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Latvijas Banka
K. Valdemāra iela 2A, Riga, LV-1050
Tel.: 67022300 info@bank.lv
https://www.bank.lv; https://www.makroekonomika.lv

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Summary

Robust access to financing is an important part of a healthy economy as it supports investment activity and so also economic growth. Having a financial system that functions well is consequently a key criterion that must be met to strengthen a country's economic development in the long run. This report analyses access to financing in Latvia from various perspectives.

Latvian companies and households mostly get their external financing from banks, so developments in the lending market have significant macroeconomic implications for the country. Lending activity is now a third of what it was at the time of the global financial crisis relative to the size of Latvia's economy, as outstanding loans amounted to nearly 90% of gross domestic product (GDP) back in 2011, whereas they stood at a mere 27.1% in the second quarter of 2023. The decline in the level of over-indebtedness following the global financial crisis was initially justified, but lending remained weak even despite the financial situation of households, companies and the government improving significantly. The reasons for the prolonged and substantial decline in lending volumes can be found on both the demand and supply sides of financing.

A significant supply-side factor is the high degree of market concentration in the banking sector that is reflected in lending conditions being more stringent and lending rates less attractive than those on offer in other euro area countries. Surveys of companies suggest that Latvia has a much larger share than most other European Union (EU) countries of companies that are dissatisfied with the availability of loans.

Lending rates in Latvia and the Baltic countries overall have remained among the highest in the euro area for a long time in almost all lending segments. The high lending rates can be explained neither by financing for banks themselves being more expensive nor by the quality of loans being significantly lower, which would imply relatively high margins. This is also confirmed by the point that the interest rates on even **the most secure** housing loans[1] in Latvia are much higher than **the average** lending rates in most other euro area countries.

Lending rates have increased sharply since mid-2022 because the interest rates of the European Central Bank (ECB) have risen. Since there are relatively few offers that fix long-term interest rates in Latvia, or in Lithuania and Estonia for that matter, a large majority of loans have an interest rate that is fixed for up to one year. This means that interest rates have risen significantly not only on new loans but also on most outstanding loans, and so borrowers in the Baltic countries are currently experiencing sharper interest rate hikes than borrowers elsewhere in the euro area.

Although banks are not the only source of external financing, the capital market is relatively underdeveloped, which limits the options companies have for attracting financing from other sources. The capitalisation of the stock market and the number of companies quoted on the stock exchange are very small next to those in other EU countries, even lagging behind Lithuania and Estonia. Moreover, the level of activity in the bond market is also low. Leasing companies and AS Attīstības finanšu institūcija Altum (Altum) play a significant role in ensuring access to financing, but the specific nature of their services means that their lending volumes are small compared to those of the banks.

Surveys of companies suggest that the demand from companies for external financing and their need for it have increased since the global financial crisis and are actually greater than in many other euro area countries. At the same time, Latvia has one of the largest shares of companies that think that the limited access to financing is a significant obstacle to making long-term investments. This contradiction between demand and supply is reflected in a widening financing gap that causes companies to postpone or even cancel their investments and so holds back economic growth in Latvia.

Meanwhile, demand for external financing alone is not enough to encourage supply if the attractiveness of companies to sources of financing is limited. Several indicators still suggest that there are some issues with the financial health of Latvian companies as almost one company in three is running its business with negative equity. Having said that, the financial health of companies has improved significantly since the

[1] The 5th percentile or the 5% of housing loans with the lowest interest rates.

global financial crisis. The capitalisation and profitability of companies, and their ability to pay off their obligations, are significantly better than they were 10 years ago despite the economic shocks experienced over the past few years, which have included the Covid-19 pandemic and Russia's invasion of Ukraine.

This leads to the conclusion that the decline in lending activity in the corporate segment comes more from the access to financing being limited than from companies being unwilling or unable to borrow. That the decrease in lending activity has been observed simultaneously with an improvement in the financial situation of companies points to the availability of loans having deteriorated. Meanwhile, it is clear that a relatively large share of companies being in poor financial health and the informal economy spreading wide prevents Latvian companies from taking on debt to the same extent that companies are able to elsewhere in the euro area.

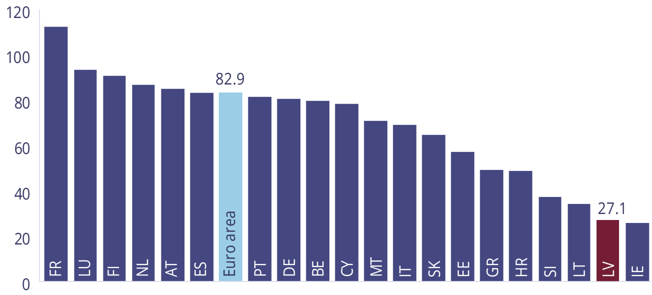
The financial situation of households, together with their ability to take on new debt has improved considerably, but this has not been reflected in a significant expansion of lending for housing. There was much less activity in the construction of new housing than in Lithuania and Estonia. The reasons for this lie in several structural flaws, such as bureaucratic obstacles to the construction process and the relatively high lending rates and limited availability of loans in the regions of Latvia away from the capital.

1. The supply of loans and competition in the banking sector

Outstanding loans to non-financial companies and households in Latvia stood at a historically low level in the second quarter of 2023 at 27.1% of GDP, which is approximately one third of the euro area average (see Chart 1). Since the global financial crisis, Latvia's lending activity has shrunk by more than two thirds, as outstanding loans amounted to nearly 90% of GDP in 2011. The decline in the level of over-indebtedness following the global financial crisis was initially justified, but several factors indicate that the current lending volumes are too low.

Chart 1

Outstanding loans to households and non-financial companies in the euro area countries in the second quarter of 2023
(% of GDP)

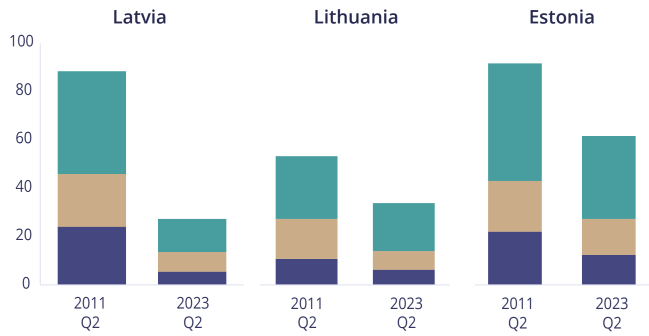


Sources: ECB Statistical Data Warehouse (SDW), Eurostat

Lending activity has been weak in both the household segment, which is mainly housing, and the corporate segment (see Chart 2). While Lithuania and Estonia have also seen their lending activity decline, their lending volumes have shrunk by less than those in Latvia. Latvia's ratio of outstanding housing loans to GDP has decreased by two thirds since 2011, while those in Lithuania and Estonia have fallen by only one third. The corporate segment recorded an even sharper decline in lending volumes. In the second quarter of 2023, Latvia's ratio of outstanding loans to non-financial companies to GDP was only a quarter of its 2011 level, while the levels in the neighbouring Baltic countries were down by approximately half.[2]

Chart 2

Outstanding loans to households and non-financial companies
(% of GDP)



Sources: ECB SDW, Eurostat

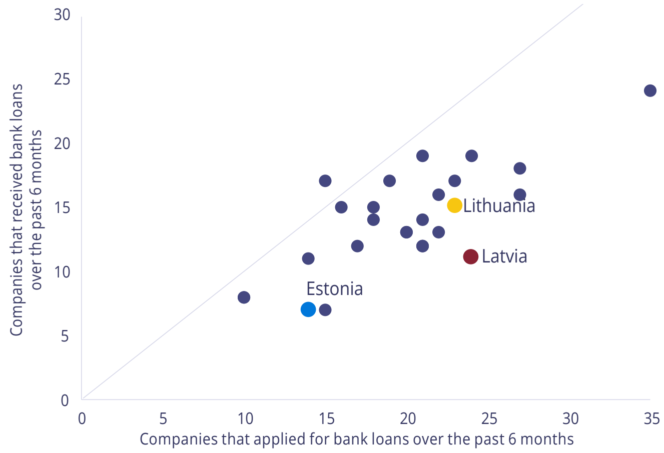
The results of business surveys suggest that one reason lending activity is at such a low level is the availability of loans. The survey on the access to finance of enterprises (SAFE) conducted by the European Commission and the ECB suggests that, even though a relatively large share of Latvian companies apply for bank loans, only a few actually receive them (see Chart 3). This implies that the number of refusals is large, which may in turn discourage companies from approaching banks in the future. The SAFE results corroborate this finding, as a relatively large number of Latvian companies do not apply for loans because they think they may be refused (see Chart 4).

[2] During this period there was considerable structural change in the banking sector in the Baltic countries, which had a negative impact on lending activity.

Chart 3

Share of companies that applied for and received bank loans over a six-month period in 2022

(%)

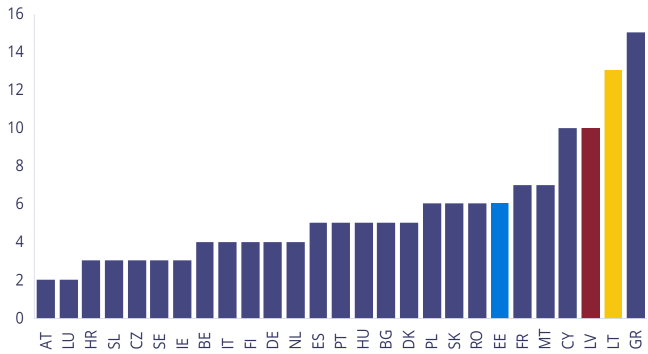


Source: SAFE, 2022

Chart 4

Share of companies that did not apply for bank loans in 2022 because they might be refused

(%)



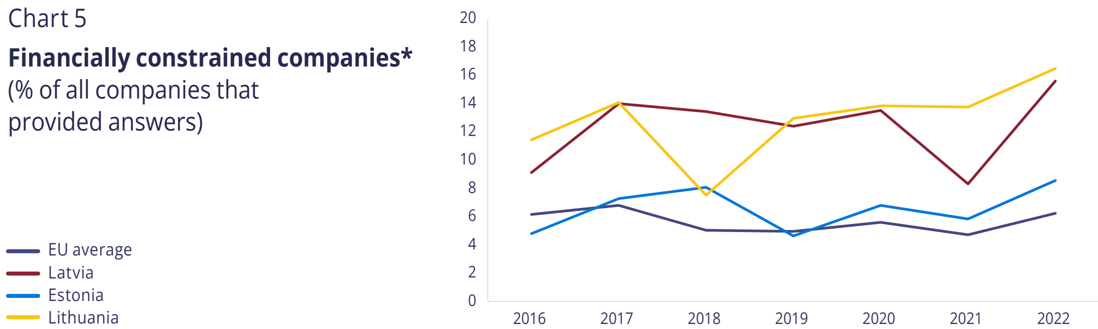
Source: SAFE, 2022

The findings of the European Investment Bank (EIB) reveal issues with access to external financing in Latvia[3]. The share of financially constrained companies in Latvia is approximately twice the EU average (see Chart 5). Financially constrained companies are those that have sought external financing but have failed to receive it or have received less than expected, or those that have not sought external financing because of the high costs or the risk of being refused. Around 6% on average of companies in the EU are considered financially constrained, whereas in Latvia up to 16% are. Companies cited unreasonable collateral requirements and the high cost of financing as their main reasons for dissatisfaction with raising external financing (see Chart 6).

Chart 5

Financially constrained companies*

(% of all companies that provided answers)



* Financially constrained companies include those companies that have sought external financing but have failed to receive it or have received less than expected, and those that have not sought external financing because of high costs or the risk of being refused.

Sources: EIB Investment Survey Country Overview 2018/2019/2020/2021/2022: Latvia/Estonia/Lithuania

[3] https://www.eib.org/en/publications/20220266-econ-eibis-2022-latvia

Chart 6

Reasons for dissatisfaction with raising external financing
(% of companies that have used external financing; 2018–2022)

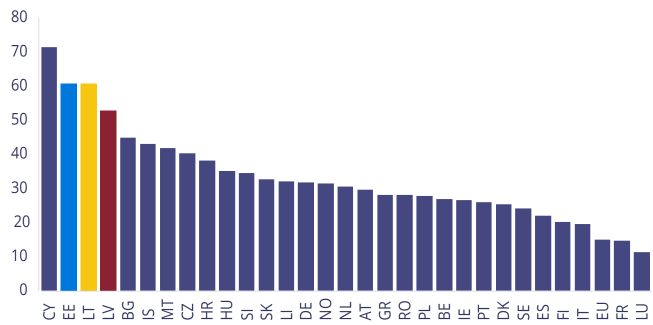
Sources: EIB Investment Survey Country Overview 2018/2019/2020/2021/2022: Latvia/Estonia/Lithuania

Information from the Credit Register of Latvijas Banka suggests that collateral requirements for households have remained broadly unchanged over the past five years, and the average collateral-to-housing loan ratio is around 1.15. Collateral requirements are significantly higher in the corporate segment, with the collateral required averaging roughly twice the value of the loan.

There is a lack of fully comparable data that makes it impossible to draw accurate comparisons between the levels of collateral required by the banks from non-financial companies in the EU countries. Nevertheless, data on the share of loans to non-financial companies that are collateralised by commercial real estate point to the implicit conclusion that collateral requirements in Latvia may be more stringent than those in most other EU countries. Data from the European Banking Authority show that outstanding loans to non-financial companies in Latvia collateralised by commercial real estate constitute more than half of the entire portfolio of loans to non-financial companies (see Chart 7). The only EU countries that have a larger share of loans collateralised by commercial real estate within the total portfolio of loans to non-financial companies are Cyprus, Estonia and Lithuania.

Chart 7

Share of loans to non-financial companies collateralised by commercial real estate in the total portfolio of loans to non-financial companies in the first quarter of 2023
(%)



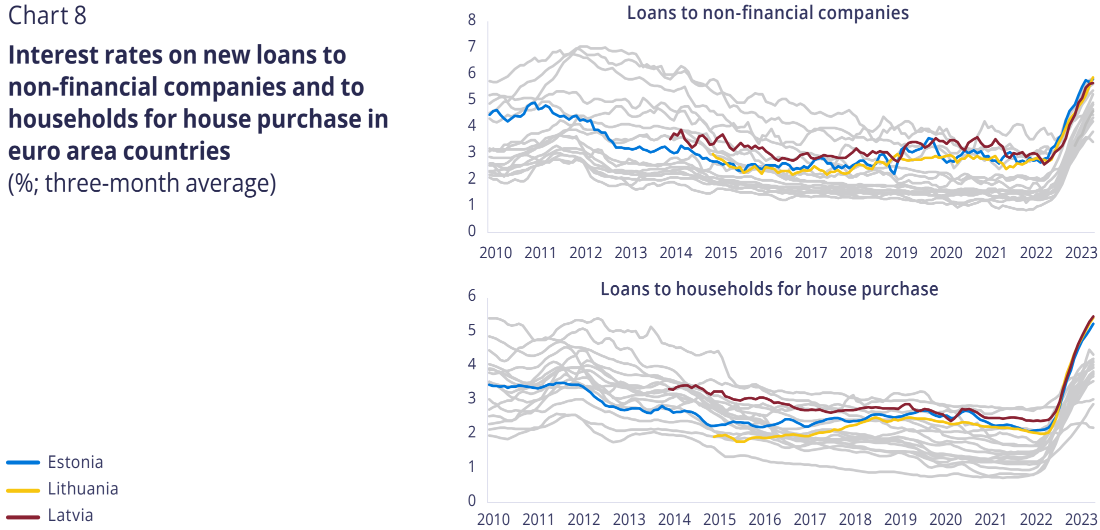
Source: EBA Risk Dashboard

The second reason why Latvian companies are dissatisfied with their access to financing is its cost. There are various different sources of external financing, but in Latvia the main source is bank loans. Lending rates in Latvia and the Baltic countries overall have remained among the highest in the euro area for a long time, and moreover, the dynamics of interest rates in the Baltic countries have been different from those in other euro area countries. Lending rates declined significantly in most euro area countries between 2014 and 2022, but they remained unchanged in Latvia and even rose in Lithuania and Estonia (see Chart 8).[4]

[4] During this period, interest rates fell overall in the euro area because the ECB lowered its key interest rates. From early 2014 until autumn 2019, the deposit facility rate fell from 0% to –0.5%, closely followed by the short-term EURIBOR rate, which is a rate that is important for lending in the Baltics. Since the widespread practice in the Baltic countries was not to apply the negative EURIBOR rate to loans, there was no overall decline in lending rates.

Chart 8

Interest rates on new loans to non-financial companies and to households for house purchase in euro area countries
(%; three-month average)



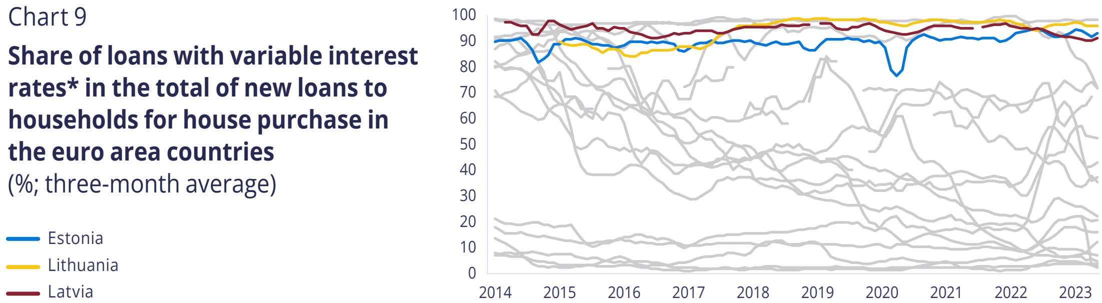
Source: ECB SDW

As the key ECB interest rates have risen, lending rates have done the same in all the euro area countries since the middle of 2022. The average interest rate on new loans to non-financial companies was 5.3% in Latvia in the first half of 2023, but 4.2% in the euro area as a whole. The difference in interest rates on housing loans was even wider, as the average interest rate on new housing loans was 5.3% in Latvia but 3.5% in the euro area. Lithuania and Estonia recorded similarly high interest rates. Moreover, it is not the case that the high average lending rates are being dictated by just a few individual banks. The ECB statistics on interest rates suggest that the interest rates on new loans set by nearly all the largest banks in the Baltic countries are among the highest in the euro area, as the highest decile for the lending rate contains most of the banks in the Baltic countries.

Interest rates have risen significantly not only on new loans but also on outstanding loans with a short fixation period for the interest rate. The overwhelming majority of loans in Latvia, Lithuania and Estonia, and roughly 90% of housing loans, have an interest rate fixation period of up to one year, while the average share of such loans is much lower in the euro area (see Chart 9). This means that borrowers in the Baltic countries are experiencing sharper hikes in their monthly loan repayments than borrowers elsewhere in the euro area are.

Chart 9

Share of loans with variable interest rates* in the total of new loans to households for house purchase in the euro area countries
(%; three-month average)



* A variable interest rate is an interest rate with a fixation period of one year or less, whereas a fixed interest rate is an interest rate with a fixation period of over one year.

Sources: Latvijas Banka, ECB SDW

Although Latvian banks do still offer lending rate fixation for over one year, such loan conditions are rather rare. This is partly because short-term interest rates were close to or below zero from the global financial crisis until the end of 2022, which may have made long-term interest rate fixation less attractive for borrowers.[5] Another reason is that loans with longer-term interest rate fixation periods tend to have less favourable terms, and the interest rates on loans in Latvia with an interest rate fixation period of over

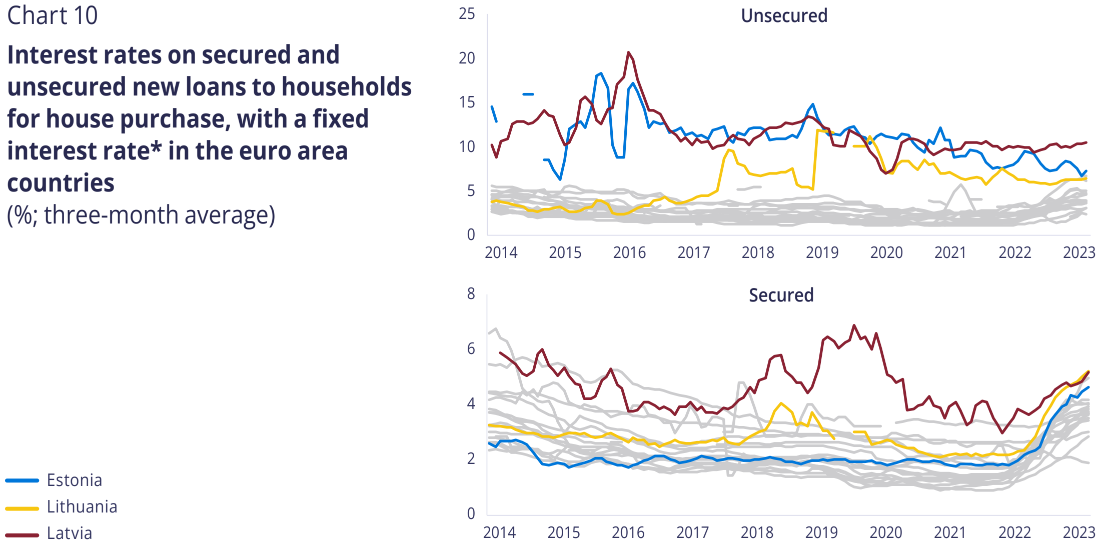
[5] This is, however, not an explanation for why longer-term interest rate fixation in Latvia is significantly less popular than elsewhere in the euro area, where short-term rates were equally low.

one year are the highest in the euro area, and they exceed the euro area average by roughly 6.4 percentage points (see Chart 10). This applies for both secured and unsecured loans.

Chart 10

Interest rates on secured and unsecured new loans to households for house purchase, with a fixed interest rate* in the euro area countries

(%; three-month average)



* A variable interest rate is an interest rate with a fixation period of one year or less, whereas a fixed interest rate is an interest rate with a fixation period of over one year.

Sources: Latvijas Banka, ECB SDW

There may be several reasons why Latvia has such high lending rates, including high financing costs for banks themselves, higher credit risk and larger expected losses, and larger margins.

Financing costs

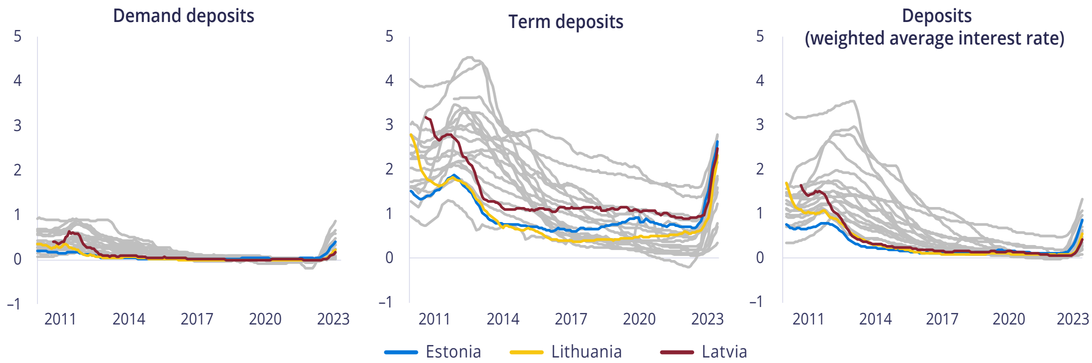
Latvian banks mostly cover their financing needs from the deposits of non-financial companies and households. Deposits are roughly 78% of the liabilities of the banks, and roughly 92% of their external liabilities, while equity is about 13% and other liabilities are the remaining 9%. This means that the financing costs of the banks are closely linked to the costs of deposits.[6] While deposit rates, and particularly longer-term deposit rates, have risen over the past few quarters[7], they have overall been among the lowest in the euro area (see Chart 11). The weighted average deposit rate in Latvia was 0.24% in the first half of 2023, while the euro area average was 0.68%. The figure for Latvia is relatively low because the share of demand deposits in the overall volume of deposits is large, and in most cases, no interest is paid on such deposits. This means that the financing costs of the banks have risen at a much slower pace than their lending rates, and this is reflected in larger profits in the banking sector.

[6] Although also equity is not free of cost for banks, as their owners need to make a certain return as profit.

[7] Partly because of calls for change from Latvijas Banka and the Ministry of Finance.

Chart 11

Interest rates on outstanding deposits in the euro area countries by deposit type
(%; 3-month average)



Source: ECB SDW

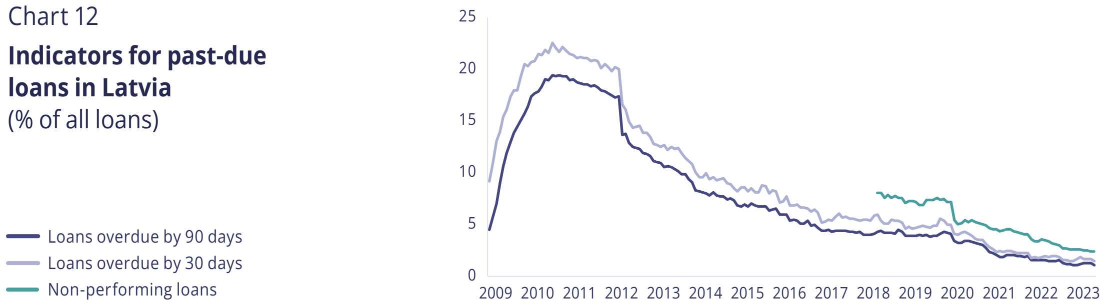
In addition, deposit rates have historically been lower overall in Latvia than in most other euro area countries. This leads to the conclusion that the root cause for lending rates being so high lies somewhere else than financing costs.

Credit risk and expected losses

The quality of loans deteriorated significantly in Latvia during the global financial crisis, and this caused considerable losses for the banks. However, the quality of the loan portfolio has by now improved substantially since the financial crisis, and the share of overdue loans has diminished each year. In early 2012, the monthly payments of some 12% of loans were overdue by more than 90 days, but in 2023 barely 1% were (see Chart 12). Other indicators of credit quality also showed positive dynamics despite multiple major economic shocks, including the Covid-19 pandemic, Russia's invasion of Ukraine, and the energy price crisis. The credit risk on new loans is also relatively low in the banks' own assessment as suggested by the amount of provisions they have made for potential losses (see Chart 13).

Chart 12

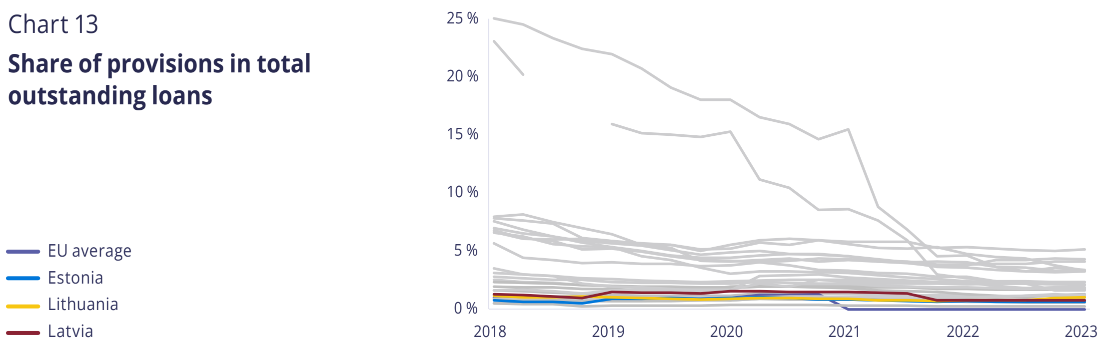
Indicators for past-due loans in Latvia
(% of all loans)



Source: Latvijas Banka

Chart 13

Share of provisions in total outstanding loans



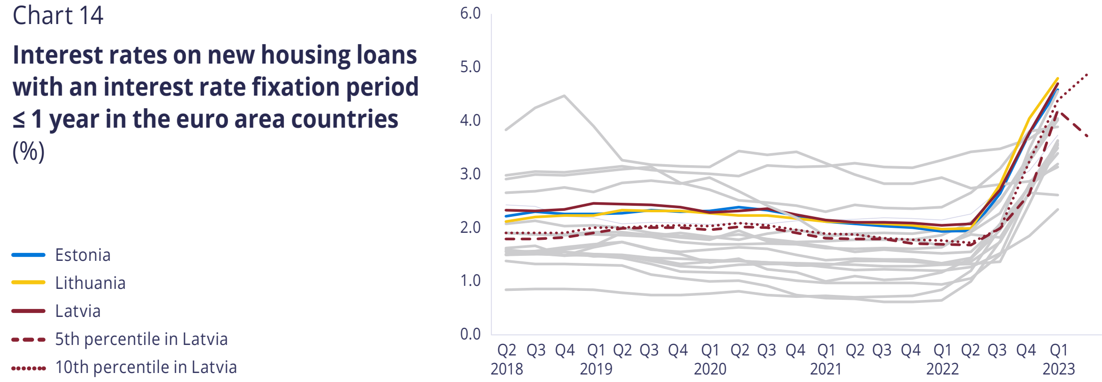
Sources: EBA Risk Dashboard, Latvijas Banka's calculations

The high lending rates in Latvia cannot therefore be explained by either financing costs or loan quality. Econometric analysis (see Box 1) suggests that each of these factors can only partly explain bank lending rates in Latvia, implying that interest rate mark-ups are wide in the banking sector. Looking at the interest rate dispersion in Latvia points to similar conclusions.

Interest rates are linked to loan quality, as the higher the credit risk is, the higher the interest rate is. This means that the lowest interest rates are generally set for the most secure loans. Information from the Credit Register of Latvijas Banka suggests however that even the interest rates on the most secure housing loans[8] in Latvia are much higher than the average lending rates in most other euro area countries (see Chart 14). This may indicate that there is a lending rate floor in Latvia, or a level below which loans, or at least housing loans, are refused irrespective of the borrower's creditworthiness and credit risk. It should be noted, however, that the interest rates on the loans with the lowest rates fell in the second quarter of 2023 despite EURIBOR rising. This is because individual banks made offers to temporary apply 0% mark-up above EURIBOR on loans granted for building and purchasing energy-efficient homes.

Chart 14

Interest rates on new housing loans with an interest rate fixation period ≤ 1 year in the euro area countries
(%)



Sources: ECB SDW, Latvijas Banka

[8] The 5th percentile or the 5% of housing loans with the lowest interest rates.

Box 1. What drives the dynamics of the lending rates?

To assess the role that various factors play in explaining Latvia's lending rates, anonymised loan-level micro-data from the Credit Register of Latvijas Banka were used. The data sample covered new loans to small and medium-sized enterprises with up to 50 employees and new loans to households for house purchase issued between the second quarter of 2018 and the second quarter of 2023. The factors that explain the lending rates were analysed using the following equation:

$$\%_{b,t}^{kred} = \%_{b,t}^{fin} + R_{b,t} + \pi_t, \text{ where:}$$

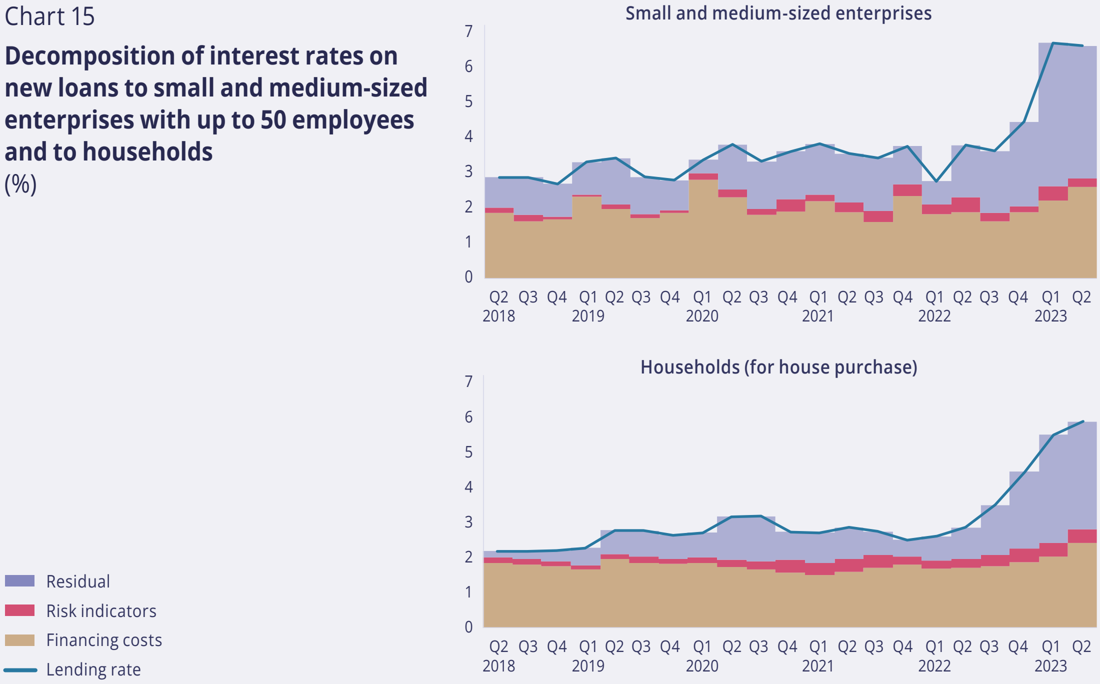
- $\%_{b,t}^{kred}$ is the weighted average interest rate on new loans granted by bank b in quarter t;
- $\%_{b,t}^{fin}$ is the financing costs of bank b expressed as the sum of:
  1) the average deposit rate in period t multiplied by the share of deposits in liabilities;
  2) the return on equity, which is set at the relatively high level of 15% in the euro area context, multiplied by the share of equity in liabilities;
  3) the three-month EURIBOR multiplied by the share of other liabilities in total liabilities;
- $R_{b,t}$ is the credit risk indicator of bank b for loans issued in period t expressed as the accumulated provisions amount;
- π_t is the residual.

Chart 15 suggests that financing costs explain a large part of lending rates. This is because of the assumption that capital costs, shown as return on equity, are relatively high.[9] Nonetheless, neither financing costs nor the credit risk indicator can explain the high lending rates in Latvia. A large part of the lending rate is consequently captured by the residual or the mark-up above financing costs and the risk margin. While it is true that a part of the residual also covers the banks' fixed and variable costs that are not directly linked to the credit risk or financing costs, it nonetheless implies that the banks have high mark-ups and relatively large profit margins.

Chart 15

Decomposition of interest rates on new loans to small and medium-sized enterprises with up to 50 employees and to households

(%)



Source: Credit Register of Latvijas

The results also suggest that the rise in lending rates in the past few quarters can mainly be explained by an increase in the lending rate margins. A rise in the EURIBOR rate causes an almost automatic rise in lending rates, whereas deposit rates and so the financing costs of banks grow much more slowly, and thus the profit margins of the banks go up.

[9] Without the cost of capital, which reflects the return expected by shareholders, financing costs would closely follow deposit rates, which were close to zero during this period.

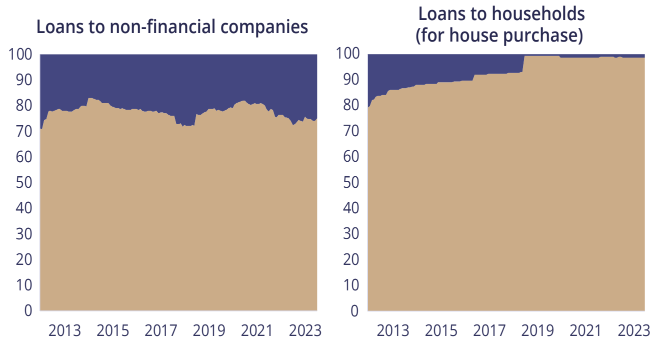
Relatively high lending rates and evidence of wide spreads are mostly observed in countries with a high degree of market concentration, which may in turn signal that competition between banks is weak.[10] Latvia's indicator for concentration in the lending market is one of the highest in the euro area. The four largest banks have market share of nearly 80% in the corporate lending segment, and their share is even larger in housing loans (see Chart 16).

Market concentration increased significantly in 2016 and 2017 when Latvia's banking sector underwent structural changes, and the breakdown of new loans by issuer bank does not promise any significant decline in concentration in the near future (see Chart 17).

[10] https://datnes.latvijasbanka.lv/papers/discussion/dp_2_2021.pdf

Chart 16

Breakdown of outstanding loans to non-financial companies and to households for house purchase in Latvia by bank group
(%)

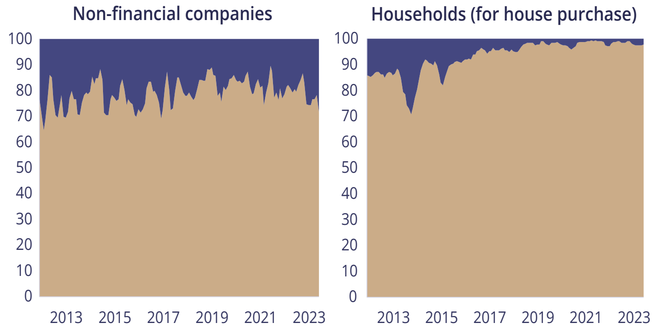


Four largest banks
Other banks

Source: Latvijas Banka

Chart 17

Breakdown of new loans to non-financial companies and to households for house purchase in Latvia by bank group
(%; three-month average)



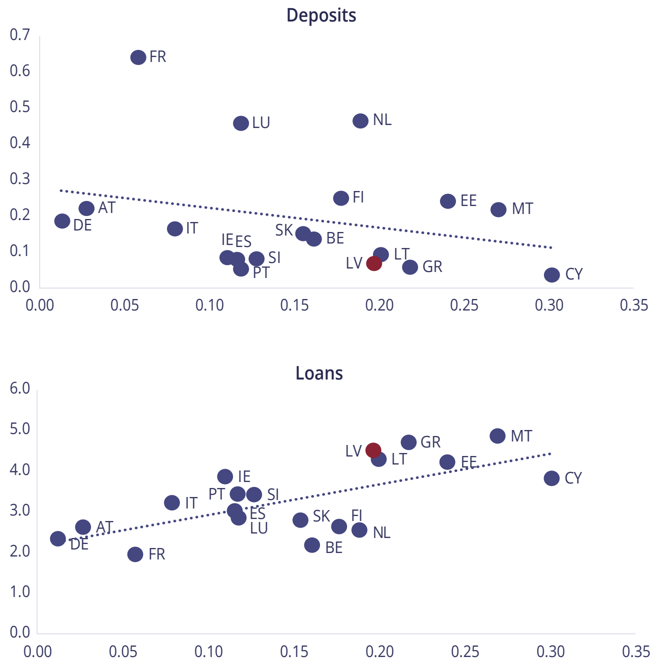
Four largest banks
Other banks

Source: Latvijas Banka

Aside from the high lending rates, the high degree of market concentration has a number of other adverse effects. Countries with highly concentrated banking sectors report lower average deposit rates (see Chart 18) and a higher share of loans with variable rates (see Chart 19). Nearly 90% of household loans in Latvia, Lithuania and Estonia have an interest rate fixation period of up to one year, while the share of variable rate loans is much smaller in countries like Austria, Germany and France that have low levels of market concentration, and this then protects borrowers from the risk of interest rate fluctuations.

Chart 18

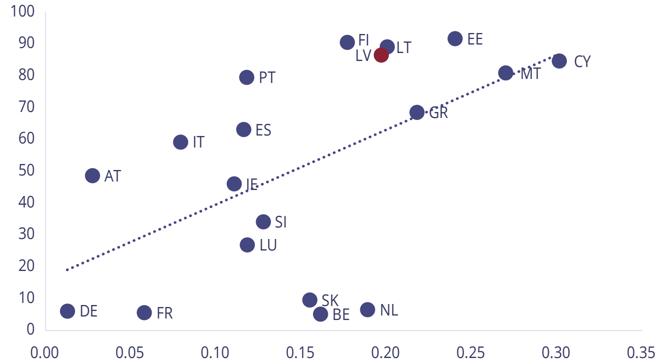
The Herfindahl-Hirschman Index (HHI) in 2022 (y-axis) **and the weighted average interest rates on outstanding deposits and loans in the euro area countries in 2022**
(y-axis; %)



Source: ECB SDW

Chart 19

HHI in 2022 (x-axis) **and the share of variable rate loans to households* in total outstanding loans to households in the euro area countries in 2022** (y-axis; %)



* Loans to households with an original maturity of over one year, a residual maturity of over one year and an interest rate fixation period of 12 months or less.

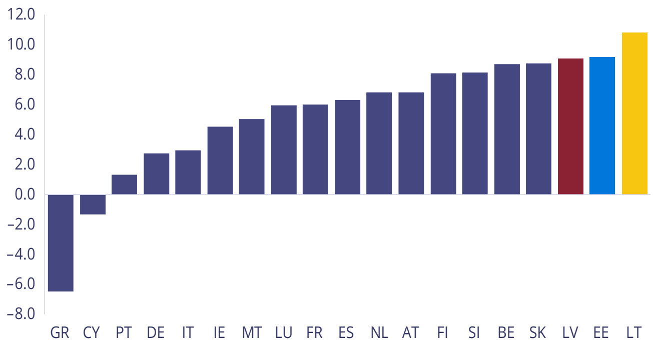
Source: ECB SDW

The level of loan refinancing activity is low, which also points to competition among banks being limited. A study by the European Commission[11] shows that only 2% of those who would benefit from refinancing in Latvia actually do it, while this figure ranges from 13% up to 35% in other EU countries. The statistics of the Credit Register of Latvijas Banka also suggest that the level of loan refinancing activity is very low. The reason for this lies in the relatively high cost of refinancing process, which takes in bank commissions, charges for notary services and the Land Register duty.

Despite lending activity being weak, the banks in Latvia, and the Baltic countries overall, have reported high levels of profitability (see Chart 20).[12] Although the volume of bank loans in Latvia as a ratio to GDP is roughly a third of the euro area average, the profits of the banks have been among the highest in the euro area. Moreover, they are expected to grow significantly this year, as lending rates increasing almost in lockstep with the EURIBOR rate and deposit rates rising at a much slower pace mean that the net interest income and profits of the banks will go up considerably.

Chart 20

Average return on equity (ROE) of banks in the euro area countries between 2014 and 2022
(%)



Source: ECB SDW

[11] https://op.europa.eu/en/publication-detail/-/publication/a11e1d38-2562-11eb-9d7e-01aa75ed71a1

[12] It should be noted, however, that the profitability of many euro area banks has for various reasons historically been lower than that of banks in other advanced economies outside the monetary union.

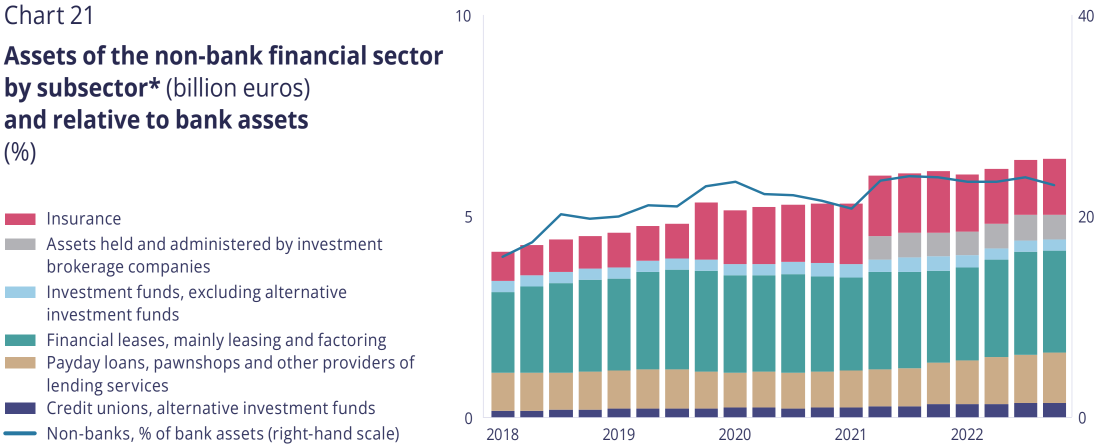
2. Non-bank financial intermediation

Banks are the most popular providers of financial services in Latvia, accounting for some two thirds of the total assets of the financial sector. Alternative sources of financing are however available to households and particularly to non-financial companies as well. Households most commonly use such sources to borrow money for consumption, including leasing cars, while non-financial companies have the option of using factoring in addition to leasing or, in some cases, of issuing debt and equity securities.

The role of non-bank financial intermediation has gradually increased in Latvia over the past few years, with the assets of the non-bank financial sector standing at almost a quarter of the assets of the banks at the end of 2022 (see Chart 21)[13]. Lease transactions, which are more popular in Latvia than in other EU countries on average (see Chart 22), and transactions with other providers of lending services, including providers of payday loans, account for a considerable part of non-bank intermediation.

Chart 21

Assets of the non-bank financial sector by subsector* (billion euros) **and relative to bank assets** (%)

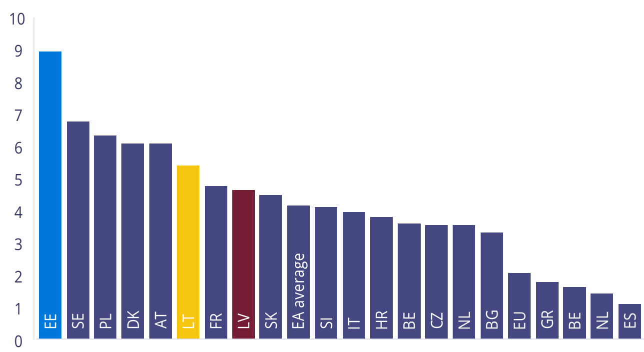


* Excluding pension funds.
Sources: Central Statistical Bureau of Latvia (CSB), Latvijas Banka

The outstanding volume of lease transactions stood at close to 5% of GDP in 2021, which was one percentage point higher than the EU average. Despite the relatively high popularity of leases in Latvia though, the total volume of outstanding leases is much smaller than that of outstanding loans, so even if the lease and loan portfolios were combined, Latvia's relative position among other euro area countries would remain broadly unchanged. At the same time, it is important to note that most of the volume of the assets of the lease companies is closely linked with the banking sector.

Chart 22

Outstanding lease transactions* in 2021 (% of GDP)



Source: leaseurope.org
* No data are available for DE, FR, PT

The capital market plays an important role in access to financing in many advanced economies, and it

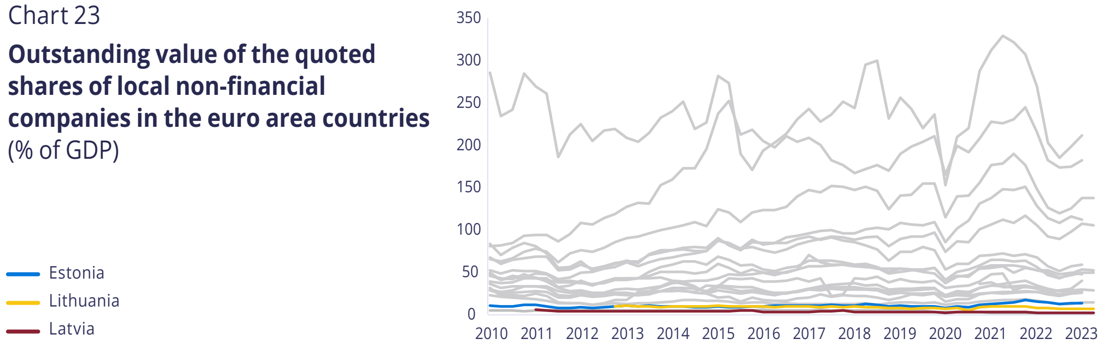
[13] Excluding pension funds.

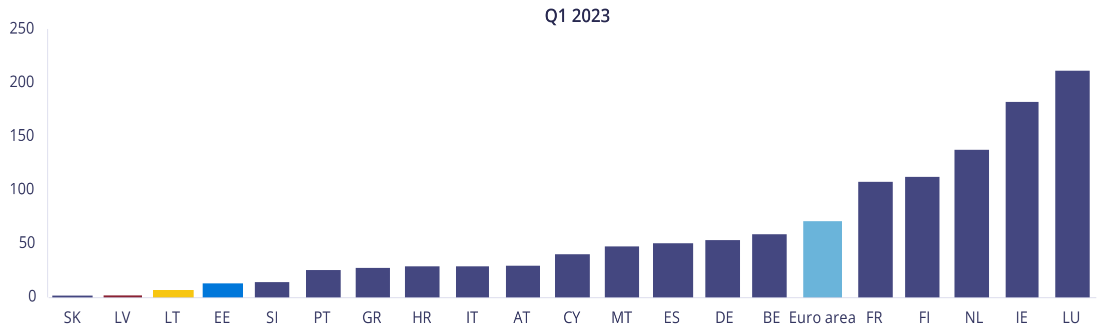
provides alternatives to bank funding by expanding options for accessing financing and diversifying conditions, including maturities and collateral requirements.[14]

The development of Latvia's capital market has so far been slow. The stock market capitalisation is very small as a percentage of national GDP compared to the capitalisation in other EU countries, and it lags behind Lithuania and Estonia as well (see Chart 23). The number of companies quoted on Latvia's stock market is also small at only 14,[15] while there are 28 listed companies in Lithuania and 34 in Estonia. Latvia also lags behind its neighbours in its stock market activity, as the turnover of the Lithuanian stock market was 12 times that of the Latvian one on average in 2023, while the turnover of the Estonian stock market was more than 23 times that of its Latvian counterpart.

Chart 23

Outstanding value of the quoted shares of local non-financial companies in the euro area countries
(% of GDP)





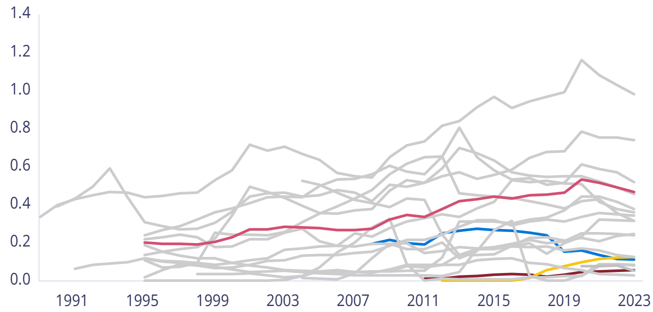
Sources: Eurostat, ECB SDW

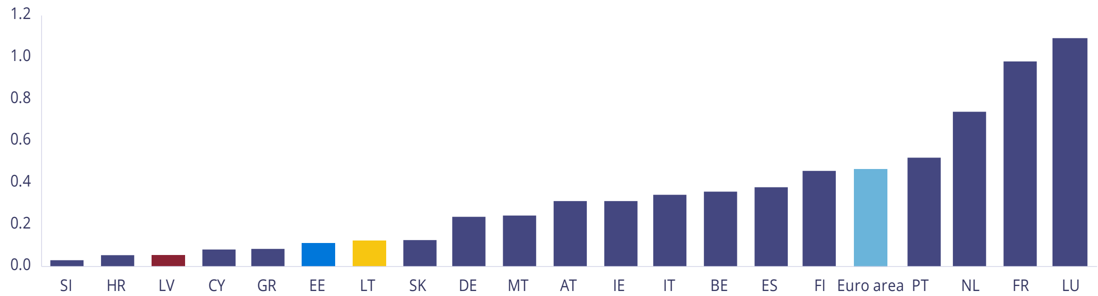
The situation is similar in the debt securities market (see Chart 24) as activity there was very weak even when low interest rates prevailed in financial markets over the previous decade. The debt securities issued by local non-financial companies in the first quarter of 2023 equalled 0.5% of GDP on average in the euro area, whereas in Latvia they were a mere 0.05% of GDP, which was the third-lowest level in the euro area.

[14] It should also be noted that from a supervisory perspective, banks are faced with limitations that may in some cases restrict their ability to provide financing for objective reasons.
[15] The figure covers companies listed on the Baltic Main List, the Baltic Secondary List, the First North Baltic Share List, and the Baltic First North Foreign Shares Trading List.

Chart 24

Outstanding value of the debt instruments of local non-financial companies in the euro area countries
(nominal value; % of GDP)





Sources: Eurostat, ECB SDW

One reason the level of activity in the capital markets is so low is that the levels of income and savings are relatively low, and so the amount of funds that could be invested in the capital markets is not large. However, this is far from the only reason as there are several advanced economies and even developing countries that have comparable income levels but where growth in the capital markets has been more buoyant. It is also important to note that the outstanding deposits at banks significantly exceed the outstanding loans from banks, which may point to untapped potential since those savings could be redirected towards capital markets.

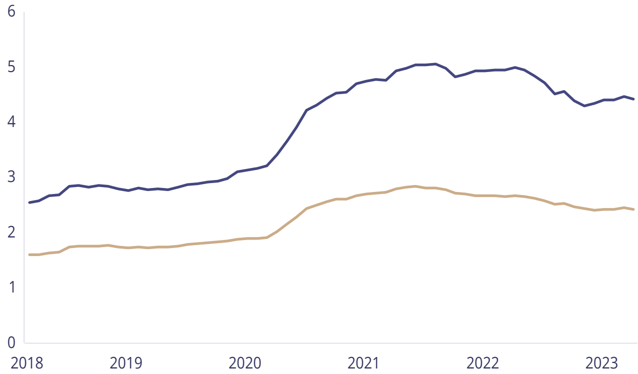
Another reason why the development of the capital markets has been weak is that there is little, or at times no, interest from international investors. For the local capital markets to come onto their radars, they would first need to reach a sufficient level of capitalisation. Communication by companies is an integral part of the capital markets since it ensures that information is available to financial market analysts and the mass media so that they can make objective assessments about those companies.

Financing can also be raised through Altum as it runs a range of various support programmes in areas that lack adequate financing from banks. As Altum specialises in addressing market failures though, its loan portfolio is relatively small against the total value of outstanding loans (see Chart 25). In mid-2023, Altum loans accounted for a mere 2.5% of the outstanding loans to non-financial companies and households. The increase in the outstanding volume that has happened since 2020 can be explained by the launch of new programmes designed to support companies and mitigate the effects of both the Covid-19 pandemic and Russia's war against Ukraine.

Chart 25

Share of outstanding Altum loans in total outstanding loans

(%)



Loans to domestic non-financial companies

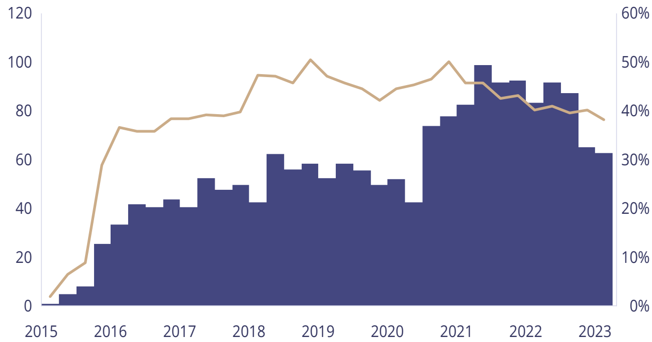
Loans to domestic non-financial companies and households

Source: Latvijas Banka

The amount issued in loans is not the only figure that illustrates the role of Altum in lending to the economy. It is particularly evident in lending for housing, where 40% of new loans are granted with Altum guarantees (see Chart 26). Such guarantees help lower the overall cost of purchasing a home by reducing the necessity for down payment on the housing loan and the duty on the duty on registering property rights with the Land Register, thereby making loans more accessible to a wider range of borrowers.

Chart 26

New state-guaranteed housing loans



Volume of loans (million euros; left-hand scale)

Share in the volume of new housing loans (right-hand scale)

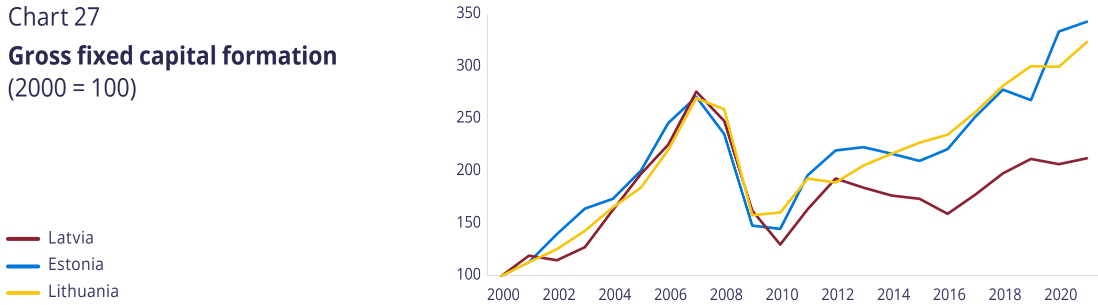
Source: Latvijas Banka

3. Corporate demand for external financing and the financial health of companies

The dynamics of investment were very similar in all three Baltic countries until the global financial crisis. Since 2012, however, investment activity in Latvia has lagged behind that in Estonia and Lithuania (see Chart 27), mainly because private sector investment has been weaker (see Chart 28). Public sector investment has stood still since 2011 at almost the same level of close to 5% of GDP that it was in 2004–2011, while the level of private sector investment has declined by a quarter from 23.3% of GDP between 2004 and 2011 to 17.7% of GDP between 2012 and 2022. By investment type, Latvia has fallen behind Lithuania and Estonia most notably in investment in construction of housing and other buildings.

Chart 27

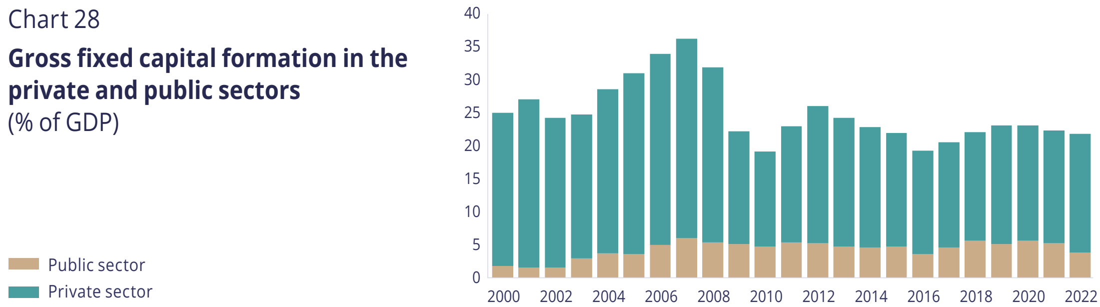
Gross fixed capital formation
(2000 = 100)



Sources: Eurostat, Latvijas Banka's calculations

Chart 28

Gross fixed capital formation in the private and public sectors
(% of GDP)



Sources: Eurostat, Latvijas Banka's calculations

The reasons why investment activity has been weak may be found on both the supply and demand sides. Factors such as limited and costly access to bank financing (see Chart 1) and the shortage of alternative sources of financing (see Chart 2) can be highlighted on the supply side, while the reluctance of companies to invest and their weak financial position, which stops them from taking on new liabilities, are often cited as factors on the demand side.[16]

Data on the outlook for companies and their investment decisions are regularly collected through surveys of companies, among them the SAFE survey run by the European Commission and the ECB, and the EIB Investment Survey. The results of these surveys imply that the decline over the past 10 years was not in the willingness of companies to invest or in their demand for financing, but rather in their access to external financing, including bank loans, with the result that the external financing gap widened.

Companies in Latvia use external financing in broadly similar ways to companies in other euro area countries (see Chart 29). The SAFE questionnaire shows that almost half of respondents direct their financing towards long-term investment and inventory funding. One quarter of Latvian companies seek financing to develop new products or services and increasing numbers of companies choose to use

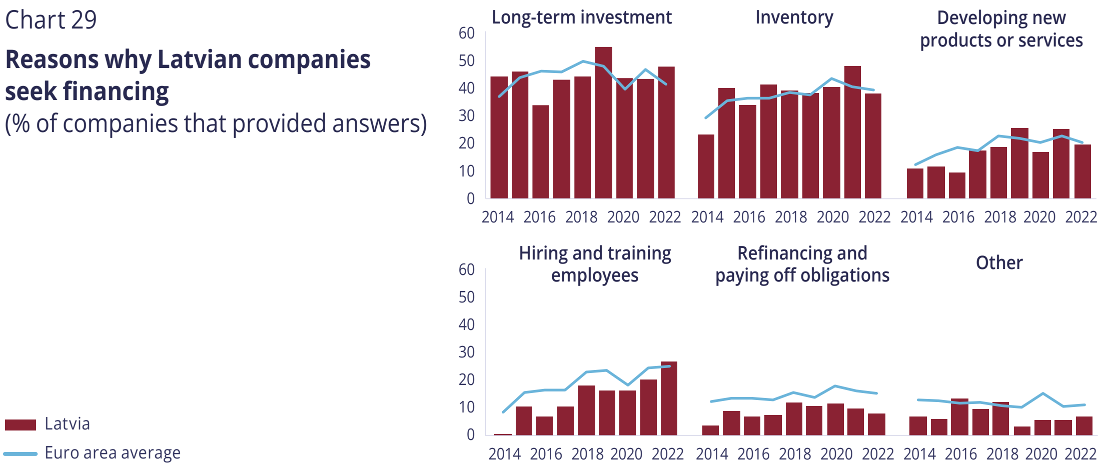
[16] https://www.financelatvia.eu/news/reditesana-lielais-vaininieks-vai-bedu-bralis/

external financing to hire employees and train them. The reasons why Latvian companies seek financing are also broadly similar to those given by companies in other euro area countries.

Chart 29

Reasons why Latvian companies seek financing

(% of companies that provided answers)



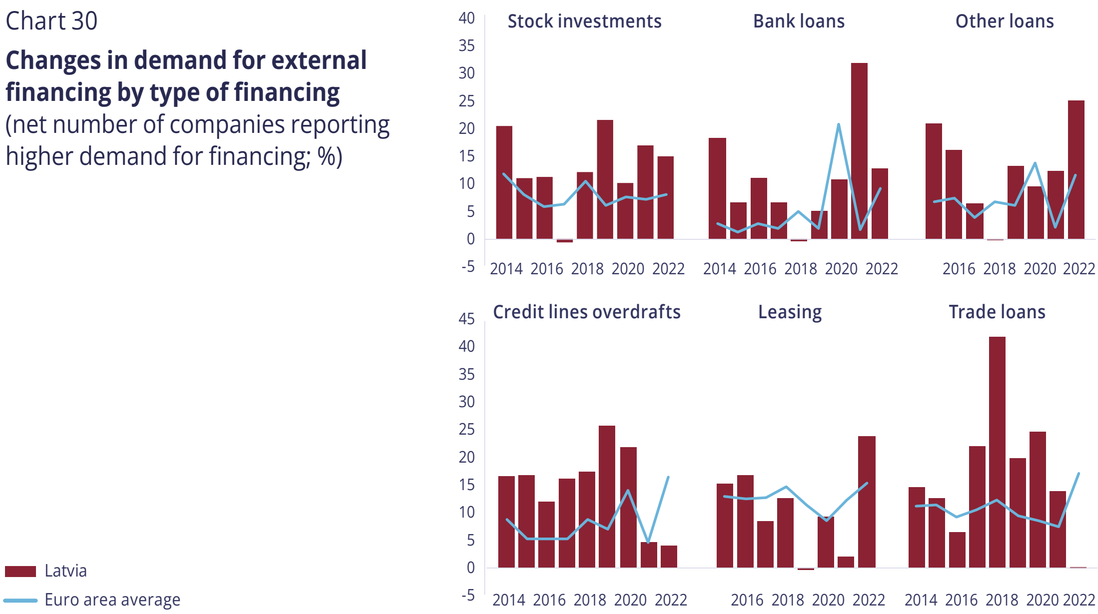
Source: SAFE

Since Latvia joined the euro area in 2014, corporate demand has increased in the country for all types of external financing, including bank loans. The number of Latvian companies reporting higher demand for bank loans has exceeded the number of companies reporting lower demand in every single year (see Chart 30). The net share of responses is consequently positive, and it is also higher than the euro area average. Demand for other sources of financing such as equity investments, leases and other loans shows similar trends. This all means that surveys of companies suggest corporate demand for external financing is relatively solid. The quarterly results of the ECB's euro area bank lending survey for the end of 2022 and the first half of 2023 point to certain shifts in trends, as the banks report that corporate demand for loans has declined because of higher interest rates (see Chart 31).

Chart 30

Changes in demand for external financing by type of financing

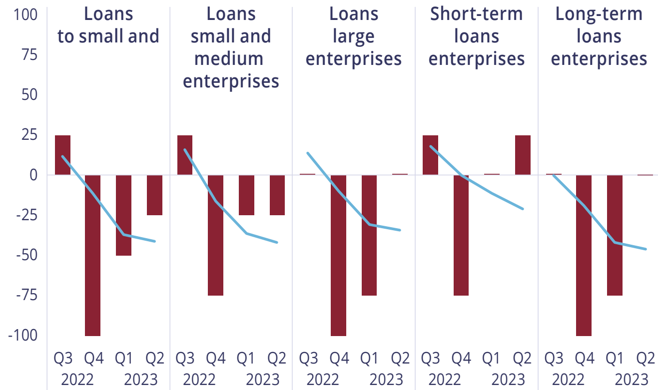
(net number of companies reporting higher demand for financing; %)



Source: SAFE

Chart 31

Changes in demand for loans to enterprises in Latvia and the euro area on average by loan type
(net number of banks reporting higher demand for loans to enterprises; %)



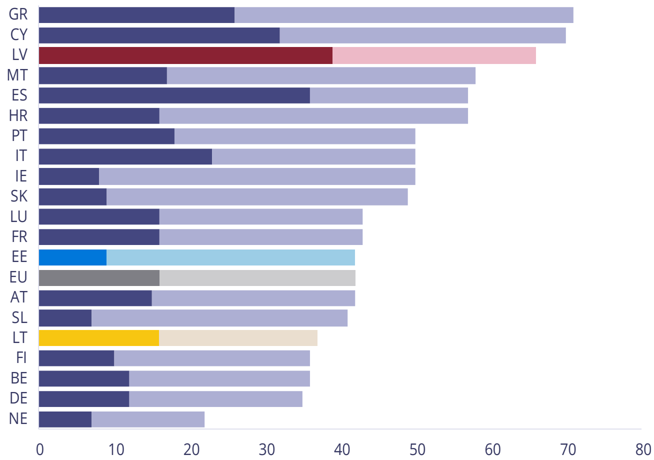
Latvia
Euro area average

Source: The euro area bank lending survey run by the ECB

Even when they are willing to invest, companies face challenges in financing their prospective investments. Approximately 60% of the Latvian companies surveyed believe that their access to financing is an obstacle to making long-term investments, and 40% of respondents consider it to be a significant obstacle, which is the highest figure in the euro area (see Chart 32). Companies in Estonia and Lithuania hold a more positive view of their access to financing as only 40% of the companies surveyed believe that their access to financing is an obstacle to making investments. These results indicate that access to financing may be one reason why Latvia's investment activity lags behind that of its neighbouring countries.

Chart 32

Share of companies believing that their access to financing is a minor or significant obstacle to making long-term investments in 2022
(%)



Significant
Minor

Source: EIB Investment Survey Country Overview 2018/2019/2020/2021/2022: Latvia/Estonia/Lithuania

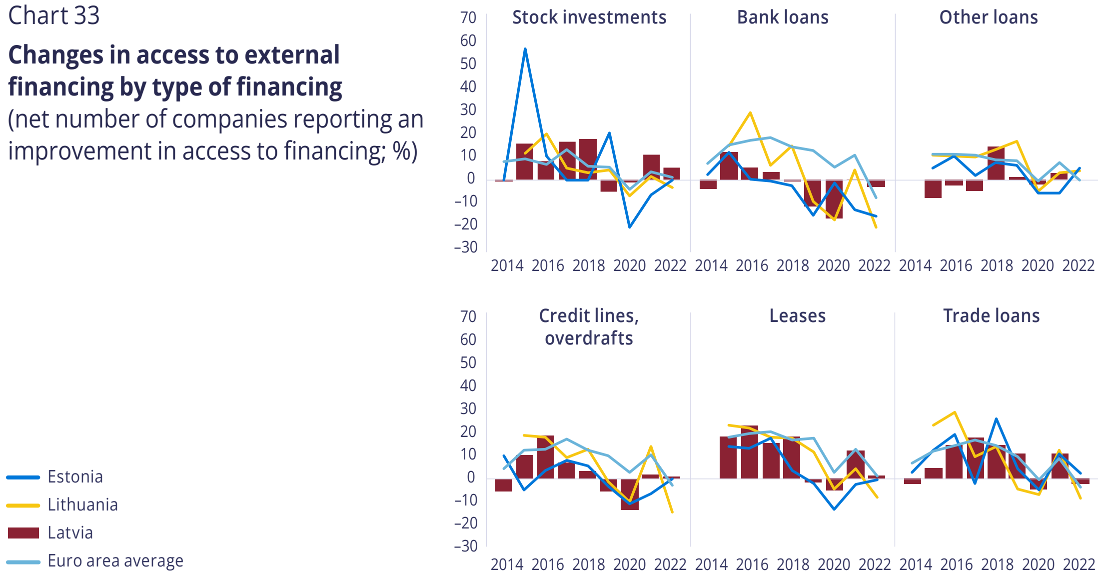
The SAFE survey results report that companies are of the view that the availability of bank loans has deteriorated over time (see Chart 33). The number of companies reporting a decline in the availability of bank loans has exceeded the number of companies reporting an improvement since 2018 and the dynamics in Lithuania and Estonia are similar. Meanwhile, a majority of companies in the euro area on average reported improvement rather than deterioration in the availability of bank loans, and a decline in availability was only observed in 2022.

Access to bank loans among the various types of financing declined most in Latvia during the Covid-19 pandemic.

Chart 33

Changes in access to external financing by type of financing

(net number of companies reporting an improvement in access to financing; %)



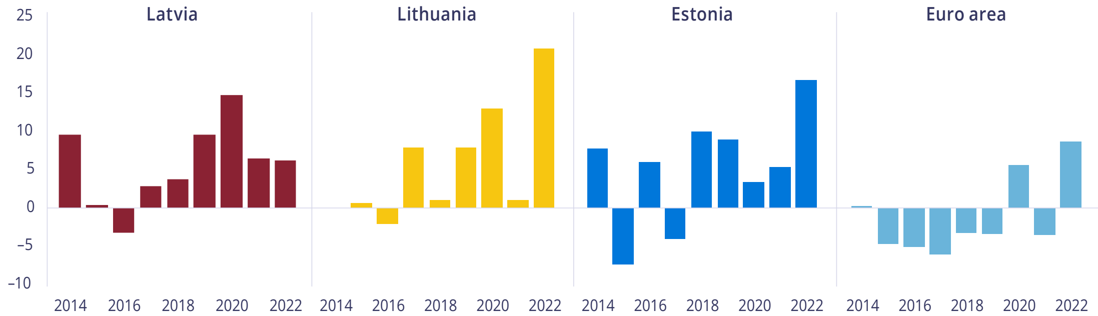
Source: SAFE

Increased demand for external financing combined with limits on the availability of it creates a financing gap for companies (see Chart 34). Latvia has seen the financing gap widen in almost every year since 2014, as have the other two Baltic countries.[17] During the five years since 2018, 8% of Baltic companies per year on average have reported an increase in the financing gap in net terms. During the same period the financing gap has mostly narrowed in the euro area, growing only during the Covid-19 pandemic, Russia's invasion of Ukraine and the energy price crisis.

Chart 34

Changes in the external financing gap*

(net number of companies reporting an increase in the financing gap; %)



* The external financing gap is calculated as the weighted average difference between the changes in demand for external financing and the availability of it for all types of external financing. If corporate demand for external financing increases and its availability decreases, then the value of the gap for the financing type is 1, and if demand decreases while availability increases the gap is –1. If the increase or decrease in the gap is only on one of the two sides, then the value of the gap for the financing type is 0.5 or –0.5.

Source: SAFE

Surveys of companies provide a direct view of the economic situation of the sector they operate in, their investment plans, and obstacles to those plans. Latvia has one of the largest shares among the euro area countries of companies that consider the lack of access to financing to be a significant obstacle to making long-term investments. At the same time, corporate demand for external financing in Latvia has been increasing even during the current economic uncertainty, while access to external financing, including bank loans, is limited. These opposing aspects are reflected in an increase in the financing gap, which may lead to companies postponing or even cancelling their investments, holding back Latvia's economic development.

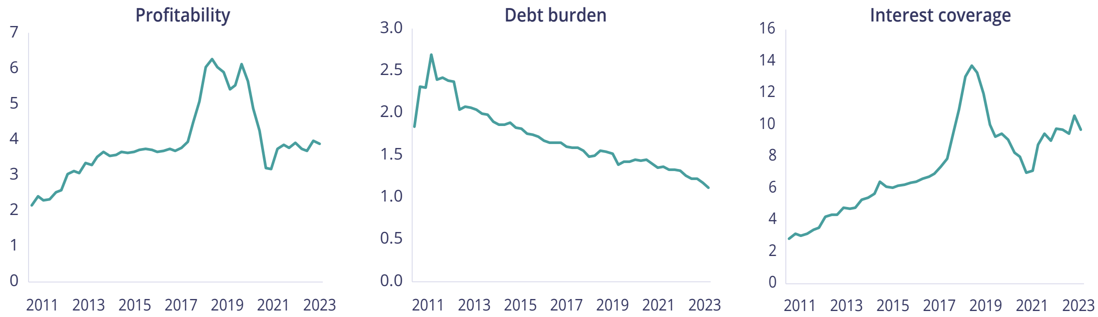
[17] Changes in the financing gap are identified by combining changes in demand for financing and the availability of it for all types of financing. If corporate demand for external financing increases or the availability of it decreases, then the gap for the type of financing grows, and if demand decreases or availability increases then the gap shrinks.

However, external financing demand alone may be insufficient if the financial situation of companies, and thus their ability to attract financing, is weak. When deciding whether to grant loans, banks assess the ability of the borrower to pay off the loan in the future by looking at the historical financial data of that company and its projected future cash flow.

The financial statistics of companies suggest that the financial health of companies has significantly improved since the global financial crisis, despite the multiple economic shocks (see Chart 35). Companies have grown notably more profitable, their debt burden has been shrinking year after year, and their ability to pay off their interest obligations has improved considerably.

Chart 35

Profitability (earnings before interest and taxes; EBIT/turnover)**, debt burden** (leverage/equity) **and interest coverage of companies** (EBIT/interest payments)



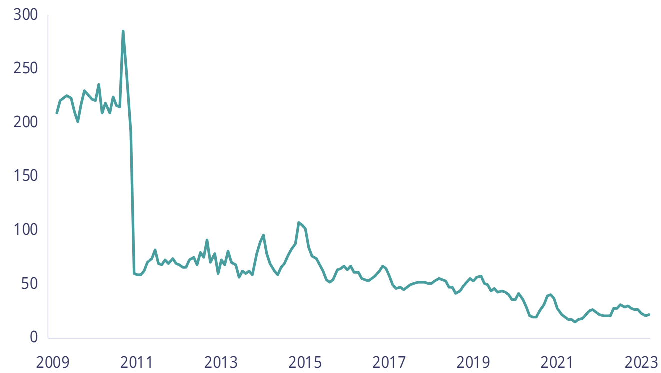
Source: CSB

Despite interest rates rising, the ability of companies to service their debt has not deteriorated yet because the debt burden is generally low. The moving 12-month interest coverage ratio remained high at 9.7 in the first quarter of 2023, meaning earnings before interest and taxes are 9.7 times higher than interest payments. However, persisting price and interest rate pressures mean that the number of companies facing financial difficulties may increase.

Numbers of insolvency cases are relatively low despite the Covid-19 pandemic and the energy price crisis. The number of insolvencies filed for legal entities has been declining since the global financial crisis and is currently half or a third of what it was in the middle of the previous decade (see Chart 36). The number of insolvencies filed for legal entities increased in 2022, as the ban on filing for the insolvency of a legal entity that was imposed on creditors during the pandemic was lifted. The number of filings declined again in the first half of 2023 though.

Chart 36

Number of insolvencies filed for legal entities



Sources: Insolvency Control Service, Latvia's Open Data Portal

However, an improvement in the average financial indicators does not reflect the wide variation in the financial health of companies. The financial situation of some companies has been hurt by energy price fluctuations and increases in other costs, rising interest rates and a decline in the purchasing power of households. Moreover, the insolvency risks of the companies that were affected by the pandemic remain high. Companies with limited options for passing higher costs through to end consumers, which include heat supply companies with administratively regulated prices, are more vulnerable, and the same applies to companies in the energy-intensive manufacturing, construction and energy sectors that face significant fluctuations in energy prices. The insolvency risks of companies have equally been mitigated by the large-scale government support measures that applied until the end of the 2022/2023 heating season, and by the decline in global energy prices at the end of 2022.

Data from the State Revenue Service (SRS) that Latvijas Banka can access[18] suggest that almost one company in three in Latvia was running its business with negative equity in 2021. This means that the liabilities of those companies exceeded the value of their assets. While the number of such companies remains significant, there have been some positive trends in the past ten years, as the share of companies with negative equity declined from 41% in 2014 to 31% in 2021.

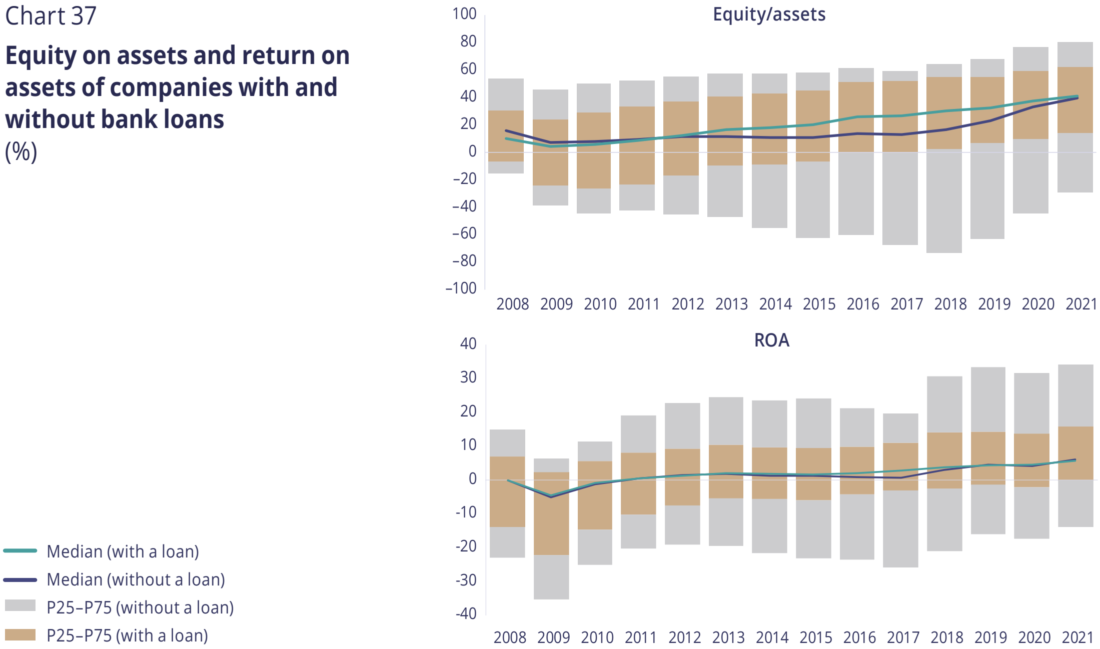
The SRS data show that companies with no bank loans have historically been in a weaker financial position as their capitalisation and profitability have on average been lower than those of companies with bank loans (see Chart 37). Over time, these differences have decreased significantly, and the medians of the two groups are currently almost identical.

Companies without bank loans demonstrate a much wider dispersion in their financial figures. Notable share of such companies have negative equity and weak profitability, but there is also a considerable share that report higher profitability and capitalisation, which may reduce their need for external financing.

Chart 37

Equity on assets and return on assets of companies with and without bank loans

(%)



Sources: CSB, Latvijas Banka's calculations

Bank lending is closely linked to the financial health of companies. In sectors where most companies report positive equity, the share of companies receiving loans is higher overall (see Chart 38).

In sectors where a large part of companies have negative equity by contrast, the share of companies receiving loans is very small. It is notable that significant financial improvement occurring in a sector does not guarantee that the share of companies receiving loans will increase. The SRS data show that the sectors reporting the largest declines in the share of companies with negative equity are not at all the ones witnessing the fastest growth in lending activity. The weakness of their financial situation during the global financial crisis has left some sectors stigmatised to a certain degree, and they consequently face restricted

[18] Data from corporate annual reports on the assets and liabilities of the balance sheet, and the income statement.

access to bank loans despite the improvement in their financial situation. This is indirectly implied by the analysis by Latvijas Banka, which finds that the business sector of the borrower is the third most significant factor in explaining lending rates.[19] The sector of the borrower accounts for more variation in the interest rates than do the value of the loan, expected losses, or the size of the company. The consequence of this can be that creditworthy companies have no access to bank loans (see Box 2).

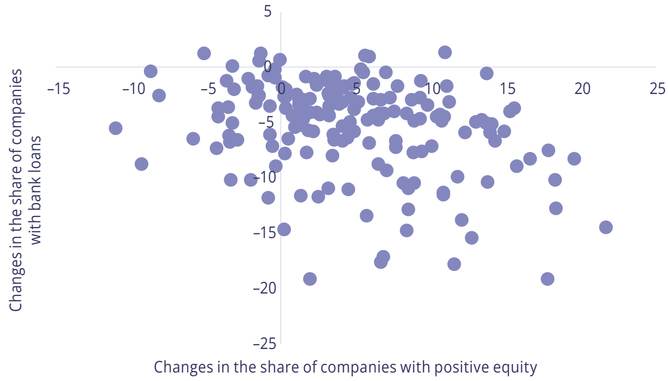
Chart 38

Share of companies with positive equity (x-axis) **and bank loans** (y-axis) **in sectors with at least 100 companies**
(%)

Sources: CSB, Latvijas Banka's calculations

Chart 39

Changes in the share of companies with positive equity (x-axis) **and bank loans** (y-axis) **in sectors with at least 100 companies (2012–2020)**
(percentage points)



Source: CSB, Latvijas Banka's calculations

Participation in the informal economy is another significant obstacle to the ability of companies to attract external financing. This is also confirmed by the analysis by Latvijas Banka, as companies that are very likely to pay undeclared wages in cash[20] get bank loans about a third as often as companies that have a low likelihood of paying undeclared wages. Econometric analysis of the factors affecting the chances of a company receiving a loan underlines the role of the informal economy, as the likelihood of wages not being declared is a significant factor even when various other company-specific and sector-specific factors have been accounted for.

[19] https://www.makroekonomika.lv/banku-procentu-likmes-uznemumiem-kas-lacitim-vedera
[20] The likelihood of wages not being declared has been estimated using the methodology from the study by Latvijas Banka (Beņkovskis and Fadejeva, 2022): https://datnes. latvijasbanka.lv/papers/wp_1_2022.pdf.

Box 2. What is the untapped lending potential of Latvia's corporate sector?

In 2021, only a small share of the more than 170 thousand Latvian companies[21] received bank loans, as 10 thousand had loans, or about 20 thousand if leases are included. The reasons why most companies have no bank loans may lie in the willingness and ability of companies to borrow or in the willingness of banks to grant loans to them. It is nearly impossible to quantify the willingness of companies to borrow and the willingness of the banks to lend, but the financial ability of companies to borrow can be assessed in various ways. One way is the relatively simple method of deducing when banks rule out companies that are unlikely

[21] https://data.stat.gov.lv/pxweb/lv/OSP_PUB/START ENT UZ UZS/UZS011/table/tableViewLayout1/

to qualify for bank loans. This method may indirectly answer the question of what the untapped lending potential of Latvia's corporate sector is.

The analysis used the SRS data on approximately 110 thousand companies in the period between 2019 and 2021, which cover the majority of Latvian companies, and the overwhelming majority by assets. Of the companies in the sample, around 10 thousand have received bank loans.[22]

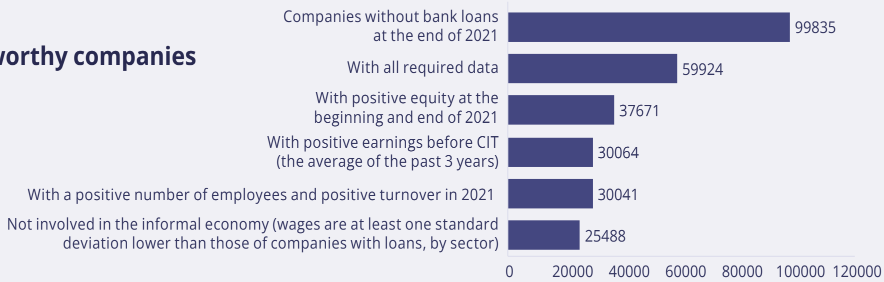
Among the 100 thousand companies without bank loans, nearly 40 thousand were economically inactive or failed to submit all the reports required of them, as there is missing information on their employees, turnover, equity or profit.

The financial situation of half of the remaining 60 thousand companies casts doubt on their creditworthiness, either because their equity is negative i.e. their liabilities exceed the value of their assets, or because their average profits before taxes have been negative between 2019 and 2021.

The remaining 30 thousand companies have positive equity, are profitable and have submitted all the required information. Of those companies, roughly 5 thousand report wages that are significantly lower by one standard deviation lower than the wages paid by companies in the same sector that have already received bank loans. Official wages being low could indicate that those wages are not being declared in full. Once the companies with the low wages are excluded, 25 thousand remain (see Chart 40).

Chart 40

Number of creditworthy companies



Sources: CSB and SRS data, Latvijas Banka's calculations

Of course, some of those companies would not qualify for loans for other reasons such as their size, age and ownership structure, and in any case, not all companies wish to borrow. Nonetheless, even if only a third of them meet all the conditions, the number of creditworthy companies increases by roughly 8 thousand. If those companies took a similar volume of loans to that of existing borrowers as a share of assets, the loan portfolio of the banks would increase by approximately 2 billion euro, or 5–6% of GDP.

Similar lending potential can be estimated from the sectoral accounts statistics of Eurostat. These show that if the loan-to-equity ratio of Latvian companies was the same as the euro area average, the volume of outstanding loans would be larger than it is now by roughly 5% of GDP.

This leads to the conclusion that there is already notable potential for corporate lending. However, the financial health of companies needs to be strengthened further if there is to be a more substantial increase in lending activity.

[22] Lease transactions with finance providers other than banks are impossible to identify from the data.

Growth has been solid since the end of the global financial crisis in the demand and need of Latvian companies for external financing. Moreover, the financial situation of companies, and thus their ability to borrow, has improved significantly. This leads to the conclusion that the weakness in the lending activity in the corporate segment is more a consequence of access to financing being limited (Chapters 1 and 2), rather than of companies being unwilling or unable to borrow. However, Latvia still has a relatively high share of companies that are in poor financial health, as one third of companies report negative equity. This combines with the spread of the informal economy to limit the potential for expansion of the overall portfolio of loans to non-financial companies.

4. Demand of households for external financing and their financial health

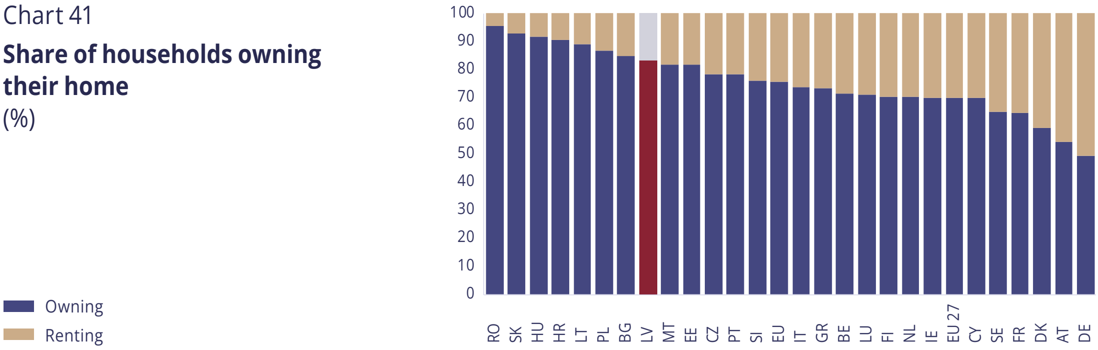
Unlike for the corporate sector, there is not a wide range of surveys of the household sector offering insights into the demand and need of households for external financing. This means that those demand-side factors can only be indirectly measured and compared internationally.

Eurostat data suggest that more than 80% of Latvian households own their home, which is a significantly higher proportion than in most other EU countries (see Chart 41). Even in the lowest income quintile, which is the 20% of households with the lowest income, more than half of households own their home (see Chart 42).

Chart 41

Share of households owning their home

(%)

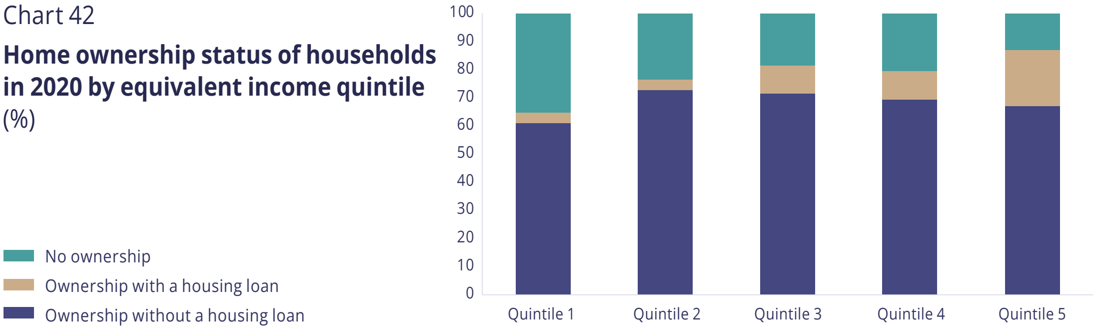


Sources: Eurostat, Household Finance and Consumption Survey (HFCS) 2020

Chart 42

Home ownership status of households in 2020 by equivalent income quintile

(%)



Note. Equivalent income allows for comparison between households of various sizes. It is obtained by dividing the household income by the equivalent household size, which is calculated using the modified OECD (Organisation for Economic Co-operation and Development) scale, on which a weight of 1.0 is given to the first adult, a weight of 0.5 to each subsequent household member aged 14 and over, and a weight of 0.3 to each child aged under 14.

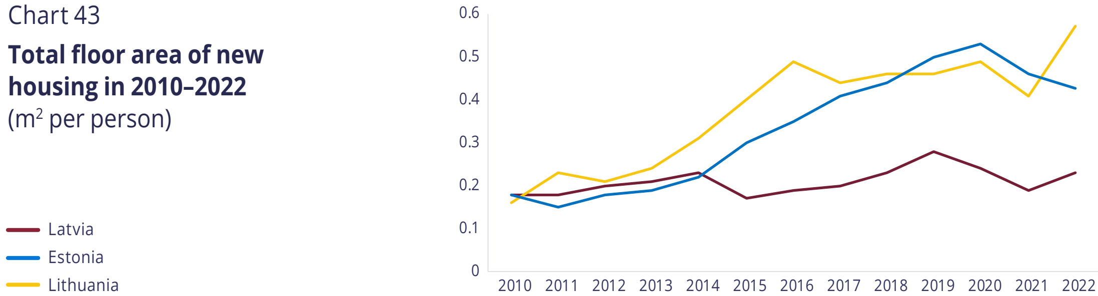
Sources: Eurostat, HFCS 2020

At the same time, many of the residential buildings were built in the middle of the 20th century. Over time, the age of this housing stock will be reflected in growing demand for new housing, particularly given high energy prices. Construction of new housing has however been slow in Latvia, and has significantly lagged behind that in Lithuania and Estonia. The floor area of new housing per person is approximately 0.2m^2 in Latvia, but roughly 0.5m^2 in Lithuania and Estonia (see Chart 43). Moreover, the amount invested by households is also considerably lower in Latvia than in its neighbouring countries and than the euro area average (see Chart 44).

Chart 43

Total floor area of new housing in 2010–2022

(m² per person)

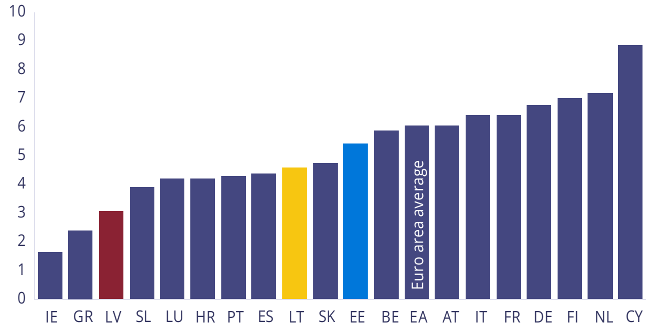


Sources: Eurostat, statistical offices of Latvia, Lithuania and Estonia

Chart 44

Household investment in euro area countries in 2021

(% of GDP)



Sources: Eurostat, statistical offices of Latvia, Lithuania and Estonia

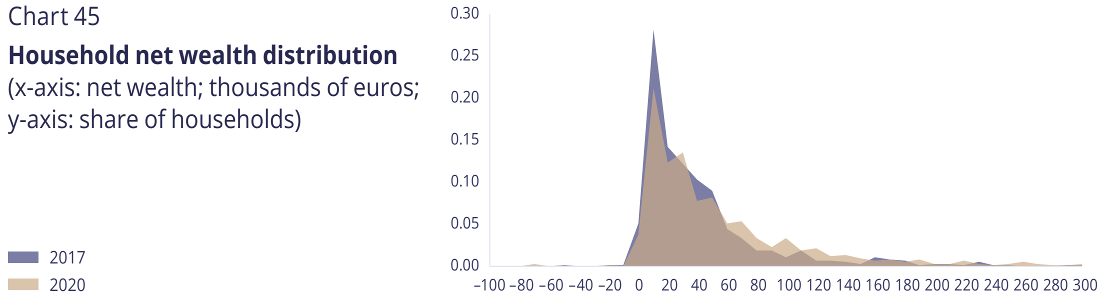
However, the developments in housing prices do not suggest that demand is weak for new housing. On the contrary, prices have risen by more for new housing than in other real estate categories, which may suggest that demand is growing and remains resilient. Estimates by SIA Colliers International Advisors find that 50–52% of the housing under construction in Riga and the Riga region was reserved in 2021 and 2022 even before it was completed. A rapid decline in the availability of new housing at the beginning of 2023 led the share of reservations to shrink, but it still remained relatively large at 38%[23].

At the same time, the financial situation of households, and consequently their ability to take on obligations, has improved significantly. With household assets increasing and their liabilities shrinking, the net wealth of households has expanded (see Chart 45). There has, moreover, been an increase in the share of households whose income exceeds their spending, allowing them to build up savings (see Chart 46). Favourable labour market conditions have put household savings on a robust upward trend, while the large-scale government support measures introduced during the 2022/2023 heating season have overall substantially mitigated the negative impact on solvency of rises in prices and interest rates.

Chart 45

Household net wealth distribution

(x-axis: net wealth; thousands of euros; y-axis: share of households)



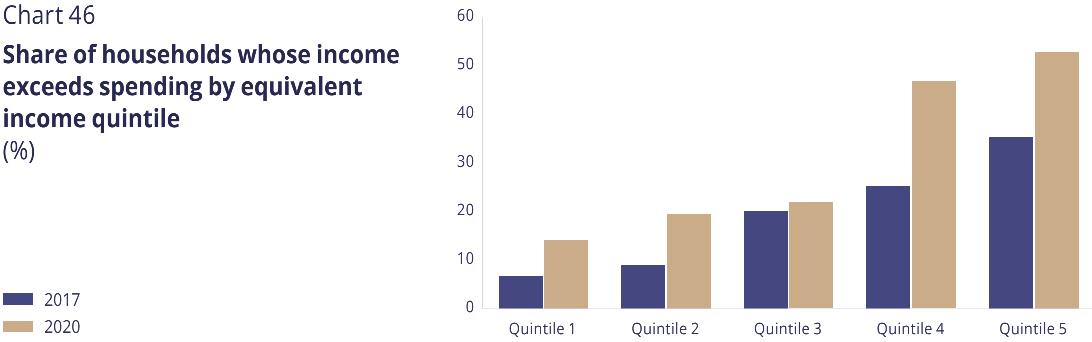
Note. Net wealth is calculated as the difference between all household assets and liabilities.
Source: HFCS 2020

[23] See https://www.colliers.com/lv-lv/research/residential-market-report-2022.

Chart 46

Share of households whose income exceeds spending by equivalent income quintile

(%)



Note. Equivalent income allows for comparison between households of various sizes. It is obtained by dividing the household income by the equivalent household size, which is calculated using the modified OECD scale on which a weight of 1.0 is given to the first adult, a weight of 0.5 to each subsequent household member aged 14 and over, and a weight of 0.3 to each child aged under 14.

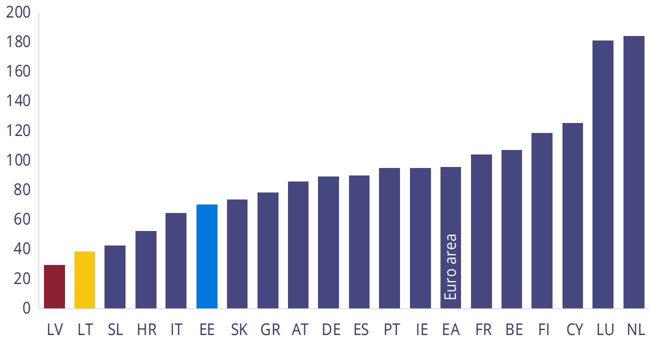
Source: HFCS 2020

The creditworthiness of Latvian households is thus good, and the liabilities-to-income ratio of households was the lowest in the euro area in 2021 (see Chart 47). It should be noted, however, that the situation has changed since early 2022, and a small share of households have seen their insolvency risks increase as the debt burden resulting from rising prices and interest rates could become excessive for them.[24]

Chart 47

Household liabilities-to-income ratio in the euro area countries in 2021

(%)



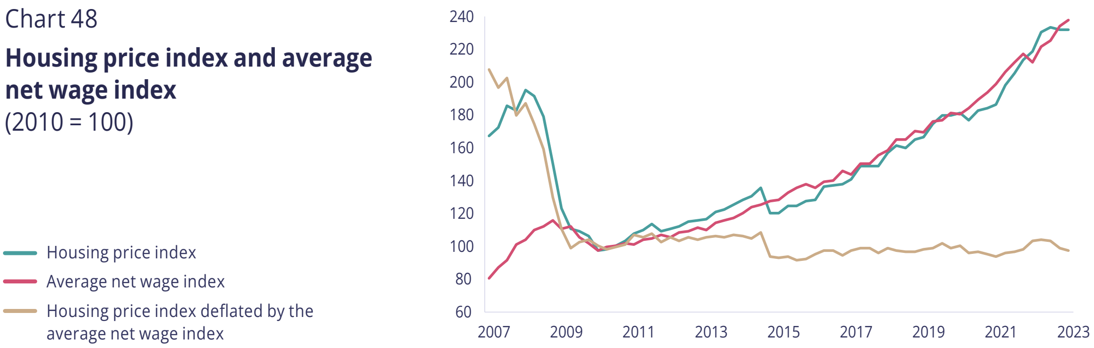
Sources: Eurostat, HFCS 2020

With average housing prices growing more quickly than wages in 2022, the affordability of housing worsened slightly overall, but it is still at a historically high level (see Chart 48). The increase in average wages has closely mirrored the rise in housing prices since the global financial crisis, and so the financial availability of housing has remained relatively stable.

Chart 48

Housing price index and average net wage index

(2010 = 100)



Sources: CSB, SIA Arco Real Estate, ECB SDW, Chatham Financial, Latvijas Banka's calculations

Before Russia's invasion of Ukraine and the related energy price crisis, the financial availability of housing was at a historically high level. This leads to the conclusion that the weakness in the development of the housing market was most probably not related to demand-side factors. The gap to Lithuania and Estonia

[24] Estimates by Latvijas Banka find that the debt servicing costs of up to 13% of households with housing loans may exceed 40% of their net income because of EURIBOR rising to 4.0% and other costs also rising; such households account for less than 2% of the total number of households.

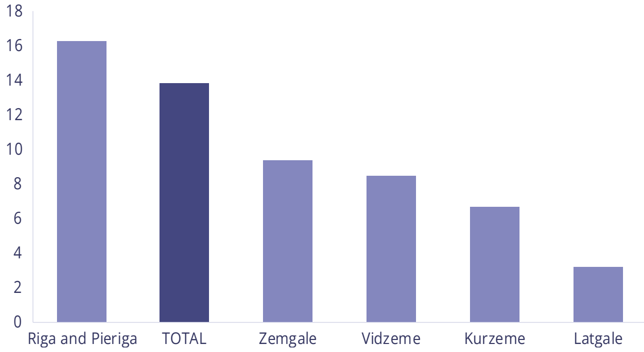
can be explained by the low level of activity in the construction of new housing. If Latvia's figure for the floor area of new housing per person were similar to that of Lithuania or Estonia, Latvia's lending volume would be roughly 6–7% of GDP larger than it is now and would reach the figure for Lithuania.[25]

The development of the housing stock has been constrained by several restrictions and obstacles. The first is that the approval process for obtaining the building permit is relatively slow and cumbersome, partly because the workload of the State Land Service is excessive, and there are ambiguities about the approval of construction projects; real estate developers report that in their experience it takes notably longer for construction documentation to be approved in Riga than it does in Vilnius or Tallinn[26]. A second obstacle is that although the financial situation of households has improved overall, there are still major differences between the degrees of purchasing power of various population groups. Prices for new housing are significantly higher than those for Soviet-era housing, and transactions involving Soviet-era housing still account for the largest part of housing purchase transactions in Riga. A third difficulty is that the relatively widespread informal economy not only distorts competition in the construction sector but also prevents those working in the informal economy from taking on housing loan obligations. Another challenge is that momentum was lost in housing construction at the end of 2014 and in 2015 following a sequence of events in Latvia's real estate market, as amendments to the Construction Law after the Zolitūde tragedy introduced stricter requirements for the construction process, amendments were made to the provisions for non-resident investment in real estate for the purpose of obtaining a residence permit, and the principle of the returned key was temporarily introduced for housing loans. The structural gaps therefore need to be closed if growth in good-quality and affordable housing stock is to be boosted.

At the same time, the price of loans and the availability of them have also contributed to some degree to activity weakening in the housing market. The interest rates in Latvia on even the most secure loans are much higher than the average lending rates in most other euro area countries (see Section 1), and this discourages households from taking on loan obligations. The availability of loans in the different regions of Latvia is another evident issue. In 2020, the outstanding housing loans in Riga and Pieriga region accounted for roughly 16% of the territorial GDP[27], while such loans accounted for much smaller shares in other regions of Latvia, equalling only 3% of the territorial GDP in Latgale for example. Moreover, the regional disparities in lending for housing have widened considerably over the past few years.

Chart 49

Outstanding loans to households for house purchase in 2020
(% of territorial GDP)



Source: Latvijas Banka

[25] The calculation is based on the assumption of the figures for the floor area of newly-constructed housing in Latvia following the averages for Lithuania and Estonia from 2015. It is also assumed that the average price of a home coincides with the price of new housing in that year and that half of home purchases are funded with a loan.

[26] The Doing Business report by the World Bank corroborates the notion that the construction process in Latvia is slower and more cumbersome than that in the other Baltic countries. The Doing Business reports for the past couple of years are unavailable, but those for several previous years, including 2020, ranked Latvia lower than the other Baltic countries and placed Latvia below the regional averages in categories such as receiving building permits and obtaining new connections to the electricity grid, and also below the other Baltic countries for registering property.

[27] Compared internationally, this figure is low. The latest available regional GDP data are for 2020.

Conclusions

Restricted access to financing has been one of the most evident issues facing Latvia's economy since the global financial crisis.[28] It has weakened investment activity and economic growth and so has prevented the standard of living from moving closer to the euro area average. Understanding the factors that underlie why access to financing in Latvia has been restricted over the past 10–15 years is vital if the situation is to be improved in the future by informed decision-making.

In Latvia, financing is mostly sought from banks, and so lending activity remaining weak has played an important role in financing becoming less accessible. The amount of outstanding loans has declined by more than two thirds since the global financial crisis, and the level of lending is currently the second-lowest among the euro area countries.

One reason why the level of lending activity is low lies in the conservative approach of the banks, which is reflected in their stringent lending conditions and in loan prices that are unattractive next to those offered in other euro area countries.

Loan interest rates have remained among the highest in the euro area in almost all lending segments for a long time in Latvia and in the Baltic countries overall. Those high rates cannot be explained either by financing for the banks themselves being more expensive, or by the quality of loans being significantly lower. On the contrary, the financial health of Latvian companies and households has improved significantly since the global financial crisis, and Latvian companies and households are in a much better place today for their ability to pay off their obligations than they were 10 years ago, despite the economic shocks experienced over recent years, including the Covid-19 pandemic and Russia's invasion of Ukraine.

These factors imply that margins are relatively high, which is also confirmed by the interest rates on even the most secure housing loans being much higher in Latvia than the average lending rates in most other euro area countries.

This state of stasis has emerged amid relatively high concentration in the lending market. Market segmentation and limited competition are reflected not only in high lending rates but also in other effects that are unfavourable to the borrower, such as relatively low deposit rates, a high proportion of variable lending rates, and a low level of refinancing transactions.

Although banks are not the only source of external financing, the capital markets are relatively underdeveloped, which limits the options of companies for attracting financing from other sources. The stock market capitalisation and the number of companies quoted on the stock exchange are very small compared to those seen in other EU countries, and also lag behind Lithuania and Estonia. Moreover, the level of activity in the bond market is also low. The services of lease companies and Altum play a fairly significant role in ensuring access to financing, but the specific nature of their services means that their lending is a small share of overall lending.

Meanwhile, surveys of companies suggest that the demand and need of companies for external financing have increased since the global financial crisis. This leads to the conclusion that the decline in lending activity in the corporate segment is due more to access to financing being limited rather than to companies being unwilling or unable to borrow. That the decrease in lending activity has been observed in parallel with improvements in the financial position of companies points to a deterioration in the availability of loans. The relatively high share of companies in poor financial health and the extent of the informal economy without question prevent Latvian companies from taking on obligations to the same extent that companies are able to elsewhere in the euro area, but these considerations cannot explain the sluggish dynamics of corporate lending over the past 10 years.

[28] The issue has been repeatedly highlighted in reports by Latvijas Banka and international institutions. See for example https://commission.europa.eu/system/files/2022-05/2022-european-semester-country-report-latvia_en.pdf and https://www.makroekonomika.lv/akroekonomisko-norisu-parskats-2021-gada-septembris.

The financial situation of households and their ability to take on obligations have notably improved. However, this has not been reflected in a significant expansion of lending for housing. The volume of construction in the new housing sector has been considerably smaller than that recorded in Lithuania or Estonia. The reasons for this lie in several structural flaws and bureaucratic obstacles to the construction process, as well as in the relatively higher lending rates and limited access to financing in the regions outside the capital area.