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Research Report on Latvia

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Introduction

Latvia is a small Baltic country which reached its independence from the Soviet Union in 1990 and accessed the European Union in 2004. Following a constant reduction of inflation rates and improvement of fiscal balance, the country met the Maastricht criteria, which allowed it to join the Euro area in 2014. After the financial crisis which the country suffered in 2007, as a consequence of the domestic credit burst and global financial instability, Latvia has been showing signs of recovery in recent years. While the debt load of the government remained at tolerable levels (35% of GDP in 2013), total private debt still remains significantly high in spite of the high deleveraging that private companies (specially banks) performed in recent years.

Main Economic Indicators of Latvia

Macro indicators	2011	2012	2013
Gross pub. debt, bill EUR	7,6	8,0	8,2
Nominal GDP, bill EUR	20,3	22,1	23,3
Nominal GDP growth, %	11,7	8,7	5,6
Gross gov. debt/GDP,%	37,5	36,4	35,0
Deficit (surplus)/GDP,%	-3,2	0,1	-1,1
Inflation rate,%	3,9	1,6	-0,4
Curr. Account balance/GDP,%	-2,1	-2,5	-0,8

Development indicators	2013
Inequality adj. HDI	0,73
GDP per capita (Thou. of USD)	22,8

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg

The Latvian economy showed a substantial recovery from the 2007 financial crisis. Driven by a significant amount of foreign capital which flew into Latvia in the years prior to the crisis, domestic credit (to private sector) to GDP more than doubled from 40,2% in 2003 to 104,6% in 2009 (see graph 1). In countries with currency boards and fixed exchange rate regimes (the case of Latvia prior to January 2014), capital inflows led to a sharp increase in domestic credit, high levels of inflation and a consequent decline in real interest rates (see graph 2). After reaching a maximum in 2009, private credit to GDP steadily declined up to 60,7% in 2013, at the same time that inflation rate found its way down to bearable figures.

Foreign banks account for a large stake of the Latvian banking sector. Latvia has a long-lasting history of foreign-owned banks concentration in the banking sector. The assets of the five largest foreign banks (Swedbank, SEB, Nordea, DNB and PrivatBank) represent 50% of total assets in the banking sector (see graph 3). Additionally, Latvia's banking sector shows a significant concentration in terms of operations (see graph 4), as 69% of loans are granted by four foreign banks (Swedbank, SEB, Nordea and DNB).

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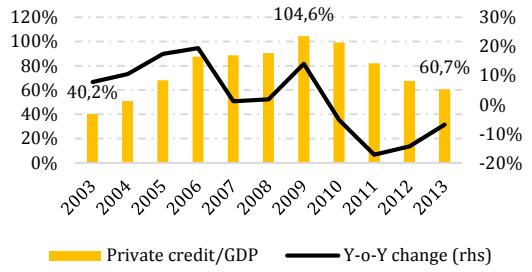
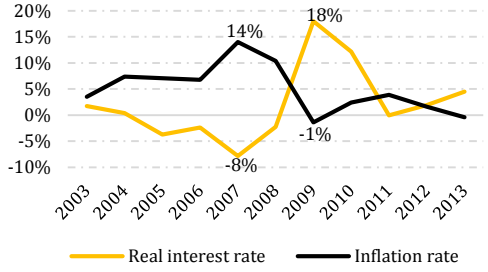
Graph 1: Domestic credit to private sector (% of GDP)



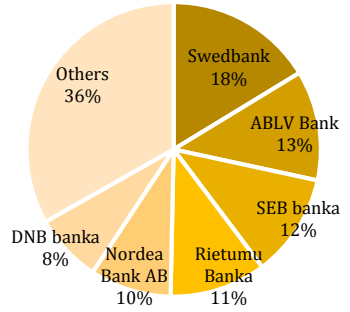
Source: RAEX (Europe) calculations based on data from IMF

Graph 2: Inflation rate vs. Real interest rate in Latvia



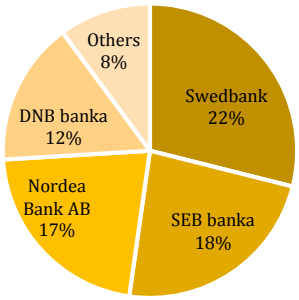
Source: RAEX (Europe) calculations based on data from IMF

Graph 3: Bank Assets in Latvia (as of 30.09.2014)



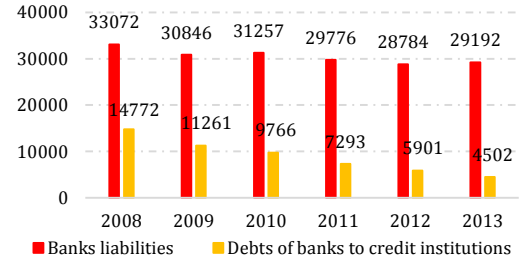
Source: RAEX (Europe) calculations based on data from Association of Commercial Banks of Latvia (ACBL)

Graph 4: Bank Loans in Latvia (as of 30.09.2014)



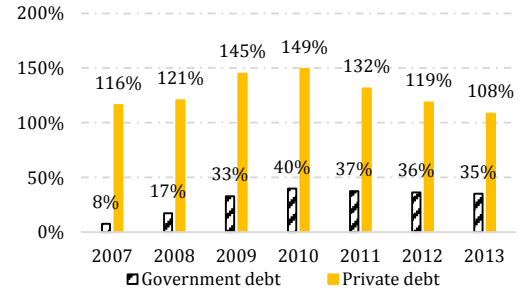
Source: RAEX (Europe) calculations based on data from Association of Commercial Banks of Latvia (ACBL)

Graph 5: Banking Liabilities (mln. of EUR)



Source: RAEX (Europe) calculations based on data from Association of Commercial Banks of Latvia (ACBL)

Graph 6: Public and private debt in Latvia (% GDP)



Source: RAEX (Europe) calculations based on data from Eurostat and World Bank

While government debt stands at reasonable levels, private debt still shows significantly high figures. Even though private sector (specially the banking sector) has shown a deleveraging trend over the last few years (see graph 5), private debt still stands at elevated levels (108% of GDP in 2013). In contrast, despite the significant increase in gross government debt/GDP in the aftermath of the 2007 financial crisis (see graph 6), this figures have remained at tolerable levels over the past 6 years (Gross government debt amounted for 35% of GDP in 2013). Additionally, short-term debt showed a markedly low value, which accounted for 1,3% of GDP and 3,7% of fiscal budget revenues in 2013.

State-owned enterprises (SOE) operate in strategic industries of the country with mixed results. While most of the Latvian SOE were privatized after the country's independence from the Soviet Union in 1990, a number of companies which operate in strategic industries (mainly energy and transport) are still fully controlled by the central government. The large share of assets of a few state-owned companies on total SOE assets is an evidence of the significant interest that the government has in controlling key strategic industries. Assets of

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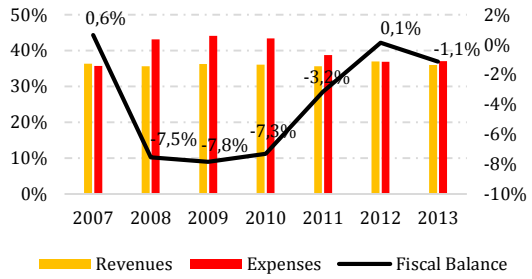
Graph 7: Fiscal position of Latvian Government



Source: RAEX (Europe) calculations based on data from IMF

"Lartvenergo", the largest energy corporation in Latvia, represent 49% of total SOE assets, followed by "Latvijas dzelzceļš", a company operating in the management of railway infrastructure and logistics services, with a share of 8% of total SOE assets. According to findings of the Baltic Institute of corporate governance, Latvia has "both the best and the worst" SOEs in the Baltic region. On the one hand, it finds SOEs with a strong corporate governance (like Lattelecom[1], which imported strong corporate governance practices from its foreign parent company), while on the other hand there are SOEs which faced significant fiscal and governance risks (for example AirBaltic, which incurred heavy losses in 2010 and 2011, requiring a state bailout to keep the airline from collapse).

Latvia's fiscal position has shown a noticeable improvement over the last years. Benefitting from sound austerity measures and sustained tax revenues over the last few years, Latvia's public finances have improved markedly since the budget almost reached -7,9% of GDP in 2009 (see graph 7). Additionally, thanks to Latvia's low inflation rate and fiscal discipline in recent years, the country met the Maastricht criteria for accession to the Eurozone in January 2014.

Conclusion

As a result of fiscal austerity and sustained budget revenues, the Latvian government was able to reduce fiscal deficit, which reached a peak of -7,9% in 2009. Furthermore, gross government debt, which stood at tolerable levels in 2013 (35% of GDP), represents one of the strongest positive features of the Latvian economy. Additionally, the country is showing significant commitment in creating the conditions to recover from the 2007 financial crisis.

[1] 51% of Lattelecom shares are owned by the Latvian government, but the remaining 49% are owned by the Scandinavian company TeliaSonera AB.

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