



# Republic of Latvia

September 2011



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# Introduction

Macroeconomic performance has strengthened significantly on the back of a severe adjustment process and consistent set of structural reforms and policies including fiscal consolidation and responsibility

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Market confidence is restored

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The country's economy is on track to meet the Maastricht criteria in 2012

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Government has benefited from public support and was assisted further by a solid institutional base and a flexible economy

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Economic growth outlook forecasted by Ministry of Finance:

GDP growth 4,2% on 2011

(In the 2nd quarter of 2011 the GDP has increased by 5.6%)

GDP growth 4,0% on 2012

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# 1. Road to Regained Competitiveness and Recovery

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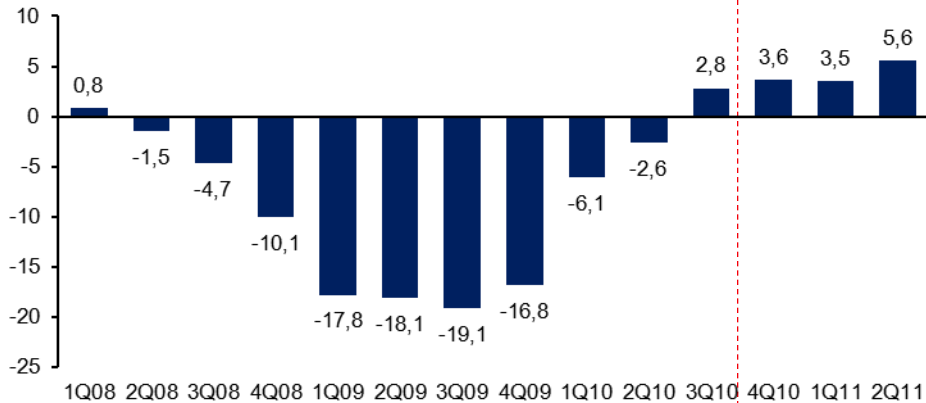


# The Latvian Economy Is Emerging from Crisis

Latvia after the crisis: GDP is growing, foreign investment is on the rise, and unemployment is decreasing

Gross Domestic Product Growth (%)

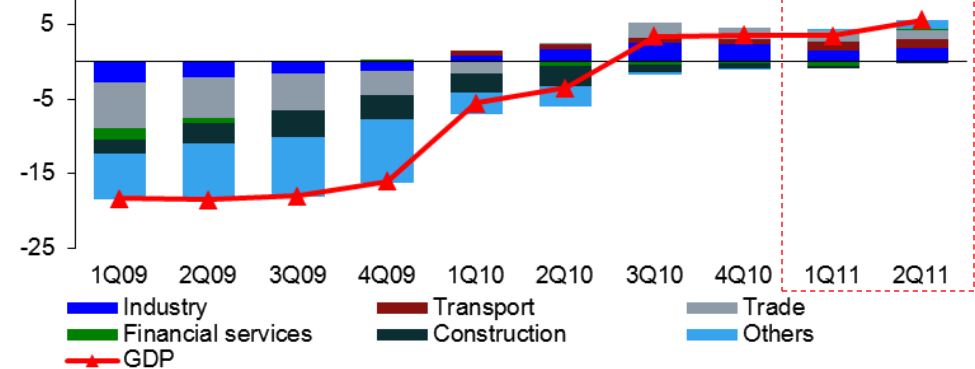
GDP growth has resumed, after a sharp contraction



Source: Central Statistical Bureau of Latvia

Structure of GDP (%)

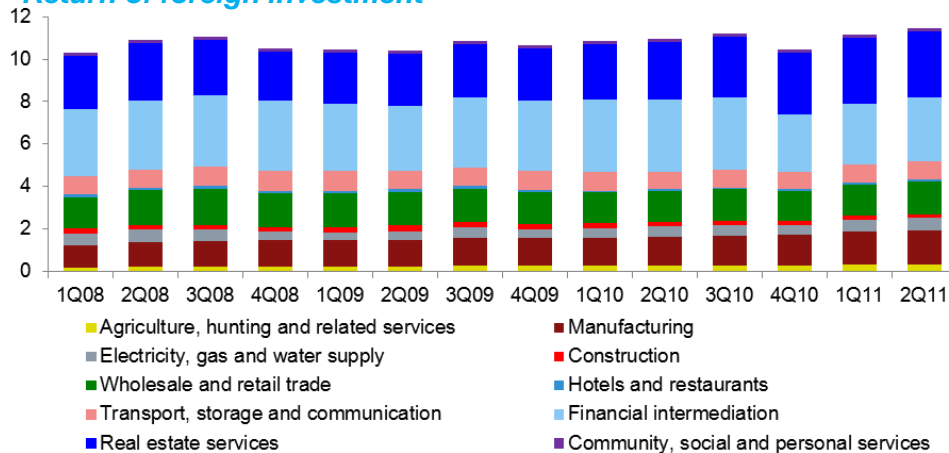
Manufacturing and trade sectors have led the export driven recovery



Source: Central Statistical Bureau of Latvia

FDI Stock by Sector (\$ mn)

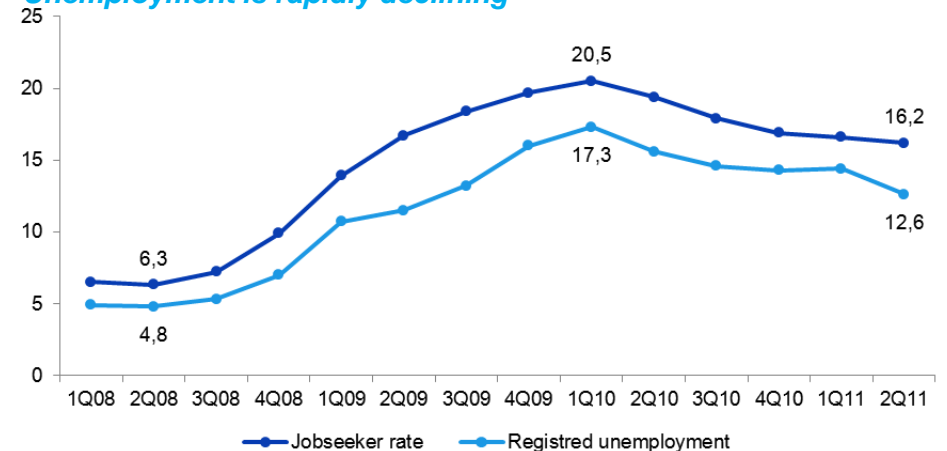
Return of foreign investment



Source: Bank of Latvia

Jobseeker Rate, Registered Unemployment Rate (%)

Unemployment is rapidly declining



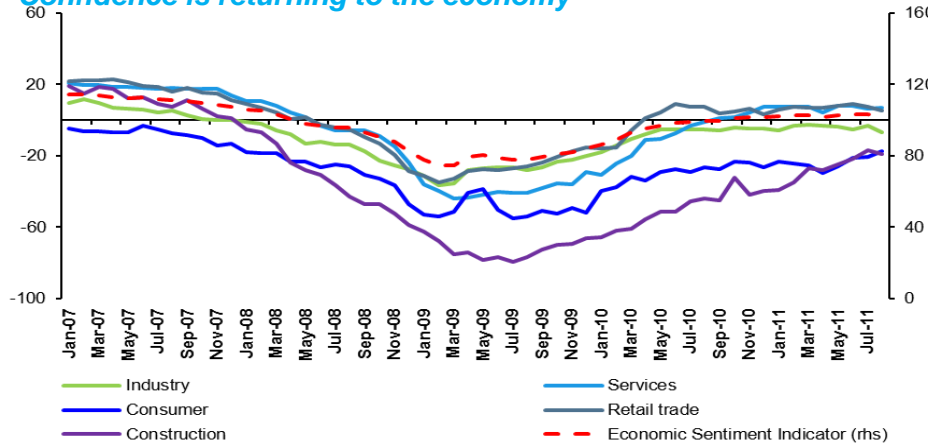
Source: Central Statistical Bureau of Latvia

# Leading Indicators Point to a Sustained Economic Recovery

As economic sentiment improves, all sectors of the Latvian economy rebound, making use of existing excess capacity

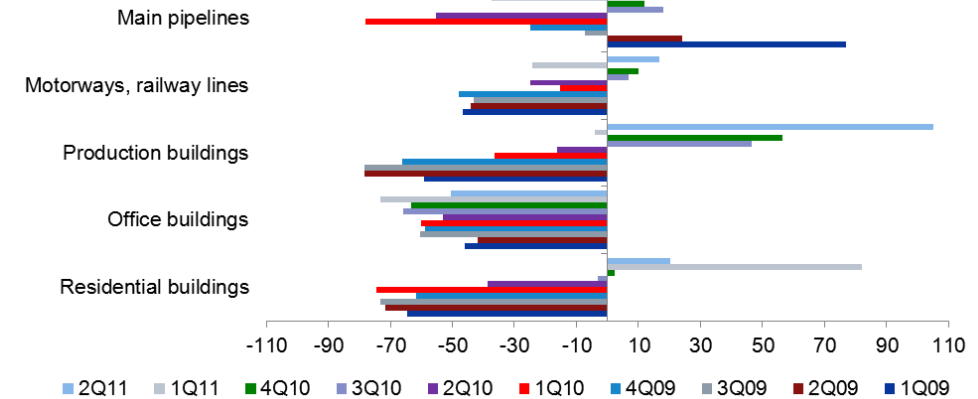
**Economic Sentiment and Confidence Indicators (Balance, %)**

*Confidence is returning to the economy*



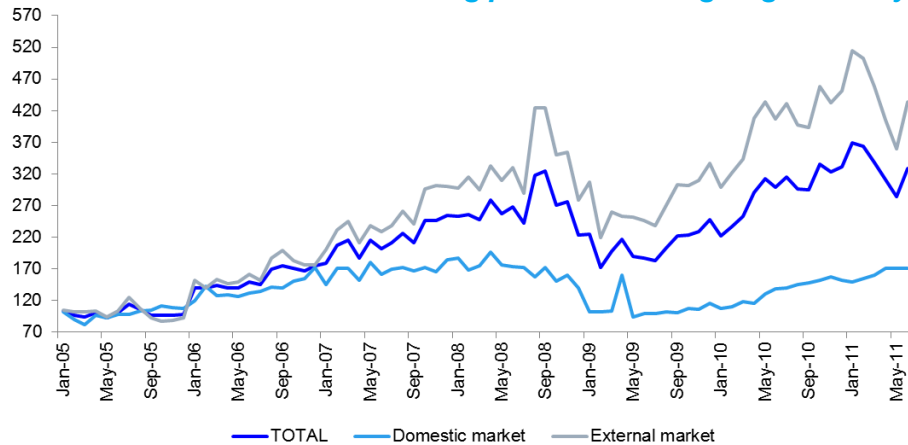
**Volume Changes of Construction Work (YoY, %)**

*A strong recovery in construction of new production buildings and infrastructure*



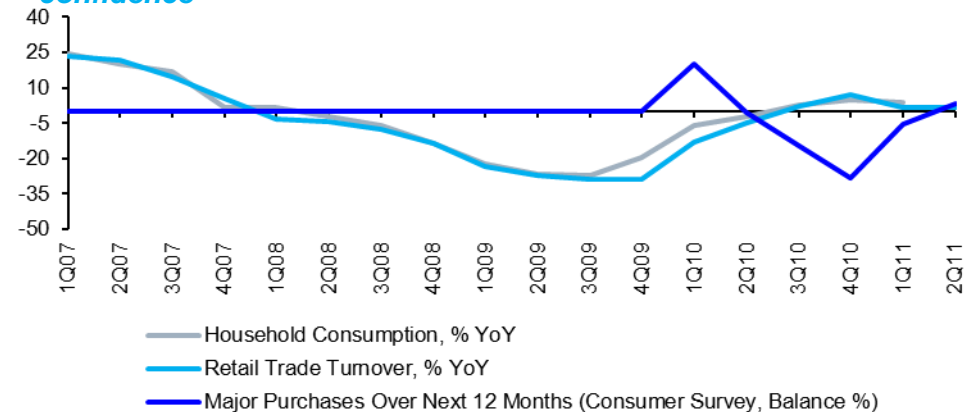
**Indices of New Orders in Manufacturing, S.A. data (2005=100)**

*New orders flow in manufacturing points to an ongoing recovery*



**Selected Indicators (YoY, %)**

*Consumption and retail trade grow, boosted by consumer confidence*

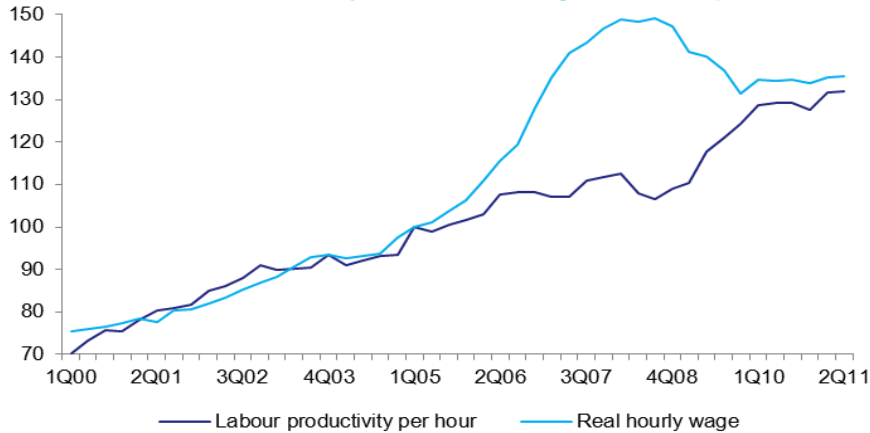


# Economic Competitiveness Is Driving Growth

The reaction of the Latvian economy to the crisis was to reduce wages and increase productivity. As a result, exports rebounded strongly

## Wages and Productivity (1Q05 = 100)

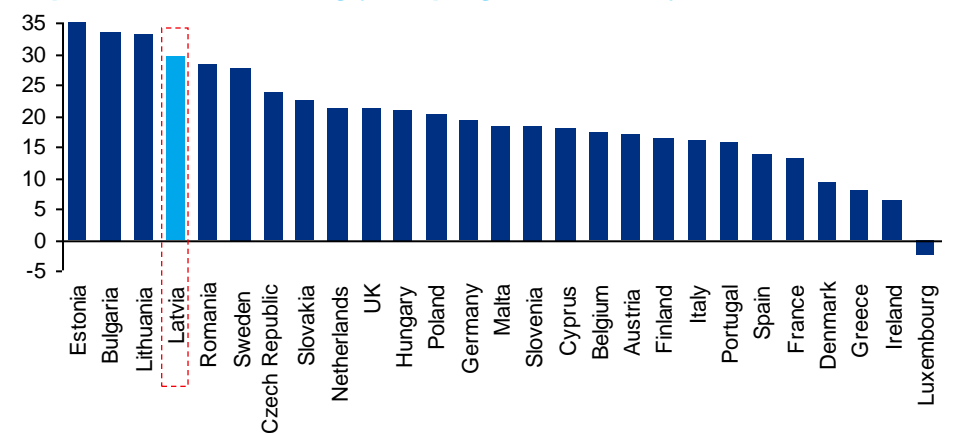
Efficient labor market – adjustment in wages, rise in productivity



Source: Central Statistical Bureau of Latvia

## Merchandise Exports in 2010 (YoY, %)

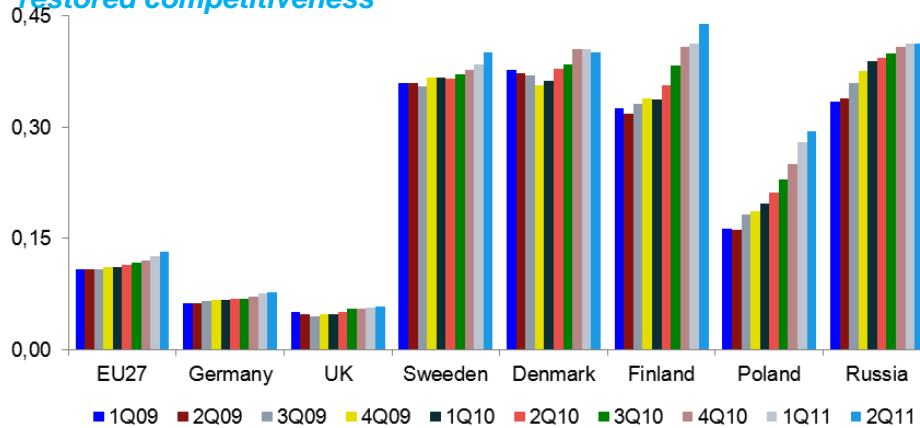
Exports rebound strongly, helping the economy



Source: Central Statistical Bureau of Latvia

## Export Market Shares (%)

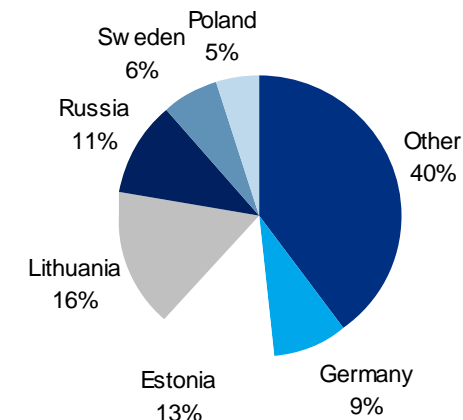
Growing export market shares in main trade partners point to restored competitiveness



Source: Central Statistical Bureau of Latvia

## Export Structure by Destination Countries in 2010 (%)

Latvia's exports are supported by a broad group of destinations

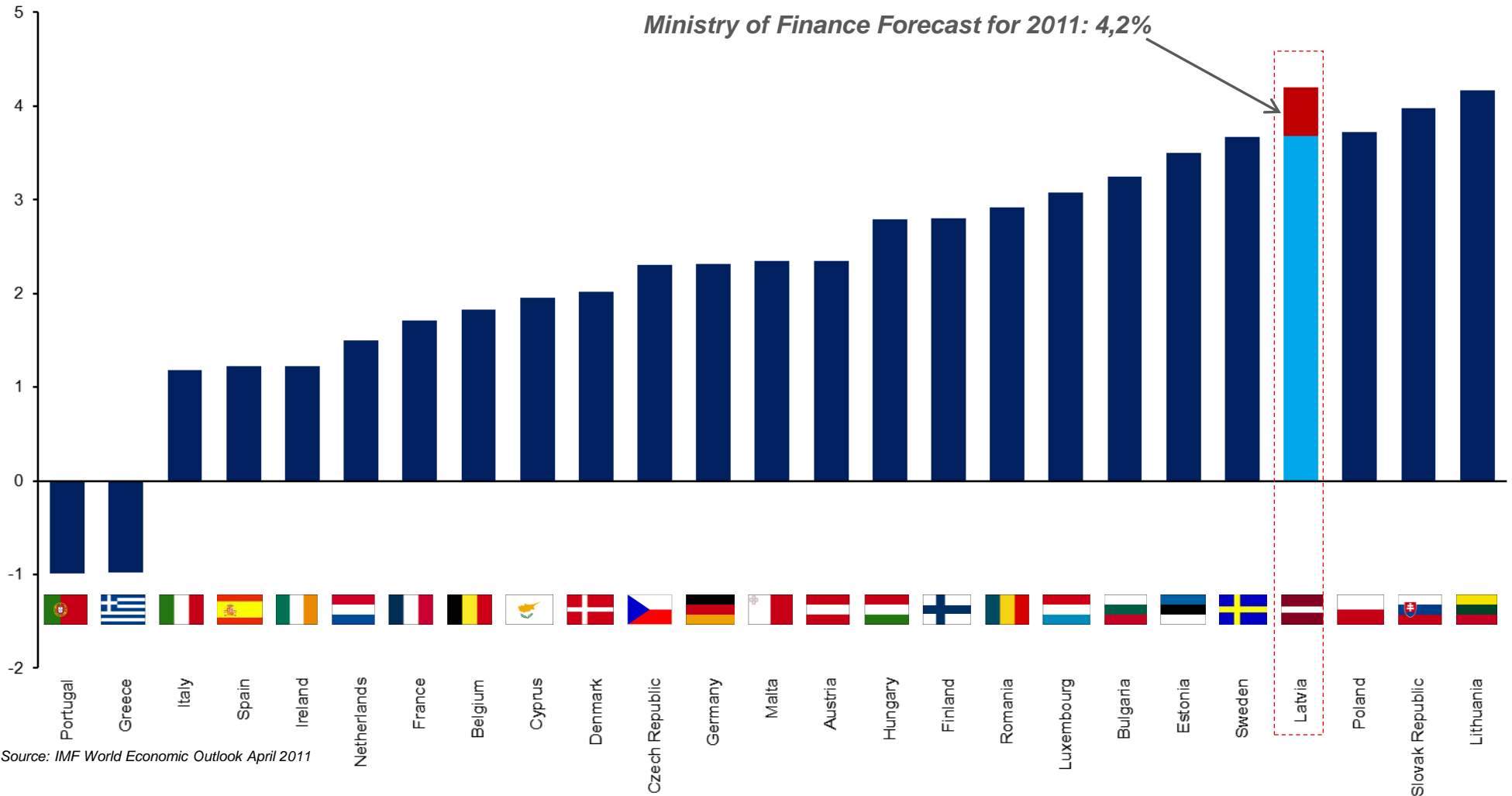


Source: Central Statistical Bureau of Latvia

# Economic Performance Stands Out Among EU Peers

Latvia's growth in 2011 is expected to be among the highest in the EU, thus reaffirming the Republic's achievements and future potential

2011 GDP Growth Forecast (%)



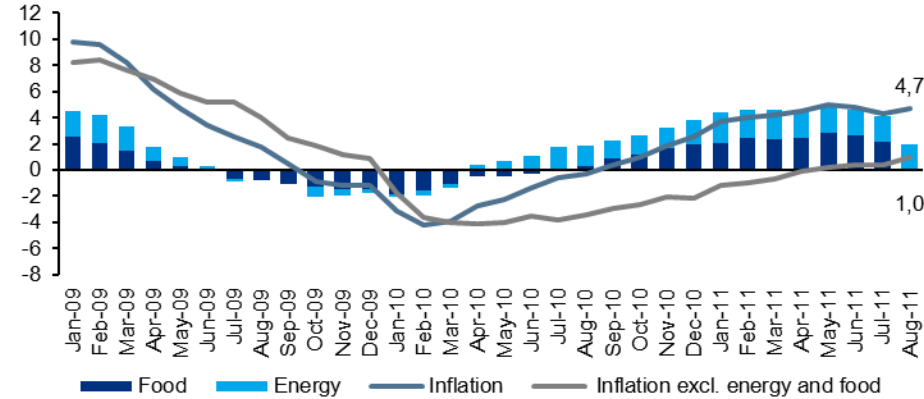
Source: IMF World Economic Outlook April 2011

# Inflation Is Up, Temporarily Driven by Global Developments

Over the past year inflation rose due to external pressures and higher taxes, though inflation is forecast to return within the Maastricht limit by end-2012

## Inflation (YoY, %)

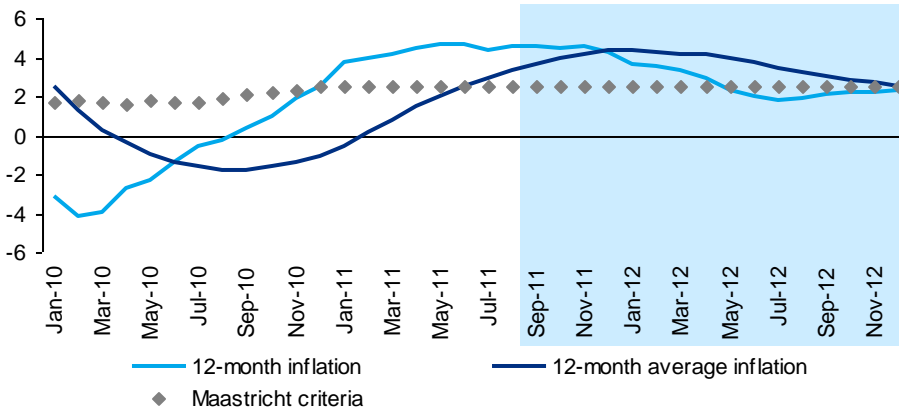
The increase in overall price level is largely driven by external factors - global energy and food prices



Source: Bank of Latvia

## Inflation: Actual and Forecast (%)

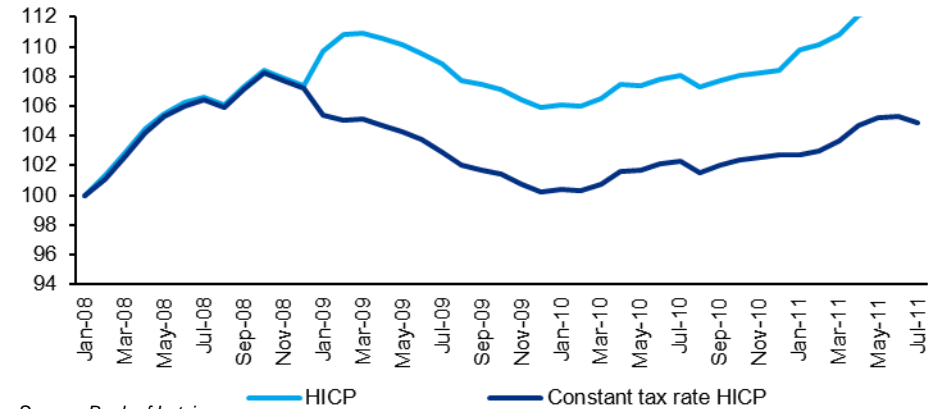
Inflation pressures are contained over medium term; Maastricht inflation criterion remains within reach



Source: Bank of Latvia

## HICP and Constant tax rate HICP (Jan 2008 = 100)

Increase in indirect taxes pushed up prices; the Government committed not to raise taxes in the forthcoming consolidation



Source: Bank of Latvia

## Commentary

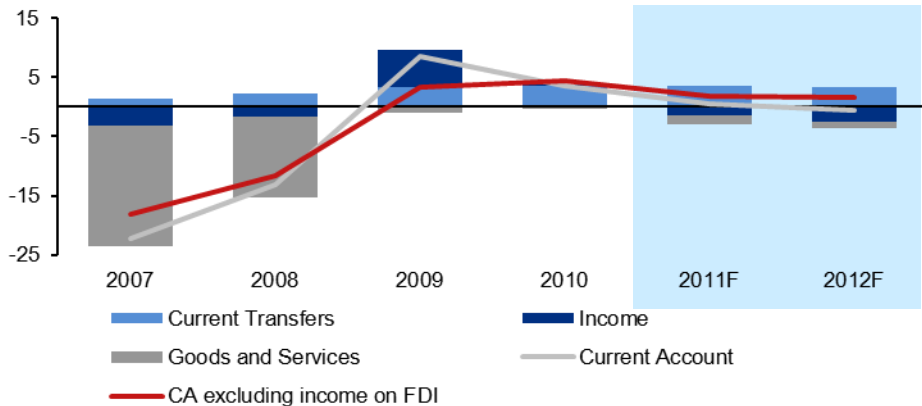
- The recent pick-up in inflation has been driven by the surge of global food and energy prices, and a rise in indirect taxes
- Moderate domestic demand and flexible labour market conditions are likely to apply downward pressure on inflation over medium term
- A return to low inflation is expected as world commodity prices ease, bringing compliance with the Maastricht inflation criteria within reach

# Strong Improvement in Balance of Payments Position

The pre-crisis external imbalances have seen a significant improvement, resulting in a more sustainable balance of payment position

## Balance of Payments (% GDP)

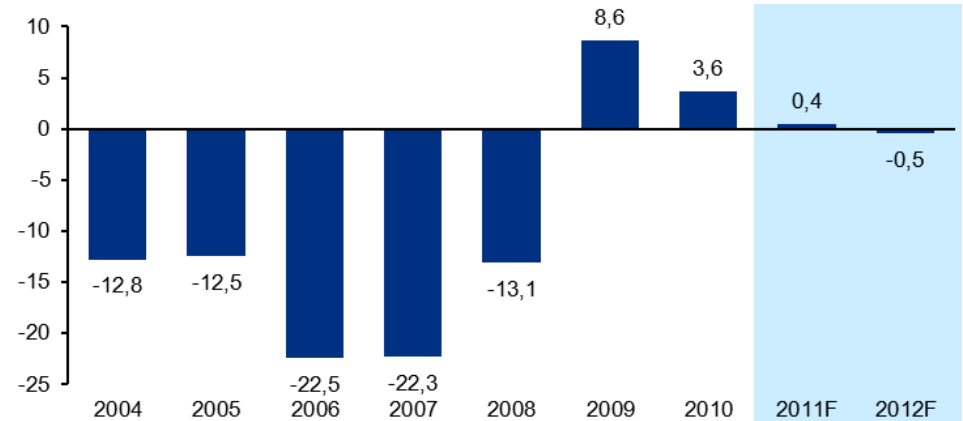
CA balance approaches a more sustainable level



Source: Bank of Latvia

## CA Balance (% GDP)

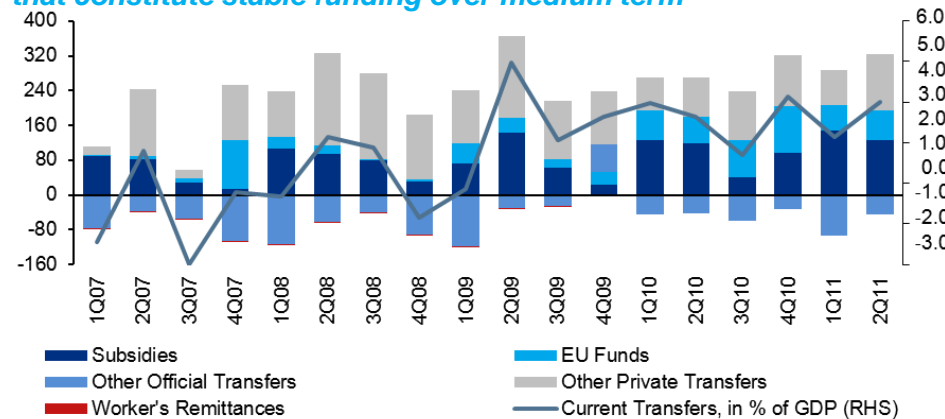
Improved export performance has resulted in positive CA balances



Source: Bank of Latvia, forecast Ministry of Finance

## Net Current Transfers (\$ mn)

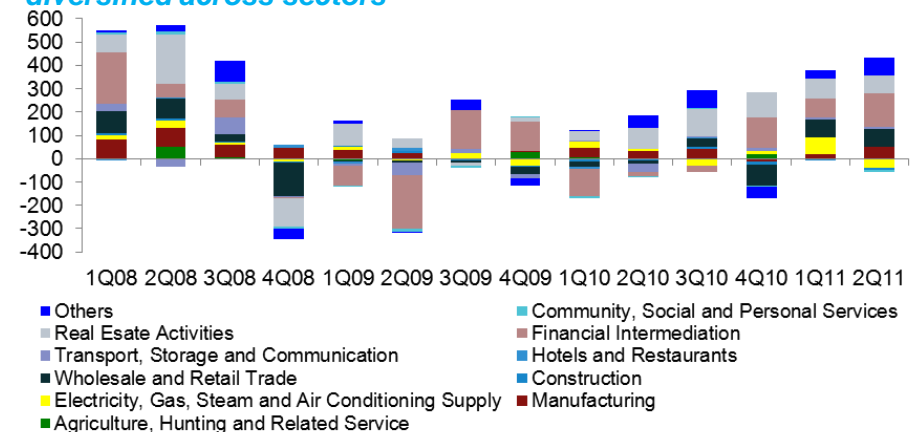
EU funds and subsidies dominate the net inflows into the economy that constitute stable funding over medium term



Source: Bank of Latvia

## FDI Flows by Sectors (\$ mn)

FDI in manufacturing started to recover, and is becoming more diversified across sectors

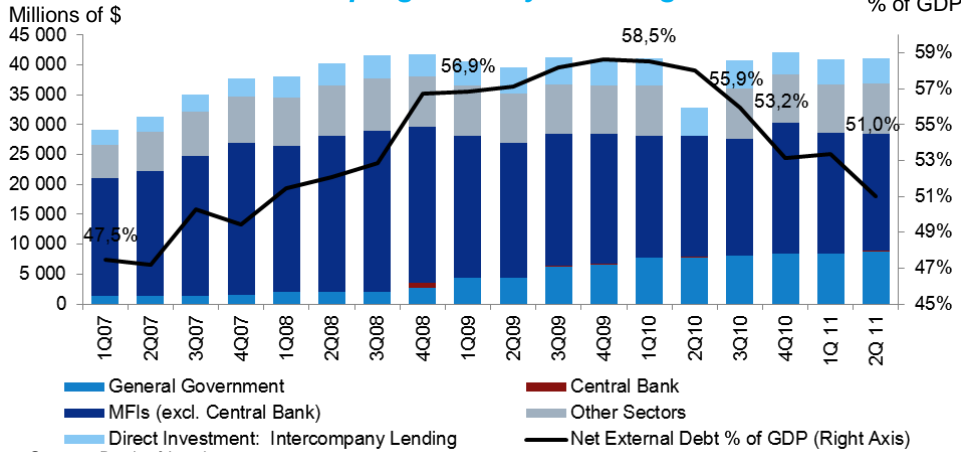


Source: Bank of Latvia

# Deleveraging Continues while the Banking Sector Remains Supported

## Net External Debt (\$ mn, % GDP)

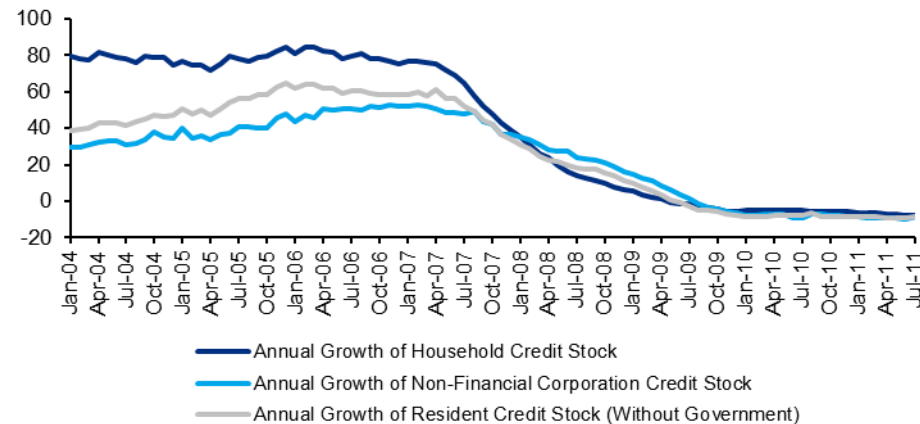
Net external debt been progressively declining as a % of GDP



Source: Bank of Latvia

## Credit to Private Sector (YoY, %)

Slow-down in credit growth has been a core component of the deleveraging process



Source: Bank of Latvia

## Reserve Assets by Type of Asset (\$ mn)

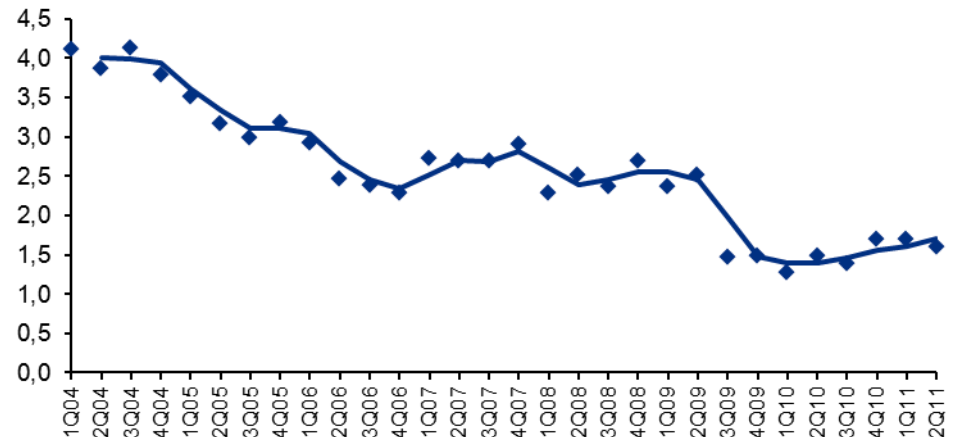
Reserve assets are increasing, adding to economic stability



Source: Bank of Latvia

## Short-Term External Debt to Reserves of BoL

Short-term debt to reserves ratio has declined substantially

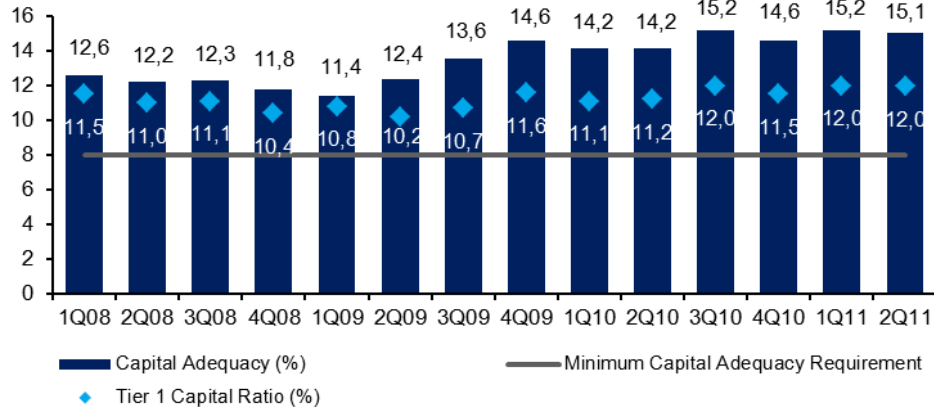


Source: Bank of Latvia

# Stable and Well-Capitalised Banking System

## Capital Adequacy (%)

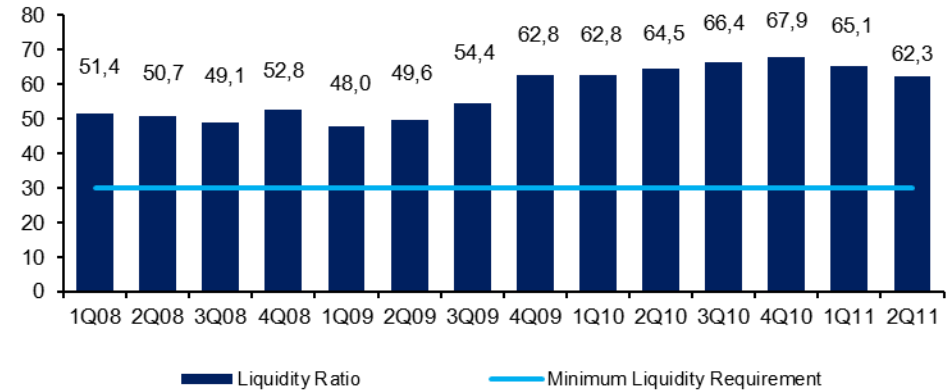
Latvia's banking sector remains well-capitalised



Source: Financial and Capital Market Commission

## Bank Liquidity (%)

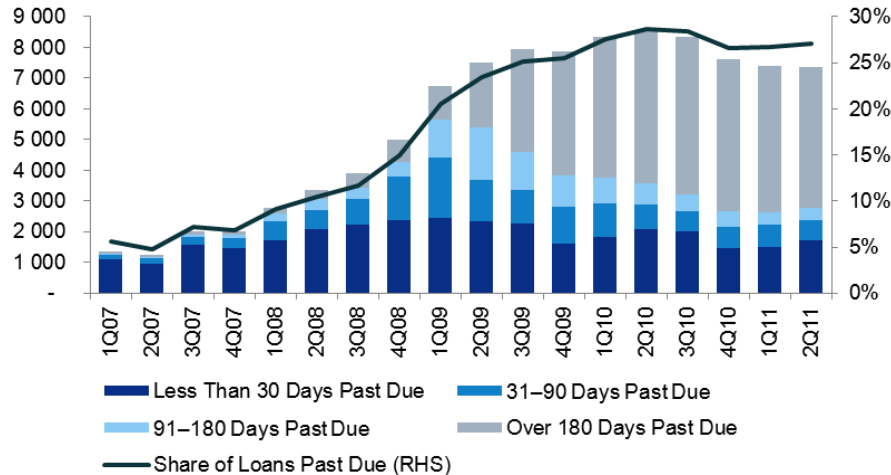
Despite the challenging environment, banks have remained liquid



Source: Financial and Capital Market Commission

## Loan Quality Indicators (\$ mn)

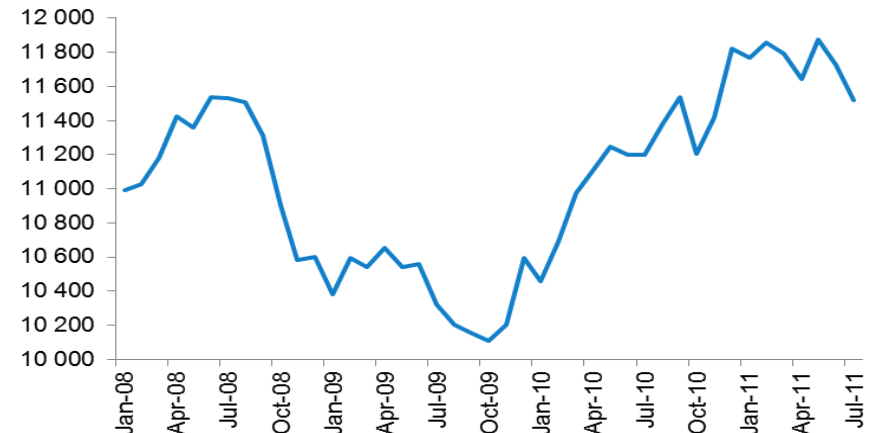
NPLs have stabilised



Source: Financial and Capital Market Commission

## Domestic Deposits (\$ mn)

Confidence in the banking system and national currency has resulted in a growing deposit base



Source: Financial and Capital Market Commission



### 3. Government's Policy Response and Reform Package

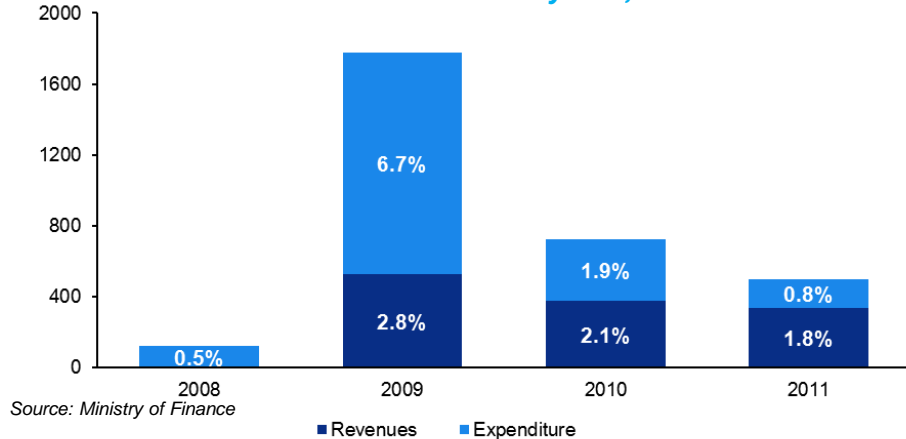


# Significant Fiscal Consolidation Has Been Carried Out

The Government has undertaken a rigorous fiscal adjustment programme, resulting in an impressive budget consolidation

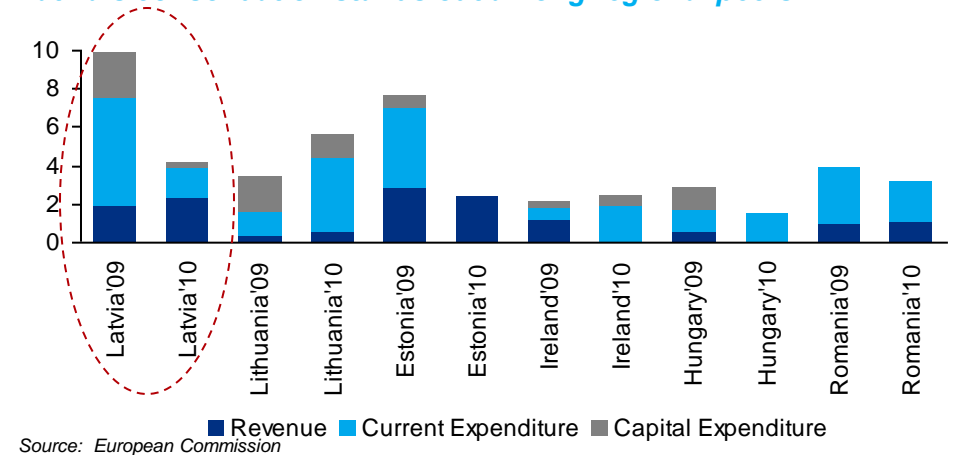
## Budget Consolidation in 2008 – 2011 (EUR mn)

Budget deficit has been reduced by implementing austerity measures in amount over €3bn in four years, or 16.6 % of GDP



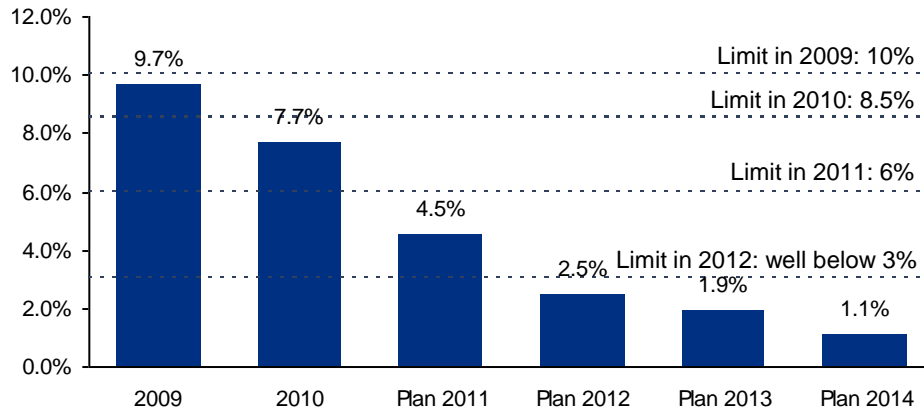
## Budget Consolidation in Latvia in Comparison (% GDP)

Latvia's consolidation stands out among regional peers



## Fiscal targets and results (% GDP, as per ESA95)

Latvia achieved great progress on the way to budget stabilisation



## Commentary

- Significant fiscal adjustment measures will contribute to meet the Maastricht criteria in 2012
- EU funds largely facilitate recovery and implementation of growth enhancing programs
- Revenue side measures frontloaded to take place in 2011, in order not to push up inflation before the euro target year of 2014
- 2012 budget consolidation planned to purely focus on expenditure side (except for real estate tax reform)
- Fiscal targets for 2011 & 2012 envisage safety margin against less favorable economic developments

# Overview of Fiscal Policy Measures

**The Government has responded immediately and decisively by implementing comprehensive fiscal consolidation measures and expenditure cuts supported by social partners**

## 2009 Budget

### • Revenue Increases

- Dividends from state-owned companies
- Excise taxes – on alcohol, tobacco, fuel, non alcoholic beverages, coffee
- Gambling tax
- Increase of the standard rate of VAT from 18% to 21%
- Monthly PIT allowance reduced from \$ 180 to \$ 70

### • Expenditure Cuts

- Defense sector
- Public administration – reduced number of employees, wages and a number of institutions abolished/ merged
- Streamlining of social welfare, health care and education
- Road maintenance optimized

## 2010 Budget

### • Revenue Increases

- Broaden PIT base and raise PIT rate from 23% to 26%
- Excise taxes – on alcohol, tobacco, natural gas
- Progressive real estate tax on housing
- Vehicle tax

### • Expenditure Cuts

- Decrease in remuneration of public sector employees
- Average monthly salary reduction
- Reduction of ministries' administrative costs
- Review of subsidies and grants (incl. agriculture subsidies)
- Reducing the level of social benefits while expanding the social safety net
- Public procurements decreased
- Implementation of investment projects carefully revised

## 2011 Budget

### • Revenue Increases

- Increasing rate of real estate tax
- Dividends from state-owned enterprises
- Increase of the standard rate of VAT from 21 per cent to 22 per cent
- Financial stability levy
- Excise taxes – on alcohol, tobacco, fuel, non alcoholic beverages, natural gas

### • Expenditure Cuts

- Subsidies and grants and non-capital expenditure cut in different sectors:
  - Transport
  - Welfare
  - Defense
  - Agriculture
  - Local government

**The government is committed to the implementation of its recovery package, despite the painful adjustments in the short-term**

# Structural Reforms to Support Recovery and Sustainable Growth

## Education & Social Sector



- Education and healthcare system reforms aimed to increase efficiency. Targeted pension freeze, increase in retirement age

## Business Environment



- SME access to financing, export oriented programmes, reduction of administrative burden

## Financial System



- Banking system recapitalised, role of regulator strengthened, deposit guarantee laws streamlined, implementing the EU Financial Sector Assessment Programme (FSAP)

## Public Administration

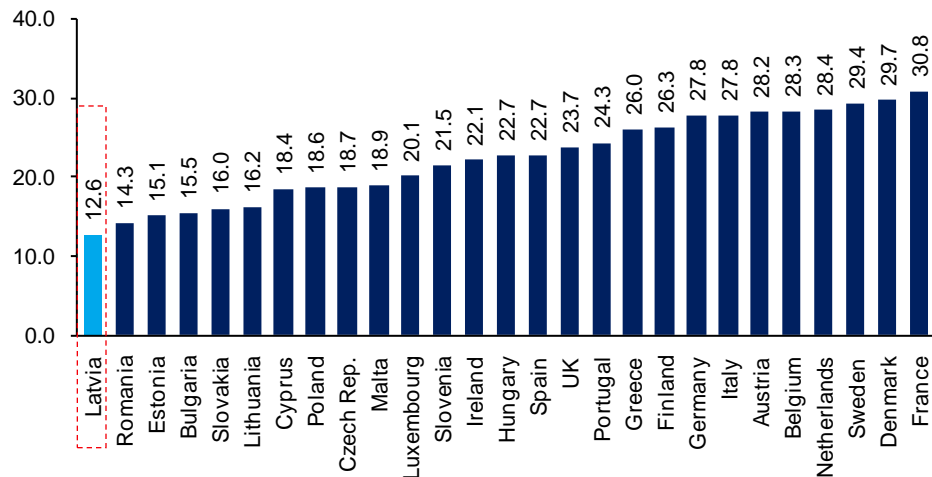


- Downsizing of public administration, unified public wage grid to keep wages under control, optimization of public services

To mitigate some of the recent policy responses, the Government is working closely with the World Bank to design a comprehensive social safety net

### Social Expenditure (% GDP)

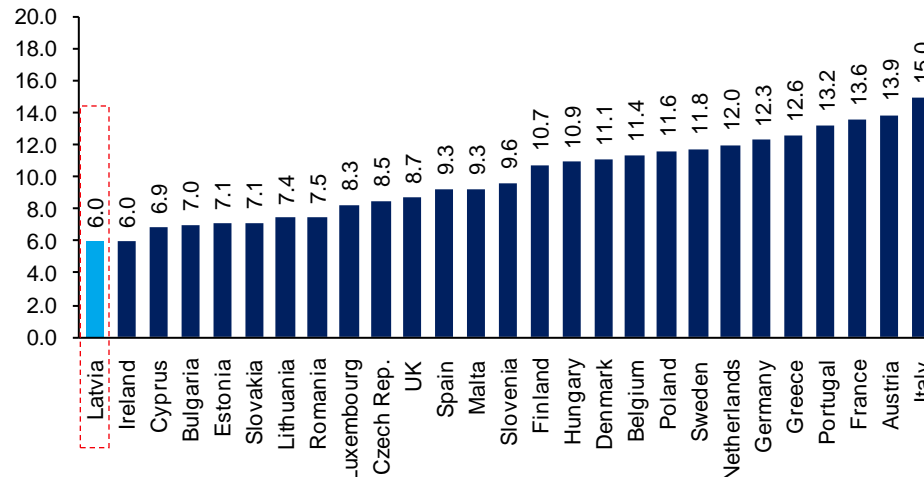
#### Lowest Social Expenditure in the EU



Source: YE2008, Eurostat

### Pension Expenditure (% GDP)

#### Lowest Pension Expenditure in the EU



Source: YE2008, Eurostat

Structural reforms are intended to promote growth and long-term competitiveness, efficient use of budgetary resources contributing to fiscal sustainability

# Key Policy Goals & Objectives

The Government's measures have been highly successful, with an improving fiscal position and the return of investor confidence

## Key Policy Goals

Competitiveness Improving



- Wage and price adjustment has taken place resulting in competitiveness gains; economy is rebalancing

Spending Cuts Enacted



- Spending cuts have had the desired effect, enabling the reduction of fiscal imbalances

Fiscal Targets Met



- Outperformed fiscal targets set by the IMF/EU; Programme is on track and expires end of 2011

Confidence is Returning



- Rebounding GDP growth, growing export, reduction in borrowing costs - all point to return of confidence

## Key Government Objectives

EMU Accession



- Latvian Lat remains within its narrow band against the euro. Euro adoption serves as a credible policy anchor.

Fiscal Discipline



- 2011 budget deficit estimated below 6% of GDP (as per ESA 95), and target of below 3% in 2012 and beyond, with strict fiscal discipline and planned fiscal governance regulation

Absorption of EU funds



- Efficient use of EU funds in order to stimulate economic growth and promote competitiveness

Structural Reforms



- Improve revenue collection by fighting against grey economy. Ensure long-term sustainability of social security system. Stable and healthy financial system

Public Sector Efficiency



- Enhanced management of state-owned assets, improved public procurement procedures and human resource management

To meet Maastricht criteria in 2012 remains the key objective which is set to drive the Government's policy framework in the short-to-medium term

# Political Stability Has Underpinned the Reform Agenda

**The Government's fiscal measures and reform package have received broad domestic support and strong backing from the international community**

- The Government proved its commitment to reforming the economy and consolidating the budget
- The Government has benefited from strong support for its policy measures from general public and social partners
- The international community – Nordic countries, IMF, World Bank and other – supported Latvia, by building up the international loan package totaling \$10.5 billion

## International Recognition of the Government Policy Agenda

**IMF statement: “Strong policy actions under the SBA have helped restore confidence, contributed to economic recovery, and enabled significant progress toward Latvia’s goal of euro adoption.”**

*-IMF Press Release No. No. 11/198, May 26, 2011 -*

**Mark Griffiths, the head of the international review mission to Latvia: “International donors suggest Latvia should borrow in international markets instead of extending the schedule for repayment of the loan it had received under the financial aid program.”**  
*- RIGA, Apr 06, 2011, BNS -*



## 4. Government Response to Banking Sector Issues



# Government Response to the Bailout of Domestic Banks

In order to protect the stability of the financial system, the government stepped in to rescue and restructure Parex bank

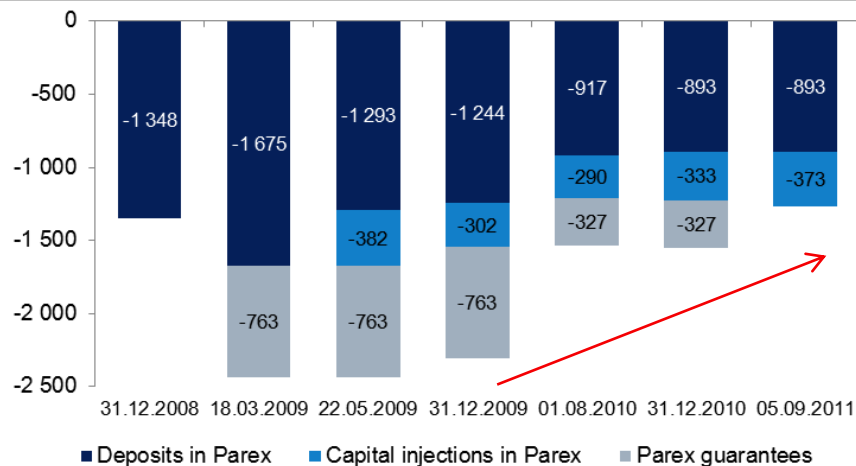
<b>PAREX - CITADELE</b>	November 2008
	March 2010
	August 2010
	May 2011
	2011 - onwards

- Parex Bank nationalized by the State
- Decision on “good out” scenario and establishment of a Citadele Bank
- Parex Bank split in two banks – performing assets in “Citadele bank”; non-performing assets - Parex bank
- Full repayment of syndicated loans by Parex Bank – All Commitments toward creditors fulfilled
- Approval of Parex Bank and Citadele Bank sales strategy
- Seeking and attracting a strategic investor
- The sale process of Citadele Bank is carried out by Nomura International and the Latvian Privatization Agency

<b>LMLB</b>	2011 - onwards
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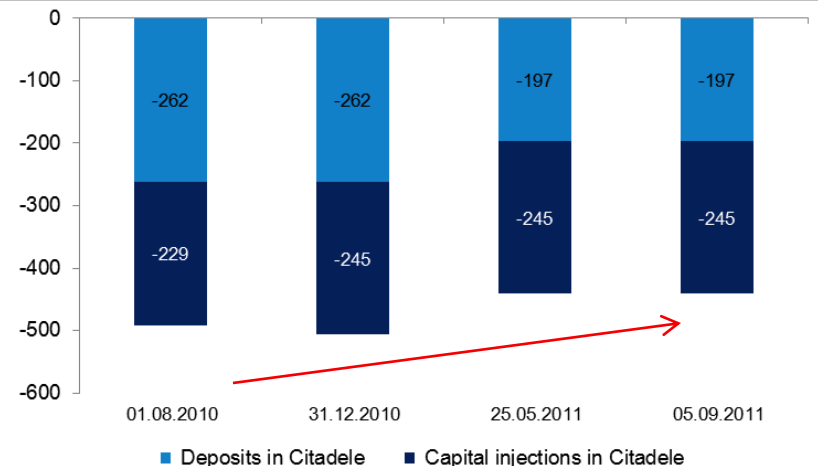
- Reorganisation of Latvian Mortgage and Land Bank - selling of commercial assets and establishment of development bank

Government exposure in resolution bank - Parex Bank (\$ mn)



Source: The Treasury

Government exposure in “good bank” - Citadele Bank (\$ mn)



Source: The Treasury



## 5. Government Debt and Funding Strategy



# International Loan Programme – Broad International Support

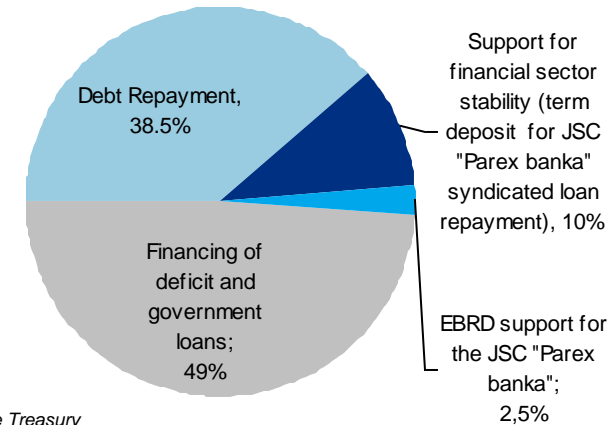
## Initially Planned vs. Disbursed Loans From Programme

(\$ Billion)	2009		2010		2011		Total	
	Planned	Disbursed	Planned	Disbursed	Planned	Disbursed	Planned	Disbursed
EU	4,1	3,1	0,1	1,0	0,1	0	4,4	4,1
Nordic Countries (SE, DK, FI, NO, EE)	0,1	0,0	2,5	0,0	0,0	0	2,7	0,0
IMF	1,7	1,1	0,6	0,4	0,1	0	2,4	1,5
World Bank	0,3	0,3	0,0	0,1	0,3	0	0,6	0,4
Other (CZ, PL, EBRD)	0,1	0,1	0,4	0,0	0,0	0	0,6	0,1
<b>Total</b>	<b>6,3</b>	<b>4,6</b>	<b>3,7</b>	<b>1,5</b>	<b>0,6</b>	<b>0</b>	<b>10,5</b>	<b>6,2</b>

\* \$ 843 million in December 2008

Source: The Treasury

## Use of Received Loans (\$ 5'223 million)



Source: The Treasury

## The International Loan Programme Has Reached Its Aim

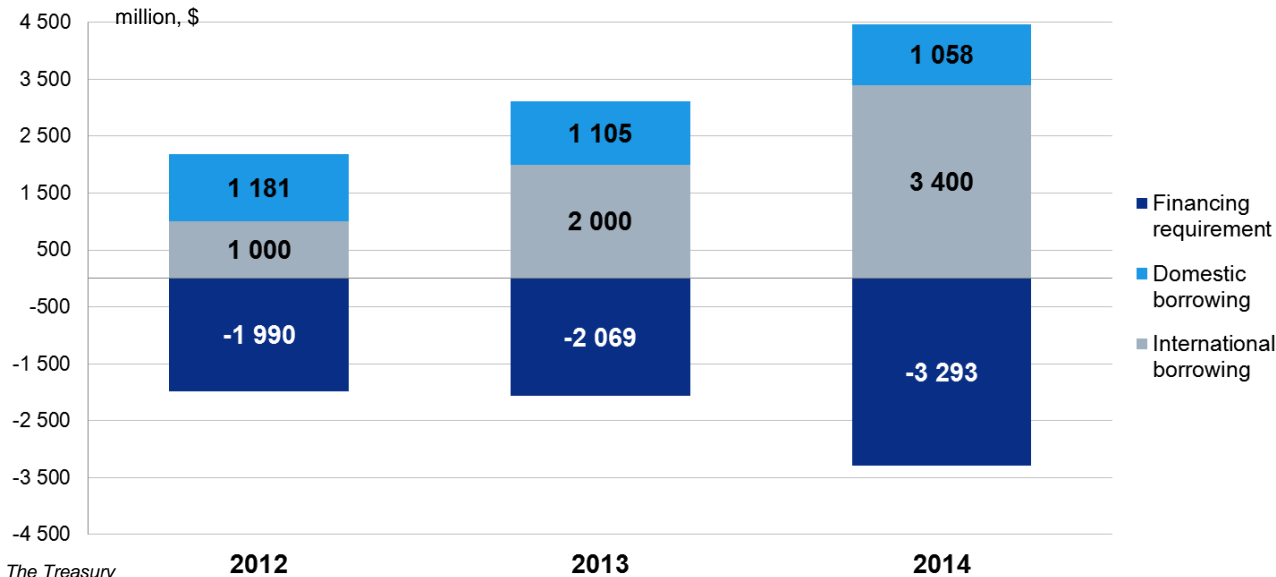
- Latvia's assistance package is small relative to the resources available to the institutions providing the support
- Further borrowings within the Program not planned, except for:
  - \$ 141 million from the World Bank
- Credit facility Agreements with Nordic lenders signed on 21 September, 2010
- Pledge from Poland and Czech Republic on credit facilities in case of necessity
- 4<sup>th</sup> review approval by IMF on 25<sup>th</sup> May 2011, EC approval expected in the beginning of June 2011

*IMF statement: "The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Latvia's performance under an economic program supported by a Stand-By Arrangement. The Board decision makes available an amount equivalent to about €121.3 million or US\$170.7 million, but the authorities do not intend to draw this amount. **The availability of Fund resources will help to provide insurance against the impact of any unforeseen deterioration in external financing conditions.**"*

*-IMF press release No. 11/198, May 26, 2011-*

# Moderate Financing Requirement in Medium-Term

## Central Government financing estimation 2012-2014



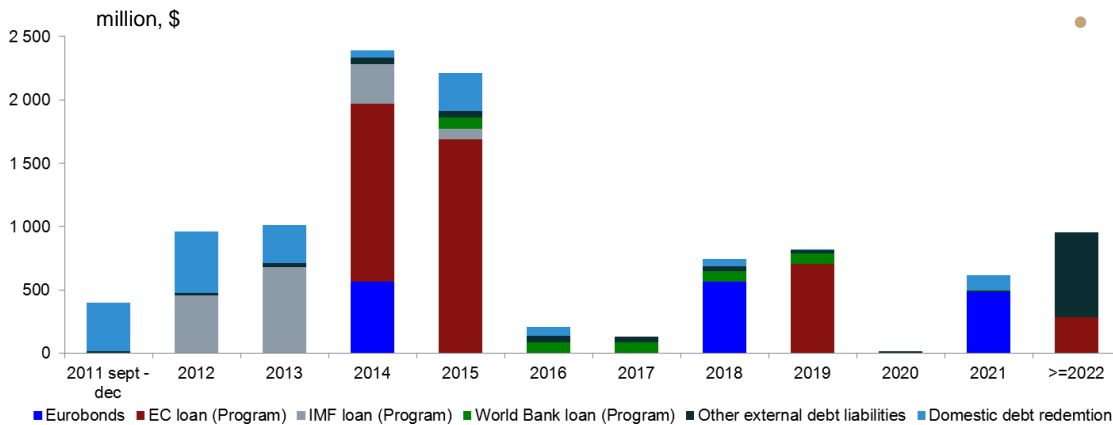
Source: The Treasury

In 2011 major borrowings completed - only domestic issues planned ~ \$ 450 million

As of September 16 the Treasury holds US\$ 2'666 million in its accounts in Bank of Latvia

## Modest government debt redemptions in the short-term

### Debt Redemption Profile (as of 31 August, 2011)



Source: The Treasury

- Latvia faces minimal government external debt repayments in the next two years
  - As 97% of 2011 debt repayments are represented by domestic currency debt, refinancing risk is minimal especially given the recent successes in terms of domestic debt auctions

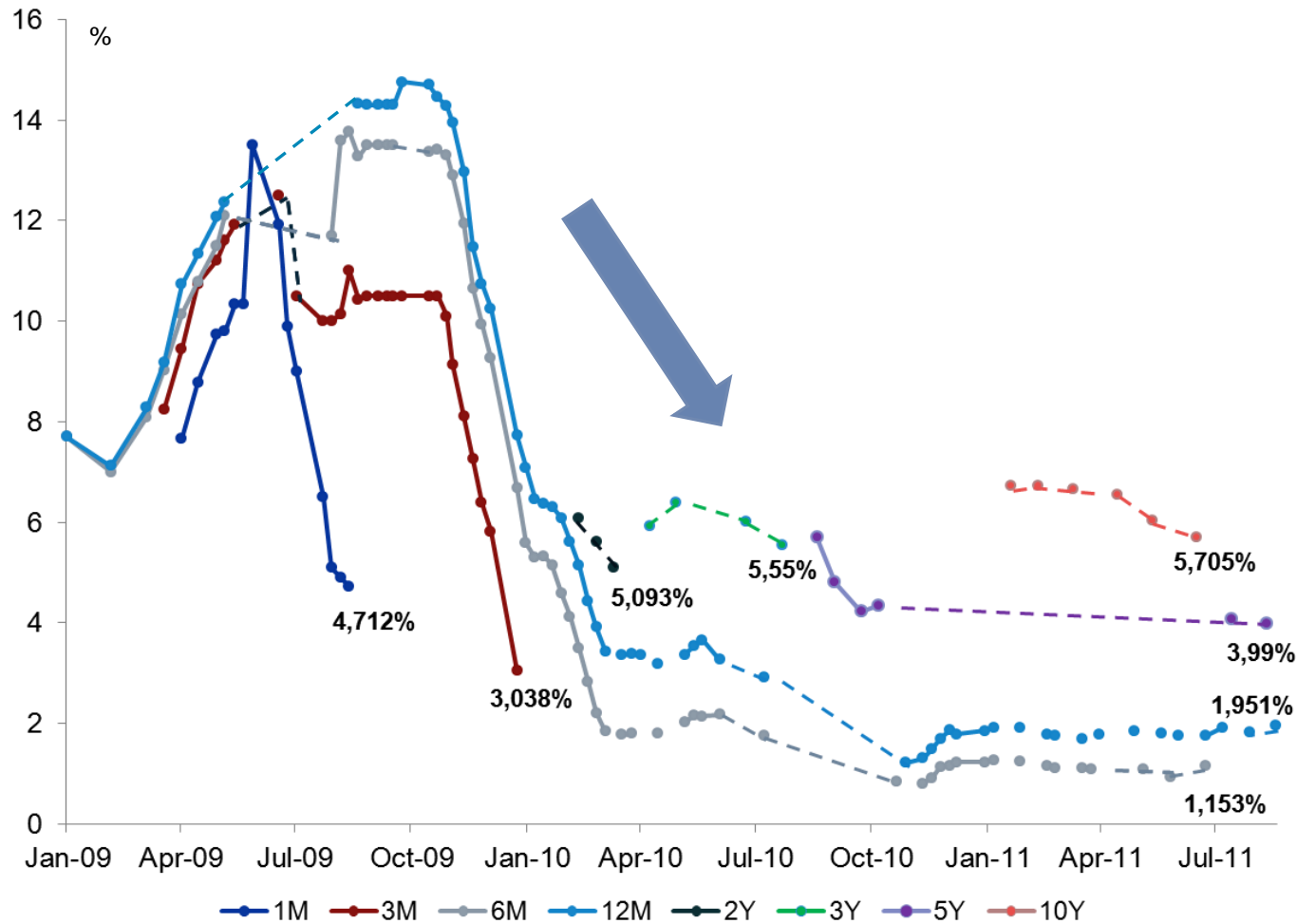
The largest portion of external government debt is now represented by the recent EU and IMF loans which were incurred since the start of the crisis

Eurobonds outstanding (3 issues) as of September 2011:

- \$ 562 million equivalent due in April 2014
- \$ 562 million equivalent due in March 2018
- \$ 500 million due in June 2021

# Domestic Market Performance Reflects Return of Investor Confidence

Average Weighted Yields of Domestic Securities (%)

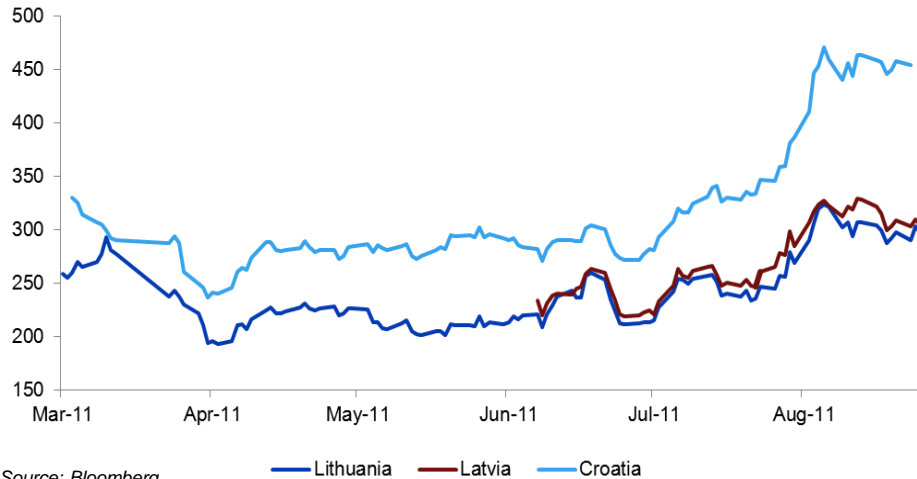


- Latvia's recovery has been further boosted by the return of regular domestic debt auctions
- 5 and 10-year programs has been reopened
- In the first half of 2011 successfully issued 10-year bond program (totally \$ 120 million)
- 6-12 month T-bills will be used to benchmark securities market with short-term instruments
- 1-3 month T-bills will be used only in case of unexpected changes in liquidity position
- Average weighted yield rates have markedly decreased over the last quarter of 2009 and in 2010 and now remain equal to record lows

Source: The Treasury

# CDS and Eurobond Trading Levels Tightened In Light of Economic Recovery

Latvia Eurobond Spread Performance vs. Mid-Swap (bps)

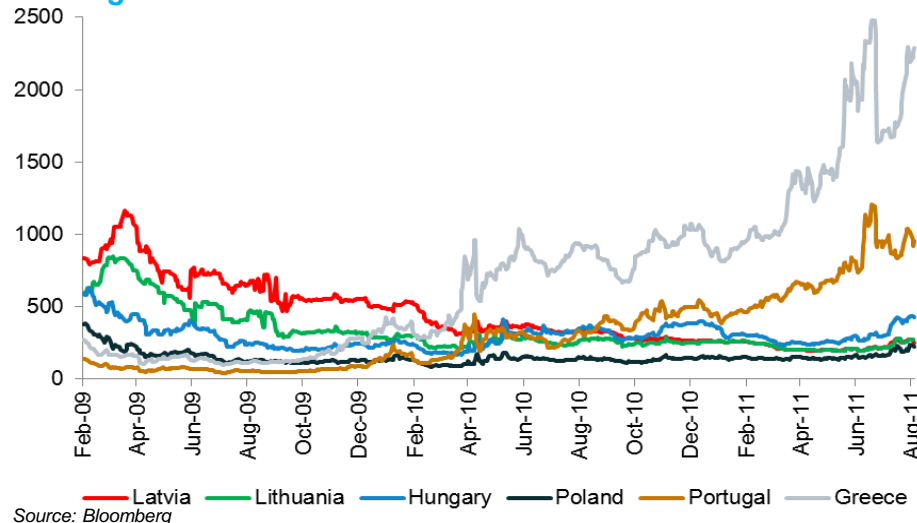


Latvia's Borrowing Strategy in medium term

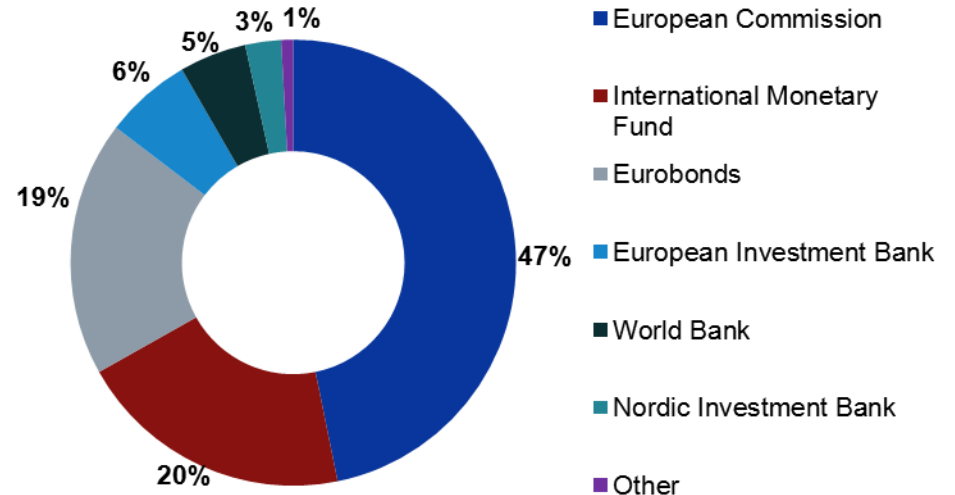
- To approach the international capital markets on a regular bases
- Keep investor diversification as priority by attracting new accounts in Europe, USA and Asia

5Y CDS Performance vs. New EU Sovereigns (bps)

*Credit default swap levels on Latvia have substantially improved, showing investors confidence in medium term*



External Debt Profile (July 30, 2011)





## US\$ 500 Million RegS/144a Bond

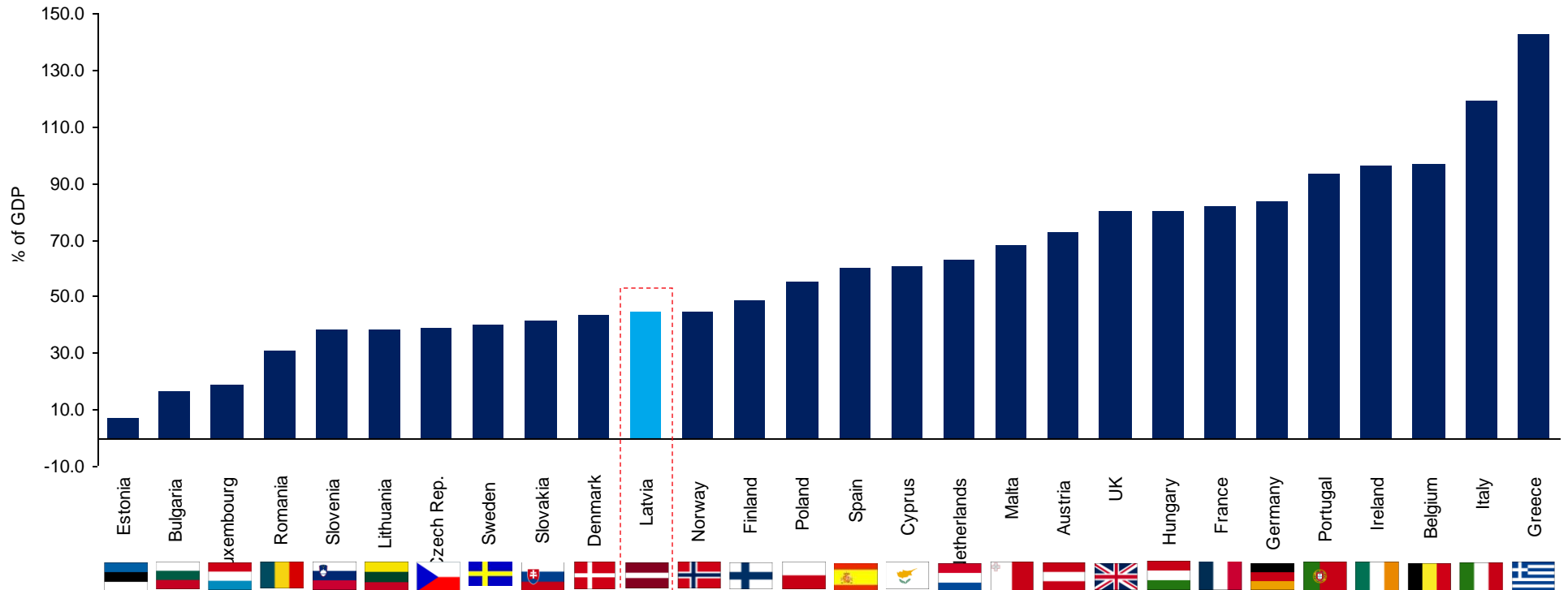
Issuer	• Republic of Latvia
Ratings	• Baa3 (+ve) / BB+ (+ve) / BBB- (+ve)
Format	• Reg S / 144a
Issue Size	• US\$500 million
Pricing Date	• 9 <sup>th</sup> June 2011
Settlement Date	• 16 <sup>th</sup> June 2011
Tenor	• 10-year
Maturity Date	• 16 <sup>th</sup> June 2021
Coupon	• 5.250%
Reoffer Price	• 98.164% of principal amount
Reoffer Yield	• 5.491%
Reoffer Spread vs. Benchmark	• +248.3 bps
Reoffer Spread vs. Midswaps	• +237.5 bps
Listing	• Luxembourg Stock Exchange

- The \$500mn Eurobond is the inaugural US Dollar benchmark transaction
- The offering attracted strong interest from investors impressed by the turnaround story
- The orderbook closed 7x oversubscribed with reoffer spread of 237,5bp at the tighter end of price guidance of 250 bp area. The orderbook allowed to allocate the bonds to a group of diverse top-quality investors

# Low Public Debt and Prudent Debt Management

Latvia has remained committed to keeping government debt at moderate levels ...

General Government Debt (% GDP, YE 2010)



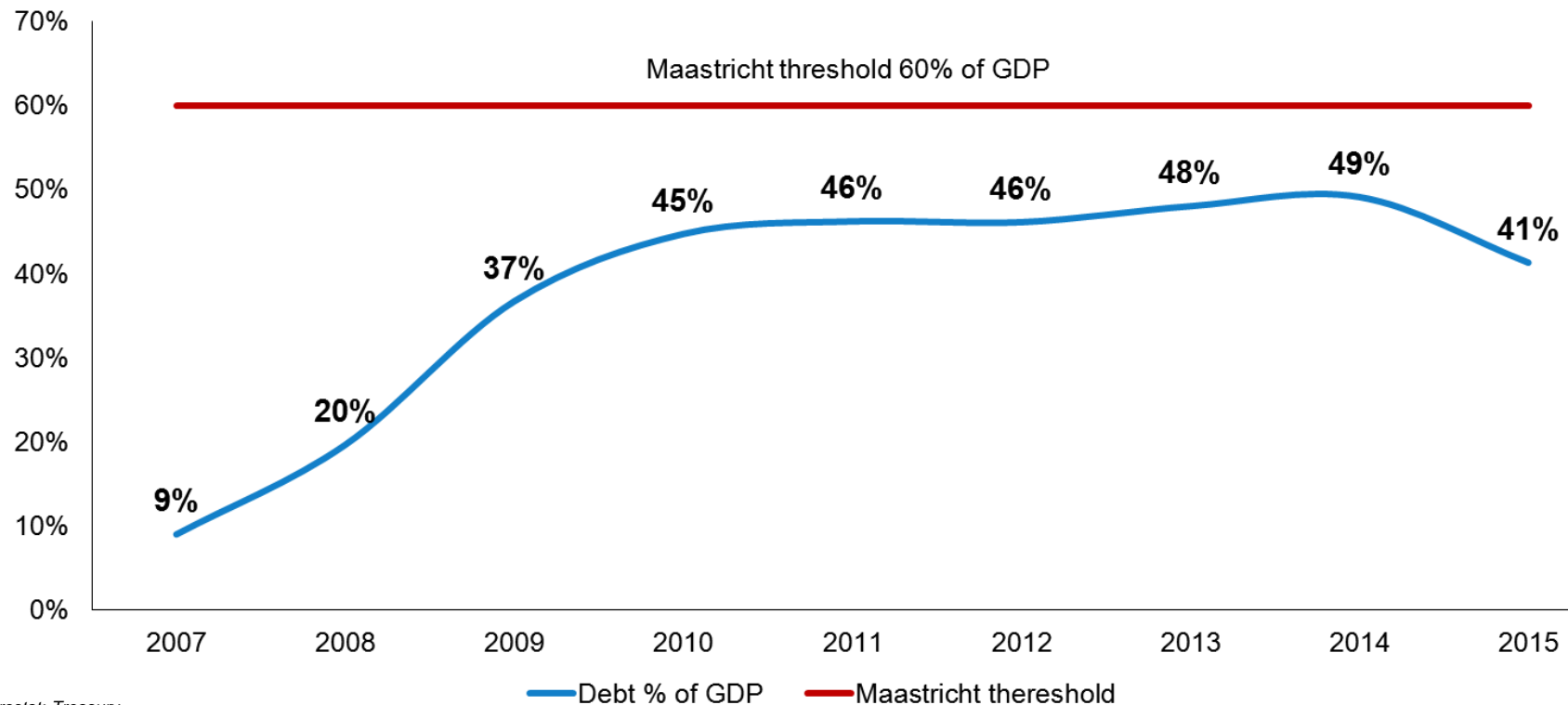
Source: Eurostat; General Government Debt comprises the subsectors of central government, state government, local government and social security funds

... thus being in a position to absorb the full impact of the recession

# Public Debt Remaining at Moderate Levels

- General government debt is amongst the lowest in the EU
- Conservative debt management policy has kept central government debt at moderate levels over the past decade
- General government debt is well within the Maastricht limit of 60% of GDP
- General government debt in 2010 was ~ 45% of GDP, \$ 11,281.3 million

General Government Debt (% of GDP, ESA 95 methodology)



Source: Eurostat; Treasury

# Borrowing Strategy - Base Scenario

## INTERNATIONAL BORROWING PROGRAMME

- **Not to disburse program funds**  
(except last disbursement from Wold Bank – € 100 million)

## FOREIGN CAPITAL MARKETS

- In **2012 – \$ 1 billion, for 2013 – \$ 2 billion** to cover **current needs** and **partly pre-fund** for 2014 and 2015 debt redemptions

## DOMESTIC MARKET

- **Continuing domestic borrowings -**  
net issuance \$ 200 million equivalent  
per year



## 6. Conclusions

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- Latvia has regained its competitiveness and the economy is steadily recovering. A shift from non-tradable to tradable sector is well underway
- Undertaken structural reforms will help to boost long-term growth
- Latvia is committed to further structural reforms and fiscal consolidation to meet its Maastricht criteria in 2012
- Latvia keeps its debt at a sustainable level and commits to finance itself mainly in public markets in the medium term

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