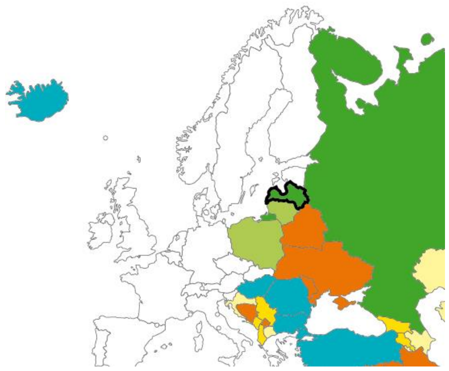
COUNTRY RISK ANALYSIS

Latvia

CREATING CONFIDENCE IN YOUR EXPORTS



COUNTRY RISK CATEGORY

3/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES TO THE COUNTRY

SHORT-TERM TRANSACTIONS: -

MEDIUM AND LONG-TERM TRANSACTIONS: SEK 4.8 MILLION

DATE

18/12/2014

Small open economy in geopolitical headwinds

Latvia went from being a heavily regulated planned economy to a well-functioning market economy in a relatively short period of time. The transition to a market economy put the economy through many difficult challenges. The country has been politically stable and there has been broad popular and parliamentary support for closer relations with the West and for increasing economic and institutional integration with the EU. From an EU perspective, there are major income differences and poverty is widespread. In recent years, both structural and cyclical factors have contributed to an increase in income gaps. The process of transforming the economy has had a consistent focus on growth and the global financial crisis led to a deep economic slowdown. Tensions between ethnic Latvians and the Russian-speaking sections of the population have flared up at times. The ongoing conflict between Russia and Ukraine is estimated to have limited real economic effects, but will cause the country's security situation to deteriorate, especially in light of a relatively large Russian minority. The economy is well on its way to recovering and Latvia is once again one of the fastest-growing countries in the EU. The previously wounded banking sector has been strengthened and Latvia's euro membership ensures increased financial stability. It is highly likely that Latvia will continue to develop in a positive direction.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- High growth and bright prospects for growth in the long term.
- Long-term sustainable public finances with low public debt.
- The country's EU membership strengthens the credibility of its fiscal frameworks, reduces risks in relation to exchange rate fluctuations and gives it access to the ECB's extensive liquidity facilities.

Weaknesses

- Small, open and vulnerable economy, which reflects the country's sharp cyclical fluctuations.
- Vulnerable banking sector since the crisis, with low loan quality and a high proportion of deposits by foreign citizens.
- Relatively large external debt in the public and private sector.

EKN'S POLICY

Improved country risk category

EKN has upgraded Latvia to country risk category 3. Latvia is a high-income country in the euro zone and is therefore not categorised within the scope of the OECD's country risk categorisation. Special rules also apply for these countries with respect to premium pricing, which means that the premium is based on market references. Latvia's membership in the euro zone gives it a low transfer and conversion risk. There are no other financial and economic circumstances that justify any restrictions on the country policy. Instead, each transaction is assessed on its own merits. In accordance with the EU's competition regulations, EKN and other export credit institutions may not cover payment risks for transactions where the risk term is less than two years.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- An improvement in the economy's inherent strength that creates a lasting period of high and stable growth.
- A reduction in external public borrowing and stronger public finances, giving the government greater fiscal flexibility and more scope for reforms.
- Continuing steps toward a stronger banking sector with improved loan quality.

The policy may be made more restrictive in the event of

- A weakening of the public finances that leads to an increase in public debt and rising financing costs for the public debt.
- An escalation of the conflict between Russia and Ukraine, which would have a negative impact on the country's export sector and create security turbulence.

EKN'S EXPOSURE AND EXPERIENCE

Limited inflow of new transactions

EKN's total exposure to Latvia is SEK 205 million, with outstanding offers accounting for just over SEK 200 million and outstanding guarantees accounting for the rest.

COUNTRY ANALYST

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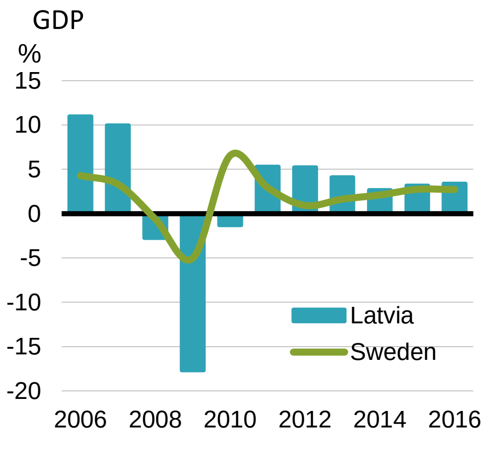
An economy characterised by rapid cyclical fluctuations

Similarly to Estonia and Lithuania, Latvia has mainly pursued liberal market-oriented economic policies since it regained independence in 1991. The country has sought increased economic integration with the EU and closer security relations with the West. Latvia has been a member of the EU since 2004 and joined NATO the same year. The country became the 19th country in the euro area in 2014. Latvia is one of the poorest countries in the EU. In comparison to the rest of the EU, the country has a low GDP per capita and an uneven distribution of income. The country's economic policies have had a consistent focus on growth and social issues have thus been neglected. There are also great regional differences, Living standards in the capital of Riga, where nearly one-third of the population live, are relatively high, but poverty is essentially at the same level as during the Soviet period in the countryside. The fact that the country has a large Russian-speaking population (around 30% of the population speaks Russian) has at times created political tensions with neighbouring Russia and a referendum to make Russian an official language was voted down after an occasionally bitter election campaign that exposed the tensions between ethnic Latvians and the Russian-speaking population.

Latvia has exhibited rapid cyclical fluctuations during its relatively short time as a market economy. The Latvian economy was thrown from overheating into a deep recession, only to then return to being one of the fastest-growing economies in the EU in a relatively short period of time. Until the global financial crisis, Latvia exhibited an annual rate of growth of around 8%. Greater access to foreign capital led to rapid credit expansion, soaring property prices and an acceleration of private debt accumulation. Foreign investment increased greatly following Latvia’s accession to the EU. Initially, the manufacturing industry was the primary target of investments due to its low wages. As wage costs rose, the inflow of foreign direct investment was instead geared towards the telecom market, the construction industry and the financial sector. The Latvian economy collapsed at the beginning of the global financial crisis. High private debt, inflated asset prices and current account deficits led to a deep slowdown and crisis in the banking sector. An acute liquidity crisis forced the Latvian government to seek an assistance loan from the IMF and EU, and they granted a loan totalling EUR 7.5 billion. The loan was conditional on extensive public savings packages to balance the national budget and measures to increase the stability of the financial sector. Latvia stuck with its decision to unilaterally peg its currency to the euro. One argument against devaluation was that private borrowing was in euro and devaluation would therefore have very noticeable effects on households with large loans in foreign currency on assets crashing in value. The government instead chose to regain its competiveness with an "internal devaluation", i.e. wage and cost cuts. Latvia was the EU country hit hardest by the international financial crisis and the price of maintaining its peg to the euro was high. But after going through its first economic baptism of fire, the economic climate turned upwards and the economy recovered unexpectedly fast. In late 2012, Latvia repaid its entire



Source: IMF, forecast years 2014-2016

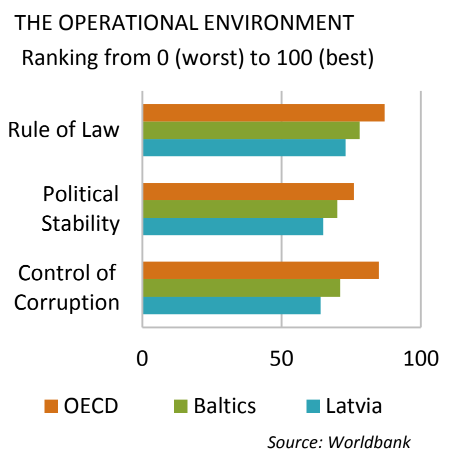
outstanding IMF loan in advance. The Latvian economy is now in a recovery phase. In the short term, growth is mainly expected to be driven by private consumption, but as demand increases internationally, investments and exports are expected to take on the role of the engine of growth. The economy's production capacity was heavily crippled during the crisis, and even though growth will gradually increase, the economy is expected to grow slower than before the crisis. In the long term, it is estimated that growth will stabilise and grow at around 4% per year, i.e. significantly slower than the decade before the crisis, but at a level that is sustainable in the long term. High unemployment and extensive labour emigration during the crisis is contributing to bringing down the potential growth rate of the economy.

Latvia has a strategically favourable geographic position as a junction serving as a key transit country for export goods between East and West. The ongoing conflict between Russia and Ukraine which led to EU sanctions and a Russian embargo on food is having a negative but relatively limited impact on the economy. The transport sector is the sector mainly being affected; the country's food exports to Russia are relatively low and can be redirected to other markets. However, the conflict is creating turbulence that is spreading to other industries that export to the Russian market and is also exacerbating the security situation.

Vulnerable banking sector

In relation to GDP, Latvia has a relatively small banking sector which primarily consists of bank subsidiaries, especially subsidiaries of Nordic banks. The credit expansion slowed down at the start of the crisis and lending has fallen since 2009 and is expected to remain negative in the coming years. Private sector debt relief has been significant and more pronounced than in other EU countries. The banks saw the loan quality of their loan portfolios deteriorate during the crisis in part due to their high exposure to the property market. The proportion of bad loans fell as the economic situation improved and the housing market strengthened. The banks are generally once again well-capitalised and profitability is on the way up. The fact that foreign citizens account for a large proportion of the deposits in the country's banks, along with the fact that the banks largely rely on deposit financing, increases the vulnerability of the banks. Latvia's adoption of the euro gave the ECB primary responsibility for bank supervision in Latvia.

BUSINESS ENVIRONMENT



Latvia has pursued very business friendly policies since it gained independence. Its operating environment has gradually improved as a part of the country's pursuit of greater economic and institutional integration with the EU. Deregu-lation, privatisation and improved competition rules have brought the country closer to being a fully developed market economy. The country has good financial transparency and follows EU standards. In comparison to the other Baltic countries, Latvia is still a step behind in the World Bank's Doing Business Index in terms of its business environment. There is a relatively large black or grey sector in the country with precarious tax discipline that the government is planning to deal with.