

**LAPSE OF  
TIME**

SM/22/186  
Correction 1

August 3, 2022

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: **Republic of Latvia—Selected Issues**

Board Action: The attached correction to SM/22/186 (7/14/22) has been provided by the staff:

**Typographical Errors: Page 3**

Questions: Mr. Akitoby, EUR (ext. 36646)  
Mr. Lissovolik, STA (ext. 34407)



# HIGH LENDING INTEREST RATES AND CREDIT-LESS RECOVERY IN LATVIA: A COMPARATIVE MACRO-FINANCIAL PERSPECTIVE FROM THE BALTICS AND THE EURO-AREA <sup>1</sup>

*Loan interest rates in the Baltic countries, and especially Latvia, have been relatively high and (recently) rising despite their membership in the euro-area. At the same time, and unlike its Baltic peers, Latvia has experienced a protracted weakness of corporate credit. An analysis of stylized facts and some empirical relationships between credit growth, interest rates, and other macroeconomic variables (i) documents some segmentation in bank lending interest rates between the Baltic states and the euro-area during 2015–22; (ii) finds that interest rates in Latvia are higher than in its Baltic peers with the gaps being yet wider at longer maturities and, within those, for smaller-sized loans; and (iii) determines that there is some relationship between Latvia's weak corporate credit and high interest rates. The findings call for broad-based actions to alleviate both supply and demand-side factors that affect Latvia's interest rates and bottlenecks to its credit provision.*

## A. Introduction

**1. Bank lending interest rates in Latvia and its Baltic neighbors have been surprisingly high in recent years despite their euro-area membership.** The puzzle of the high rates in the Baltics was recently highlighted by Benkovskis et al. (2021), whose bank-level analysis suggests that the differences in interest rates on corporate credit and lending margins between the Baltics and the euro-area cannot be explained by conventional bank-specific factors, including funding costs and credit risk. In parallel, Bank of Latvia (2021) explored the determinants of high corporate lending rates in Latvia through a microstudy of credit register data, finding that the characteristics of the loan-issuing credit institution were the most significant determinant, followed by the borrowers' size and type of sectoral activity. Karmelavicius et al. (2022) analyzed the problem of high lending rates focusing on Lithuania, attributing it to bank margins and market concentration. In the context of the euro-area, the problem of high rates in the Baltics raises concerns over the efficiency of transmission of monetary policy. A broader related concern is that the high cost of borrowing limits access to finance and opportunities for economic growth.

**2. In parallel, Latvia has experienced an unusually protracted credit-less recovery.** While credit growth turned negative in all Baltic countries in the aftermath of the global financial crisis (GFC) of 2008–09, credit started recovering in Lithuania and Estonia by 2013–14. By contrast, Latvia's credit continued to contract for the entire decade that followed the GFC. And while the household segment of Latvia's credit market has finally turned around and registered positive growth in 2021,

<sup>1</sup> Prepared by Bogdan Lissovlik (EUR). The analysis benefitted from discussions with the authorities, particularly Karlis Villerts and Konstantins Benkovskis.