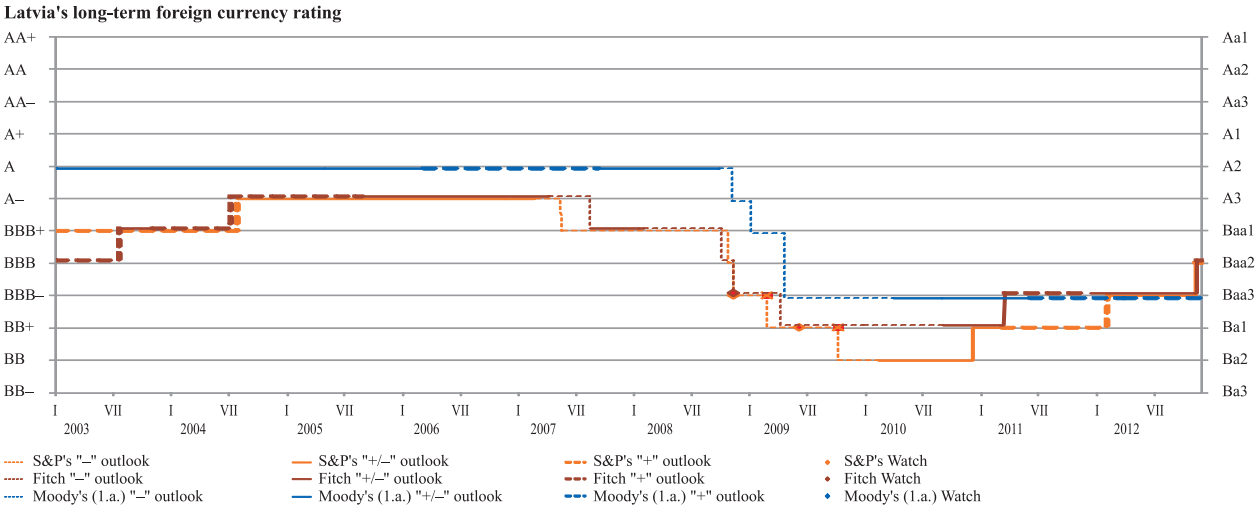
3. In Focus

Latvia's credit rating upgrades and their influence on borrowing costs

In November, two of the three leading world credit rating agencies, S&P and Fitch, increased the Latvian sovereign credit rating from BBB- to BBB. Just a few weeks after these rating upgrades, on December 5, Latvia was able to issue 7-year bonds in the amount of 1.25 billion US dollars at an all-time-low yield of just 2.9%. Part of this money will be used to fully repay the IMF loan received as part of the international economic aid programme.

The rapid deterioration of Latvia's rating in 2008–2009 was caused by a combination of domestic problems (high fiscal deficit, insufficient competitiveness, turbulences in the local financial market) as well as negative developments in the international financial market (see Chart). Starting from late 2010, S&P and Fitch upgraded Latvia's credit rating taking into consideration the improvements in Latvia's current account and international competitiveness as well as the credibility of its fiscal policy. Further credit rating upgrades followed in May and November this year. **In May, S&P increased Latvia's credit rating in appreciation of the commitment of the Latvian authorities to meet the fiscal targets and implement political reforms. Strong economic recovery, decreasing external debt ratios as well as persistent pursuit of a sound fiscal policy supported the last upgrades by S&P and Fitch in November.**



Currently, all the "Big Three" credit rating agencies have a positive outlook on Latvia's sovereign ratings which means that there is a higher probability of a credit rating upgrade (by one or two notches) within the next one or two years. Factors like the strong economic growth, favourable current account position and reductions in external debt ratios play a significant role in explaining the currently positive outlook on the future prospects. **The credit rating agencies themselves explain that their latest decision reflects expectations that Latvia will be able to adopt the euro in January 2014. Overall, all three credit rating agencies believe that the potential euro adoption will benefit the Latvian economy, sovereign creditworthiness and monetary flexibility.**

Latvia will definitely benefit from a higher credit rating in the longer term. The number of market participants who take their investment decisions taking in consideration the credit ratings is sufficiently large to be able to influence the market as a whole. Therefore, even those market participants who run their own creditworthiness analysis of debtors must take into account the opinion of the credit rating agencies. A credit rating as a measure of a borrower's creditworthiness has a more important role in small countries like Latvia. For an equivalent investment in sovereign bonds, the costs of conducting an independent creditworthiness analysis in a large number of small countries are higher than the costs of a similar exercise in a few or even a single large country. The most recent Latvia's bond auction illustrates how higher credit ratings help the states to tap the international financial market on more favourable terms (lower interest rates and longer maturity). Furthermore, a sovereign credit rating upgrade usually lowers the borrowing costs not only for the state, but also for the private sector.

Overall, the most recent developments in Latvia's financial market confirm that the present political and economic course has a favourable effect on Latvia's credit rating as well as its borrowing opportunities in the international markets. The positive consequences of the most recent credit rating upgrades are evident already now, but it will take some time before the full effect is seen.