes

GDP growth (4Q cumulated, %)



Sources: National sources, IHS, Euler Hermes

Number of insolvencies and percentage change



Sources: National sources, Euler Hermes

The successful internal devaluation allowed the country to regain competitiveness

Following the hard landing of economy and the severe financial crisis and protracted recession in 2008-2010, the Latvian government embarked on a tough policy course of "internal devaluation" (massive real wage cuts and sharp fiscal tightening), supported by a USD10.5 bn IMF/EU-led bailout package. Eventually this led to an impressive rebalancing of the economy and the government's return to capital markets in mid-2011, while the existing currency peg was maintained. Growth has rebounded strongly since mid-2010. Thanks to the wage cuts, Latvia also regained competitiveness, reflected in the real effective exchange rate which is now about -9% below the peak in 2009.

The adoption of the euro in January 2014 should not change the picture since Latvia's currency was previously pegged to the euro for a long time.

Public finances are sound

Thanks to sharp fiscal tightening, the fiscal deficit has been reduced successively from -8.9% of GDP in 2009 to -0.9% in 2013. It is forecast to widen slightly to -1.2% of GDP in 2014 and 2015, still clearly fulfilling one Maastricht criterion for sound public finances (fiscal deficit below -3% of GDP).

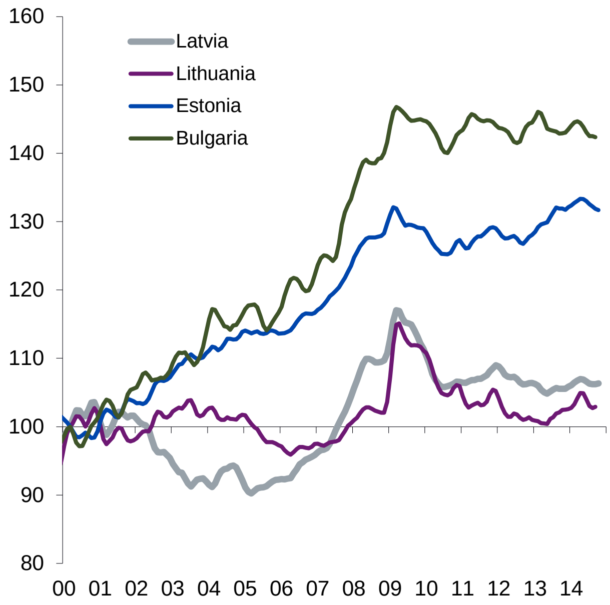
Gross government debt rose sharply from just 8.4% of GDP in 2007 to 46.8% in 2010 in the wake of the deep economic crisis. It has since fallen and should stabilise around 40% of GDP in the next few years, which is still relatively low by current EU standards and meets the other Maastricht criterion for sound public finances (government debt below 60% of GDP).

Current account close to balance, but external debt remains high

After years of unsustainably large annual deficits during the overheating period, the current account swung into a large surplus in 2009 (+8.0% of GDP), followed by a surplus of +2.3% of GDP in 2010, reflecting the rebalancing of the economy. It has moved back to moderate but unproblematic deficits thereafter. In 2013, the deficit was equivalent to -2.2% of GDP, and Euler Hermes expects similar deficits in 2014-2015. Net foreign direct investment inflows, which have more than covered the current account deficit in 2011-2012, have moderated since 2013, covering since about half of the deficit.

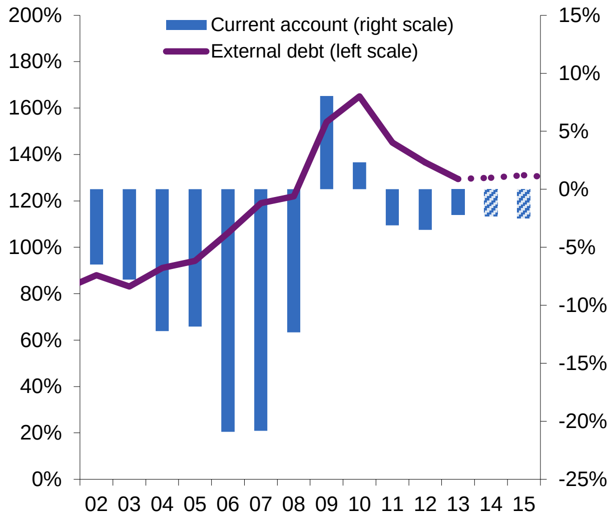
The external debt burden soared to an alarming level of 165% of GDP in 2009, built up by the earlier large current account deficits. Although the ratio has declined to about 130% of GDP in 2013, it is still very high and remains a cause of concern.

Real effective exchange rate (2000=100)



Sources: National sources, ECB, Euler Hermes

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

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