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September 7, 2023

**Statement by Mr. Ubissee and Mr. Mansaray on Republic of Latvia
(Preliminary)
Executive Board Meeting
September 11, 2023**

We thank staff for the concise report, as well as Mr. Vasiliauskas and Ms. Allika for the helpful Buff Statement.

Latvia's strong economic growth in the first half of 2022 was largely spurred by household consumption. However, high inflation and rising geopolitical tensions continue to weigh on the economic recovery momentum. Further, near-term growth prospects remain clouded by global uncertainties, tighter global financial conditions, a skilled labor shortage, an aging population, and low levels of digitalization. That said, strong policy actions would be required to tame rising inflation, support public investments, and accelerate structural reforms that reduce skills shortages and promote inclusive green growth and income convergence within the EU. We therefore share staff's views and wish to provide the following remarks for emphasis:

Maintaining a tight fiscal policy stance remains critical to accelerating disinflation, addressing macroeconomic imbalances, and creating the fiscal space to address future shocks. That said, the authorities' decision to roll back COVID-19-related expenditures is a step in the right direction. This will create the required fiscal space together with the authority's commitment to implement well-targeted transfers to the most vulnerable households while at the same time supporting the disinflation process. Fiscal reforms will be needed to address the high labor tax wedge, old-age poverty, and depressed investments. In this regard, we urge the authorities to expedite the completion of the ongoing fiscal reforms and adopt appropriate tax policies to ensure a balance between revenue gains from broadening the tax base and reduced tax exemptions and revenue losses from reducing the high labor tax wedge. That said, we welcome the authorities planned structural balance and their current fiscal path consistent with their fiscal rules, as highlighted in the Buff statement. Going forward, implementing a credible and well-communicated medium-term fiscal framework remains vital. While accelerated efforts to fully implement the National Recovery and Resilience Plan (NRRP) to boost investment and minimize supply bottlenecks are

required, we urge the authorities to stand ready to adjust their policy stance as and when necessary, should any demand or supply surprises emerge.

While the financial sector remains resilient, strengthening surveillance and risk-based supervision remains critical to addressing emerging risks and financial sector vulnerabilities. That said, high interest rates amid high inflation could affect the housing market and non-financial institutions, which could pose risks to commercial banks' loan portfolios. We therefore urge the authorities to pay close attention to banks' asset quality, liquidity, and develop a clear contingency plan to mitigate any emerging risks. We applaud actions taken by the authorities to amend the 2021 AML/CFT regime and plans for further improvement. Relatedly, integrating the Financial and Capital Market Commission into the BoL and the plan to gradually implement the positive-neutral countercyclical capital buffer by December 2023 are welcome. Going forward, strengthening the AML/CFT framework to meet FATF standards and close collaboration with relevant authorities and institutions with clear roles will be important to improve supervision and beneficial ownership information declaration.

Finally, structural reforms should be advanced to support the labor market, promote green growth, and build resilience. We commend the authorities' efforts and progress made towards transitioning to renewable energy sources, the digitalization of processes and procedures, and plans to provide high-quality training for female students. Despite efforts to reduce old-age poverty and the steps taken to increase the retirement age, the shortage of skilled labor warrants immediate action. That said, labor market reforms are necessary to recruit and retain a highly skilled labor force, address the aging population, reduce emigration, and promote the return of competent human resources from the diaspora. We welcome the authorities' plan to implement amendments to the Insolvency Law focusing on the implementation of the EU directive on restructuring and insolvency and plans to develop the capital market. To this end, we encourage the authorities to prioritize SMEs in the development and implementation of business regulatory reforms. Further, we welcome the adoption of the Anti-Corruption Plan and the National Strategy alongside the authorities' plan to introduce a code of ethics for public officials and adapt the law on conflicts of interest. *We would appreciate staff's comments on the implementation status of these measures.*