Republic of Latvia

Entering A New Phase of Reforms

February 2019
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Key Strengths Underpinning Latvia’s Credit Profile

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

2. Broadly-diversified exports, important factor underpinning the sustainable 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 Ascending Sovereign Credit
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<td>1) Overview: Portrait of an Ascending Sovereign Credit</td>
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Latvia belongs to core Europe. The country is also deeply integrated in the international community and committed to high standards in terms of the quality of economic policies and governance.

Key Facts

- **Territory**: 64,573 sq. km
- **Borders**: Estonia, Lithuania, Belarus and Russia
- **Capital**: Riga
- **Population 2018**: 1.93 million
- **Currency**: Euro
- **GDP per capita 2017**: EUR 13.926
- **Nominal GDP 2017**: EUR 27.03 billion
- **Main economic sectors 2017**: Services (74%) and Manufacturing (13%)

Source: ^1Central Statistical Bureau of Latvia

Latvia is a Member of the Eurozone, NATO and OECD

Europe

Eurozone Members

NATO Members

OECD Members

Latvia Belongs to Core Europe

Latvia Regains Independence

Latvia Enters EU

Latvia Becomes UN Member

Latvia Becomes OECD Member

Approval of Loan Programme with IMF, EC and Bilateral Lenders

Latvia joins Eurozone/ Economic and Monetary Union

International Loan Programme with IMF/EC Closed Successfully

Latvia’s Presidency of EU Council

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**Timeline**

- Aug 1991: Latvia Regains Independence
- Sep 1991: Latvia Enters EU
- Mar 2004: Latvia Becomes UN Member
- May 2004: Latvia Admitted to NATO
- Dec 2004: Latvia Enters EU
- Dec 2008: Approval of Loan Programme with IMF, EC and Bilateral Lenders
- Dec 2011 - Jan 2012: Latvia joins Eurozone/ Economic and Monetary Union
- Jan 2014: International Loan Programme with IMF/EC Closed Successfully
- Jan - Jun 2015: Latvia’s Presidency of EU Council
- Jul 2016: Latvia Becomes OECD Member
Latvia’s Credit Ratings are on an Improving Trend

Rating agencies acknowledge Latvia’s low general government debt, small fiscal deficit and institutional strength as key factors bolstering its creditworthiness. In September 2018, S&P raised its sovereign credit rating on Latvia to A from A-.

Long-term Foreign Currency Rating Development

Key Strengths of Latvia’s Sovereign Credit Profile

- Sustained strong economic and fiscal performance
- Eurozone membership further strengthens 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 Profile

- 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
- Latvia’s GDP per capita is below the median level of its ‘A’ category peers

Source: S&P, Fitch and Moody’s
Key Events Since September 2018 Bond Issuance

1. Completion of the 2018 funding program in the international markets with September bond issuance

2. Latvia’s credit rating was upgraded by S&P in September 2018 to A from A-.

3. Formation of a new government, whose priorities include strengthening the financial sector and maintaining fiscal discipline.

4. While the new government is working on a budget for 2019, the government operates under the terms of a Technical Budget, described at right.

5. According to the Cabinet of Ministers’ schedule, a draft of the Annual State Budget Law will be submitted to the Parliament on 8 March 2019.

6. Latvia’s economic growth in Q4 2018 was robust and balanced, continuing the trends established earlier in the year.

7. Latvia’s export market share continues to expand.

Technical Budget 2019

• Due to the length of time taken to form a government following the elections for the thirteenth Parliament and the fact that the 2019 government budget had not been approved, on 6 December 2018 the Parliament approved amendments to the Law on Budget and Financial Management relating to the principles for the preparation of a temporary budget. These amendments provided that the budget expenditure for 2019 cannot exceed the expenditure planned for the respective year in Latvia’s medium-term budget framework, ensuring that policies and measures started in the previous year will be continued in 2019.

• The authorisations granted in accordance with these amendments will terminate when the Annual State Budget Law comes into force, and at that time all expenditure from the beginning of the financial year will be registered in accordance with the new Annual State Budget Law.

• On 29 January 2019, the Cabinet of Ministers adopted a schedule for the preparation and submission of the Annual State Budget Law for 2019. According to the adopted schedule, a draft of the Annual State Budget Law will be submitted to the Parliament on 8 March 2019.
2. The Economy

Strong, Sustainable Growth
Growth Accelerated in 2017 and Remains Elevated Today

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 domestic demand, private investment inflows, the EU funding cycle and favourable foreign trade conditions.

Source: Central Statistical Bureau of Latvia

Source: Ministry of Finance

Source: Eurostat
Wage and Employment Growth Boosts Domestic Demand

Unemployment is slightly below the natural rate; 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: Eurostat, Bank of Latvia
Source: Central Statistical Bureau of Latvia data
Source: Eurostat
Inflation Declined in 2018 to 2.6%

Latvia has maintained moderate and predictable inflation for years. Core inflation is moderate and stable.

**Harmonised Index of Consumer Prices**
(Dec 2018, 12 months average %)

- **Estonia**: AA-/A1/AA- 2.6%
- **Latvia**: A/A3/A- 2.6%
- **Belgium**: AA/Aa3/AA- 1.5%
- **Austria**: AA+/Aa1/AA+ 1.7%
- **Czech**: AA-/A1/AA- 1.5%
- **France**: AA/Aa2/AA 2.0%
- **Finland**: AA+/Aa1/AA+ 1.5%

**EU-28**: 1.9%

**Harmonised Index of Consumer Prices Projection**
(2018-2019, %)

- **Estonia**: AA-/A1/AA- 2.7%
- **Latvia**: A/A3/A- 2.7%
- **Belgium**: AA/Aa3/AA- 1.5%
- **Czech**: AA-/A1/AA- 1.5%
- **Austria**: AA+/Aa1/AA+ 1.7%
- **France**: AA/Aa2/AA 2.0%
- **Finland**: AA+/Aa1/AA+ 1.5%

**EU-28**: 1.8%

Source: European Commission, Autumn projection, 2018

Source: Central Statistical Bureau of Latvia data, Bank of Latvia calculations
Improved Competitiveness and Value-Added Products Drive Exports

Favourable position in both price and quality competitiveness underpins strong current account position.

**Export of Goods and Services (2010=100)**

Source: World Trade Organization

**Goods Exports Growth (% growth between 2009 and 2017)**

Source: Eurostat

**High – Tech Exports (% Of Total Exports)**

Source: Eurostat

**Current Account Balance (% GDP)**

Source: Bank of Latvia; F – Bank of Latvia’s forecast
3. Banking Sector

Well-Capitalized, Profitable, and Beginning to Lend Again
Sound, Well Capitalised and Liquid Banking Sector

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 countries¹
- Capitalisation and liquidity ratios are well above minimum requirements.
- The three largest banks are directly supervised by the ECB. Four banks fall under the remit of the Single Resolution Mechanism
- The fallout from the closure of Latvia’s largest non-resident-serving banks in February 2018 has been well contained. Non-resident deposits have continued to fall, but the liquidity and capital ratios of the banks serving the sector remain high. The reduction of non-resident deposits has markedly lowered Latvia’s short-term external debt without undermining the country’s economy, fiscal position, or financial system

Source: ¹FCMC, ²EBA risk dashboard, fully loaded ratio

Capital Adequacy (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total capital ratio</th>
<th>CET1 ratio</th>
<th>Minimum requirement for total capital ratio (8%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>12%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>14%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>16%</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>2014*</td>
<td>18%</td>
<td>14%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>20%</td>
<td>16%</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>22%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>24%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>26%</td>
<td>22%</td>
<td></td>
</tr>
</tbody>
</table>

Source: FCMC | Note: As of Q1 2014 capital adequacy is calculated according to the CRDIV/CRR requirements and is not directly comparable with the data until Q1 2014 due to differences in methodology. Tier 1 ratio matches CET 1 ratio. The regulatory minimum capital adequacy requirement is 8%. Since 28 May 2014 the FCMC also applies a 2.5% capital conservation buffer.

Liquidity Coverage Ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>Liquidity Coverage Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>20%</td>
</tr>
<tr>
<td>2017</td>
<td>18%</td>
</tr>
<tr>
<td>2018</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: FCMC

Capital Ownership of the Banking System (4Q 2018)

- Domestically: 55%
- Nordic: 27%
- Other: 18%

Source: Bank of Latvia
Bank Lending Recovers and Supports Growth

Domestic lending recovers and loan portfolio quality is above EU average.

Key Highlights

- After a prolonged period of deleveraging, lending growth turned positive in April 2016
  - Loans to domestic households and NFCs stood at 36% of GDP in June 2018, 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 the loan portfolio is above EU average and 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. Expansionary monetary policy of the ECB is a supportive factor for lending

Total Loan Portfolio Quality

Loans to Domestic Clients excluding Government (yoy)

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 (%)
Banking Sector Profitability Remains Healthy

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

Key Highlights

- Profitability of domestically active banks is sound and returns gradually increase as a result of a favorable macrofinancial conditions.

- The profitability of banks servicing foreigners is volatile due to ongoing de-risking that resulted in a decline in their business volume. Although banks servicing foreigners posted a profit in 2018, a further deterioration in their profitability is expected.

- Average Return on Equity (RoE) of the Latvian credit institutions is relatively high and still exceeds the EU average. In 2018, average RoE was 10.2% (9.1% in 2017); EU average – 7.2% (EBA Risk Dashboard Q3 2018).

- As a result of record-low loan and deposit rates, interest rate spread on outstanding amounts remains stable at around 3 pp.
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**

- **Total Banking Assets**: 21%
- **Total Domestic Lending**: 7%
- **Total Domestic Deposits**: 7%

Source: Bank of Latvia, December 2018

**Growth Rates of Domestic and Foreign Client Deposits**

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

Source: Bank of Latvia

**Economic Impact of ABLV Bank Liquidation in February 2018**

- There have not been obvious spill-overs to the resident serving sector, which is dominated by subsidiaries of Scandinavian banks, due to their lack of interconnectedness
- NRDs fell mostly in the first half of 2018, in the second half of 2018 NRDs have stabilized; the liquidity and capital ratios of foreign clients serving banks remain high
- The reduction of NRDs has markedly lowered Latvia's short-term external debt without undermining the country’s economy, fiscal position, or financial system
- Funds covering guaranteed deposits were transferred from ABLV and currently the deposits are being paid out
- Deposit flight has not spread to other banks whose business models are based primarily on domestic funding and lending

Source: Bank of Latvia, *Fitch (Latvia sovereign risk from ABLV Bank failure appears limited, 27.02.2018.)*

**Bank Liquidity Ratios Well Above CRR IV Requirement**

Source: FCMC
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 January 2, 2019 Luminor Bank Latvia was branch of Estonian registered Luminor Bank. Luminor completes its banks’ cross-border merger.

**Banks Financial Information**

<table>
<thead>
<tr>
<th>Assets (EUR mil)*</th>
<th>Swedbank</th>
<th>SEB</th>
<th>Luminor*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5,583</td>
<td>3,585</td>
<td>4,591</td>
</tr>
<tr>
<td>CAR (%)*</td>
<td>26.6</td>
<td>18.9</td>
<td>16.9</td>
</tr>
<tr>
<td>ROE (%)*</td>
<td>15.0</td>
<td>11.9</td>
<td>9.9</td>
</tr>
<tr>
<td>S&amp;P Global long term rating</td>
<td>AA-</td>
<td>A+</td>
<td>*</td>
</tr>
<tr>
<td>Moody’s long term rating</td>
<td>Aa2</td>
<td>Aa2</td>
<td>*</td>
</tr>
<tr>
<td>Fitch long term rating</td>
<td>AA-</td>
<td>AA-</td>
<td>*</td>
</tr>
</tbody>
</table>

Source: Association of Latvian Commercial Banks – financial reports, 3rd 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.

**Deposits (EUR bn)**

Source: The Financial and Capital Market Commission
4. Fiscal Policy

Disciplined Approach Drives Improved Credit Profile
Fiscal Sustainability Remains Top Priority

Prudent fiscal management targets low and sustainable government deficit while improving the quality of spending.

**General Government Budget Balance (€, % of GDP)**

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-1.2</td>
<td>-1.2</td>
<td>-1.4</td>
<td>-1.5</td>
<td>-0.6</td>
<td>-0.7</td>
<td>0.0</td>
<td>-0.6</td>
<td>-0.2</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance*

**Spending Review Results (€, Million)**

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget Balance</td>
<td>28.6</td>
<td>25.4</td>
<td>29.7</td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance*

**Budget Balance (2017, % GDP)**

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

*Source: Eurostat*

**2018 Budget: Expenditure Measures (€ 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
- Combating shadow economy, modernizing tax information services
- Support to cultural projects and media, implementation of integration measures
- Eastern border and strengthening internal security

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spending</td>
<td>336.6</td>
<td>367.8</td>
<td>401.1</td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance*
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

The 2nd Tier Pension Net AUM (EUR billion, % GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>2nd tier pension net assets (EUR billion)</th>
<th>2nd tier pension net assets (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>1.2</td>
<td>6.2%</td>
</tr>
<tr>
<td>2012</td>
<td>1.5</td>
<td>6.7%</td>
</tr>
<tr>
<td>2013</td>
<td>1.7</td>
<td>7.4%</td>
</tr>
<tr>
<td>2014</td>
<td>2.0</td>
<td>8.5%</td>
</tr>
<tr>
<td>2015</td>
<td>2.3</td>
<td>9.6%</td>
</tr>
<tr>
<td>2016</td>
<td>2.8</td>
<td>11.0%</td>
</tr>
<tr>
<td>2017</td>
<td>3.3</td>
<td>12.2%</td>
</tr>
<tr>
<td>2018</td>
<td>3.5</td>
<td>12.0%</td>
</tr>
<tr>
<td>2018 2Q</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

Age-related Spending, Projected Change (2016-2070, % GDP)

Latvia’s age-related spending is among the lowest in EU (2016, % GDP)

Source: European Commission Ageing Report, May 2018
5. New Reform Push

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

Expanded structural reforms build on existing high institutional strengths and favourable business environment.

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>16</td>
</tr>
<tr>
<td>Finland</td>
<td>17</td>
</tr>
<tr>
<td>Latvia</td>
<td>19</td>
</tr>
<tr>
<td>Austria</td>
<td>26</td>
</tr>
<tr>
<td>Czech</td>
<td>32</td>
</tr>
<tr>
<td>Belgium</td>
<td>35</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>45</td>
</tr>
</tbody>
</table>

Source: World Bank, Doing Business 2018

### Adjusted Top Statutory Tax Rate on Corporate Income (2018, %)

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia</td>
<td>19</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>20.5</td>
</tr>
<tr>
<td>Estonia</td>
<td>20</td>
</tr>
<tr>
<td>Estonia (Regional Average)</td>
<td>20.5</td>
</tr>
<tr>
<td>Austria</td>
<td>25</td>
</tr>
<tr>
<td>Austria (Regional Average)</td>
<td>25.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>30</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>30.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>34</td>
</tr>
<tr>
<td>Belgium (Regional Average)</td>
<td>34.5</td>
</tr>
</tbody>
</table>

Source: European Commission, Taxation Trends in the European Union 2018

### World Bank Worldwide Governance Rankings

- Control of Corruption
- Rule of Law
- Regulatory Quality
- Government Effectiveness
- Political Stability and Absence of Violence
- Voice and Accountability


### The Global Competitiveness Index Rankings

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>16</td>
</tr>
<tr>
<td>Latvia</td>
<td>19</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>20.5</td>
</tr>
<tr>
<td>Finland</td>
<td>21</td>
</tr>
<tr>
<td>Belgium</td>
<td>22</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>23</td>
</tr>
<tr>
<td>Czech</td>
<td>29</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>30.5</td>
</tr>
<tr>
<td>Austria</td>
<td>34</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>35.5</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
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<tr>
<td>Latvia (Regional Average)</td>
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<tr>
<td>Latvia (Regional Average)</td>
<td>38</td>
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<tr>
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<td>39</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>40</td>
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<tr>
<td>Latvia (Regional Average)</td>
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<tr>
<td>Latvia (Regional Average)</td>
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<tr>
<td>Latvia (Regional Average)</td>
<td>43</td>
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<td>44</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>45</td>
</tr>
<tr>
<td>Latvia (Regional Average)</td>
<td>46</td>
</tr>
</tbody>
</table>

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

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

- **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 chronic hepatitis C).

**Education Reform** (2015, % GDP)

- Funding for education is adequate, but the education system network 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.


Source: Eurostat
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

![Pie chart showing allocation of EU funds 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: 9%
- Promoting social inclusion and combating poverty: 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%

### EU Cohesion Policy Accompanies Structural Reforms

- The Latvian economy and the goals envisaged by the National Development Plan are strongly supported by well targeted and smart EU cohesion policy funds (EU funds like Structural funds and Cohesion Fund) and investments.
- EUR 4.4 billion EU funds are available for targeted and smart investments in Latvia within the 2014 - 2020 programming period across major nine priority areas with the general aim to enhance competitiveness of Latvia’s economy and reinforce the country’s solid foundation for sustained and smart growth.
- EUR 3.2 billion EU funds are already contracted for investment projects.
- During 2007 - 2013 period Latvia has successfully completed the investment programme supported by EUR 4.5 billion Cohesion Policy EU funds (100% of EU funds "envelope" for Latvia).

### 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. EU leaders aim to reach an agreement for the new multiannual financial framework in autumn 2019.
- The European Commission expects to start negotiations regarding planning documents of the framework in 2019.
- Initial European Commission proposal for Latvia’s Cohesion policy allocation is 4.26 billion EUR (in 2018 prices). Allocation will be a subject of negotiations and Latvia will insist on bigger allocation.
- Latvia will remain eligible to receive support from all three Cohesion policy funds (Cohesion Fund, European Regional and Development Fund, European Social Fund).
- EU funds investment progress is transparent and can be followed: www.esfondi.lv

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 disposable income of employees and induce 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

<table>
<thead>
<tr>
<th><strong>Non-taxable minimum – EUR 250</strong></th>
<th>Differeced depending on income level from EUR 0 / month to EUR 250 per month (2020)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Allowance for dependents</strong></td>
<td>EUR 250 per month (2020)</td>
</tr>
<tr>
<td><strong>Minimum salary</strong></td>
<td>from EUR 380 to EUR 430</td>
</tr>
<tr>
<td><strong>Social contribution</strong></td>
<td>increase by 1% directed to health care</td>
</tr>
<tr>
<td><strong>Reform of Solidarity tax</strong></td>
<td></td>
</tr>
<tr>
<td><strong>PIT rate smoothing</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Progressive Personal Income Tax</strong></td>
<td>Decrease from 23% to 20% for year’s salary up to EUR 20,004, 23% for EUR 20,004 – 62,800, 31,4% for above EUR 62,800</td>
</tr>
<tr>
<td><strong>Corporate Income Tax</strong></td>
<td>20%, on distributed profit; no CIT is payable on undistributed profits</td>
</tr>
</tbody>
</table>

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

- 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.

Key Characteristics of Latvia’s Government Debt

General Government Debt Year End
(EUR million, % GDP, ESA methodology)

- Latvia: 39%
- Lithuania: 41%
- EU-28: 82%
- Eurozone: 39%

Debt Servicing Costs (% GDP)

- Latvia: 8893
- Lithuania: 9669
- EU-28: 10092
- Eurozone: 10891

General Government Debt (2017, % GDP)

- Latvia: 89% 40%
- Estonia: 9%
- Czech Republic: 5% 40%
- Lithuania: 40%
- Finland: 61%
- Austria: 78%
- France: 99%
- Belgium: 103%

Source: Eurostat, The Treasury
Source: European Economic Forecast, Autumn 2018, European Commission
Source: Eurostat
Latvia is conducting a prudent and efficient debt management strategy.

**Government Gross Borrowing (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>763</td>
<td>905</td>
</tr>
<tr>
<td>2017</td>
<td>621</td>
<td>529</td>
</tr>
<tr>
<td>2018</td>
<td>737</td>
<td>593</td>
</tr>
<tr>
<td>2019F</td>
<td>534</td>
<td>936</td>
</tr>
<tr>
<td>2020F</td>
<td>1087</td>
<td>833</td>
</tr>
<tr>
<td>2021F</td>
<td>156</td>
<td>944</td>
</tr>
</tbody>
</table>

Source: The Treasury

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

- Latvia tapped the market twice with dual tranche Eurobond issues
- In May, Latvia priced the Eurobond dual-tranche in the international capital markets in a total amount of EUR 650 million
- In September, Latvia reopened two of its outstanding Eurobonds:
  - Notes maturing May 30, 2028, with coupon 1.125% were increased by EUR 150 million (yield 0.997%);
  - Notes maturing February 15, 2047 with coupon 2.250% were increased by EUR 200 million (yield 1.861%).

Source: Data as of 7th February 2019, Bloomberg
Domestic Market Continues to Perform Strongly

Demand is steady and average yields remain low.

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

- 65.4%
- 20.3%
- 13.4%
- 0.4%
- 0.5%

**Domestic T-Bond Competitive Multi-Price Auctions**

<table>
<thead>
<tr>
<th>Month</th>
<th>5 years</th>
<th>3 years</th>
<th>10 years</th>
<th>11 years</th>
<th>Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan</td>
<td>5.8</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Feb</td>
<td>3.6</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Mar</td>
<td>4.6</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Apr</td>
<td>3.2</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>May</td>
<td>2.5</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Jun</td>
<td>3.5</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Jul</td>
<td>3.6</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Aug</td>
<td>6.2</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Sep</td>
<td>3.3</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Oct</td>
<td>4.1</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Nov</td>
<td>5.1</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Dec</td>
<td>4.9</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Jan</td>
<td>4.6</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Feb</td>
<td>4.4</td>
<td>13.4%</td>
<td>0.4%</td>
<td>0.5%</td>
<td>20.3%</td>
</tr>
</tbody>
</table>

**Last 5 year T-Bond auction results**

- On 9th of January, Latvia had its last T-bond auction
- Nominal value of 24 million EUR were sold in a competitive multi-price auction with total demand of 75.2 million EUR (bid-offer ratio of 3.13)
- In addition, 6 million EUR were sold in non-competitive (fixed price) auction
- The weighted average yield rate was 0.561%

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.
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

<table>
<thead>
<tr>
<th>Parameters</th>
<th>Strategy</th>
<th>30/09/2017</th>
<th>31/12/2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maturity profile (%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• up to 1 year</td>
<td>≤ 25%</td>
<td>13.5%</td>
<td>13.4%</td>
</tr>
<tr>
<td>• up to 3 year</td>
<td>≤ 50%</td>
<td>41.9%</td>
<td>40.5%</td>
</tr>
<tr>
<td>Share of fixed rate(^1)</td>
<td>≥ 60%</td>
<td>90.1%</td>
<td>90.1%</td>
</tr>
<tr>
<td>Macaulay duration (years)</td>
<td>5.00 – 9.00</td>
<td>6.64</td>
<td>6.49</td>
</tr>
<tr>
<td>Net debt(^2) currency composition</td>
<td>100% EUR with a deviation of +/- 5%</td>
<td>99.96%</td>
<td>100.07%</td>
</tr>
</tbody>
</table>

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.
Central Government financing estimation (2019-2021, EUR million)

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government budget balance, net lending and other flows</td>
<td>-503</td>
<td>-505</td>
<td></td>
</tr>
<tr>
<td>Outstanding central government debt redemption</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic debt repayment</td>
<td>0</td>
<td>-114</td>
<td>-91</td>
</tr>
<tr>
<td>External debt repayment</td>
<td>-20</td>
<td>-1 181</td>
<td>-1 340</td>
</tr>
<tr>
<td>Total</td>
<td>-20</td>
<td>-1 295</td>
<td>-1 432</td>
</tr>
</tbody>
</table>

Pre-funding Strategy For Refinancing Debt

The borrowing volume could be increased in case of:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability management activities</td>
<td></td>
</tr>
<tr>
<td>Possible restructuring of the government guaranteed commitments (loans) of several hospitals by refinancing / early repayment</td>
<td></td>
</tr>
</tbody>
</table>
7. Conclusion

Building on Past Success, Facing Future Challenges
Latvia has fully recovered from the economic recession and restored its strong 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
  - 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

- **Higher Credit Ratings**
  - Investors confidence boosted due to reforms and sound macroeconomic fundamentals