Euler Hermes Economic Research

Country Report

Latvia

Growth improves despite faltering external demand

General Information

GDP	USD31.921bn (World ranking 100, World Bank 2014)
Population	1.99mn (World ranking 147, World Bank 2014)
Form of state	Parliamentary democracy
Head of government	Laimdota STRAUJUMA
Next elections	2018, legislative

Strengths

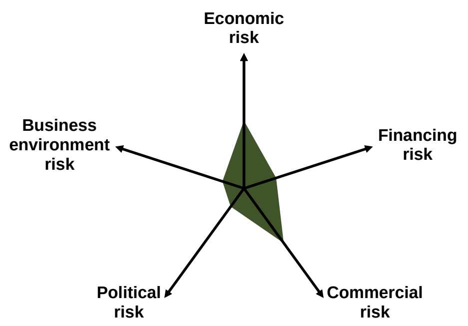
- Low systemic political risk
- Good international relations
- Eurozone membership provides for low transfer and convertibility risk
- Robust economic growth after the deep economic crisis in 2008-2010 and resilience to the crises in the Eurozone and Russia
- Solid public finances and access to international capital markets
- Strong business environment

Weaknesses

- Very high external debt burden
- Private sector credit still contracting (since the 2008-2010 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	16%	1	35%	Russia
Estonia	12%	2	11%	Lithuania
Russia	11%	3	6%	Germany
Poland	6%	4	6%	Poland
Germany	5%	5	6%	Estonia

By product (% of total)

Exports		Rank		Imports
Refined Petroleum Products	17%	1	35%	Refined Petroleum Products
Non-Edible Agricultural Prod.	8%	2	3%	Telecommunications Equipment
Beverages	5%	3	3%	Natural Gas
Wood Articles	4%	4	2%	Miscellaneous Hardware
Telecommunications Equipment	4%	5	2%	Plastic Articles

Source: Chelem (2013)

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Domestic demand powers growth

Following the financial crisis and severe recession in 2008-2010, Latvia's economy rebounded strongly and showed resilience to the unfolding Eurozone crisis, growing by an average annual +5.1% in 2011-2012, making it the fastest growing economy in the EU during that period. The recovery was broad-based but soaring gross capital formation was a particular growth driver. As a consequence, however, base effects led to declining capital formation in 2013-2014, curbing average annual growth to +2.7%, as well as in the first quarter of 2015. External trade activity has also decelerated recently as a result of sanctions on and the economic slowdown in Russia.

In Q1-Q3 2015, real exports expanded by just +2.2% y/y and real imports by +2.6% y/y. Hence net exports subtracted -0.3pps from annual growth in this period. Gross capital formation has recovered since Q2 2015 and in the first nine months of the year, fixed investment increased by +2.8% y/y while inventories still subtracted -0.4pps from overall y/y GDP growth (solely due to a sharp drop in Q1). Meanwhile, private consumption (+3.6% y/y) and public spending (+3.5% y/y) continued to expand robustly in Q1-Q3. Euler Hermes expects full-year GDP growth of +2.6% in 2015. The negative impact from Russia should fade next year as trade with the eastern neighbour should stabilise, such that an acceleration of economic growth to +3% in 2016 and +3.3% in 2017 is forecast.

Banking sector continues to improve but credit still tight

Private sector credit growth has remained negative (-2.9% y/y in September 2015) since the credit bubble burst in 2009. Private agents remain burdened with legacy debts, while the banks' significantly tightened lending standards after the crisis are only gradually eased, making the recovery slower. Meanwhile, capital adequacy and profitability in the banking sector overall have continued to improve. The share of non-performing loans to total loans has declined from 6.4% at end-2013 to 4.6% in Q1 2015.

Deflation to give way to mild inflation

Headline consumer price inflation has been subdued since early 2013 – as elsewhere across the Eurozone – averaging just +0.3% over the past three years. In September (-0.5% y/y) and October (-0.2% y/y) Latvia even returned to mild deflation as a result of falling global oil prices. Euler Hermes forecasts inflation to pick up to an average +0.5% in 2016 as the effect of low oil prices will gradually wane.

Public finances are sound

Thanks to sharp fiscal tightening, the fiscal deficit was reduced successively from -8.9% of GDP in 2009 to -0.8% in 2012. Thereafter it has widened slightly to -1.5% of GDP in 2014 and is forecast to reach similar ratios in 2015 and 2016, thus remaining well below one Maastricht criterion for sound public finances (fiscal deficit below -3% of GDP).

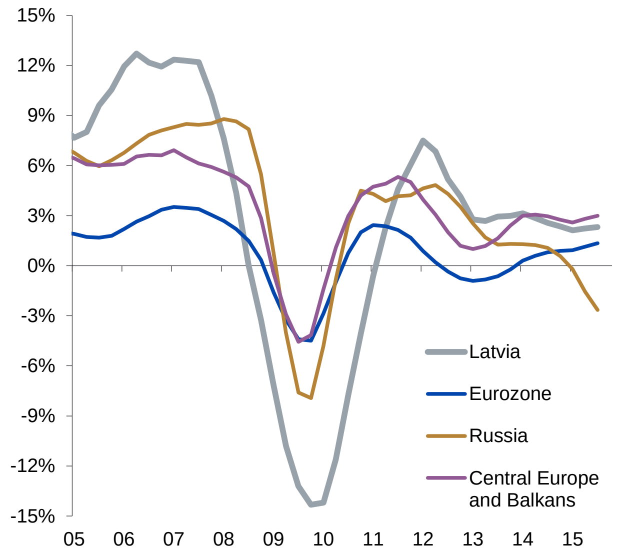
Gross government debt rose sharply from just 8.4% of GDP in 2007 to 46.8% in 2010 in the wake of the deep economic crisis. It has since fallen and should stabilise around 40% of GDP in the next few years, which is still relatively low by current EU standards and meets the other Maastricht criterion for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

Key economic forecasts

	2014	2015f	2016f	2017f
GDP growth (% change)	2.4	2.6	3.0	3.3
Inflation (%, end-year)	0.2	-0.1	1.0	1.5
Fiscal balance (% of GDP)	-1.5	-1.7	-1.5	-1.4
Public debt (% of GDP)	40.6	39.0	41.5	40.0
Current account (% of GDP)	-2.0	-1.5	-1.8	-2.0
External debt (% of GDP)	142.2	149.2	150.0	145.0

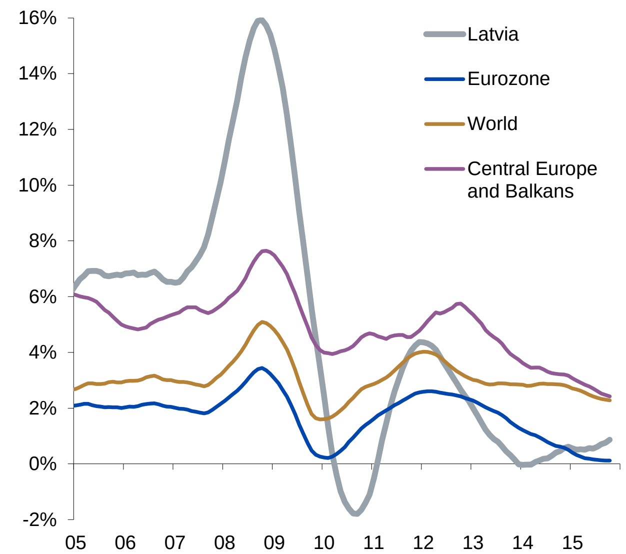
Sources: National sources, IHS, Euler Hermes

GDP growth (% y/y, 4 qtrs cumulated)



Sources: National sources, IHS, Euler Hermes

Inflation rate (% y/y, 12-month moving average)



Sources: National sources, IHS, Euler Hermes

Eurozone membership is beneficial

Latvia joined the Eurozone at the start of 2014. While monetary policy is now conducted by the European Central Bank (ECB), membership of the Eurozone provides for low transfer and convertibility risk and has substantially decreased external vulnerabilities related to exchange rate risk.

Export growth hit by Russia crisis

The Baltic States are more vulnerable to disruptions to export flows to Russia than other EU countries because their share of exports to Russia in total exports is much higher: 21% for Lithuania, 15% for Latvia and 10% for Estonia in 2014, as compared to an average 4% for the 11 EU members in Central Europe or just 2% for the whole EU. In H1 2015, Latvia's nominal exports of goods to Russia dropped by -18% y/y. As a result total nominal exports of goods edged up by just +0.3%.

Current account deficit is unproblematic

The current account balance has recorded moderate but unproblematic deficits since 2011. In Q1-Q3 2015 the deficit narrowed to EUR281mn (down -34% y/y) as growth of imports was even weaker than exports. Euler Hermes expects the full-year current account shortfall at about -1.5% of GDP in 2015, followed by a deficit of around -1.8% of GDP in 2016. Net foreign direct investment inflows have improved from EUR233mn in full-year 2014 to EUR696mn in Q1-Q3 2015, thus so far covering more than in full this year's current account deficit.

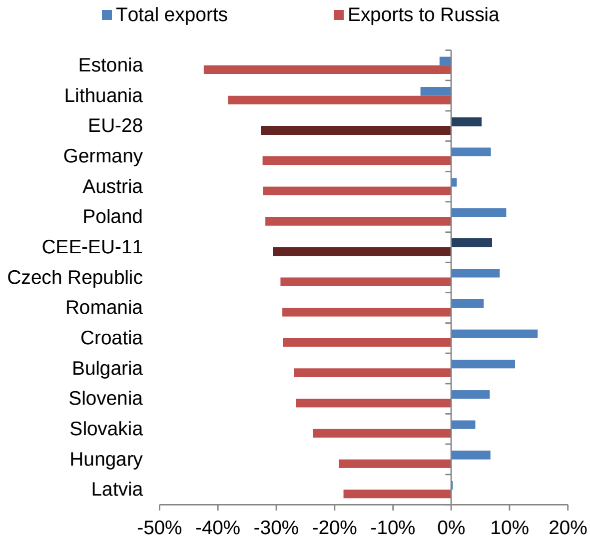
External debt is high and rising again

The external debt burden soared to an alarming level of 168% of GDP in 2010, built up by earlier large current account deficits. The ratio declined to 134% in 2013, but has since grown again and is expected to reach about 150% in 2015-2016. Hence external debt remains a cause of concern and requires close monitoring.

Insolvencies remain below pre-crisis level

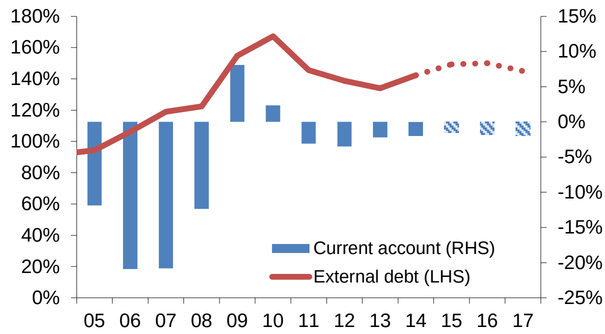
Corporate insolvencies rose by a hefty +19% to 960 cases in 2014. However, based on monthly data until September 2015, Euler Hermes expects a slight decline by -1% in 2015 and forecasts a further fall of -5% to around 900 cases in 2016. This will be about -16% below the pre-crisis level (average annual 1,073 cases in 2003-2007).

Change in exports to Russia and total exports (% y/y, H1 2015), selected economies



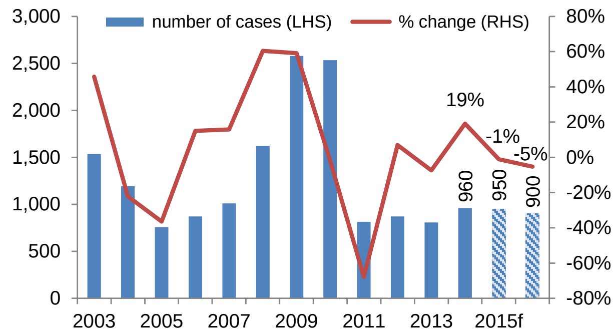
Sources: IMF, Euler Hermes

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Number of insolvencies and percentage change



Sources: National sources, Euler Hermes

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