Republic of Latvia

Entering A New Phase of Reforms

August 2018
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Five Points Underpinning Latvia’s Credit Profile

1. Flexible, resilient economy, among fastest growing in the Eurozone

2. Broadly-diversified exports, important factor underpinning the stable current account balance

3. Fiscal discipline, deeply embedded, reflected in low, and still declining, government debt

4. New era of reforms launched in 2017, focused on improving productivity and more inclusive growth

5. Well-capitalized and profitable banking sector, supporting moderate expansion of credit, with tighter AML/anti-terrorism funding regime
1. Overview

Portrait of an Improving Sovereign Credit
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</table>
Latvia Belongs to Core Europe

Latvia belongs to core Europe. Latvia is deeply integrated in the international community and committed to high standards in terms of economic policies and governance.

Key Facts

<table>
<thead>
<tr>
<th>Territory</th>
<th>64,573 sq. km¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borders</td>
<td>Estonia, Lithuania, Belarus and Russia</td>
</tr>
<tr>
<td>Capital</td>
<td>Riga</td>
</tr>
<tr>
<td>Population</td>
<td>1.93 million¹</td>
</tr>
<tr>
<td>Currency</td>
<td>Euro</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>EUR 12,691¹</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>EUR 26.85 billion¹</td>
</tr>
<tr>
<td>Main economic sectors</td>
<td>Services (73%) and Manufacturing (14%)</td>
</tr>
</tbody>
</table>

Source: Central Statistical Bureau of Latvia

Latvia is a Member of the Eurozone, NATO and OECD

Eurozone Members

NATO Members

OECD Members

Europe

Latvia Regains Independence

Aug 1991

Latvia Admitted to NATO

Sep 1991

Approval of Loan Programme with IMF, EC and Bilateral Lenders

Mar 2004

May 2004

Dec 2008

Dec 2011 - Jan 2012

Jan 2014

Jan - Jun 2015

Jul 2016

Latvia Becomes UN Member

Latvia Enters EU

International Loan Programme with IMF/EC Closed Successfully

Latvia's Presidency of EU Council
Latvia`s Credit Ratings are on an Improving Trend

Rating agencies acknowledged Latvia’s low general government debt, small fiscal deficit and institutional strength.

### Key Strengths of Latvia’s Sovereign Credit Rating

- **Rapid growth** without worries about overheating
- **Eurozone membership** enhances Latvia’s creditworthiness:
  - underpins economic policy coherence and credibility
  - improves fiscal and external financing flexibility
  - reduces foreign-currency risks on balance sheets
  - gives Latvian banks access to European Central Bank liquidity facilities
- **Membership in the OECD with its accompanying commitments to structural reforms and economic liberalization**
- **Sound banking sector** – dominated by foreign Scandinavian banks

### Key Risk Factors Affecting Latvia’s Sovereign Credit Rating

- **Social expenditures and defence spending could be higher** than anticipated
- **External financing risks and geo-political tensions with Russia** continue to constrain the ratings
- Latvia is a small and highly open economy, making it **vulnerable to external shocks**

Source: S&P, Fitch and Moody’s
2. The Economy

Strong, Sustainable Growth
Growth Accelerated in 2017 and expected to remain solid in 2018

Latvia is among the top 5 fastest growing countries in the EU with a 3.0% average growth in the last 6 years. Robust growth is currently supported by strong consumption, private investment inflows, the EU funding cycle and favourable foreign trade conditions.

Real GDP Growth (%)

GDP Growth Composition (%)

Real GDP Growth (%)

GDP Growth (2017, %)

Source: Central Statistical Bureau of Latvia, Ministry of Finance

Source: Eurostat
Wage and Employment Growth Boosts Domestic Demand

Unemployment is close to the natural rate since 2013 and productivity growth is on the rise

Unemployment: Headline and Natural Rates

Participation and Employment Rates (age 15-64, %)

Real Productivity Growth Per Worker (2012-2017 average, %)

Average Monthly Wage For Full-time Job (Y-o-y, %)

Source: Central Statistical Bureau of Latvia data, Bank of Latvia

Source: Eurostat

Source: Central Statistical Bureau of Latvia data

Source: Central Statistical Bureau of Latvia data
Inflation decreased to slightly above 2%

Latvia has maintained moderate and predictable inflation for years. Headline inflation decreased recently; core inflation moderate and stable

### Inflation (HICP, %)

- **Energy**
- **Food, alcohol, tobacco**
- **Inflation**
- **Inflation excl. energy, food, alcohol, tobacco**

Source: Central Statistical Bureau of Latvia data, Bank of Latvia calculations

### Harmonised Index of Consumer Prices (HICP)

(June 2018, 12 month average rate of change; %)

- **EU-28**: 1.7%
- **Estonia**
- **Latvia**
- **Czech**
- **Austria**
- **Belgium**
- **France**
- **Finland**

Source: Eurostat

### HICP Projection (2018-2019, %)

- **EU-28**: 1.85%
- **Estonia**
- **Latvia**
- **Czech**
- **Austria**
- **Belgium**
- **France**
- **Finland**

Source: European Commission, Summer projection, 2018
Improved Competitiveness and Value-Added Products Drive Exports

Favourable position in both price and quality competitiveness

**Export Market Shares (2010=100)**

- Czech Republic
- Estonia
- Latvia
- Slovakia
- Slovenia

Source: World Trade Organization

**Real Effective Exchange Rate (REER) Index (2005 = 100)**

- REER (deflator: consumer price indices - 37 trading partners)
- Profit margin in manufacturing, (4-q moving avg), rhs

Source: Eurostat

**Goods Exports Growth (2009-2017, %)**

- Latvia
- Czech Republic
- Finland
- Estonia
- Belgium
- France
- Austria

Source: Eurostat
3. Banking Sector
Well-Capitalized, Profitable, and Beginning to Lend Again
Latvia’s outstanding growth engine has been supported by well capitalized banking sector, majority of which is owned by large Nordic banking groups.

Key Highlights

- The Latvian banking sector is dominated by subsidiaries and branches of banks from the European Economic Area, mostly Nordic countries\(^1\) (54\% of the banking sector capital, 67\% of assets, 85\% of domestic loans and 81\% of domestic deposits)

- Capitalisation and liquidity ratios are well above minimum requirements. The banking sector’s capital is mostly made of CET1 capital:
  - CET1 ratio \(_{1Q\ 2018}=20.0\%\) vs. EU average \(_{1Q\ 2018}=14.2\%\)\(^2\)
  - LCR \(_{2Q\ 2018}=251\%\)

- The three largest banks are directly supervised by the ECB. Four banks fall under the remit of the Single Resolution Mechanism (12.07.2018. licence of ABLV Bank AS was withdrawn)

Source: \(^1\)FCMC, \(^2\)EBA risk dashboard, fully loaded ratio

Source: Bank of Latvia

Capital Adequacy (%)

Liquidity Coverage Ratio

Source: FCMF | Note: Data on 2Q 2018
Bank Lending Recovers and Supports Growth

Domestic lending recovers and loan portfolio quality is above EU average

**Key Highlights**

- After prolonged period of deleveraging, lending growth turned positive in April 2016
  - Loans to domestic households and NFCs stand at 46% of GDP, down from almost 100% at the outset of the crisis
  - Loan-to-deposit ratio has fallen substantially leading to more balanced and sustainable domestic funding for loans
- The quality of loan portfolio is above EU average and continues improving further. The coverage ratio of overdue loans remains high
- The ECB bank lending survey indicates gradual increase in demand for loans in Latvia. Lending standards remain stable, however, banks plan to ease them. Expansionary monetary policy of the ECB is a supportive factor for lending

**Total Loan Portfolio Quality**

![Graph showing total loan portfolio quality over time with data points for 2011 to 2018 for Estonia, Latvia, Lithuania, and Eurozone.](image)

Source: FCMF

**Loans to Domestic Clients excluding Government (yoy)**

![Graph showing loans to domestic clients excluding government from 2012 to 2018 for Estonia, Latvia, Lithuania, and Eurozone.](image)

Source: ECB

*The time series have been adjusted excluding the one-off effects of loan write-offs, exchange rate fluctuations, reclassification, etc.*

**Domestic Loan-to-Deposit Ratio (%)**

<table>
<thead>
<tr>
<th>Country</th>
<th>2012 June</th>
<th>2018 June</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>145.1</td>
<td>112.3</td>
</tr>
<tr>
<td>Latvia</td>
<td>178.9</td>
<td>99.7</td>
</tr>
<tr>
<td>Lithuania</td>
<td>135.4</td>
<td>98.0</td>
</tr>
<tr>
<td>Eurozone</td>
<td>112.2</td>
<td>96.6</td>
</tr>
</tbody>
</table>

Source: ECB
Banking Sector Profitability Remains Healthy

Banking sector profitability is supported by stable interest spread and economic growth

Key Highlights

- In 2017, profitability of domestically active banks gradually increases as a result of favorable macrofinancial conditions.

- The profit of banks servicing foreigners continues to decrease due to decline in business volume and increased administrative expenses, which were largely caused by implementing enhanced AML/CFT requirements. In the light of recent events, a further deterioration of their profitability is expected. In 2017, severe losses of one credit institution (RoE < -50%; not shown on chart) were caused by a sale of a subsidiary.

- RoE and RoA of the Latvian credit institutions are relatively high, and still exceeds the EU average. In 2017, average RoE was 9.1% (when adjusted for the one-off write-off of DTAs and creation of the Luminor Group); EU average – 6.1% (EBA Risk Dashboard Q4 2017).

- In 2018, domestically active banks’ returns remain more stable, less dispersed, while returns of banks servicing foreigners remain quite volatile. Average RoE decreased to 8.1% in first half of 2018, mainly due to poorer returns of banks servicing foreigners.

- With record-low loan and deposit rates, interest rate spread on outstanding amounts remains stable at around 3%
Parent Banks are Stable, Financially Sound and Profitable

Banks have high credit ratings, good profits, and on average they outperform their European peers on stock exchanges (compared to Eurostoxx Bank index)

Key Highlights

- Financial performance and capitalization level of the parent banks are strong
- Nordic banking groups' profitability is higher than the average in Europe
- Banks continue to invest in IT related projects to increase their operational efficiency and lower administrative expenses
- Since October 1, 2017, Nordea Bank AB Latvia branch and DNB Bank have merged their operations in the Baltic States. The newly-established Luminor Bank. Q1 2018, Luminor Bank is:
  - The second largest bank in Latvia by assets (4.8 billion EUR, 19% market share)
  - The second largest bank by equity (509 million EUR) and deposits value (2.9 billion EUR, 16% market share)
  - The first largest bank by the issued loans value (3.5 billion EUR, 25% market share)

Banks Financial Information

<table>
<thead>
<tr>
<th></th>
<th>Swedbank</th>
<th>SEB</th>
<th>DNB</th>
<th>Nordea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets (EUR mil)*</td>
<td>5,530</td>
<td>3,589</td>
<td>4,803</td>
<td></td>
</tr>
<tr>
<td>CET1 ratio (%)*</td>
<td>25.57</td>
<td>22.49</td>
<td>17.35</td>
<td></td>
</tr>
<tr>
<td>ROE (%)*</td>
<td>17.75</td>
<td>12.64</td>
<td>4.82</td>
<td></td>
</tr>
<tr>
<td>S&amp;P Global long term rating</td>
<td>AA-</td>
<td>A+</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>Moody's long term rating</td>
<td>Aa3</td>
<td>Aa3</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>Fitch long term rating</td>
<td>AA-</td>
<td>AA-</td>
<td>*</td>
<td></td>
</tr>
</tbody>
</table>

Source: Association of Latvian Commercial Banks – financial reports, 1st quarter 2018 | *October 2017 Nordea group and DNB entities merged in the Baltics into one financial institution Luminor. Data on Luminor credit rating to be assigned.
4. Banking Sector Reforms

Strengthening AML/Anti-Terrorism Funding Controls
The events leading to the liquidation of ABLV Bank triggered regulatory efforts to significantly reduce high risk transactions by Latvian banks. New business models are being implemented in targeted banks as part of this initiative.

Key Highlights

- All credit institutions in Latvia specialising in foreign customer service have been provided with initial information about the necessity to ensure faster changes in the business model of the bank, in order to prevent and decrease the share of high risk transactions and in doing, non-residents servicing banks had to submit the FCMC plans for restructuring their business by April.

- FCMC is supervising the change of the business models of the credit institutions, by reducing the share of large exposure customers and achieving the target variables set by the FCMC for the sector as a whole.

- On April 10 the Government approved the amendments to the Law on the Prevention of Money Laundering and Terrorism Financing banning cooperation between banks and shell companies in Latvia which have no real economic activity, thus even more strengthening the AML/CFT requirements.

- In addition Law plans to establish Financial Crime Investigation Special Task force, enabling effective cooperation of private and public sector in financial intelligence and investigation of financial crimes.

- Respective amendments were adopted by the Parliament on April 26 and the amended Law on the Prevention of Money Laundering and Terrorism Financing is fully effective from May 9, 2018.

- The Law would prescribe that within 14 days after the date when the Law is effected, banks shall notify their high-risk clients of closing their accounts and within 60 days banks no longer can perform any operations with the accounts.

Timeline for the enforcement of the amendments to the Law on the Prevention of Money Laundering and Terrorism Financing

- **April 10th**
  - Government approves the amendments to the Law on the Prevention of Money Laundering and Terrorism Financing

- **April 26th**
  - The amended Law approved by the Parliament (Saeima)

- **May 9th**
  - The amended Law is fully effected

- **May 22nd**
  - The deadline of 2-week notice by Banks to their clients in question

- **July 8th**
  - Banks no longer can perform any operations with the high risk clients accounts.
The Economic Impact of Tighter AML CFT is Minimal

Latvia’s banking system is dominated by banks owned by strong Nordic parents, funded through domestic deposits, lending to Latvia-based clients. Banks funded through foreign currency deposits play a small role in Latvia’s economy.

The Role of Foreign Clients Banks in Latvia (without ABLV Bank)

- **Total Banking Assets**
  - 32% for Banks servicing Foreign Clients (FC)
  - 7% for Total Domestic Lending
  - 7% for Total Domestic Deposits

Growth Rates of Domestic and Foreign Client Deposits (%)

- Introduction of tougher AML/CFT requirements
- Weaker CIS economies

Bank Liquidity Ratios Well Above FCMC Requirement

- Source: Fitch (Latvia sovereign risk from ABLV Bank failure appears limited, 27.02.2018.)
- Source: Bank of Latvia, data 2Q 2018

Economic Impact of ABLV Bank Liquidation

- The liquidation of ABLV has had little impact on the Latvian economy
  - Government revenues from ABLV were 0.06 % from GDP in 2017, with 0.3 % from GDP generated overall from NRD sector.*
  - Funds covering guaranteed deposits were transferred from ABLV
  - ABLV has already repaid the emergency liquidity assistance extended to it earlier by the Bank of Latvia.
  - Deposit flight has not spread to other banks whose business models are based primarily on domestic funding and lending.

Source: Bank of Latvia, Latvia’s banking system is dominated by banks owned by strong Nordic parents, funded through domestic deposits, lending to Latvia-based clients. Banks funded through foreign currency deposits play a small role in Latvia’s economy

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*Fitch (Latvia sovereign risk from ABLV Bank failure appears limited, 27.02.2018.)
5. Fiscal Policy

Disciplined Approach Supports Improved Credit Profile
Fiscal Sustainability Remains Top Priority

Prudent fiscal management and fiscal discipline regulation ensures public deficits to be at low and sustainable level.

### General Government nominal balance (% of GDP)

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</tr>
</thead>
<tbody>
<tr>
<td>Balance</td>
<td>-1.2</td>
<td>-1.2</td>
<td>-1.4</td>
<td>-1.5</td>
<td>-0.5</td>
<td>0.1</td>
<td>-0.9</td>
<td>-0.9</td>
<td>-0.4</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

### Budget Balance (2017, % GDP)

- **EU-28**: (-1.0)%
- France: AA/Aa2/AA
- Belgium: AA/Aa3/AA-
- Finland: AA+/Aa1/AA+
- Austria: AA+/Aa1/AA+
- Estonia: AA-/A1/A-
- Latvia: A-/A3/A-
- Czech: AA-/A1/A+

### Expenditure Review Results (Eur, Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reallocating resources to common government priorities</td>
<td>28.6</td>
<td>25.4</td>
</tr>
<tr>
<td>Internal resources for own sectoral priorities</td>
<td>52.5</td>
<td>47.6</td>
</tr>
</tbody>
</table>

### 2018 Budget: Expenditure Measures (EUR million)

- Healthcare services
- Strengthening national security
- Demographic measures, support to foster families and guardians, strengthening social program
- Road maintenance and construction
- Remuneration of higher education teachers, additional funding for research
- Eastern border and strengthening internal security
- Support to cultural projects and media, implementation of integration measures
- Combating shadow economy, modernizing tax information services

### Source

- Ministry of Finance
- Eurostat
Pension Reform Underpins Stability of Public Finances

Latvia is well positioned to withstand fiscal challenges arising from an aging population.

Latvia’s Pension System And Recent Reforms

- Latvia’s reformed pension system consists of three tiers:
  1. state compulsory unfunded pension scheme (the 1st tier)
  2. state funded pension scheme (the 2nd tier)
  3. private voluntary pension scheme (the 3rd tier)

- In 2012, measures were introduced to address long-term sustainability:
  - starting with 2014 retirement age is gradually increased by 3 months each year until it reaches 65 years in 2025
  - minimum contribution period to secure full pension was increased from 10 to 15 years starting from 2014 and up to 20 years starting from 2025
  - contributions to the funded, e.g. 2nd tier, pension scheme increased from 2% to 4% in 2013, to 5% in 2015, and to 6% in 2016

Source: The State Social Insurance Agency

Age-related Spending, Projected Change (2013-2060, % GDP)

Latvia’s age-related spending is one the lowest in EU (2013, % GDP)

6. New Reform Push

Targets Productivity and More Inclusive Growth
Latvia’s Advanced Country Status Reflected in “Soft” Metrics

Expanded Structural reforms to build on existing high institutional strength and favourable business environment.

**World Bank “Ease of Doing Business” Ranking**

- Estonia: AA-/A1/A+
- Latvia: A-/A3/A-
- Austria: AA+/Aa1/AA+
- Czech: AA+/Aa1/AA+
- France: AA/Aa2/AA
- Belgium: AA/Aa3/AA-

Source: World Bank, Doing Business 2017

**World Bank Worldwide Governance Rankings**

<table>
<thead>
<tr>
<th>Category</th>
<th>Latvia</th>
<th>Regional Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control of Corruption</td>
<td>64</td>
<td>67</td>
</tr>
<tr>
<td>Rule of Law</td>
<td>66</td>
<td>80</td>
</tr>
<tr>
<td>Regulatory Quality</td>
<td>70</td>
<td>84</td>
</tr>
<tr>
<td>Government Effectiveness</td>
<td>69</td>
<td>79</td>
</tr>
<tr>
<td>Political Stability and Absence of Violence</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Voice and Accountability</td>
<td>66</td>
<td>74</td>
</tr>
</tbody>
</table>

Source: World Bank, 2016 Rankings

**Adjusted Top Statutory Tax Rate on Corporate Income** (2017, %)

- Latvia: 15
- Czech: 19
- Finland: 20
- Estonia: 15
- Austria: 25
- Belgium: 34
- France: 34

Source: Financial and Capital Markets Commission, Central Statistical Bureau of Latvia

**The Global Competitiveness Index Rankings**

- Sweden: 10
- Belgium: 20
- Estonia: 29
- Czech Rep.: 31
- Lithuania: 41
- Portugal: 42
- Italy: 43
- Slovenia: 48
- Bulgaria: 49
- Latvia: 54
- Slovakia: 59
- Hungary: 60
- Romania: 66
- Croatia: 74

Reform Policies Laying Foundation for New Growth Model

Structural reforms in education, employment and judicial environment help improving labour market and business conditions

### Education, Research and Innovations
- Increasing the quality of education and research, fostering investments in R&D and innovations

### Labour Market, Social Policy and Healthcare
- Addressing labour market issues through education and employment policies; decreasing tax burden on labour; activating social benefit recipients; improving accessibility, quality and efficiency of healthcare
- SME access to financing, export oriented programmes, reduction of administrative burden

### Business Environment
- Increasing efficiency of public administration, strengthening the conflict of interest prevention regime, improving tax compliance; improving the insolvency regime and accountability of insolvency administrators

### Public Administration and Judiciary
- Increasing efficiency of public administration, strengthening the conflict of interest prevention regime, improving tax compliance; improving the insolvency regime and accountability of insolvency administrators

### Healthcare Reform
- Aimed to improve governance, clearer principles of resource allocation and more efficient use of funds
- Implementation of Public Health Guidelines 2014 - 2020 to encourage the healthcare system availability, quality and cost-effectiveness
- Healthcare long term funding reform
- Stability and Growth Pact deficit derogation for 2017 - 2019 was granted for healthcare reform (e.g., reducing waiting line; detection of cancer and improving access to treatment; reform of reimbursable drugs for patients of the Chronic hepatitis C).

### Education Reform (2015, % GDP)
- Funding for education is adequate, but the network of education system and number of pupils per teacher are not optimal.
- Teacher remuneration reform starting from September, 2016: (i) fixed minimum salary for teacher; (ii) school network rearrangement; (iii) increase in funding for teachers’ salaries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Rating</th>
<th>Stability and Growth Pact Derogation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech</td>
<td>AA-/A1/A+</td>
<td>6.0%</td>
</tr>
<tr>
<td>Austria</td>
<td>AA++/Aa1/AA+</td>
<td>EU-28: 4.9%</td>
</tr>
<tr>
<td>France</td>
<td>AA/Aa2/AA</td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>A-/A3/A-</td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>AA-/A1/A+</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>AA+/Aa1/AA+</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>AA/Aa3/AA-</td>
<td></td>
</tr>
</tbody>
</table>


Source: Eurostat

26
EU Playing Key Role in Funding Structural Change in Latvia

Efficient and well targeted absorption and use of EU funds will promote competitiveness and stimulate economic growth as well as support necessary structural reforms

### Allocation Of EU Funds For 2014-2020 By Priority Axes

- Promoting sustainable transport and removing bottlenecks in key network infrastructures: 26%
- Protecting the environment and promoting resource efficiency: 14%
- Investing in education, skills and lifelong learning: 12%
- Supporting the shift towards a low-carbon economy in all sectors: 11%
- Strengthening research, technological development and innovation: 11%
- Promoting social inclusion and combating poverty: 9%
- Investing in education, skills and lifelong learning: 7%
- Enhancing the competitiveness of small and medium-sized enterprises: 4%
- Enhancing access to, and use and quality of, information and communication technologies: 4%
- Promoting employment and supporting labour mobility: 2%
- Technical assistance: 2%

### EU Cohesion Policy Accompanies Structural Reforms

- Latvian economy and the goals envisaged by the National Development Plan are strongly supported by implementation of EU cohesion policy and effective utilization of EU structural funds and Cohesion Fund.
- EUR 4.4 billion EU funds are available for targeted and smart investments in Latvia within 2014 - 2020 programming period. During 2007 - 2013 period Latvia has successfully and fully used EUR 4.5 billion of Cohesion Policy EU funds.
- The funds were allocated and will be utilised across major nine priority areas with an aim to enhance competitiveness of Latvia’s economy, and to build foundation for the sustained growth.

Source: Ministry of Finance

### EU Funds After 2020 and Government’s Support

- The European Commission has published a proposal for the new multiannual financial framework after 2020 in May 2018. According to the proposal, cohesion policy funding will be cut by approximately 10%. The reduction is caused by the following aspects:
  - Brexit and the consequent financial gap;
  - Increase in expenditures caused by new challenges and unforeseen events.

  The overall impact on the Latvia’s envelope will be estimated after the Commission will publish legislative sectoral proposals for spending programmes at the end of the May 2018.

- Government is providing support (via intermediary - JSC Development Finance Institution Altum) and offers financing – such as loans, guarantees, equity capital or grants – mainly to SMEs, start-ups, mid-caps and micro-enterprises, but also to individuals and companies active in the agricultural sector.

Source: Ministry of Finance
Pro-growth Tax Reform in Line with Balanced Budget Mandate

Key goals: improve competitiveness, promote exports, reduce inequality and raise revenue to one-third of GDP

Strategy framework

- Tax structures and rates review
- Improving tax administration
- The fight against the shadow economy

Principles

- Predictability and a long-term vision
- Regional competitiveness, at least in the Baltic region
- Tax motivation for improvement
- A similar tax burden on similar types of revenue
- Lending and capitalization improvement
- Reducing the cost of tax administration

Positive impact on economy

- Raise of disposable income of employees inducing private consumption;
- More competitive entrepreneurs on regional and global scene as well as stimulation of own investment;
- Better capitalized businesses, more opportunities to raise additional funds for development;
- Increased prospects to raise production capacity of goods and services, more effective and efficient production process;
- More equality between different income groups and types of income;
- Higher tax revenue resulting from increased economic activity and less tax avoidance.

Main changes

- Non-taxable minimum – EUR 250
  - Differenced depending on income level from EUR 0/month to EUR 250 per month (2020)
- Allowance for dependents
  - EUR 250 per month (2020)
- Minimum salary
  - from EUR 380 to EUR 430
- Social contribution
  - increase by 1% directed to health care
- Reform of Solidarity tax
- PIT rate smoothing
- Progressive Personal Income Tax
  - Decrease from 23% to 20% for year’s salary up to EUR 20,004, 23% for EUR 20,004 – 55,000, 31.4% for above EUR 55,000
- Corporate Income Tax
  - 0% for reinvested profit; 20% - distributed profit

Source: Ministry of Finance
7. Government Debt and Funding Strategy
Latvia remains committed to keeping government debt at moderate levels

**Key Characteristics of Latvia’s Government Debt**

- Fiscal consolidation and reduction of the deficit along with economic growth has helped stabilise levels of government debt.
- General government debt is amongst the lowest in the EU at 40% of GDP at the end of 2017. It is the 4th lowest in the Eurozone and the 8th lowest in the EU.
- Latvia enjoys one of the lowest debt servicing costs across the region, significantly lower than the EU and Eurozone averages.
- Since March 2014 Latvia participates in the European Stability Mechanism, which provides additional financial stability to its members.

**General Government Debt Year End**

<table>
<thead>
<tr>
<th>Year</th>
<th>EUR million</th>
<th>% GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>8,893</td>
<td>39%</td>
</tr>
<tr>
<td>2014</td>
<td>9,669</td>
<td>41%</td>
</tr>
<tr>
<td>2015</td>
<td>8,953</td>
<td>37%</td>
</tr>
<tr>
<td>2016</td>
<td>10,092</td>
<td>40%</td>
</tr>
<tr>
<td>2017</td>
<td>10,782</td>
<td>40%</td>
</tr>
<tr>
<td>2018F</td>
<td>11,072</td>
<td>38%</td>
</tr>
<tr>
<td>2019F</td>
<td>11,468</td>
<td>37%</td>
</tr>
<tr>
<td>2020F</td>
<td>12,326</td>
<td>38%</td>
</tr>
<tr>
<td>2021F</td>
<td>12,169</td>
<td>36%</td>
</tr>
</tbody>
</table>

**Debt Servicing Costs (%) GDP**

Source: Eurostat, The Treasury

**General Government Debt (2017, % GDP)**

Source: Eurostat
Latvia is conducting a prudent and efficient debt management strategy

**Government Gross Borrowing (nominal, EUR million)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total gross borrowing</th>
<th>Pre-funding reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>1,668</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>1,150</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>1,370</td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td>1,390</td>
<td></td>
</tr>
<tr>
<td>2020</td>
<td>1,210</td>
<td></td>
</tr>
<tr>
<td>2021</td>
<td>1,100</td>
<td></td>
</tr>
</tbody>
</table>

**Secondary Market (mid yield to maturity, %)**

<table>
<thead>
<tr>
<th>Year</th>
<th>LATVIA EUR bond yield curve</th>
<th>LATVIA USD Eurobond</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>3.15</td>
<td>0.0</td>
</tr>
<tr>
<td>2017</td>
<td>3.02</td>
<td>0.27</td>
</tr>
<tr>
<td>2018</td>
<td>0.59</td>
<td>0.77</td>
</tr>
<tr>
<td>2019</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>2020</td>
<td>1.52</td>
<td>1.81</td>
</tr>
<tr>
<td>2021</td>
<td>2.00</td>
<td>2.52</td>
</tr>
</tbody>
</table>

**Borrowing activities in international capital markets in 2017**

- Latvia tapped the market twice with dual tranche Eurobond issues.
- For the first time 30-year Eurobonds were issued as the longest tenor so far, setting a coupon at 2.250% (yield 2.330%), providing a benchmark issue size of EUR 500 million.
- In order to increase liquidity, Latvia also reopened two of its Eurobonds in 2017:
  - maturing October 7, 2026 increasing the outstanding amount by EUR 300 million in two transactions;
  - maturing May 16, 2036 increasing the outstanding amount by EUR 200 million in two transactions.

Source: The Treasury

Source: Data as of 31st July 2018, Bloomberg
Domestic Market Continues to Perform Strongly

Demand is steady and average yields remain low

Domestic Securities Outstanding by Original Maturity (end of the June 2018, %)

- 5 years bonds: 13.8%
- 3 years bonds: 2.2%
- 10 years bonds: 0.5%
- 11 years bonds: 21.5%
- Savings bonds: 62.1%

Source: The Treasury

Domestic T-Bond Competitive Multi-Price Auctions

- Jan 2017: 4.1%
- Mar 2017: 4.0%
- May 2017: 5.3%
- Nov 2017: 4.6%
- Dec 2017: 6.5%
- Jan 2018: 5.8%
- Feb 2018: 4.6%
- Apr 2018: 3.2%
- May 2018: 2.5%
- Jun 2018: 3.5%
- Jul 2018: 3.8%

Source: The Treasury | Note: Bid-to-Cover ratio: Bid Amount to State Treasury offered amount, * Since 2015 6m T-Bills benchmarks are tap issues of original 12m T-Bills in maturity brackets from 4.5 to 9 months.

### Last 5 year T-Bond auction results

- On 11th of July Latvia had last T-bond auction
- Nominal value of 16 million EUR were sold in a competitive multi-price auction with total demand of 57.1 million EUR (bid-offer ratio of 3.57).
- In addition 4 million EUR were sold in non-competitive (fixed price) auction.
- The weighted average yield rate was 0.478%.

- Primary dealer system operates since 11 February 2013. Domestic debt securities outstanding constituted EUR 1.097 billion as of 20th July 2018.
- The Treasury maintains regular domestic debt securities auctions offering medium term T-bonds. Long term segment is covered by international issues.
- For several years Latvia has concentrated domestic supply mainly in 5-year segment and focuses on increasing the liquidity.
- Last 5 year T-bond program (via 6 auctions) reached of 150 million EUR outstanding.
- A new 5-long T-bond program was opened in the beginning of 2018. Coupon was fixed at the 0.250%. Currently amount outstanding is 170 million EUR. In order to maintain liquidity it is expected to continue regular auctions and gradually increase on-the-run 5-long T-bond program.
Central Government Debt Profile

International Loan Programme has been largely refinanced in international capital markets, while government debt redemptions remain moderate.

Debt structure by Instruments (%)

Outstanding Bonds in the International Markets (nominal amount, million)

Debt Redemption Profile (EUR million)

Debt Portfolio Management

Parameters | Strategy | 31/03/2017 | 30/06/2018
---|---|---|---
Maturity profile (%) |  |  | |
- up to 1 year | ≤ 25% | 10.2% | 14.6%
- up to 3 year | ≤ 50% | 43.8% | 44.1%
Share of fixed rate (1) | ≥ 60% | 93.8% | 89.1%
Macaulay duration (years) | 5.00 – 9.00 | 6.05 | 6.47
Net debt (2) currency composition | 100% EUR with a deviation of +/- 5% | 99.96% | 99.97%

Source: The Treasury | (1) Fixed rate central government debt with a maturity over one year; (2) Central government debt at the end of the period less the amount of loans and receivables, where impairment loss of guarantees are not taken in account (including Treasury’s cash accounts, investments in deposits and fixed income securities, loans, receivables (including receivables of derivative financial instruments which are not classified as risky from credit risk perspective)), and increased by provisions of guarantees as well as liabilities of derivative financial instruments which are not classified as risky from credit risk perspective.
Medium Term Funding Requirement and Borrowing Strategy 2018-2020

External borrowing instruments will represent the most significant share of the overall borrowing volume

### General Financing Requirement

- **Central Government Budget Balance**
- **Net Lending**
- **Other Flows at the Treasury’s Accounts**
- **Outstanding Central Government Debt Redemptions (domestic and external)**

### Medium Term Borrowing Strategy

**Goal**
- Ensure timely and full availability of financial resources for covering the financing requirement, by maintaining continuous borrowing opportunities in the international and domestic financial markets on optimal terms and conditions.

**Principles**
- Flexibility (towards timing, maturities and currencies)
- Achieve balance between risks and costs
- Consistency and transparency to markets

### Borrowing Instruments (BASE scenario)

- Benchmark issuances in global capital markets
- Continuing issuances in domestic market

### Alternative Instruments

- Niche capital market instruments (JPY, CHF, etc.)
- Private placements (reverse enquiries)
- Loans from international financial institutions (EIB, CEB, etc.)

### Central Government financing estimation (2018-2020, EUR million)

<table>
<thead>
<tr>
<th></th>
<th>31-July-2018</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government budget balance, net lending and other flows</td>
<td>635</td>
<td>-1 179</td>
<td>-510</td>
<td>-449</td>
</tr>
<tr>
<td>Outstanding central government debt redemption</td>
<td>-700</td>
<td>-175</td>
<td>-982</td>
<td>-1 285</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic debt repayment</td>
<td>-221</td>
<td>-144</td>
<td>-383</td>
<td>-114</td>
</tr>
<tr>
<td>External debt repayment</td>
<td>-480</td>
<td>-32</td>
<td>-599</td>
<td>-1 171</td>
</tr>
<tr>
<td>Total</td>
<td>-65</td>
<td>-1 355</td>
<td>-1 492</td>
<td>-1 733</td>
</tr>
<tr>
<td>Gross borrowing</td>
<td>820</td>
<td>550</td>
<td>1 390</td>
<td>2 120</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>International issuance</td>
<td>650</td>
<td>350</td>
<td>1 000</td>
<td>2 000</td>
</tr>
</tbody>
</table>

Note: Indicative in the planned period

### The borrowing volume could be increased in case of:

- **Liability management activities**
- Possible restructuring of the government guaranteed commitments (loans) of several hospitals by refinancing / early repayment
8. Conclusion

Building on Past Success, Facing Future Challenges
Latvia has fully recovered from the economic recession and has built-up an outstanding fiscal position, returning to its previous standards of fiscal prudence. The economy is on a sustainable, robust growth path, characterized by improved competitiveness, solid domestic demand, and a flexible business sector able to adjust to external shocks.

**Flexible and Resilient Economy**
- Decreasing Unemployment

**Belongs to the Core of Europe**
- EZ membership
- The member of all the important international organizations

**Well Capitalised Banking Sector**
- Credit Growth is being restored
- Economic Development promoted

**Sustainable Debt Levels and Prudent Fiscal Management**
- Investor attractiveness

**Resilient towards external shocks**
- Proven track record in overcoming economic crisis in the past

**Predictable public policies and outstanding track record of successful structural reforms**
- Long term growth reinforced

**Solid Export Growth**
- Balance of Payments improvement
- Sustainable Current Account Balance

**Credit rating gains**
- Investors confidence boosted due to reforms and sound macroeconomic fundamentals