# Development of Interest Rates in Latvia after Euro Adoption

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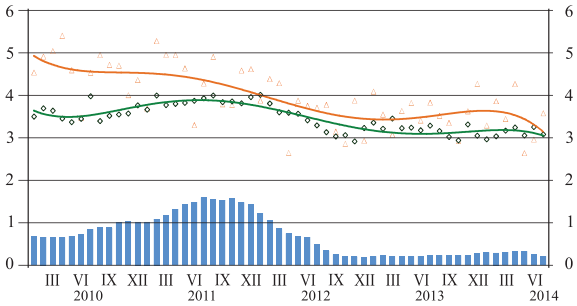
Economists widely agree that euro adoption leads to lower borrowing costs for households and enterprises in the medium term, thereby stimulating housing, consumption and investment activities. Historical evidence shows that small and medium-size enterprises usually benefit most from euro adoption. More than half a year has passed since Latvia adopted the euro; and one may wonder whether borrowing costs have already declined.

In principle, borrowers could benefit from euro adoption in two ways. On the one hand, those who took loans in the local currency (lats) would benefit immediately from re-fixing the loan from a higher and more volatile lats' money market index to a lower and more stable euro money market index. On the other hand, those who took loans in euro could save on currency conversion for loan monthly payments, since after the euro adoption income and monthly loan payments are in the same currency. Over the medium term, credit spreads that measure the difference between the new interest rates faced by households and enterprises and the respective money market rates should gradually decrease.

**Borrowing costs and money market indices**
(%)




EURIBOR 3M
Interest rates on new euro loans issued to domestic enterprises with a floating rate and an initial period of rate fixation of up to one year
Interest rates on new euro loans issued to domestic households for house purchase with a floating rate and an initial period of rate fixation of up to one year
Trend of interest rates on new euro loans to domestic enterprises
Trend of interest rates on new euro loans to domestic households for house purchase

Latvian borrowers have already been experiencing most of these benefits. Since the middle of 2013, the lats money market indices started to converge to the lower level of the euro money market indices faster than before. As a result, borrowers in lats could save on monthly payments even before the official date of re-fixing their loans to the euro money market index. Now they are in a favourable situation as their loans are fixed to the stable euro money market indices that could be hardly affected by the uncertainty regarding economic developments and geopolitical tensions, which currently are in the focus of society's attention across the globe. Moreover, savings from the conversion of monthly payments are self-evident.

The euro money market indices have been slightly decreasing since May when market participant expectations of further ECB monetary policy easing strengthened. The decline of euro money market interest rates was even more pronounced after the decisions of the Governing Council meetings of 5 June and 4 September lowering the key ECB interest rates and introducing additional monetary policy measures. The pass-through from money market interest rates to lending rates in Latvia is relatively high as the majority of loans in Latvia are fixed to money market indices, most often to 3 month EURIBOR. Therefore, as compared to April of this year, the overall borrowing costs in Latvia have decreased. The decline in lending rates exceeded that in money market rates in the segment of enterprise lending, suggesting that credit spreads in this segment have also shrunk.

The MFI interest rate on loans to domestic households and non-financial corporations fell from 4.9 percent in April to 4.2 percent in August, partly reflecting a drop in money market interest rates, partly a decrease in the margin on loans in several banks, and partly a fall in the share of riskier loans. Interest rates on loans in euro to domestic enterprises with a floating rate and an initial period of rate fixation of up to one year fell by 1.1 percentage point to 3.6% in the period from April till August. Interest rates on loans in euro to domestic households for house purchase with a floating rate and an initial period of rate fixation of up to one year remained at 3.3% in the same period.

The time span elapsed since euro adoption is too short to gauge whether the observed credit spread trends will persist. Tightness of the credit market as well as uncertainty of market participants about economic developments might limit a further decrease in credit spreads. Uncertainty about external developments is rooted in the observations of the economic activity slow-down in the main trading partners and of the geopolitical tensions in Ukraine. Uncertainty about internal developments arises mainly from the political debate and discussions about the necessity to amend the insolvency law by introducing the principle of "surrendered keys". In addition, credit risk of borrowers, as judged by the share of non-performing loans in the total amount of outstanding loans, has been decreasing slowly. At the same time, a further fall in credit spreads might be supported by the recently announced ECB monetary policy measures, and, in particular, targeted longer-term refinancing operations (TLTROs). These operations are aimed at improving bank lending to the euro area non-financial private sector. Banks operating in Latvia also have an opportunity to participate in those operations and borrow funds at very favourable rates in the long term.

Therefore, it can be concluded that almost all existing borrowers experienced some benefits from the euro adoption in the form of savings from conversion or lower and more stable money market rates. Now potential borrowers can obtain very attractive interest rates on loans due to the low level of euro money market rates. According to the financial market expectations, money market rates will stay low for a long period. But the decrease in credit spreads, as previously thought, would be gradual and would take several years.