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Raising investment
to support growth in Latvia

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Robert Grundke

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ABSTRACT

Raising investment to support growth in Latvia

Weak investment has weighed on the convergence process of Latvia towards higher living standards. Limited access to finance coupled with high informality, costly insolvency procedures, skilled labour shortages and weak competition have hampered business dynamism and innovation, weighing on productivity growth. To reduce high credit costs, it is key to foster competition in financial markets by reducing information asymmetries and switching costs for bank customers and strengthening competition enforcement. As capital markets are shallow compared to other euro area countries, listing of large state-owned enterprises and facilitating greater exposure of pension funds to domestic securities could help attract investors and raise access to finance. Improving contract enforcement and fostering the reallocation of resources to more productive firms will require reducing the cost of filing insolvency, expanding the remit of the Economic Court and continuing to fight corruption. This will also help raise the low level of trust in institutions, which is key to reducing high informality. As training provided by firms is among the lowest across EU countries, better cooperation among firms and with training providers in the design and delivery of training is needed. Further strengthening the resources and investigative powers of the Competition Council would help improve the enforcement of competitive neutrality, reduce the high barriers to entry and competition, and foster business dynamism and innovation.

JEL classification codes: E22,E26,G21,G24,J32,O16,O32

Keywords: Investment, bank credit, pricing power, Lerner index, reputational risk, capital markets, institutional investors, allocative efficiency, digital adoption, competition

RÉSUMÉ

Augmenter les investissements pour soutenir la croissance en Lettonie

La faiblesse des investissements a pesé sur le processus de convergence de la Lettonie vers des niveaux de vie plus élevés. L'accès limité au financement, associé à une forte informalité, à des procédures d'insolvabilité coûteuses, à des pénuries de main-d'œuvre qualifiée et à une faible concurrence, a entravé le dynamisme des entreprises et l'innovation, ce qui a pesé sur la croissance de la productivité. Pour réduire les coûts élevés du crédit, il est essentiel de favoriser la concurrence sur les marchés financiers en réduisant les asymétries d'information et les coûts de changement pour les clients des banques et en renforçant l'application des règles de concurrence. Les marchés de capitaux étant peu profonds par rapport à d'autres pays de la zone euro, la cotation des grandes entreprises d'État et la facilitation d'une plus grande exposition des fonds de pension aux titres nationaux pourraient contribuer à attirer les investisseurs et à améliorer l'accès au financement. Pour améliorer l'exécution des contrats et favoriser la réaffectation des ressources à des entreprises plus productives, il faudra réduire le coût des procédures d'insolvabilité, étendre les compétences du tribunal économique et continuer à lutter contre la corruption. Cela contribuera également à améliorer le faible niveau de confiance dans les institutions, ce qui est essentiel pour réduire le niveau élevé d'informalité. La formation dispensée par les entreprises étant l'une des plus faibles de tous les pays de l'UE, il convient d'améliorer la coopération entre les entreprises et avec les organismes de formation en ce qui concerne la conception et la mise en œuvre de la formation. Le renforcement des ressources et des pouvoirs d'enquête du Conseil de la concurrence contribuerait à améliorer l'application de la neutralité concurrentielle, à réduire les barrières élevées à l'entrée et à la concurrence, et à favoriser le dynamisme des entreprises et l'innovation.

Classification JEL: E22,E26,G21,G24,J32,O16,O32

Mots-clés: Investissement, crédit bancaire, pouvoir de fixation des prix, indice de Lerner, risque de réputation, marchés des capitaux, investisseurs institutionnels, efficacité allocative, adoption du numérique, concurrence

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Raising investment to support growth in Latvia

Enes Sunel

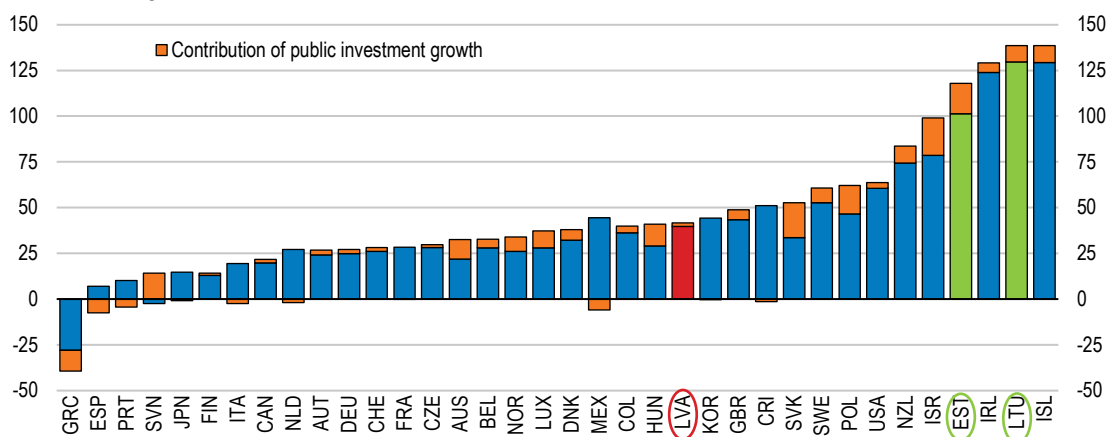
Robert Grundke¹

Weak investment has held back growth

Investment growth in Latvia has been weak compared to the other Baltic countries since the global financial crisis (Figure 1). This has weighed on potential growth and slowed down the convergence in living standards towards the OECD average. Residential net investment growth has even been negative, and public investment has only made a modest contribution to total investment growth. Raising investment is key to tackle the challenges of the demographic, green and digital transformations, and address a significant infrastructure backlog, particularly in housing and transport.

Figure 1. Latvia's investment performance has been weak compared to neighbouring countries

Growth in total real gross fixed capital formation in 2023 compared to 2009, %



Note: For countries where volumes for public real gross fixed capital formation do not exist, volumes are obtained by dividing values for public gross fixed capital formation based on appropriation accounts by the gross fixed capital formation deflator. Real gross fixed capital formation includes residential investment.

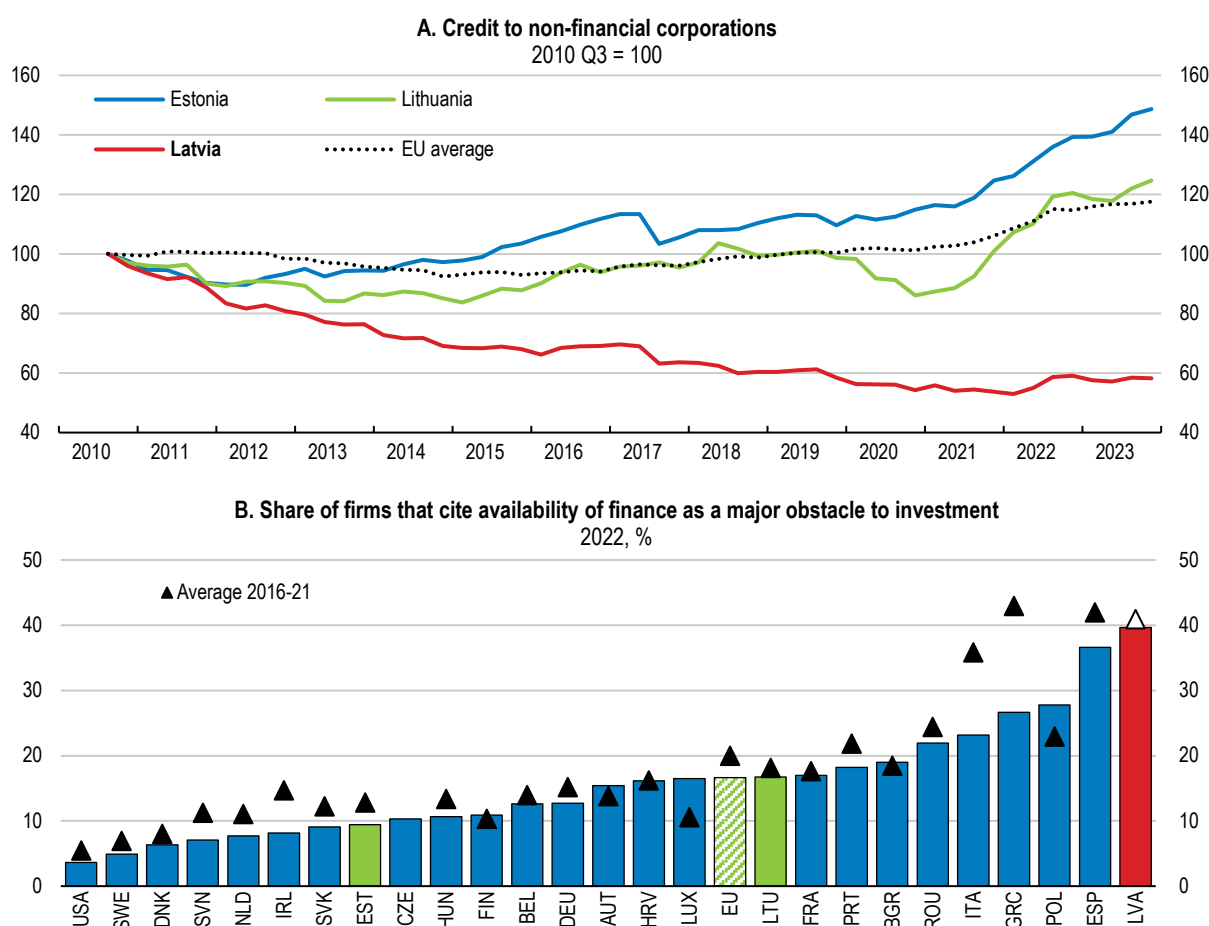
Source: OECD Economic Outlook database; and OECD calculations.

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Constrained access to finance is a serious barrier to business investment. After the global financial crisis, which ended a five-year period of excessive lending, the economy has undergone severe deleveraging in contrast with the rest of the EU, mainly due to high credit and reputational risk aversion in the banking sector. In addition, weak competition in the financial sector has led to high lending rates and stringent collateral requirements, severely restricting access to credit (Figure 2), especially for smaller firms. Shallow corporate equity and bond markets and the lack of institutional investors limit non-bank sources of corporate finance.

In addition to limited access to finance, domestic investment is discouraged by factors that weaken the business environment. Latvia has attracted large amounts of foreign direct investment, thanks to its integration into the EU market, low business taxes, an efficient customs system and a low administrative burden for foreign investments (OECD, 2022^[1]). However, around 40% of firms report obstacles related to the effectiveness of legal protection of investments, due to opaque administrative conduct, difficulties in challenging administrative decisions in court and frequent changes in legislation (European Commission, 2023^[2]). Transport infrastructure remains poor, and digital adoption is constrained by weak management and digital skills. Many firms remain small and are reluctant to borrow even when financially healthy (OECD, 2019^[3]). Resource allocation towards more productive firms is hampered by inefficiencies in the insolvency regime that allow insolvent firms to continue operating, weak competition and persistently high informality.

Figure 2. Weak credit supply hinders investment



Note: Credit in Panel A refers to loans and securities other than shares.

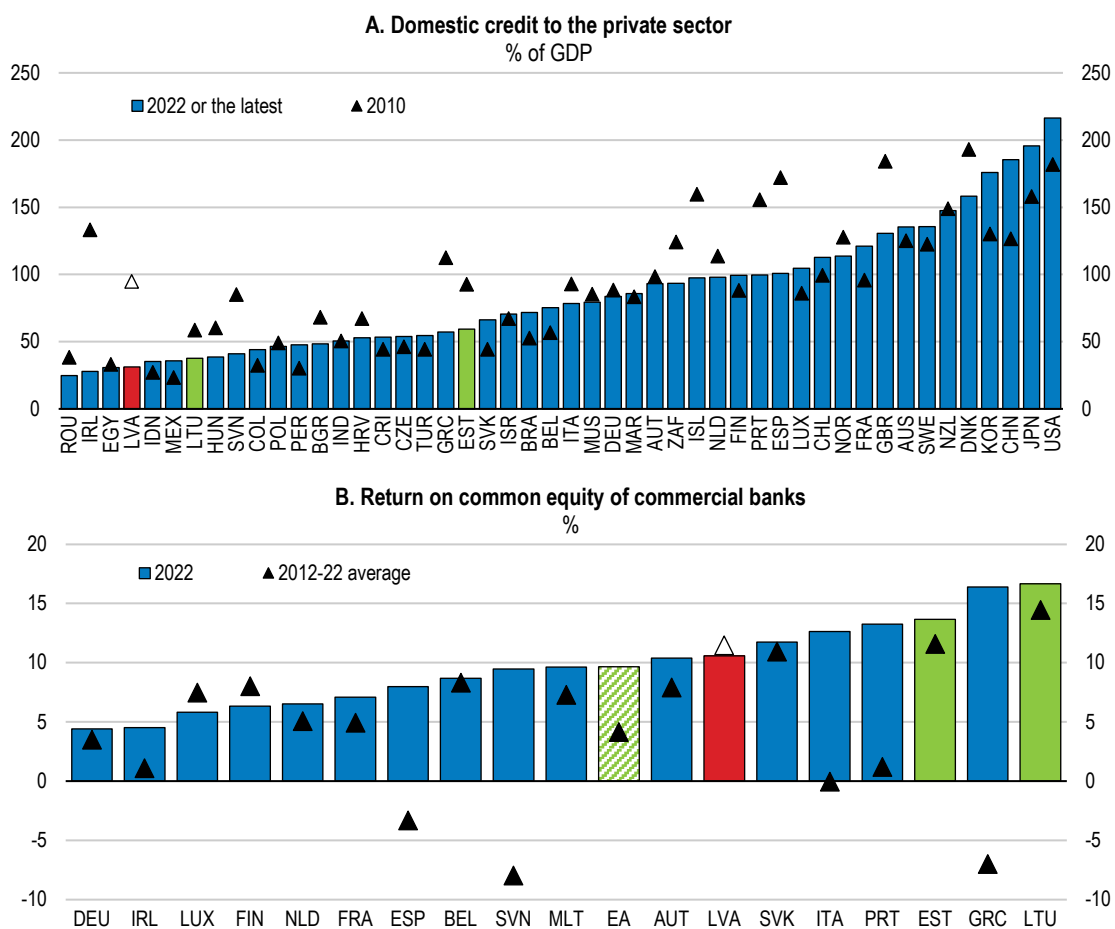
Source: ECB Data Portal; EIB Investment Survey Country Overview 2022: Latvia; and OECD calculations.

The remainder of the paper is structured as follows. The next section examines bank lending and discusses policy options to enhance competition in the banking sector and improve reputational risk management practices. The following section discusses non-bank financing options for Latvian firms. The third section examines how resource allocation and digital adoption by Latvian firms can be strengthened to raise investment demand. The final section concludes the paper.

Improving access to credit to boost investment

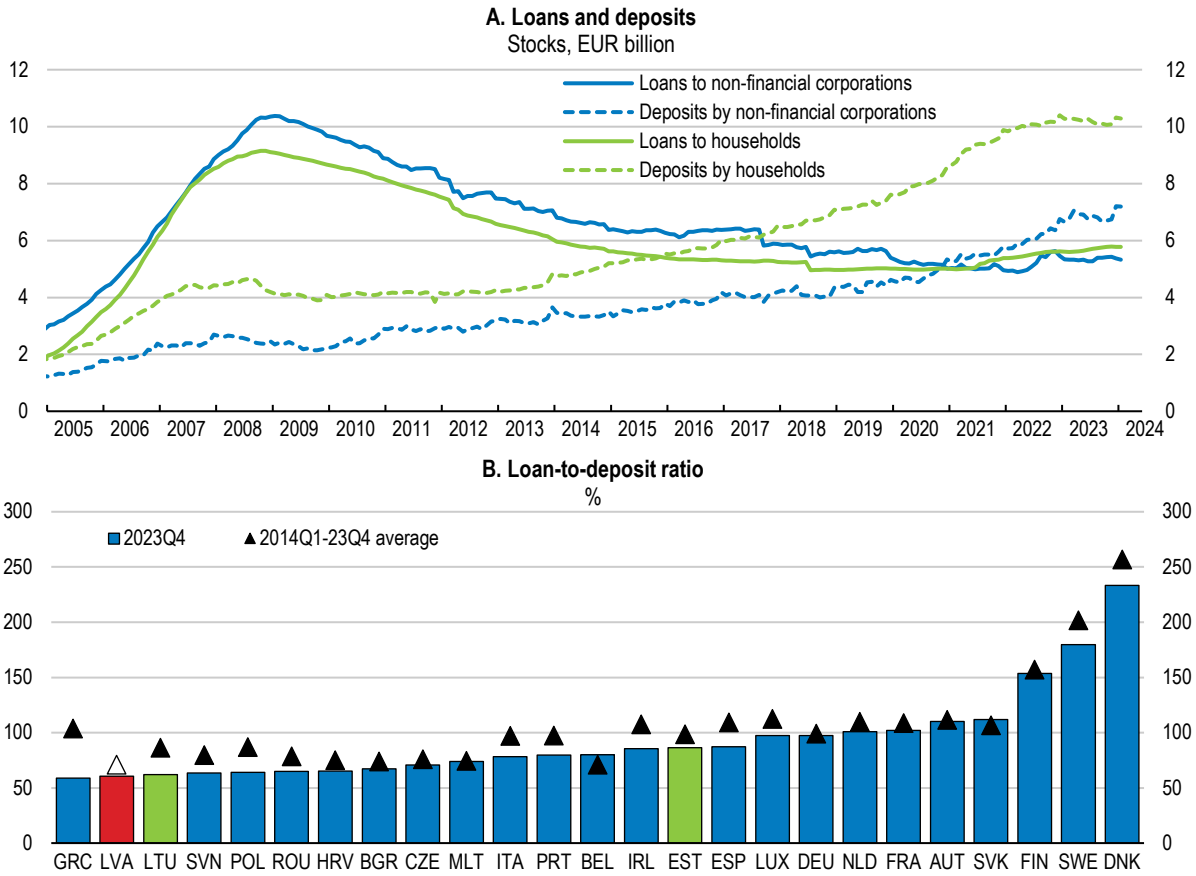
Despite being healthy and profitable, Latvian banks are hesitant to lend (Figure 3). Deposits from firms and households have steadily increased since the global financial crisis and the share of loans that are in arrears or non-performing have decreased (Bank of Latvia, 2023^[4]). Nevertheless, only a small proportion of bank deposits are converted into loans (Figure 4), in contrast with other OECD countries, where higher banking sector profitability has been associated with higher credit-to-GDP ratios (Richter and Zimmermann, 2018^[5]). One main explanation is high risk aversion by banks due to experience during and after the global financial crisis, which had led to large bank losses, soaring non-performing loans and low asset recovery rates due to dysfunctional insolvency procedures (OECD, 2016^[6]). The capital adequacy ratio of the Latvian banking system is very high, with a system-wide average Common Equity Tier 1 ratio exceeding 22% in 2022, around 3 percentage points above the EU average and about three times the regulatory minimum (Bank of Latvia, 2023^[7]). Sufficient capital in the banking sector is essential to absorb large losses in case of a banking crisis and prevent a bail-out by tax payers, but excessive capitalisation in the banking system could also impair financial intermediation and reduce access to finance (OECD, 2011^[8]).

Figure 3. Lending is weak despite high profitability of banks



Note: In Panel A, 2014 data is the earliest available for New Zealand. Panel B shows unweighted country averages for a total of 147 major euro area banks, representing about 83% of total assets of monetary and financial institutions excluding the Eurosystem of central banks. Source: World Bank World Development Indicators database; Bloomberg; and OECD calculations.

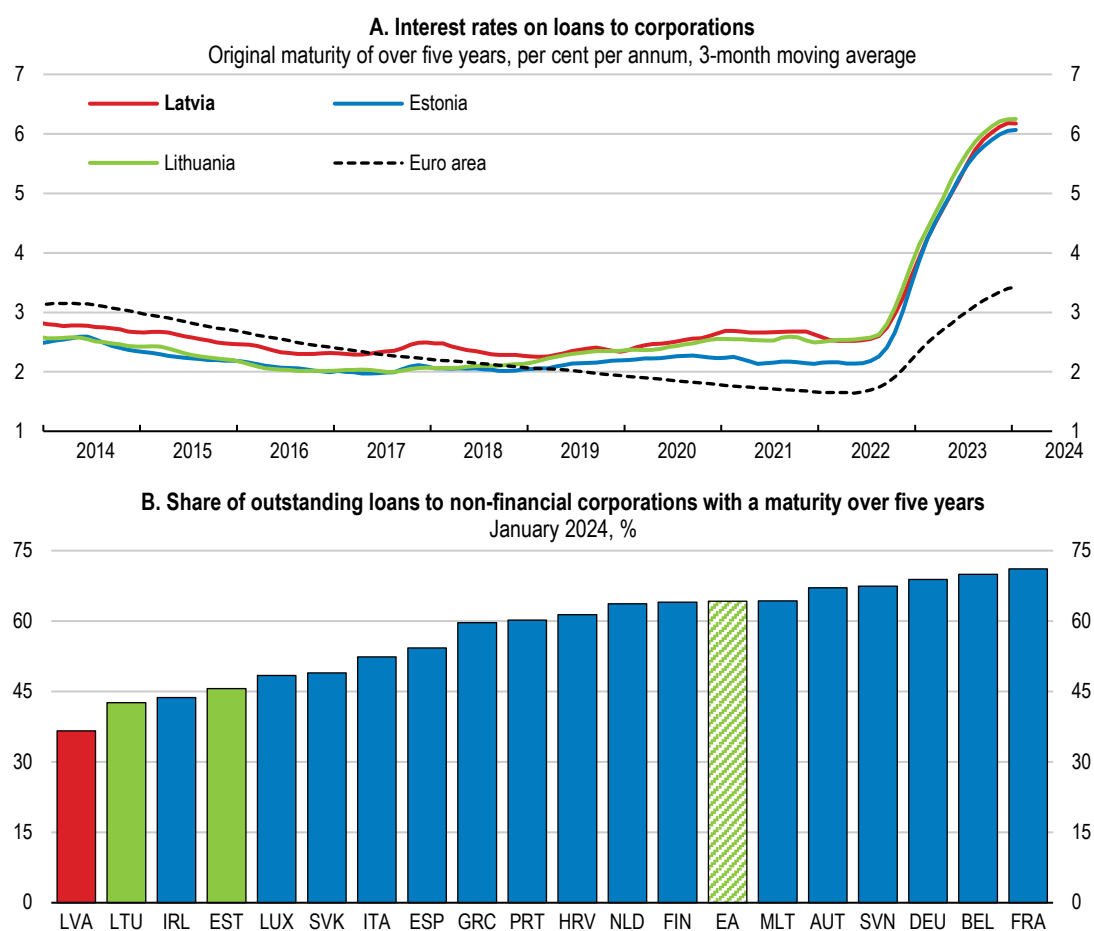
Figure 4. Bank lending has decreased despite rising deposits



Source: Bank of Latvia; Risk Assessment Indicators at the ECB Data Portal; and OECD calculations.

Interest rates are much higher than in other European countries and the share of long-term loans is very low (Figure 5). Easing financing conditions in the euro area over the past decade did not result in lower interest rates on loans to households and non-financial corporations in Latvia. Although real interest rates have recently declined due a rise in inflation in 2021-22, they remain among the highest in the euro area. Long-term borrowing rates for corporations have also diverged significantly from the rest of the euro area, making it difficult for firms to finance investment over long time horizons. As shorter debt maturities discourage business investment over a medium-term horizon and more so for firms with higher profitability and growth, the lack of access to longer-term loans hampers the overall growth potential of the economy (Hong, Hou and Nguyen, 2023^[9]).

Figure 5. Lending rates are high and the share of long-term loans is low



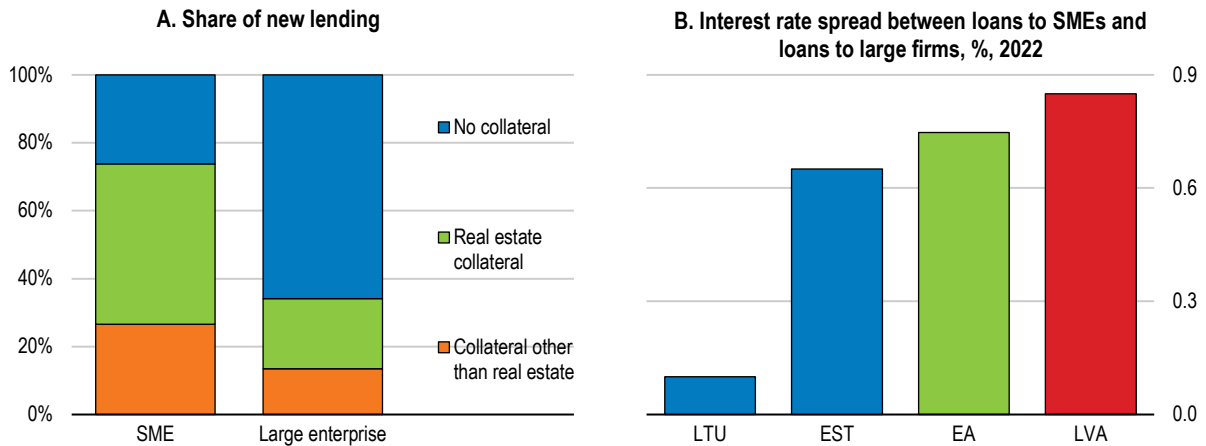
Note: Panel A shows the bank loan rate on outstanding amounts. Panel B covers loans by monetary and financial institutions excluding the Eurosystem of central banks.

Source: MFI Interest Rate Statistics and Balance Sheet Items at the ECB Data Portal; and OECD calculations.

Access to finance is especially weak for smaller firms (Figure 6). More than 80% of loans require collateral and requested collateral values are very high (Figure 6). This is particularly an issue for smaller and younger firms, which have less assets to offer as collateral. In addition to higher collateral requirements, small firms also face significantly higher interest rates than larger firms (Figure 7). This is related to the fact that the most common collateral requested from small and medium sized firms (SME), real estate, has a low valuation in many regions and the cost of resolving insolvency and recovering assets is still high, which leads to a low pre-contractual value of collateral. Moreover, smaller firms often have higher levels of accumulated arrears and untested business models, leading banks to charge higher interest rates to compensate for the credit risk. Smaller firms in manufacturing and agriculture face relatively low collateral requirements but higher interest rates (Figure 7), as their main source of finance is leasing from non-bank providers to meet their relatively higher demand for machinery and equipment.

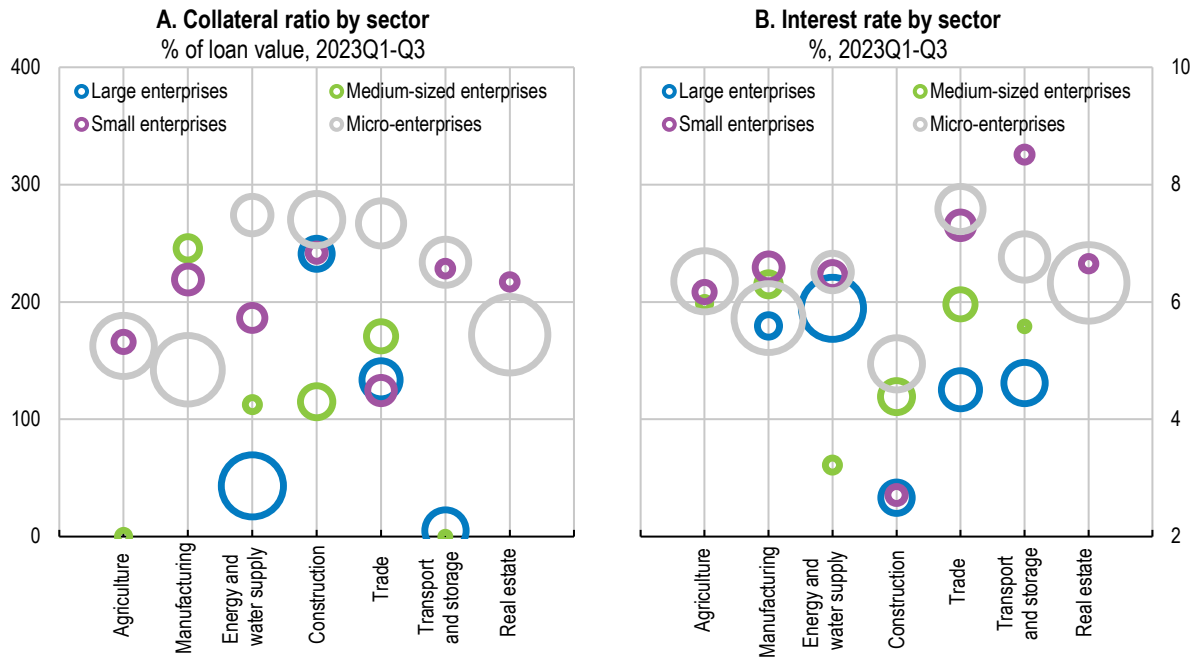
About two-thirds of non-financial enterprises in Latvia have no access to credit. These partly include inactive firms that remain on the business register but also those that may not be able to provide complete income statements or employee records or may have negative equity, which in many cases is related to partly operating in the shadow economy, making it impossible for them to even apply for a loan (Bank of Latvia, 2023^[41]). Some enterprises are financially viable but cannot obtain a bank loan. Given the high prevalence of smaller firms in Latvia, limited access to finance severely limits the ability of smaller firms to grow (see below) (OECD, 2021^[10]).

Figure 6. SMEs face stricter collateral requirements and higher lending rates than larger firms



Source: Bank of Latvia calculations using firm-level credit register data; and Financing SMEs and Entrepreneurs 2024: An OECD Scoreboard.

Figure 7. Tight credit conditions restrict bank lending to smaller firms in some key sectors

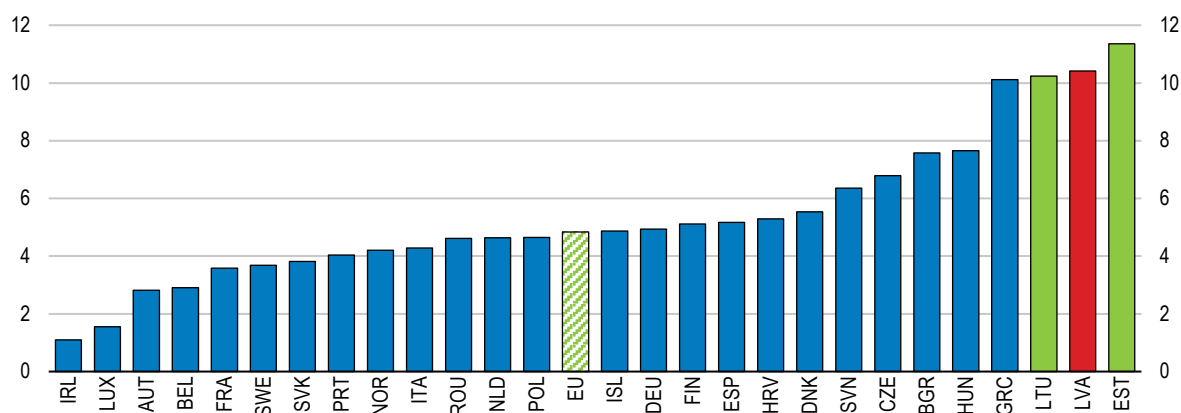


Note: The size of the bubbles corresponds to the volume of bank loan. Collateral ratios and interest rates are weighted averages. Values for certain enterprise size-sector pairs are not shown if the number of loans granted is lower than 10.
Source: Bank of Latvia calculations using micro data at the credit register.

Besides the high cost of credit, the willingness to borrow is also low due to high risk aversion of firms. Only a small share of the population borrows from a financial institution and many firms operating in the formal economy with strong balance sheets choose not to borrow (Bank of Latvia, 2023^[4]). This reflects the legacy of the global financial crisis, which led to many bankruptcies of over-leveraged firms, and the prevalence of many founder-managed firms that prefer to finance investments out of retained earnings (OECD, 2022^[1]). Fear of possible rejection by banks, which is related to past negative experiences, and low levels of financial literacy also discourage firms from approaching banks for finance (Figure 8).

Figure 8. A significant share of firms are reluctant to apply for bank loans

Share of firms that did not apply for bank financing because of possible rejection, 2023, %

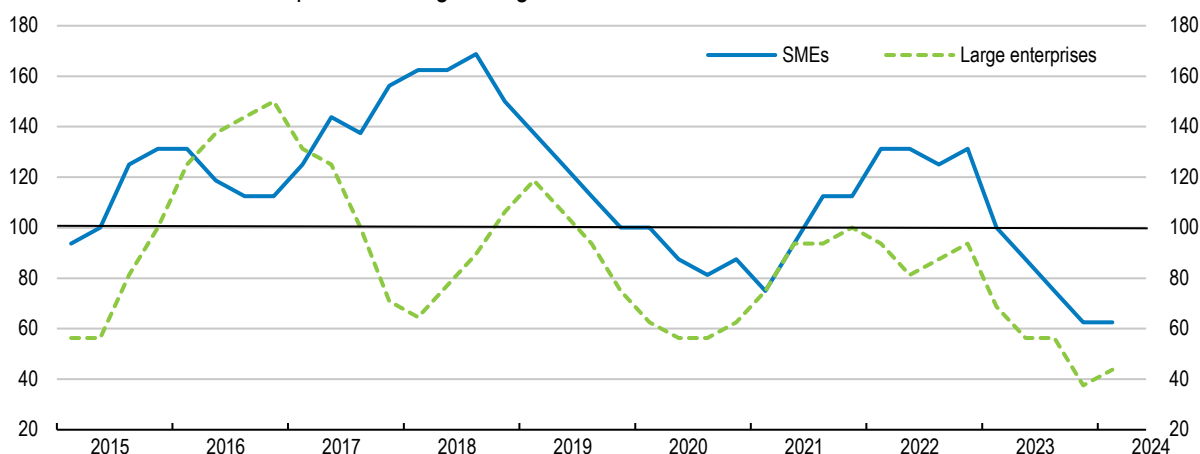


Source: 2023 SAFE Survey on the access to finance of enterprises.

Demand for credit has been higher among smaller firms, partly because of existing tax incentives for retained earnings, which tend to benefit more profitable, larger firms (Figure 9). Undistributed corporate profits are not taxed, which strengthens the internal financing structure of more profitable, larger firms allowing them to finance investments out of retained earnings. Although SME demand for credit remains higher than that of larger firms, the rapid rise in bank lending rates following the recent monetary tightening has reduced credit demand for all firms. A reduced appetite for longer-term investment have also contributed to weak credit demand (Bank of Latvia, 2022^[11]).

Figure 9. Demand for credit remains higher among smaller firms, but has fallen sharply

Evolution of loan demand, 4-quarter moving average. An index level of 100 indicates neutral demand.



Note: An increase in the lines corresponds to a higher net percentage of banks which indicate that loan demand is increasing. The 4-quarter moving average is backward looking. Raw indices from 2014Q2 onwards are normalised.

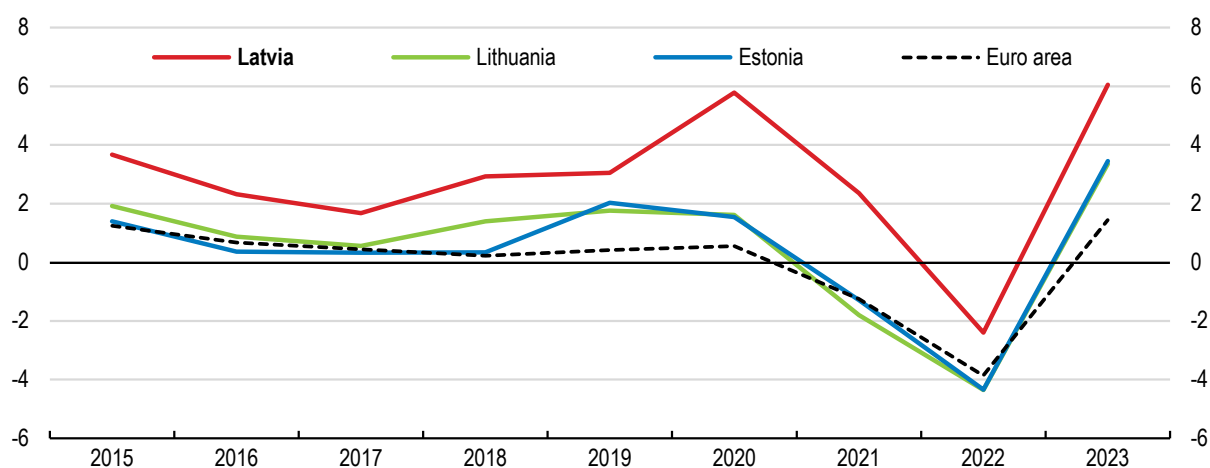
Source: ECB Euro Area Bank Lending Survey; and OECD calculations.

The low level of credit provision in Latvia is likely to reflect constrained supply conditions rather than reduced demand. Supply constraints lead to lower credit availability and higher borrowing costs. Conversely, weak demand would lead to both reduced credit volumes and borrowing costs. Real lending rates in Latvia, which represent the equilibrium price in credit markets, have been persistently higher than those in the euro area and other Baltic countries to a similar extent over the past decade (Figure 10). Given the lower level of loan origination in Latvia compared to the peer group over the same period (Figure 3),

the constrained supply conditions in the Latvian credit markets are likely to have outweighed the weak demand conditions.

Figure 10. The real cost of credit has been persistently higher than in peer countries

Real cost of loans to non-financial corporations and to households for house purchase, % per annum



Note: Real lending rates are calculated by adjusting the nominal cost of loans to non-financial corporations and to households for house purchase for one-year ahead annual inflation expectations.

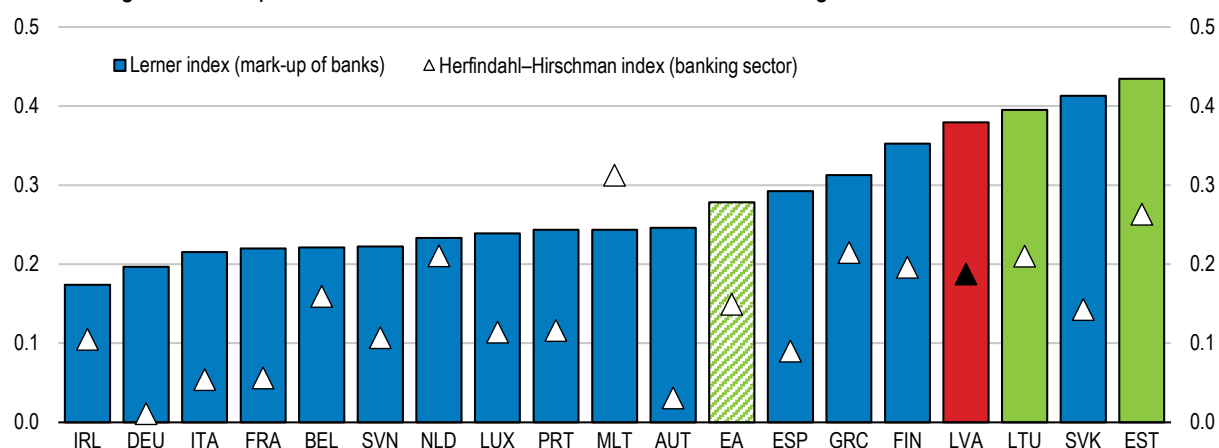
Source: MFI Interest Rate Statistics at the ECB Data Portal; Consensus Forecasts; and OECD calculations.

Improving bank credit provision

Weak competition in the banking sector may help to explain low supply and high cost of credit, in addition to high risk aversion of banks. Four banks in Latvia account for about 80% of loans to enterprises and around half of bank customers have their banking relationship with a single bank (Competition Council, 2021^[12]; Bank of Latvia, 2023^[13]). As a result, the Herfindahl-Hirschman index, a common measure for market concentration, shows much higher values for the Latvian banking sector than for other EU countries (Figure 11).

Figure 11. The local banking sector is concentrated and bank mark-ups are high

Local banking sector competition and concentration measures, 2012-22 average



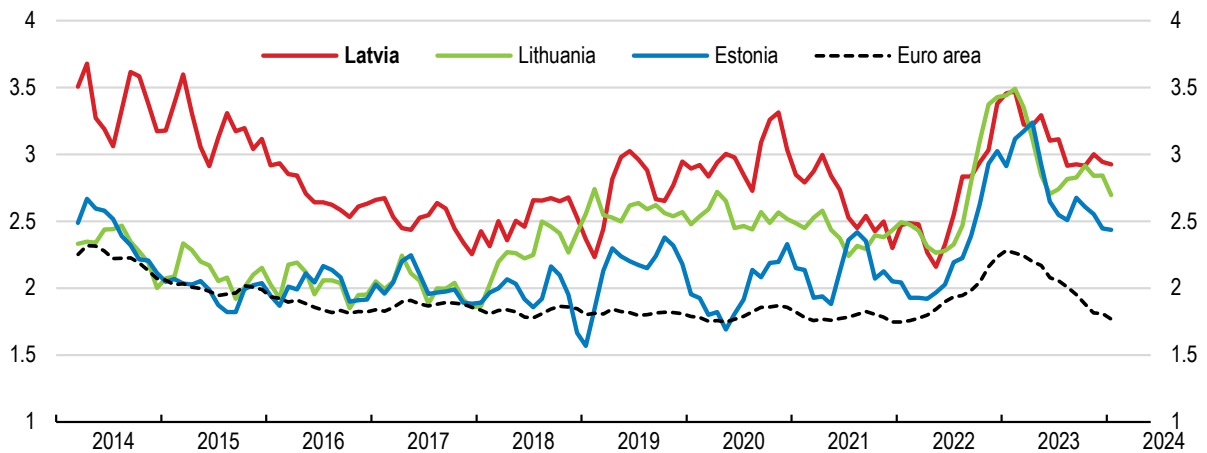
Note: The Herfindahl-Hirschman index (HHI) ranges from 0 to 1. Increasing values of the HHI correspond to higher market concentration in total lending. The bank-level estimates of the Lerner index, which is a direct measure of the price mark-up, follow closely (Demirguc-Kunt and Martínez Pería, 2010^[14]) and are aggregated to the country level by taking unweighted averages across banks. See Box 1 for further details.

Source: Banking Structural Financial Indicators at the ECB Data Portal; Bloomberg; and OECD calculations.

The high concentration of banks could be related to the small size of the Latvian economy and does not necessarily imply that banks do not behave competitively (Demirguc-Kunt and Martínez Pería, 2010^[14]). However, the high concentration in the banking sector has also been accompanied by stronger pricing power in lending over the past decade, possibly indicating weak competition in the banking sector. The Lerner index, which measures competitive pressure based on the mark-ups charged by banks over their marginal costs and controls for time-invariant bank-specific factors as well as time-varying macroeconomic variables, has been higher than in many other EU countries over the last decade (Figure 11). Lower competitive pressures for banks could, for example, be related to lower threat of entry of new lenders, lower customer mobility or less competition from other financial market players. Moreover, spreads between bank lending and deposit rates are higher in Latvia than in other Baltic or EU countries, which can be related to the high concentration in the banking sector, but also to other factors such as higher borrower risk (Figure 12) (Benkovskis, Tkacevs and Vilerts, 2021^[15]). These spreads also have been more volatile than in other EU countries, as the higher number of single-bank borrowing firms amplifies the impact of negative credit supply shocks on the availability of credit to firms (Degryse et al., 2019^[16]).

Figure 12. Intermediation margins in the banking sector are high and volatile

Difference between lending and deposit rates, per cent per annum, 3-month m. a.



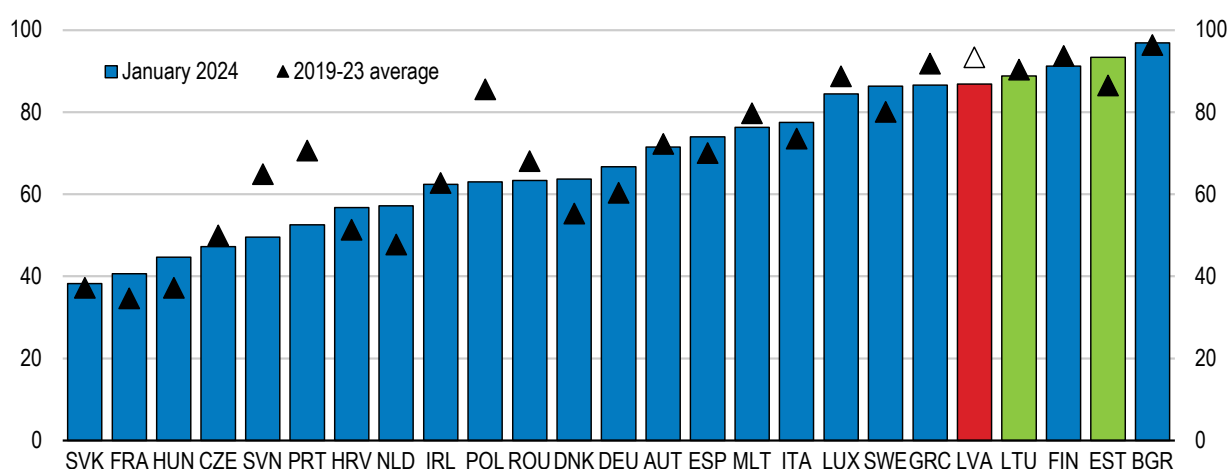
Note: The intermediation margin is defined as the difference between the weighted average lending and deposit rates of monetary and financial institutions, using business volumes as weights. Lending rates are for new loans to households for house purchase and new loans to non-financial corporations, both excluding revolving loans and overdrafts, convenience, and extended credit card debt. Deposit rates are for new deposits of households and non-financial corporations with agreed maturity.

Source: Risk Assessment Indicators at the ECB Data Portal.

Strong pricing power and concentration, to the extent that they reflect weak competition in the banking sector, hamper the credit channel of transmission of euro area monetary policy. Also most loans in Latvia have either a variable interest rate or a rate fixation period of less than one year and use the six-month Euro Interbank Offered Rate (EURIBOR) as the base rate (Figure 13). However, although the six-month EURIBOR turned negative between 2014 and 2022, most banks in Latvia and the other Baltic countries set the effective base rate for lending at zero (Bank of Latvia, 2023^[4]). As a result, average bank lending rates have remained relatively high during the monetary easing in the euro area over the past decade, weakening the pass-through of the ECB's monetary easing to lending rates (Figure 13). In contrast, when the ECB's policy rates turned positive, the high prevalence of variable interest rate loans allowed banks to raise their lending rates to fully reflect the monetary policy tightening and to do so very quickly (Figure 14). These developments suggest that there is an effective floor on bank lending base rates, which has deprived Latvia of the benefits of monetary policy easing and has contributed to hold back investment. To address this issue, the powers and tools of the Competition Council to investigate price setting coordination in financial markets should be strengthened. In Portugal, for example, the competition authority has imposed fines in 2019 in response to the concerted practice of exchanging sensitive commercial data in retail banking between 2002 and 2013 (OECD, 2020^[17]). The infringement affected the setting of lending rates for mortgage, consumer and business loan products. Since then, banks in Portugal, where the share of variable-rate loans is higher than that of fixed-rate loans, as in Latvia, have used EURIBOR as the base rate for setting lending rates, regardless of whether it is below or above zero.

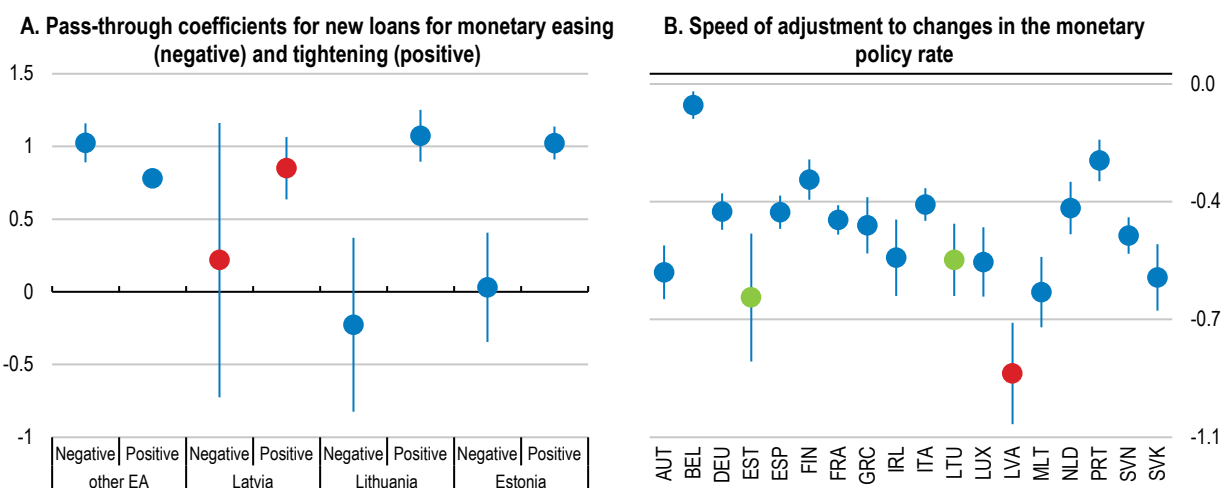
Figure 13. Most loans have a flexible interest rate

Share of loans with a floating rate or an initial rate fixation period of one year or less, %



Note: Calculations are for total new loans from monetary and financial institutions to households and non-financial corporations.
Source: Risk Assessment Indicators at the ECB Data Portal; and OECD calculations.

Figure 14. Monetary policy easing has not led to lower lending rates, while tightening strongly increased the cost of credit



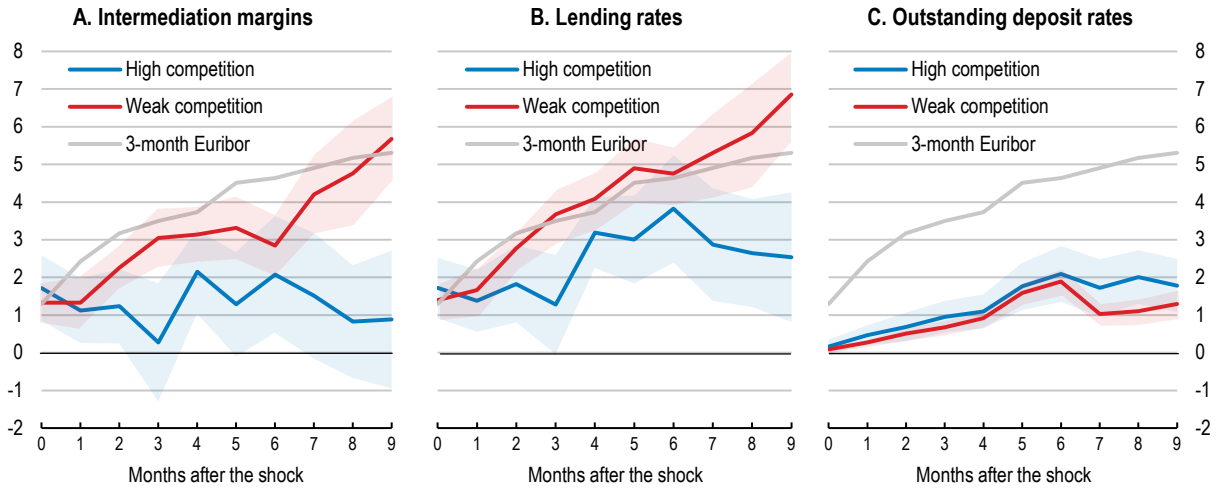
Note: Estimates for the July 2007 – September 2023 period. The dots in Panel A are point estimates of the long-term adjustment of lending rates to non-financial corporations relative to a change in the monetary policy rate, distinguishing between the sign of the policy rate, and with higher values indicating stronger transmission and unity perfect transmission. “Monetary easing” refers to a level comparison between negative and positive policy interest rates, rather than a reduction in the policy interest rate. The point estimates shown in Panel B are the speed of adjustment to the equilibrium level of lending rates without distinguishing between the sign of the policy rate. A value closer to -1 indicates a faster pace of adjustment. The ranges around the point estimates in both panels are 95% confidence intervals. See Box 1 for further details.
Source: (Benkovskis et al., forthcoming^[18]).

Competition needs to be strengthened to improve the functioning of credit markets. This paper shows that in less competitive markets, where banks have a stronger pricing power due to lower threat of entry, low customer mobility or limited competition from other financial market players, the pass through of higher monetary policy rates to lending rates is much stronger and more rapid than on deposit rates. In response to an increase in the euro area monetary policy rate, euro area banks that have stronger pricing power raise lending rates significantly more and deposit rates less than banks operating in a more competitive market, while the asymmetric impact on deposit rates is less pronounced (Figure 15, Box 1) (Benkovskis

et al., forthcoming^[18]). As a result, lending conditions in these less competitive markets are tighter and bank profitability is much higher, while depositors do not fully benefit from rising interest rates.

Figure 15. Weak competition increases credit spreads after a positive monetary policy shock

Response to an increase in monetary policy rates in the euro area



Note: Cumulative impulse responses are estimated using local projection methods (Jordà, 2005^[19]). The intermediation margin is the spread between the lending rate for new loans to non-financial corporations (Panel B) and the outstanding deposit rate (Panel C). Impulse responses differ between banks that are below the first quartile (high competition) or between the first and the third quartile (weak competition) of the distribution of Lerner indices. Results are similar when comparing banks facing high competition with banks that are above the fourth quartile of the Lerner index distribution. The monetary policy shock following an ECB press release is the “target monetary policy surprise” mainly loaded on the one-month Overnight Index Swap rate, and its impact on the three-month Euribor rate is also shown (Altavilla et al., 2019^[20]). Shaded areas indicate 90% confidence intervals. See Box 1 for further details.

Source: Benkovskis et al. (forthcoming^[18]).

Box 1. The role of banking sector competition in the transmission of monetary policy

The transmission of the ECB's monetary policy to financing conditions in euro area member states could be uneven due to differences in the financial frictions across member state banking systems. Financial frictions could arise from information asymmetries, limited commitment to the enforcement of debt contracts, high costs of asset recovery and imperfect competition in the banking sector (Gerali et al., 2010_[21]). In markets with weaker competition, banking sector concentration could hinder the bank lending channel of monetary policy.

To make a preliminary analysis of the pass through of monetary policy on lending and deposit rates in the euro area, a study conducted for this Survey uses a bank-level panel error-correction model to regress the level of lending and deposit rates on the ECB's deposit facility rate, controlling for bank and year fixed effects. The sample covers the period from July 2007 to September 2023 and includes banks from 19 euro area countries. Country-specific results are then shown by interacting country dummies with the monetary policy rate. To analyse the asymmetric pass-through across countries, triple interactions of the policy rate with country dummies and dummies indicating the sign of the policy interest rate are included in the regression. In a second step, the speed of adjustment is estimated by regressing changes in the level of the lending and deposit rates on the lag of the error term obtained in the regression run on the full sample in the first step. The country-specific speed of adjustment term is obtained by interacting with country dummies.

To investigate the effects of competitive pressures for banks on the pass-through of monetary policy to lending and deposit rates, the Lerner index is used.¹ This index, which measures the mark-up over marginal cost at the bank-level, is a better measure for competition compared to indices of banking sector concentration, particularly for smaller economies like Latvia (Demirguc-Kunt and Martínez Pería, 2010_[14]). For example, competition can be high in concentrated markets, if barriers to entry for new lenders and to exit for unprofitable institutions are low, and customer mobility is high. A lower level of the Lerner index indicates a higher price elasticity of demand and thus stronger competitive pressures and lower pricing power.

To analyse the effects of competition on the monetary policy pass-through, the impulse responses of the loan-deposit spread and the level of lending and deposit rates to a monetary policy shock are obtained for the sub-samples of banks facing high and weak competition. The thresholds for the different levels of competition are determined by sorting the estimated values of the Lerner indexes at the bank level. Monetary policy shocks are obtained from market reactions around ECB Governing Council announcements (Altavilla et al., 2019_[20]).² These monetary policy shocks are then interacted with thresholds for competition to explore the heterogeneous response of banks to a monetary policy tightening, depending on the level of their pricing power in local projections estimations to address endogeneity concerns (Jordà, 2005_[19]). The event-analysis based monetary policy shocks can be assumed to be exogenous to the outcome variables and competition measures used in the single-equation regressions for each point of the impulse responses.

1. The Lerner index is estimated for about 140 euro area banks over the period 2012-22, which account for about 83% of the total assets reported by monetary and financial institutions over this period (excluding the Eurosystem of central banks). It is calculated as $L_{it} = (P_{it} - MC_{it})/P_{it}$, where the bank-level price P_{it} at time t is proxied by the ratio of total revenues to total assets and MC_{it} is the bank-level marginal cost. Marginal cost estimates are obtained from a panel estimation with bank fixed effects by fitting a trans-log total cost function over total assets and input prices for interest and non-interest expenses, as well as the quadratic terms of these regressors including their cross-interaction terms. The proxies for input prices are the ratio of interest expenses to the sum of total deposits and short-term debt and the ratio of non-interest expenses to total assets. Additional controls include time fixed effects.

2. The regressions control for bank-level and country-level variables. Bank-level controls include the share of deposits, the share of short-term loans, the liquidity ratio, the capital-to-assets ratio and the external liability ratio. Country-level controls include the GDP growth rate, the inflation rate, country-level credit default swap rates and the share of non-performing loans to non-financial corporations in the banking system. Additional controls include bank fixed effects and monthly dummies.

Source: Benkovskis et al. (forthcoming_[18]).

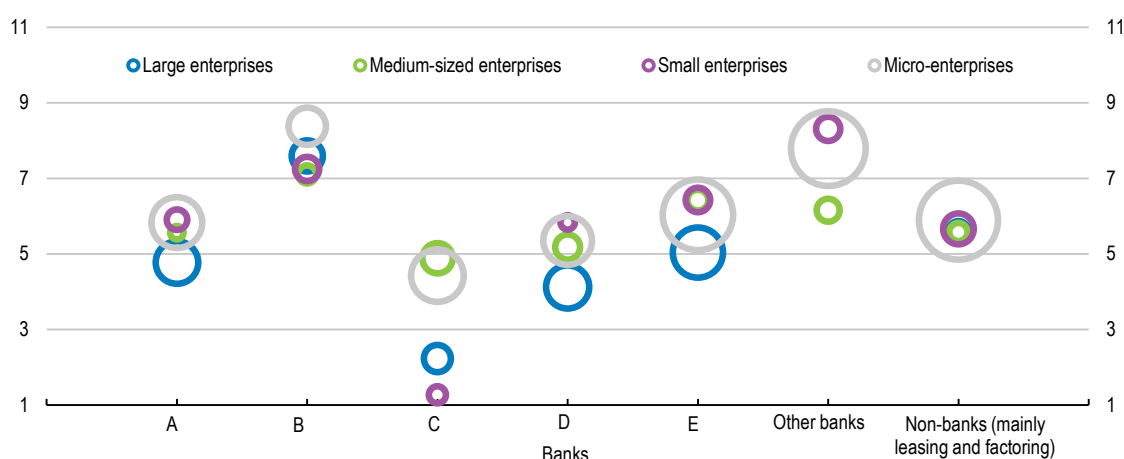
Increasing competition in the banking sector to reduce the cost of credit

Enhancing competition in the banking sector has great potential to reduce excessive intermediation margins and increasing the availability of credit. To improve competition enforcement, it is key to collect information on the ownership structure of banks and other firms to identify situations where firms competing in a market have common shareholders, typically an investor with a minority stake. Cross-shareholdings are commonly observed in countries with bank-based systems such as Germany, Japan and Italy and reduce banks' incentives to compete and increase the risks of coordination (OECD, 2008^[22]). For example, the cost of losing customers to rivals is mitigated for a common shareholder if it also owns shares in competing rivals that win new customers. Another angle is the possibility of large industrial groups having ownership links with banks, which could reduce access to credit for firms that are not connected to these industrial groups. Even in the context of merger control, the Latvian Competition Council does not have the tools to assess the extent of minority shareholdings and has not yet made a specific assessment of common ownership between banks and its impact on competition in the banking sector. This also applies to ownership links with insurance firms and pension funds, which can similarly hamper banking sector competition (see below).

Low customer mobility related to high fees is reducing competitive pressure on banks. Lending rates differ substantially across lending institutions, indicating that customer mobility is low (Figure 16). This is partly due to high commissions and fees, as indicated by their high share in the total banking sector income (Figure 17). High loan refinancing fees can discourage bank customers from switching to another bank (Competition Council, 2019^[23]). More than 80% of customers in 2018 had a relationship with one of the big three banks, and three-quarters said they had not switched banks in the last five years, citing high switching fees as the main reason, especially if they had taken out a loan. These patterns are consistent with previous evidence suggesting that a significant proportion of the marginal value of a bank customer is related to switching fees, and that a large part of a bank's market share is explained by established bank-customer relationships (Kim, Kliger and Vale, 2003^[24]). Such costs, combined with long-term loans, can lock customers into the same bank for long periods of time, allowing banks to enjoy a degree of protection from competitors even when market interest rates are falling (OECD, 2011^[8]).

Figure 16. Loan rates vary across lending institutions

Interest rate on loans by firm size and lending institution, % per annum



Note: Capital letters on the horizontal axis are used to anonymise the largest banks. The increasing size of the bubbles corresponds to higher loan volumes. Weighted averages for the interest rates over the period of 2023Q1-Q3.

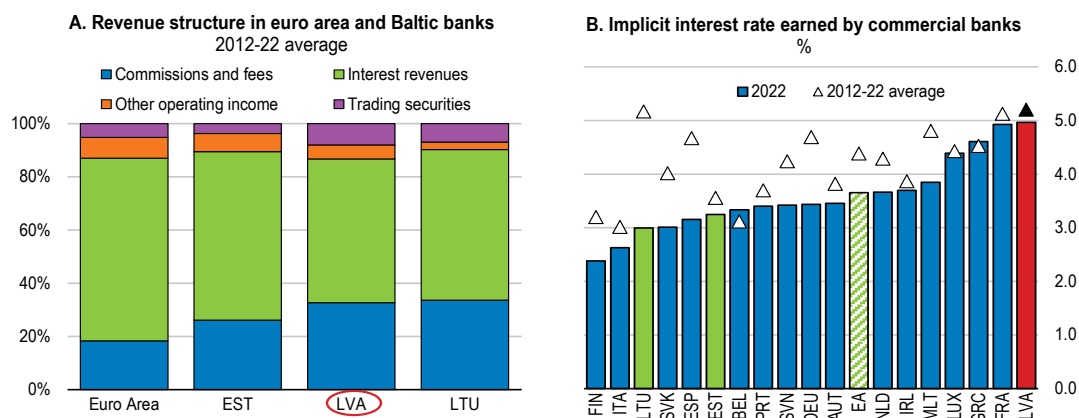
Source: Bank of Latvia calculations using firm-level credit register data.

Encouraging banks to reduce the administrative costs of switching banks and refinancing a loan, including through regulation, would increase customer mobility and create incentives for banks to lower lending

rates. The government has proposed amendments to the Law on Consumer Protection and the Law on Credit Institutions, to make it easier for customers to switch banks. In particular, the proposals introduce a cap on refinancing fees set at 1% of the refinanced loan amount and allow borrowers to pay this fee in three instalments. Credit institutions will be required to provide information on the borrower to the lender refinancing the mortgage, and the refinancing process will take no more than 2 months and can be done online. Advertising restrictions for mortgage loans and loans for real estate construction or energy efficiency improvements will also be removed. The proposed amendments to the Insurance Contract Law will allow borrowers to unilaterally terminate their property insurance contract when refinancing. These are steps in the right direction and should be complemented by reducing administrative costs for refinancing loans, which are due to differences in contracts across banks, particularly concerning the registration and valuation of collateral. Requiring banks to provide standard contract templates and develop switching packages to simplify the administrative steps involved would further facilitate switching.

The introduction of regulation to directly reduce mortgage interest rates should be avoided. In December, the parliament adopted amendments to the Consumer Rights Protection Law, which introduced a levy on banks to provide mortgage interest rebates to borrowers. 30% of borrowers' interest payments will be rebated for loans of less than EUR 250 000 and granted before the end of October 2023, corresponding up to a maximum of 2 percentage points of the original lending rate charged to the borrower. Banks will make quarterly payments in 2024 of 0.5% of the outstanding balance of the specified loans to the State Revenue Service, which will transfer the rebates to mortgage borrowers. These transfers will be exempt from income tax and debt collection. No ex-ante impact assessment of the measure on distributional effects across households and future lending behaviour of the banking system has been conducted. As most mortgages are held by higher-income households, the policy is likely to benefit richer households more (Bank of Latvia, 2023^[4]). Moreover, due to weak competition banks could pass on the cost of the rebate to customers through other commissions and fees and higher lending rates for newly issued loans.

Figure 17. Banking commissions and fees and implicit lending rates are high



Note: The euro area aggregate accounts for about 83% of the total assets reported by monetary and financial institutions excluding the Eurosystem of central banks and reflects the unweighted average of around 150 major euro area banks (the exact number varies according to data availability) in the calculations. The implicit interest rate shown in Panel B is the ratio of interest revenue to total assets.

Source: Bloomberg; bank-level financial statements; and OECD calculations.

Information asymmetries due to the lack of a centralised information platform listing all possible bank fees further increase switching costs and weaken competition among banks. Monthly maintenance fees for debit cards and fees for in-person transfers, including within the same bank, have increased significantly since 2012 (Competition Council, 2019^[23]). Since 2019, the Consumer Rights Protection Centre has published the fees charged by major banks for services related to payment accounts, which is welcome as it contributes to reducing information asymmetries and increasing customer mobility. However, some banking services are offered in bundles, making it difficult for customers to compare the fees of individual services across banks. Expanding the existing platform on payment account commissions to include fees

and conditions for other services, such as minimum fees charged by banks for loan refinancing or the cost of debit cards and transfers, would significantly contribute to reducing information asymmetry and improve competition. This is particularly important to reduce switching costs for consumers whose level of financial literacy may not be high enough to make an informed comparison between banks and would help foster financial inclusion. This initiative should be combined with improving access to financial education for vulnerable individuals, which would help them to manage their personal finances prudently. To this end, the National Strategy for Financial Literacy, led by the Bank of Latvia, is a step in the right direction.

The low number and uneven distribution and size of bank branch and ATM networks also hinders customer mobility and bank competition (Figure 18) (OECD, 2011^[8]). Low physical and digital accessibility and ease of use of banking services is the second most cited reason by customers for low customer mobility (Competition Council, 2019^[23]). The number of physical bank branches and ATMs has even decreased in recent years, resulting in Latvia ranking below the EU average in the availability of access points per inhabitant. This can lead to financial exclusion of older people as they tend to prefer branch banking compared to online or mobile banking (OECD, 2020^[25]). Banks have agreed not to charge additional fees for other customers to use their ATM networks, which is an important step to mitigate this availability problem. However, regional heterogeneity in access to banking services remains high. Possible solutions include informing communities about the decision to close a branch, using mobile branches on accessible vehicles such as buses, or working with other service providers such as post offices or supermarkets to provide banking services in remote areas. It is also important to further incentivise online banking and better educate senior citizens to use mobile banking. Fees for online transfers are low, which has incentivised online banking for transfers and led to more frequent use of mobile banking than the EU average (Figure 18). Further reducing information asymmetries on fees and contract conditions and improving cyber security could help to develop online banking and improve competition. In this respect, the inclusion of IT security and outsourcing management in the Bank of Latvia's supervisory priorities for 2024 is a step in the right direction.

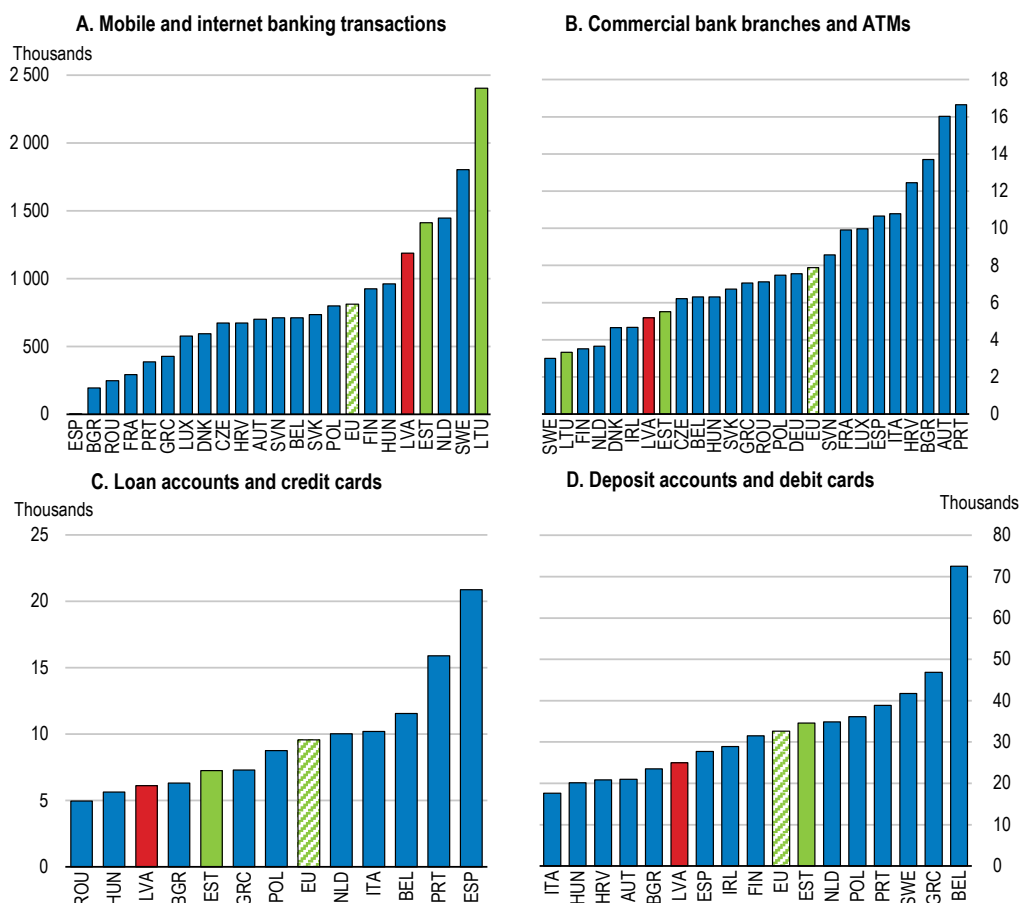
Foreign-owned banks focus their lending activities on larger cities and do less relationship lending, which limits lending in the regions (Havrylchuk, 2012^[26]). Scandinavian banks have been important players in Latvia and other Baltic countries since the 1990s. Due to their extensive and complex organisational hierarchies and limited access to soft information on borrowers, they engage less than domestic banks in lending to SMEs, especially those operating in the hinterland (OECD, 2017^[27]; OECD, 2019^[3]). The restructuring of the second largest bank after the global financial crisis, which used to mainly serve borrowers in the hinterland, has transferred a large share of its ownership to large foreign investors, further reducing relationship lending in the remote or lower population density regions (OECD, 2016^[6]). Collecting information on the availability of banking access points and services at the municipal level would allow policy makers to analyse regional disparities in access to financial services, including borrowing (OECD, 2017^[28]; OECD, 2020^[29]). Information on borrowing activity is only available at the national level, and Latvia is below the EU average and its peers in terms of the number of loans and credit card holdings per inhabitant (Figure 18). In this respect, the efforts of the Ministry of Economy to establish a dataset on the number of credit operations at the municipal level by the second half of 2024 are welcome.

Increasing the role of credit unions could help to partially close the relationship lending gap. Credit unions have a comparative advantage in accessing soft information about their members and may be subject to a lower degree of moral hazard, as borrower members have an incentive not to damage their local credit union by defaulting on their loan. However, it has proved difficult to persuade credit unions to make more business loans, for example in the UK, as this has been perceived as very risky by credit union managers, since business lending is an area in which they lack expertise and skilled staff (Talbot, Mac an Bhaird and Whittam, 2015^[30]). In the case of Latvia, credit union lending is very small, with a balance of around EUR 24 million in 2022, and more than half of the loan book being mortgage loans and almost all the rest being consumer loans. Allowing well-capitalised credit unions to lend to a wider community than their membership and provide small unsecured loans to microenterprises could increase the availability of credit

in the regions, where bank collateral requirements are restrictive. Similar regulatory relaxation in addition to consolidation of small regional banks, has allowed a significant increase in business lending by credit unions in the US (Ely and Robinson, 2008^[31]).

Figure 18. There is room to increase financial inclusion

Total number per 10 000 residents, 2022 or the latest



Note: Per capita concentration measures shown in Panels C and D are for commercial banks.

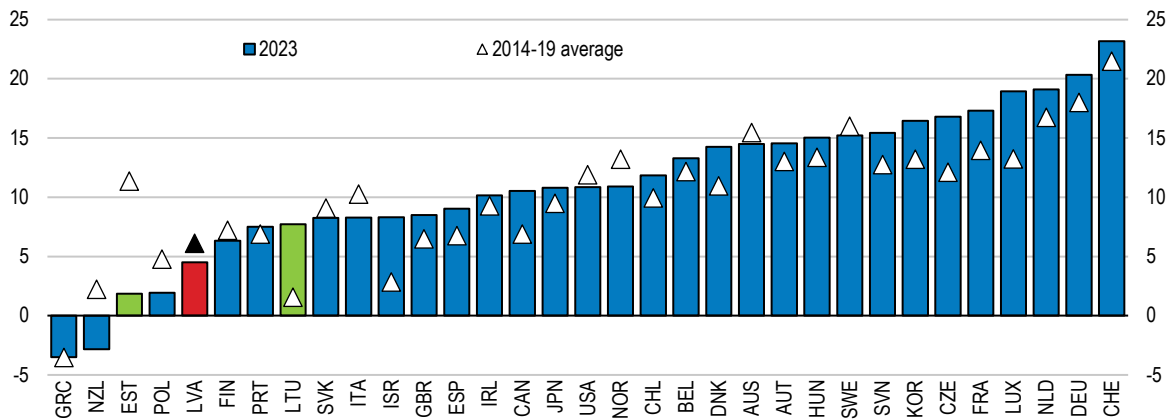
Source: IMF Financial Access Survey data; OECD Economic Outlook database; and OECD calculations.

Weak competition in the banking sector may have led to low deposit rates and weak trust in banks, partly explaining why few households save in time deposits. Currently, around 80% of all deposits are in current accounts and the penetration of deposit accounts is lower than the EU average (Figure 18). The failure of Latvia's second largest bank during the global financial crisis led to deposit flight and a government takeover, which initially contributed to low trust in banks, although Latvian depositors have the same level of deposit guarantees as in the rest of the euro area (OECD, 2016^[6]). The subsequent successful payout of guaranteed deposits has improved trust in banks, but relatively low deposit rates have continued to discourage customers from switching to interest-bearing time deposits, which are less liquid than current accounts. Although deposit rates have increased significantly in recent months, the weighted average annual deposit rate in the Latvian banking system in the first half of 2023 was around 40 basis points lower than in the euro area (Bank of Latvia, 2023^[4]). As rising deposit rates tend to boost household saving more when overall interest rates are higher, it is important for Latvian banks to catch up with the rest of the euro area to help lift the household saving ratio (Figure 19) and the funds available for investment (Felici, Kenny and Friz, 2023^[32]). The Bank of Latvia has been publishing the deposit rates offered by individual commercial banks since April 2023, which will help reduce information asymmetries among depositors,

increase customer mobility and enhance competition among banks. This should be coupled with raised awareness of the deposit insurance scheme.

Figure 19. Bank deposit rates need to increase to foster household savings

Household gross saving ratio, %



Source: OECD Economic Outlook database.

Barriers to entry for FinTech firms may have reduced the threat of contestability in the banking sector. The cost of entry for FinTech firms is significant due to high capital requirements and licencing fees for lending activities, and sources of private external finance to fill this gap are limited. Latvia has only one angel investor network, which limits FinTech firms' access to venture capital funding at the pre-seed or seed stage. In addition, FinTech start-ups are not eligible for venture capital financing support schemes offered by the public development finance agency, ALTUM, as they are classified as financial intermediaries. Alternative investment funds also remain small, although they have been operating since 2014, following the adoption of the EU Alternative Investment Fund Managers Directive (Bank of Latvia, 2023^[41]). Increasing the visibility of FinTech firms to alternative investment funds or making FinTech start-ups eligible for venture capital support by ALTUM, until private venture capital funding becomes more accessible, can help bridge the external financing gap for FinTech start-ups.

The coexistence of FinTech companies with the banking system reflects cooperation rather than competition. In Latvia, FinTech companies did not have direct access to the payment system until recently and are subject to high capital requirements. This makes larger SME lending infeasible, which is why they mostly provide small consumer loans at relatively high interest rates (Fintech Latvia Association, 2023^[33]). In contrast, FinTech firms contribute to facilitating bank lending by providing online loan comparison platforms, credit scoring tools to facilitate the loan underwriting process and automation of payment collection to minimise manual intervention and help banks to monitor Anti-Money Laundering (AML) compliance (Berg et al., 2020^[34]; Bank of Latvia, 2023^[35]).

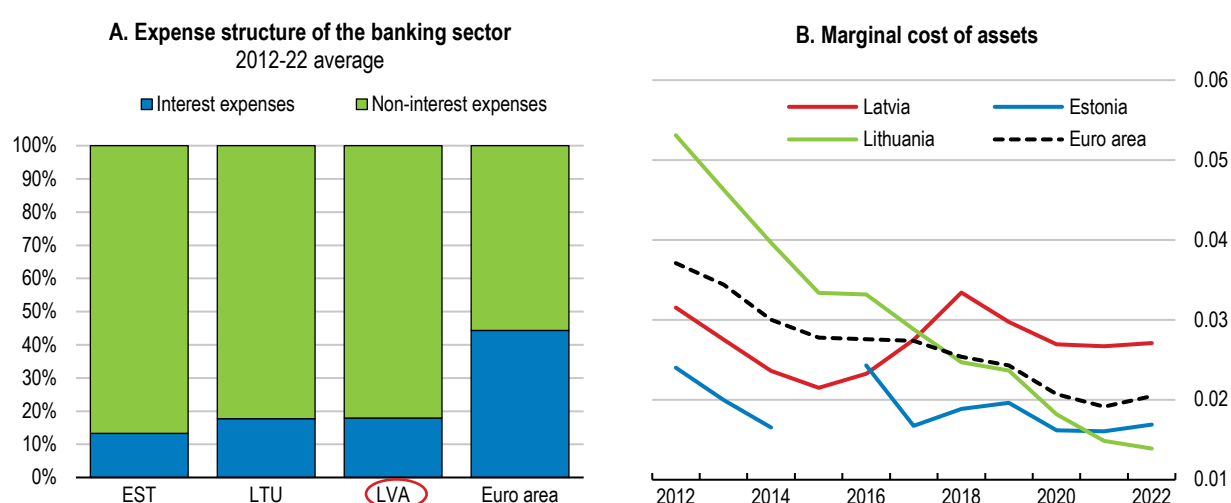
The introduction of a regulatory sandbox for FinTech firms was an important step to develop the sector but should be expanded gradually to include lending activities. Latvia was one of the few European pioneers to introduce a regulatory sandbox in 2018, which provides ample opportunities for potential market entrants to test innovative FinTech solutions and familiarise themselves with the regulatory framework (European Parliament, 2020^[36]). While the initial scope of product testing was limited to electronic payment or e-money services, the areas of testing were later expanded to include crowdfunding and crypto-asset service providers, technology solutions for regulatory compliance and for increasing the efficiency of the insurance industry. The sandbox was accompanied by the establishment of the Innovation Hub, where the Bank of Latvia provides free expert advice to FinTech companies on compliance of innovative financial products and new business models with licensing, supervision and regulatory requirements. The number of such consultations has steadily increased since the establishment of the hub (Fintech Latvia Association,

2023^[33]). Extending the scope of testing in the regulatory sandbox to lending activities would facilitate the entry of FinTech firms into this market segment. To increase competition in the banking sector, Lithuania introduced a well-communicated toolkit for FinTech firms, including a simplified regulatory regime, a fast licencing process, direct access to the payment system, and an additional blockchain-based sandbox. This allowed the sector to expand in the areas of crowdfunding, digital currencies and fast data analytics, leading to one of the EU's largest FinTech industries, providing 15% of financing to businesses and accounting for 0.4% of country's workforce by the end of 2021 (OECD, 2022^[37]).

Improving anti-money laundering (AML) risk management to preserve financial inclusion

Excessive aversion of banks to AML-related reputational risks has led to a high administrative burden, possibly putting upward pressure on the cost of loans. Following Russia's invasion and annexation of Crimea in 2014 and money laundering scandals related to several banks, including the resignation of senior managers related to AML/CFT (Counter-Terrorist Financing) compliance issues, AML/CFT measures have been appropriately strengthened, in line with previous OECD recommendations (OECD, 2016^[6]). Accordingly, the share of non-resident deposits in the banking system and cross-border financial flows to and from high-risk jurisdictions have steadily declined (IMF, 2023^[38]). Although the efforts to reduce AML/CFT risks are welcome, aversion to AML-related reputational risks in lending are also likely to have contributed to the increase in the non-interest costs of making loans (Figure 20). In fact, while costs of lending in the banking sector have declined in other Baltic countries and on average in the euro area, in Latvia, they have increased since 2015 and then remained relatively stable (Figure 20) (van Leuvensteijn et al., 2013^[39]). Due to weak competitive pressures, these costs have been passed on to borrowers, raising the cost of credit and contributing to excessive deleveraging relative to the other Baltic countries.

Figure 20. Banking sector costs are skewed towards non-interest expenses



Note: The euro area aggregate accounts for about 83% of the total assets reported by monetary and financial institutions excluding the Eurosystem of central banks and reflects the unweighted average of around 150 major euro area banks (the exact number varies according to data availability). Marginal costs shown in Panel B relate to interest expenses and non-interest expenses, which include administrative burden. See Box 1 on the estimation of the marginal costs. For Estonia, bank-level data in 2015 are discontinued.

Source: Bloomberg; Benkovskis et al. (forthcoming^[18]); and OECD calculations.

AML risk aversion by banks has also increased barriers to market entry and costs for FinTech firms. FinTech companies surveyed by the Bank of Latvia indicate that it is difficult to open current accounts in banks in Latvia, pointing to AML risk aversion (Bank of Latvia, 2023^[35]). Banks have increased fees for FinTech companies due to the high costs of conducting a thorough AML compliance audit, which increases prices for the customers of FinTech firms. These audits are likely to be more costly for payment or e-money FinTech firms that have not yet improved their AML/CFT risk management procedures (EBA, 2023^[40]). A

lack of understanding of the business model of FinTech firms by counterparty bank staff is also a commonly cited issue. In particular, FinTech companies owned by foreign investors face costly and lengthy document reviews. In December 2023, the Bank of Latvia and the Ministry of Finance have agreed on the principles for making the necessary regulatory changes to grant FinTech companies direct access to the Electronic Clearing System. The granting of the access to the national payments system is subject to the approval of the new regulatory framework until June 2024. This is a welcome step and its implementation in line with the EU Payment Services Directive 2 would maintain security and consumer protection and increase competition in lending.

Continuing to implement AML/CFT compliance measures while avoiding unwarranted de-risking is important to preserve financial inclusion. Unwarranted de-risking could result from refusing to establish or terminate a banking relationship with an individual or a whole category of customers based on AML/CFT compliance without due consideration to the risk profile of individual customers. Such a lack of due diligence is often related to a lack of relevant expertise to assess the risks associated with the business model, a risk appetite that is lower than the perceived reputational risk or a judgement that the cost of compliance would outweigh the benefits of providing the banking product. In fact, the European Banking Authority (EBA) has assessed that a range of customers including payment or e-money institutions have often been affected by de-risking in the European Union (EBA, 2022^[41]). In the case of Latvia, surveyed firms pointed to banks' lack of expertise in distinguishing between transactions involving investors from Russia or Belarus and those involving counterparties from AML/CFT compliant countries. Unduly blocking some transactions in advance could result in diversion into the shadow economy, thus making the prevention of financial crime less effective.

Following the EBA guidelines on AML/CFT risk-based supervision would increase the effectiveness of financial crime prevention, while preserving the availability of credit (EBA, 2021^[42]). A risk-based approach to due diligence, while distinguishing between lower and higher risk situations, would also reduce unwarranted de-risking. Such lower-risk situations would include public company borrowers that are listed on a stock exchange and therefore are subject to appropriate disclosure of beneficial ownership, or customers operating in countries which are identified by credible sources as having effective AML/CFT systems, or low levels of corruption or criminal activity. However, it is important to ensure that risk-based due diligence legislation does not pre-determine entire countries or products or services as low risk (OECD, 2022^[43]). Continuously requiring financial institutions to record the results of customer due diligence in cases of refusal or termination would help supervisors to assess whether unwarranted de-risking is common (EC, 2021^[44]). Outcomes of AML/CFT risk management have improved in recent years, as the share of assets held by high-risk institutions has been declining (Bank of Latvia, 2023^[45]). However, to continue improving AML/CFT risk-management of banks, while ensuring financial inclusion, it is necessary to better define low-risk cases, assess the current degree of de-risking, and better train financial sector employees.

Improving the governance of financial regulation and supervision

The financial regulation and supervision agency has been merged with the central bank to reduce costs and address skilled labour shortages in the public sector. The former financial regulator, the Financial and Capital Market Commission, was dissolved on 1 January 2023 and the Bank of Latvia took over all its powers and functions, following a parliamentary decision adopted in September 2021. Besides economies of scale, other benefits of merging macroprudential policy, microprudential banking supervision and bank resolution functions with the central bank include easier access to information and the benefit of the central bank's independence, which is guaranteed by law (D'Hulster and Unsal, 2019^[46]).

Risks to the governance of financial sector policies should be carefully monitored. For example, macroeconomic stability objectives could lead to prioritise the macroprudential dimension of policy and de-prioritise the objectives of microprudential banking supervision. To avoid such conflicts of objectives, the

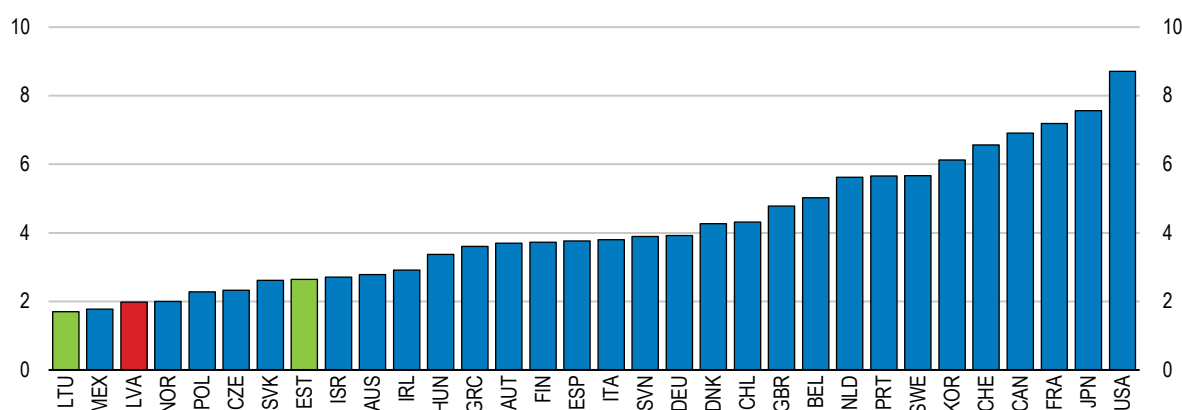
current separation of reporting and budget lines, as well as staffing arrangements between the two functions, should be maintained (D’Hulster and Unsal, 2019^[46]). The framework for crisis preparedness and management should clearly assign mandates to the different departments of the central bank through legislation. To better address competition issues in the financial sector, the central bank should make better use of the expertise of the Competition Council, especially in assessing the effects of common ownership among banks, leasing companies, privately managed pension funds and insurance companies.

Deepening capital markets to create alternative sources of financing

Efforts to improve competition and risk management in the banking system should be accompanied by the promotion of non-bank financing alternatives to increase the availability of credit to Latvian borrowers. Currently, banks in Latvia account for about two-thirds of the total assets of the financial system and corporate bond and equity markets are very thin, contributing to low corporate leverage (Figure 21) (Bank of Latvia, 2023^[4]). In May 2023, the government set medium-term policy priorities for capital market deepening until 2027, which is a step in the right direction. These priorities include facilitating the listing of SMEs on the stock market, conducting Initial Public Offerings (IPOs) for some large state and municipal SOEs, raising awareness of capital markets among domestic retail investors and expanding the domestic investment opportunities for institutional investors.

Figure 21. Non-financial corporate leverage is very low

Non-financial corporations debt-to-profit ratio, 2022 or latest

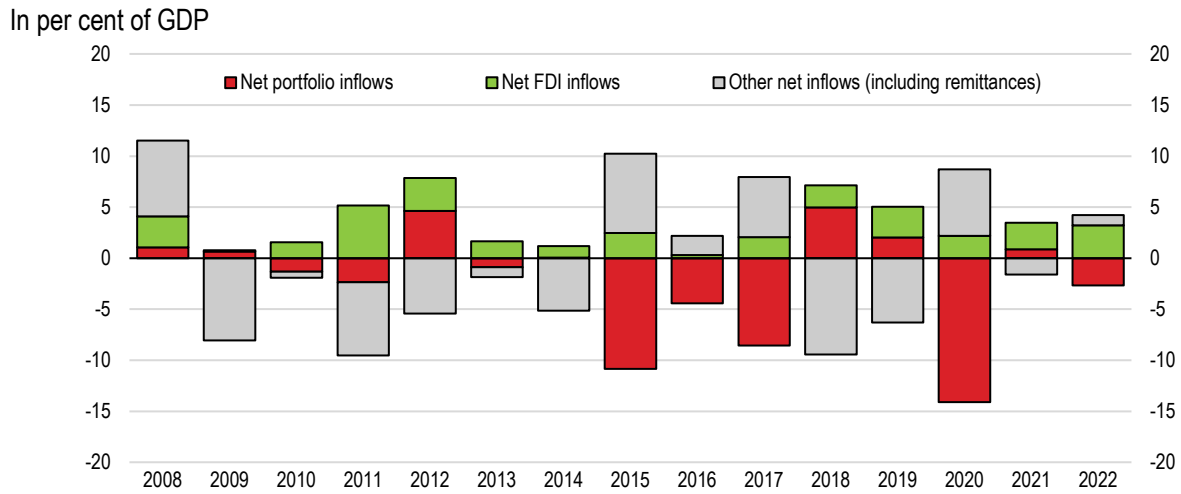


Note: Debt is an aggregate measure and refers to the sum of the following liability categories: currency and deposits, debt securities, loans, insurance, pensions and standardised guarantee schemes and other accounts payable. Profit refers to aggregate gross operating surplus.

Source: OECD National Accounts at a Glance database.

Although Latvia receives significant foreign direct investment, portfolio inflows are limited. A well-designed regulatory environment has strongly contributed to attracting FDI inflows, but they are not sufficient to compensate for low domestic savings. Attracting portfolio inflows can be an important way to boost investment for countries with low saving rates, such as Latvia. However, net portfolio inflows have been negative since the global financial crisis (Figure 22). In addition, the sizeable remittances inflows from the diaspora are very volatile. It is important to create synergies between investors returning to Latvia and incentives for them to start their own businesses to ensure a steady inflow of funds from the diaspora (OECD, 2022^[1]). In this respect, the business incubation programme of the Investment and Development Agency, LIAA, which encourages remigration and assists returning investors in the idea development and implementation phases, is a welcome step.

Figure 22. Net portfolio inflows are weak

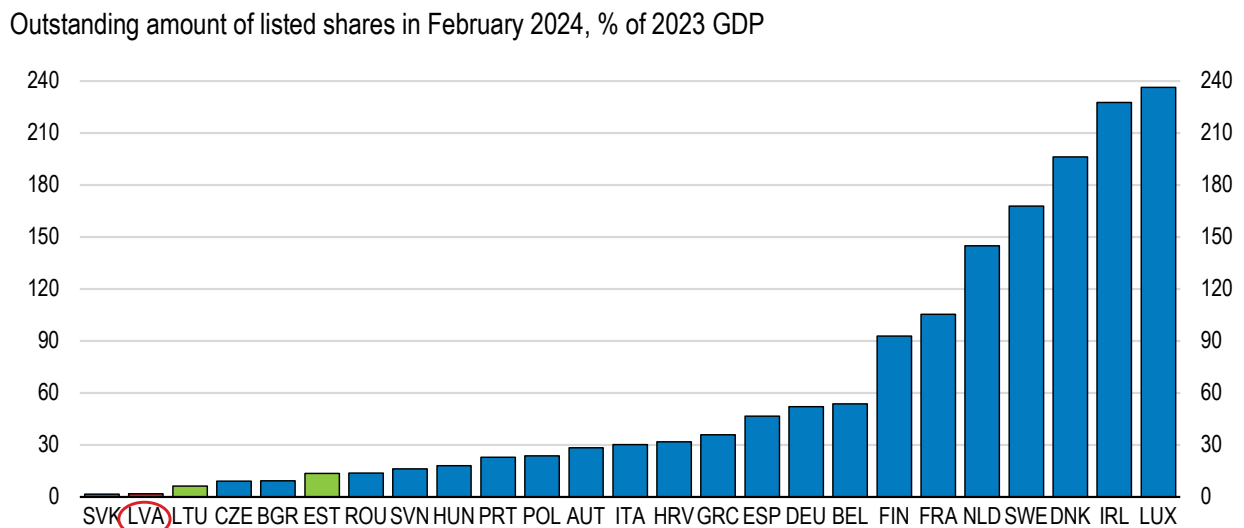


Note: Foreign capital inflows in US dollars are converted into local currency units using average annual market exchange rates. Source: OECD Economic Outlook database; OECD Monthly Capital Flows dataset; and OECD calculations.

Developing stock markets to improve access to finance

The stock market is very shallow by international standards (Figure 23). Latvian companies are small with a concentrated ownership structure, which reduces the visibility and availability of traded stocks in international financial markets. Stock market listing is relatively costly for many companies due to the administrative burden of corporate compliance, reporting and legal document preparation. Currently, only 14 stocks are traded on the Latvian stock exchange and stock market turnover rates are much lower than in Lithuania and Estonia (Bank of Latvia, 2023^[4]). The European Bank for Reconstruction and Development in cooperation with the European Commission, Nasdaq Baltic and the finance ministries of Estonia, Latvia and Lithuania, has led an initiative to create a single index combining the three Baltic capital markets, and introduced the MSCI Baltic index in August 2023. The initiative aimed to raise the profile of the region, and Latvia should benefit most as its stock market capitalisation is the smallest in the whole euro area. The inclusion of the Latvian stock exchange in the benchmark indices will also increase the visibility of Latvian stocks among international investors seeking to diversify their portfolios.

Figure 23. Stock market capitalisation is among the smallest in the euro area



Source: ECB Data Portal; OECD Economic Outlook database; and OECD calculations.

Listing large SOEs would help deepen capital markets and improve their governance. Latvia has not listed any of its large SOEs in the stock market, in contrast to the other Baltic countries, where SOEs account for about one third of stock market capitalisation. The listing of minority stakes in SOEs has also helped to attract domestic investors to capital markets in other European countries and Israel, and improved access to finance for SMEs (Box 2). The Latvian authorities are currently considering the listing of airBaltic, the national commercial airline, which is now almost wholly owned by the state following its recapitalisation during the COVID-19 crisis. A wind farm, *Latvijas vēja parki*, is also being considered for listing as its internal resources and the planned bond issue are not sufficient to cover total investment plans of around EUR 1 billion. The government has also asked the Riga City Council to study the possibility of issuing minority shares in SOEs owned by the municipality of Riga. According to preliminary estimates, the listing of these SOEs, including two large ones with a market capitalisation of around EUR 1 billion, would increase the capitalisation of the stock market from its current level of less than 2% of GDP to around 9% of GDP by 2027. Timely implementation of these plans and considering the listing of additional SOEs would help to increase net portfolio inflows, attract domestic institutional and retail investors and strengthen the governance of listed SOEs (OECD, 2022^[47]; OECD, 2021^[48]; OECD, 2022^[11]). SOEs that do not meet the size criteria for a prime market listing could be consolidated or listed in the lower segments (OECD, 2021^[49]).

Box 2. Listing of SOEs to deepen capital markets: The case of Romania

Latvia can draw policy lessons from the Romanian case, as the current proposals in Latvia on initial public offerings (IPOs) for SOEs and SMEs have been among the key features of the Romanian stock market (2022^[47]). The stock market capitalisation in Romania has increased from around 5% of GDP to 12% of GDP over the past two decades, while the stock market capitalisation in Latvia has been stagnating below 4% of GDP during the same period. The development of the Romanian stock exchange has crowded in domestic investors in addition to attracting foreign investors. Simplified listing procedures and post-listing requirements tailored to SMEs have also facilitated Romanian SMEs' access to non-bank finance and improved their corporate governance.

In 2015, the Bucharest Stock Exchange (BVB) launched the secondary segment, AeRO Market, dedicated to SME listings. At the end of 2020, about three-quarters of the BVB's share capital was owned by Romanian institutional investors, while one-fifth of the share capital was owned by Romanian private individuals and the remaining shares were owned by foreign institutional investors. The BVB's upgrade from Frontier to Secondary Emerging market status in 2019 has increased the visibility of the exchange and reduced the country's risk premium.

The BVB consists of a Main Market, where listed companies are joint stock companies with a minimum market capitalisation of EUR 1 million, with at least one quarter of their shares publicly traded and a financial reporting history of at least three years. Listing conditions in the AeRO Market are more relaxed, with a minimum capital requirement of EUR 250 000, a minimum ratio of traded shares of 10% or a minimum of 30 shareholders. Companies in the AeRO Market should also be a joint stock company prior to listing. Companies listed on the Main Market are required to submit quarterly financial reports and to comply with the Corporate Governance Code, which regulates the independence of the board of directors, risk management and internal audit of the listed companies, on a comply-or-explain basis. Companies traded on the AeRO Market, on the other hand, are required to file annual and half-yearly reports and are only obliged to comply with a specific set of Principles of Corporate Governance.

The listing of SOEs has significantly increased the depth of the Romanian stock exchange. During 2000-19, 18 IPOs on the BVB raised a total of EUR 1.3 billion, with 5 SOE issues in the utilities and energy sectors raising about 90% of the total proceeds. 95% of the equity is held by domestic investors, with domestic corporate investors holding significant stakes in telecommunications and industrial companies, beyond SOE equity. In contrast, foreign corporate investors concentrate their holdings in

healthcare, financials, energy, consumer non-cyclicals and basic materials industries.

Source: OECD Capital Market Review for Romania (2022^[47]).

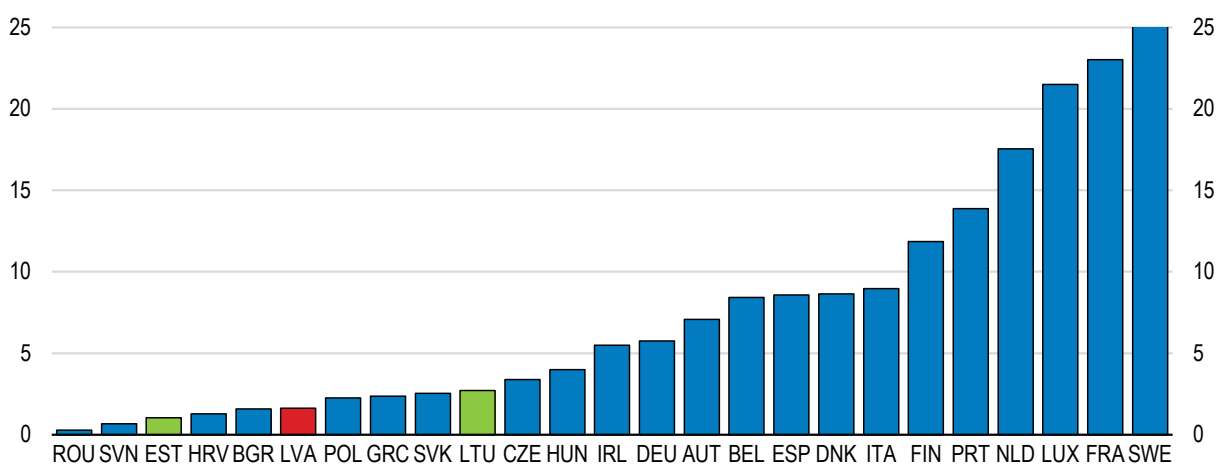
For small companies, the administrative burden for listing on the Nasdaq Baltic stock exchange is high. While a higher burden for SMEs is not unusual across countries, the costs for a listing can be as high as half a million euros, which represents a high barrier to entry for small firms. The Ministry of Economy is planning a support programme to cover part of the costs of listing for SMEs. To further facilitate SMEs' access to non-bank finance, it would be important to simplify listing procedures to shorten the time to raise equity capital and provide direct or indirect financial support for advisory fees associated with listing (OECD, 2022^[47]). Designing mechanisms for companies listed in the Baltic Secondary List, the growth market, to transfer to the Main List would help already listed SMEs to scale up (OECD, 2021^[10]).

Developing corporate bond markets as an alternative source of financing

Corporate bond issuance can help to improve access to finance and corporate governance. The main advantage of corporate bond financing is its lower collateral requirements and longer maturities compared to bank loans, two aspects that limit SMEs' access to bank finance in Latvia (see above). Moreover, like shareholders, corporate bond holders can exit by selling their portfolios and express their concerns when initiating bond contracts, which improves corporate governance and external monitoring (Çelik, Demirtaş and Isaksson, 2015^[50]). Although corporate bond issuance has grown rapidly around the world since the global financial crisis, it remains subdued in Latvia compared to the euro area (Figure 24) (Çelik, Demirtaş and Isaksson, 2020^[51]). The main obstacles to corporate bond issuance in Latvia include the high costs for companies to prove their creditworthiness and the difficulty of finding institutional investors on the demand side of the corporate bond market.

Figure 24. The corporate bond market is very thin

Outstanding amounts of debt securities by non-financial corporations in February 2024, % of 2023 GDP



Source: ECB Data Portal; OECD Economic Outlook database; and OECD calculations.

Steps that have been taken to reduce the administrative costs of corporate bond issuance go in the right direction, but more needs to be done to promote corporate bond markets. Given the low leverage ratio and the healthy profitability of companies that operate in the formal sector, firms that are able to issue bonds are likely to receive higher credit ratings and enjoy lower rates on newly issued corporate bonds compared to bank loans (Bank of Latvia, 2023^[4]; Ayres and Blank, 2017^[52]). As the cost of obtaining credit assessments add to barriers to bond issuance, such as low financial literacy, the Bank of Latvia or the State Revenue Service could support the development of bond markets by providing low-cost

creditworthiness information on SMEs. They have the capacity and necessary detailed firm-level data to provide credit assessments at low cost. For example, the German Bundesbank uses annual financial statements and provides credit ratings for companies, which are free of charge and can be compared within the applicant's sector and over time (Deutsche Bundesbank, 2022^[53]). The Banque de France provides corporate credit ratings through its FIBEN database, which significantly reduces the cost of issuing bonds for French companies (OECD, 2022^[47]). These efforts should be accompanied by increasing the financial literacy of potential corporate bond issuers, as the Banque de France is doing.

Corporate bond issuance should be further facilitated by easing issuance conditions and broadening the buyer side of the corporate bond market. In Italy, for example, mini-bonds can be issued by unlisted companies with less stringent administrative requirements, which has improved access to finance particularly for medium-sized manufacturing firms (Box 3). However, those mini-bonds can only be traded on the stock exchange by institutional or qualified retail investors (OECD, 2020^[54]). This is similar to the private placement market in the US, Germany and France, where bonds are sold to a select group of institutional investors who can assess the creditworthiness of the issuer, so that the cost of issuance is lower and the disclosure requirements are more relaxed. A major difficulty in the case of Latvia is the small size of companies, which reduces the demand for individual corporate bond issues by large institutional investors. To make Latvian corporate bond issues marketable to large institutional investors, cooperation between firms and banks specialising in arranging corporate bond issues should be strengthened by facilitating securitisation. For example, Italian mini-bonds have been securitised four times since 2016, making them available to the European Investment Bank. In this respect, the adoption of the Securitisation Law in June 2023, in line with EU Regulation 2017/2402 on simple, transparent and standardised securitisation, is a welcome step.

Box 3. The Mini-bond market in Italy supports non-bank financing for SMEs

The Italian government introduced legislative changes in 2012 to facilitate non-bank financing for unlisted SMEs. Easing restrictions on company size and tax liability for corporate bond issuance led to the introduction of “mini-bonds”, which could be issued by companies with more than 10 employees and an annual turnover and/or assets of more than EUR 2 million. Although mini-bonds could be issued by unlisted firms, some issuances in the mini-bond market still had the characteristics of public debt offerings by being traded in a multilateral trading facility and providing publicly available information sheets. Between 2013 and 2018, the number of issuers in the mini-bond market increased steadily, with average proceeds of EUR 14 million, and in 2018 average maturity of issuance for small and large non-financial corporations stood at 3.8 and 6.3 years, respectively. Increased bond issuance was mainly driven by medium-sized manufacturing firms.

Source: OECD Capital Market Review for Italy (2020^[54]).

Attracting institutional investors to deepen capital markets

Attracting Latvian institutional investors such as pension, insurance and investment funds, which manage and invest other savers' money, to the domestic capital markets is key for improving companies' access to finance. The total asset base of pension schemes is equivalent to almost half of total domestic credit to the private sector and represents a large potential buyer of equity or debt instruments that could be newly issued by Latvian companies. However, only about 10% of all mandatory pension funds are invested in Latvia. This provides ample room for contributing to the development of Latvian capital markets without undermining the need for risk diversification in investment decisions of these institutions. Latvia has two mandatory earnings-related pension schemes and one voluntary pension scheme. The mandatory schemes comprise a pay-as-you-go notional defined contribution scheme (first pillar) and a funded defined contribution scheme (second pillar), where contributions to the second pillar are privately managed, involving a custodian bank for the investment funds managed by banks. Total contributions to the

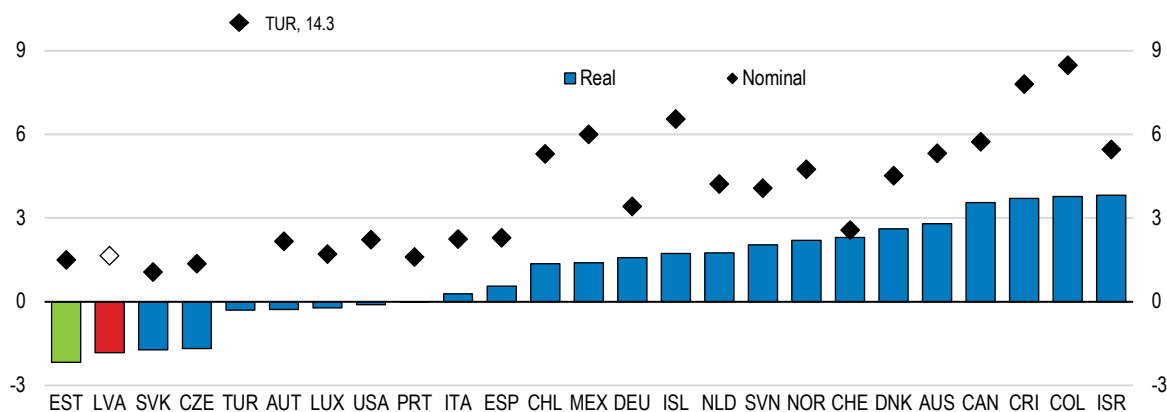
mandatory schemes amount to 20% of gross wages, of which 30% is allocated to the second-pillar pension funds. The mandatory pension scheme investment plans cover almost the entire working-age population and accounted for over 16% of GDP in 2022 (OECD, 2023^[55]). The funds accumulated in voluntary schemes only represent about a tenth of those in the second-pillar schemes.

Changing pension fund regulations to facilitate increased pension fund investments in domestic private assets could improve portfolio returns and help to deepen capital markets (Figure 25). In Iceland, for example, pension funds are large investors in the domestic equity market (OECD, 2023^[56]). In a regional comparison, while only about a quarter of pension assets in Estonia and Lithuania are invested in fixed income assets, the portfolio share of bills and bonds is about half for Latvian pension assets, indicating a more conservative and mostly foreign investment profile as the local corporate bond market is shallow (OECD, 2023^[55]). The recent relaxation of the rules governing the management of second-pillar pensions in Latvia to allow greater exposure to private assets is welcome. For example, equity allocation of private pension funds has increased to 44% by 2022, which is not low by international standards. The portfolio limit for equity investments was increased to 100% for plans that have been registered since 2018, and new participant plans are automatically assigned to 100% equity portfolios as the default option.

More can be done to make the investment rules of the Latvian pension funds less conservative. For example, equity investment limits for plans registered before the end of 2017, and private investment fund limits are 50% and 25%, respectively, and second-pillar pension management companies cannot invest directly in real estate and face low concentration limits on equity holdings (OECD, 2023^[57]). Investment limits in single issuer instruments are also low in all asset categories. In Australia and Denmark, where asset-backed pension investment fund returns have been higher than the OECD average over the past two decades, these limits are either set at 100% for direct investments or there is no specific limit at all. Allowing second-pillar pension funds to invest also in viable real estate instruments, facilitating greater exposure to private investment funds and raising low investment limits in other instruments would help to close the domestic institutional investor gap in the corporate bond market, given the strict EU rules on the conditions for individual qualified investors (European Parliament and Council, 2014^[58]). Expanding the universe of investable assets of Latvian pension funds would also increase their real returns, which have underperformed those of other OECD countries' pension funds over the past 15 years, with an average annual real return of -1.9% (Figure 25). In 2022, the real return strongly decreased to 30%, the lowest return of all OECD countries after Lithuania, which is related to the comparatively high domestic inflation in 2022 (OECD, 2023^[55]). As private assets tend to be complex and risky investments, the pursuit of increased investment in private assets should be accompanied by appropriate risk management and governance processes (OECD, 2022^[59]).

Figure 25. Pension fund returns have been low

Geometric average annual rate of return on pension plan investments over the last 15 years as of 2022

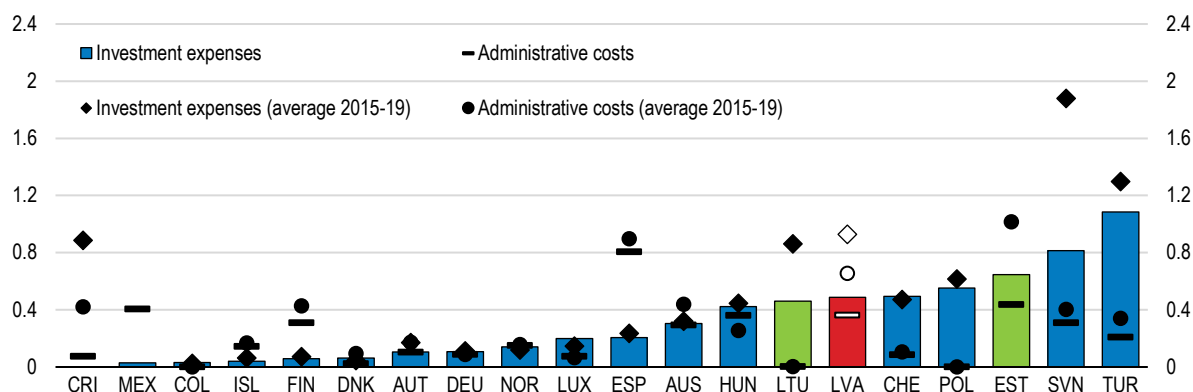


Source: OECD Pension Markets in Focus 2023.

Although pension fund operating expenses, including administrative costs and investment expenses, have declined in recent years, they remain high by international standards, which reduces pension asset returns for participants and limits incentives to save in voluntary pensions (Figure 26). High operating expenses are linked to higher fees collected by asset managing companies. In general, charging fees is necessary for asset managers, to reward expertise in market analysis for investing in search of risky returns. However, the high fees charged by asset management companies for passively managed investment funds risk reducing returns for clients, without contributing to the deepening of domestic capital markets. The authorities should consider limiting fixed fees for passive investment strategies, while allowing higher performance-related fees only for active investment portfolios that outperform a passively managed portfolio. This should be accompanied by addressing information gaps among pension plan holders, as complex fee structures can also make it difficult for individuals to choose between available options and can hinder competition. In fact, many pension plan participants do not monitor their plans and about half of them have never changed their plan (Viluns, 2023^[60]). In this respect, the government's *My pension* website has already gone a long way in providing complete and comparable information on privately managed second-pillar pension plans and their historical investment performance. Further improving the design of key information documents and aggregating information on both investment performance and fees charged when offering pension management plans would contribute to a level playing field for asset managing companies that are not subsidiaries of banks (OECD, 2018^[61]). If total management fees vary significantly between market participants, existing caps on administrative fees could further be tightened (Box 4).

Figure 26. Pension fund operating expenses are high

Pension fund operating expenses, % of assets under management, 2021



Note: Investment expenses data for Estonia over 2015-19 are not available. Data on administrative costs are also not available for Mexico over 2015-19. For the remaining countries, historical averages use the available data over 2015-19. "Administrative costs" are mainly related to the voluntary third-pillar pension funds in Latvia.

Source: OECD Funded Pensions Indicators.

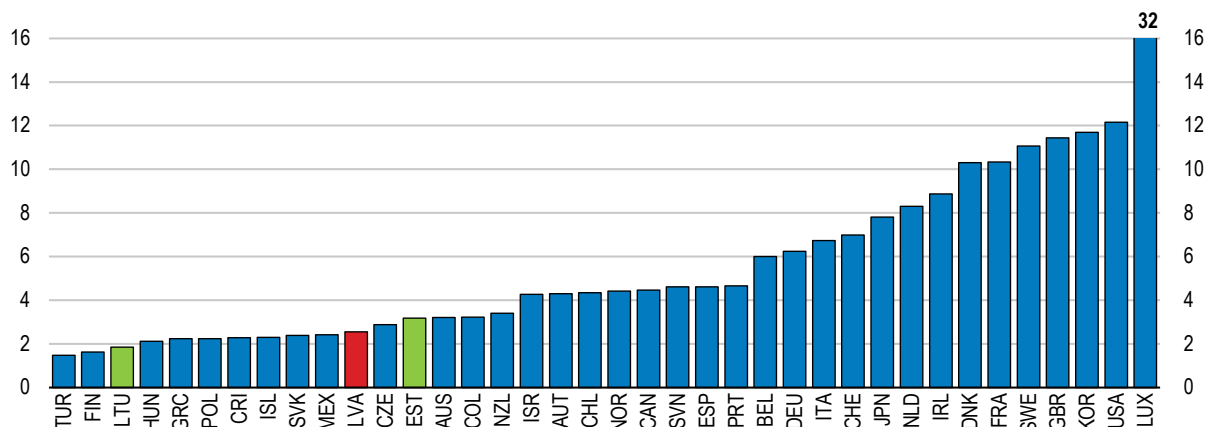
Measures to better inform workers about the performance of their pension plans are welcome but should be limited to increasing competition between asset managers while preserving the depth of the second pillar. Recent fluctuations in global asset prices have affected second-pillar pension assets for older clients shortly before retirement. This has led the Ministry of Welfare to submit a proposal to parliament to allow plan holders to transfer their funds managed under the second pillar to the first pillar during the five years before reaching retirement, which would guarantee them the public pension under the first-pillar scheme. This could lead to large capital losses for individual pension plans due to short-termism by less informed pensioners and, in the tail event that redemptions outweigh inflows, curb the development of capital markets by reducing the funding base of private institutional investors. Instead, further fostering the prevalence of life-cycle investment plans by improving information on pension plans and increasing competition among pension asset managers would be a preferable solution. The government has made an important step into that direction by amending the regulations on the management of second-pillar

pension funds – to come into force in July 2024 – requiring asset managers to inform clients about the investment performance of their plans, and the suitability of their pension plans for their age and investment preferences.

Strengthening insurance markets could also help deepen capital markets. Insurance companies invest mainly in bonds, followed by collective investment schemes, cash, deposits and equities (Çelik and Isaksson, 2014^[62]). However, the pool of premiums collected by insurance companies is very small in Latvia, which limits their contribution as potential buyers of securities in private capital markets (Figure 27). Health insurance coverage is weak, and medical practitioners often do not have malpractice insurance (OECD, 2022^[1]). Life insurance funds are also small compared to OECD countries due to low household savings and competition from voluntary contribution (third pillar) pension funds, which are mostly managed by large bank subsidiaries (OECD, 2023^[63]). However, insurance penetration is relatively high in the transport sector, supported by the compulsory civil liability insurance for vehicle owners, which covers damage to both property and persons. Making home insurance also compulsory and facilitating the leasing of high-value and non-movable assets, such as machinery (see below), would be steps in the right direction to close the funding gap of insurance companies. Strengthening enforcement efforts to reduce informality in the construction sector would also increase insurance penetration as civil liability insurance is compulsory for contractors (OECD, 2016^[64]).

Figure 27. Insurance penetration is low

The ratio of direct gross premiums to GDP, 2022 or the latest, %



Note: Data as of 2018 for Canada and as of 2021 for New Zealand.

Source: OECD Insurance Indicators database.

Common ownership between institutional investors and banks weakens competition and the development of capital markets in a small economy such as Latvia, and reduces asset returns for clients. Although two new non-bank entities have recently entered the pension market, four of the eight existing second-pillar asset management companies are owned by banks, with a market share of more than 80% in terms of both assets and participants. Two out of six insurance companies are also owned by banks. Brand recognition and the convenience of using different financial services, such as loans, pension savings and insurance products within a single institution, could pose a challenge and hinder contestability for potential new entrants that are not bank subsidiaries (OECD, 2018^[61]). In addition, as asset management companies pay fees to their custodian bank – the parent bank in the case of common ownership – banks may steer their clients towards the pension or insurance plans for which they are custodians. Common ownership could also lead to conflicts of interest as parent banks are often a major shareholder in the subsidiary pension or insurance fund and have a say in the appointment of its board members. Latvia should learn from Israel's experience and reduce common ownership between institutional investors and banks by mandating a reduction in bank's share in pension and insurance funds. This would increase competition in the financial system and reduce possible conflicts of interest (Box 4).

Box 4. Reducing bank involvement in the management of investment funds and allowing more active investment portfolios for pension funds: The case of Israel

Until the mid-1990s, Israel's capital markets were characterised by a lack of competition due to the dominant position of leading banks and heavy state involvement. Operating as universal banks, commercial banks managed long-term savings instruments offered to households such as mutual funds and provident funds, while controlling subsidiaries that underwrote risky lending and mortgages. Pension funds, on the other hand, were owned by the largest employee organisation *Hahistadrut*, which primarily invested in government bonds. In 2003, the pension funds were sold to four insurance companies, and other private institutions were allowed to initiate new pension funds. However, these early reforms were not enough to raise competition, as banks continued to be the predominant institutional investors. Under weak competition, this led to conflicts of interest as banks enticed customers to use their financial instruments. For example, investment funds owned by banks performed significantly worse than the market, with a portfolio bias towards companies that also borrowed from the parent bank. In addition, bank-owned investment funds accumulated excessive cash deposits, in contrast to the cash position of other funds.

The combination of high concentration, poor investment performance, and conflicts of interest led the Israeli parliament to pass a comprehensive reform in 2005, known as the Bachar reform. The reform banned banks from owning mutual funds and prohibited companies owned by the banks to manage these funds, and restricted underwriters from providing services to entities which owed them capital. The series of reforms have also allowed increased exposure of pension funds to corporate bonds and equity. These reforms have increased competition in the Israeli long-term savings market and improved the allocation of funds in the economy. In particular, the reforms fostered the non-bank credit market, which was a milestone in the Israeli financial markets, as the share of commercial banks in credit generation fell from 96% in 2004 to 76% in 2010. The reforms also allowed large companies to issue more bonds and to raise more funds from the mutual funds and mandatory pension funds, which were introduced in 2008, whereas prior to the reform, bank-owned investment funds often invested in cash, mainly to improve the liquidity position of the banks. Concerns about the reform included an increase in pension management expenses. In fact, there was a sharp increase in management fees following the implementation of the reforms, however, fees returned to pre-reform levels over a few years, due to regulatory intervention in fee structures, which imposed caps on fees.

Source: Goldwasser et al. (2007^[65]); OECD (2011^[66]); Avramov, Dressler and Metzker (2021^[67]).

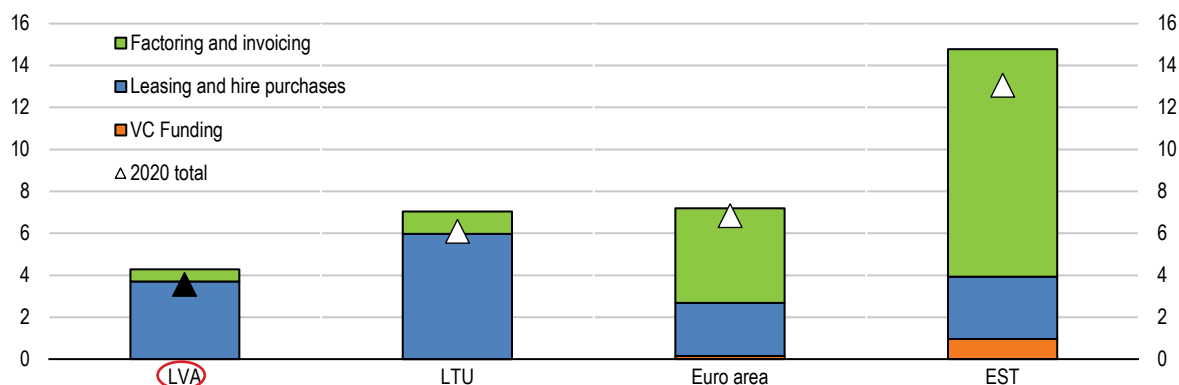
Facilitating leasing and start-up financing opportunities

There is ample scope to boost leasing and start-up financing such as venture capital (VC) or invoice factoring to improve access to finance for SMEs (Figure 28). Although leasing is fairly common for the purchase of movable assets, leasing of non-movable assets remains subdued, limiting the investment possibilities of SMEs. Most leasing contracts are for private consumption and firms in the agriculture, forestry and fishery sectors. In its latest review of the Latvian financial system, the OECD recommended to expand the leasing portfolio towards machinery as a non-movable asset to improve access to finance of SMEs (OECD, 2016^[6]). However, the share of machinery in leased assets has remained stable since 2017, with cars or commercial vehicles accounting for more than half of all leased assets (Finance Latvia Association, 2023^[68]). Improving the implementation of asset recovery laws to reduce the costs of asset recovery (see below) would boost leasing in the use of non-movable assets, such as machinery. Compulsory insurance when leasing these high-value assets would further increase insurance premium payments and thus the assets managed by insurance companies and help deepen capital markets. Moreover, common ownership between large banks and leasing companies could prevent a level playing field for new entrants in the leasing market, as brand recognition could be a barrier to entry for potential

new entrants (OECD, 2018^[61]). Assessing whether the ownership structure in the sector preserves contestability could help enhance competition and reduce high interest rates, which currently prevent many small firms from using leasing as a source of finance.

Figure 28. Access of SMEs to non-bank finance is lower than in the other Baltic countries

Non-bank financing for SMEs, 2016-19 average and 2020, % of GDP

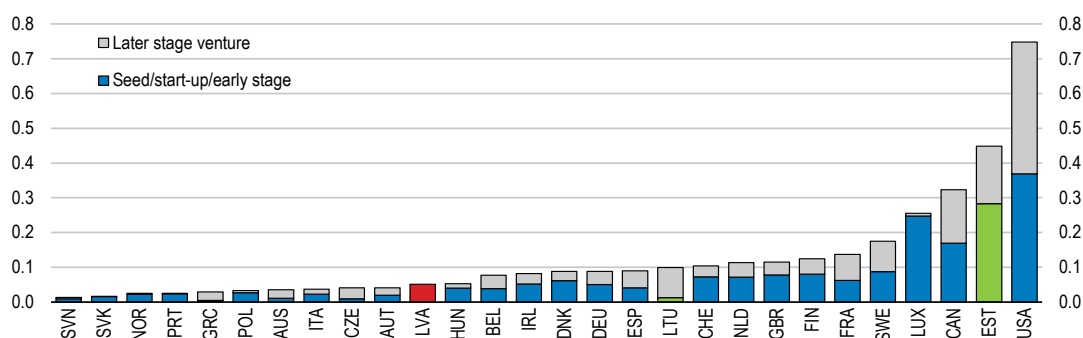


Source: Financing SMEs and Entrepreneurs 2022: An OECD Scoreboard; and OECD calculations.

Despite some recent improvements, venture capital funding, which is critical for young SMEs without collateral and credit history, remains low (Figure 29). Latvian start-ups are active in various fields such as BioTech, cybersecurity, FinTech, eCommerce and others. However, the small size of the market and a lack of sectoral start-up clusters prevent them from building a strong reputation and sectoral expertise, making it difficult to attract large international venture capital funds. The lack of viable exit strategies for start-up investors, such as listing or selling the start-up, due to shallow domestic capital markets and the small network of angel investors, also limits access to private capital.

Figure 29. Venture capital investments are weak

Venture capital investments, % of GDP, 2022 or latest available year



Source: Venture capital investments (Edition 2022), OECD Structural and Demographic Business Statistics.

Improving the governance of public support programmes could help to attract more venture capital financing. Despite significant risk-sharing with the private sector through government and EU structural fund support, only 364 deals were completed in 2011-23, raising only 40% of funds raised in Estonia and putting Latvia behind other OECD economies in terms of the size of the venture capital market. The government currently provides tax relief to eligible start-ups and wage subsidies to their highly qualified employees. Additional annual funding of EUR 400 000 is planned in the 2024-26 budgets to finance international exhibitions, investment advice for early-stage start-ups and sessions to attract investors. The start-up visa scheme to facilitate skilled migration, the introduction of the FinTech regulatory sandbox (see above) and incubator programmes to support the pre-seed, seed and growth stages of start-ups are steps

in the right direction to attract venture capital funds. However, high staff turnover and a lack of institutional memory have reduced the capacity of the public sector. Government involvement in investment decisions of firms receiving government funds limits the extent to which private managers can use their skills to make investment decisions and reduces the effectiveness of the co-invested funds (Matisone and Lacey, 2020^[69]). Moreover, application and reporting requirements for support programmes are very stringent, resulting in a heavy administrative burden for fund managers. Additional staff capacity building in ALTUM's investment teams and simplification of registration and reporting requirements for venture capital funds, in line with EU regulation, would reduce the administrative burden.

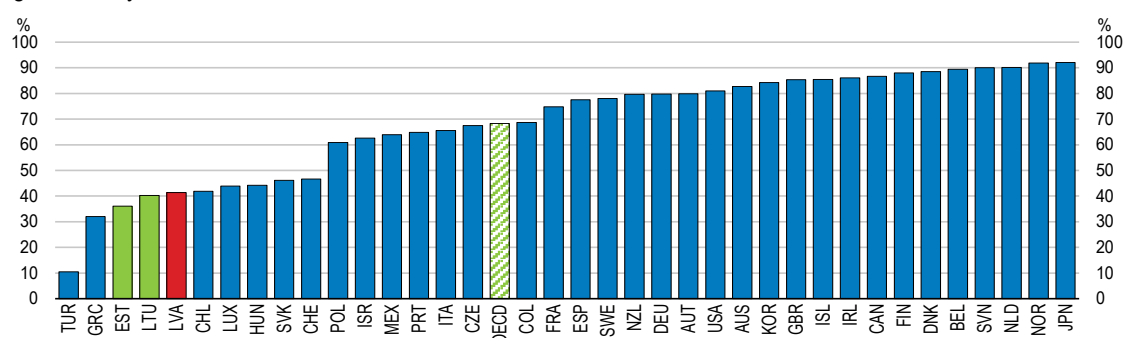
Regulation of the licencing of crowdfunding platforms has improved and could help to improve access to finance for SMEs. In addition to serving as an alternative financing option, such as venture capital, crowdfunding offers additional benefits to businesses, such as validating a business concept, providing entrepreneurs with access to a diverse pool of investors, and serving as a promotional tool. In France, for example, funds of more than EUR 1 billion raised through crowdfunding financed close to 14000 SMEs in 2020 (OECD, 2022^[70]). In November 2023, the Bank of Latvia issued a licence to Latvia's second crowdfunding service provider, following the adoption of the EU regulation on crowdfunding (2020/1503) in November 2021. The implementation of the new regulations will improve licencing and transparency requirements, strengthen investor protection, and increase the role of crowdfunding platforms in financing investments of Latvian companies (OECD, 2019^[3]).

Continuing to improve contract enforcement and reduce the administrative burden for investors

Improving the insolvency regime and the property registry would strengthen the effectiveness of the collateral framework and reduce barriers to accessing finance in Latvia. Past weaknesses in the insolvency regime have led to high collateral requirements and financial frictions (OECD, 2022^[1]; OECD, 2022^[70]). One reason why lenders impose collateral requirements on borrowers is to secure debt contracts, as ownership of the pledged collateral may be transferred from the borrower to the lender in the event of default. However, lengthy and inefficient insolvency procedures as well as asset hiding and fraud had led to lower debt recovery rates in Latvia compared to other OECD countries, reducing the effectiveness of the collateral regime (Figure 30). To compensate for these lower asset recovery rates, banks have imposed even stricter collateral requirements, which rationed borrowers and made their balance sheets more vulnerable to asset price volatility (OECD, 2019^[3]).

Figure 30. Asset recovery rates have been weak

Average recovery rate, 2020



Note: The recovery rate calculates how many cents on the dollar secured creditors recover from an insolvent firm at the end of insolvency proceedings.

Source: World Bank, Doing Business 2020 database.

The insolvency regime has improved significantly in recent years, especially after the adoption of the recent judicial reform to further align the insolvency law with the EU Restructuring and Insolvency Directive

2019/1023. According to the OECD Insolvency indicator, the asset recovery rate for secured creditors has increased, reaching 52% by 2023, and the cost of insolvency proceedings has decreased. However, the average duration of insolvency proceedings was 2.1 years in 2023, which is still long by international standards. The establishment of a specialised Economic Court has helped to train judges and improve the efficiency of judicial proceedings concerning commercial law, including insolvency cases but also economic crimes, money laundering and corruption cases. However, its remit is confined to larger and complex commercial disputes. Expanding its remit, while raising its resources, could help to further improve the efficiency of judicial proceedings, improve contract enforcement and help raise trust in institutions. Salaries for judges and insolvency administrators have risen strongly, helping to recruit and retain skilled staff and potentially reducing the scope for corruption. Full implementation of the EU Restructuring and Insolvency Directive 2019/1023 will foster out-of-court restructuring and help reduce the burden on the judiciary and the length of remaining insolvency proceedings.

Court fees for filing insolvency proceedings are high, even for small claims. In addition to an upfront fee charged to the debtor (EUR 70) or the creditor (EUR 355), a deposit of EUR 1 440 must be paid to the insolvency administrator, which is the only source of compensation for the insolvency administrator if the debtor has no assets to recover. This discourages non-viable small business owners from filing for insolvency, and prevents the reallocation of labour and capital to more productive firms, hampering business dynamism, innovation and productivity growth (see below). The State Revenue Service has the right to initiate insolvency procedures as a creditor of tax debts for companies with negative equity, but it often does not exercise this right due to a lack of financial resources. The income threshold for the eligibility of natural persons for legal aid has increased in recent years, but is still below the poverty line, leaving many debtors without the opportunity to access legal services (European Commission, 2023^[2]). In this respect, the project on the promotion of mediation and legal aid services, co-funded by the European Union and the Council of Europe, will help Latvia get closer to best practices in European countries (CEPEJ, 2023^[71]). The second phase of the project includes a pilot programme to provide primary legal aid in seven locations in Latvia and aims to increase the awareness of mediation as a method of conflict resolution. This should be complemented by reducing the cost of filing insolvency for low-income debtors, including small firms, so that fees do not act as an upfront barrier to file insolvency, while compensating insolvency administrators out of general tax revenue.

The effectiveness of the collateral framework could be further increased by improving the property registry. Latvia's property registry is well streamlined, with a small number of procedures that take relatively little time and cost less than in higher income OECD countries. However, property registries are only established for large immovable assets, such as land and real estate. This creates uncertainty for leasing companies about the ownership of other leased assets, as two-thirds of the leasing portfolio is financial leasing, where the borrower becomes the owner of the asset only after full repayment (Finance Latvia Association, 2023^[68]). In fact, interviewed medium-sized companies in the electronics manufacturing sector indicated that their machinery is not accepted as collateral, which may reflect a reluctance on the part of banks due to the uncertainty of ownership. The introduction of a deed register for all leased assets would prevent lessors from repledging leased assets as collateral, facilitate the collateral framework and significantly increase the access of smaller and younger firms to bank finance (Love, Martínez Pería and Singh, 2015^[72]; OECD, 2016^[6]).

Considering the high granularity of available credit information, the existing collateral requirements seem excessive. Collateral requirements help lenders to distinguish between creditworthy and risky borrowers. However, the credit registry in Latvia covers 97% of all adults with the highest available score for the depth of credit information, while the average credit registry coverage in the high-income OECD economies is around 25%. The credit register, which is maintained by the Bank of Latvia, contains detailed information on individual loans and is shared with lending institutions so that they can develop their own internal credit assessment frameworks. Lenders also benefit from the services of two licenced credit bureaus, which complement the information provided by the central bank in assessing credit risk. For consumer credit

providers, the Consumer Rights Protection Centre has also published detailed guidelines on credit assessment (CRPC, 2021^[73]). As a result, information gaps on borrowers' creditworthiness cannot be a precursor to excessive collateral requirements in Latvia.

Assessing the role of subsidised loans and loan guarantees in addressing market failures

Development finance is provided in a wide range of areas, but on a small scale. ALTUM provides support for business start-ups, particularly in the areas of venture capital financing, business development, export facilitation and competitiveness enhancement. ALTUM also supports regional development projects and provides guarantees for loans granted to households for energy efficiency improvements and home purchases. The balance of loans provided by ALTUM in the first half of 2023 accounted for about 3% of all loans granted to non-financial corporations and households (Bank of Latvia, 2023^[4]).

The subsidised loan and loan guarantee programmes of ALTUM have so far not been evaluated by ex-post impact assessment, which is important to monitor potential gaps between the objectives and results of the programmes. For example, loan guarantees provided by ALTUM have not led to a significant reduction in the cost of loans for house purchase and are not well targeted. Approximately, 40% of all newly issued mortgage loans for house purchase come with a guarantee from ALTUM. However, the guarantee received only helps to reduce the cost of transferring the change in ownership status to the property register (Bank of Latvia, 2023^[4]). In addition, most mortgage loans are held by higher-income households, which are more likely to be offered lower interest rates by banks. While larger mortgage guarantees for households with more children are welcome, they should be accompanied by an increase in the effective guarantee amounts for lower-income households, which would reduce the credit risk for banks and facilitate a lower lending rate. This is a better policy option than the recently imposed levy on banks to finance lower lending rates for all mortgage borrowers, which is regressive and likely to increase non-interest costs of credit. Another option is to provide low-interest loans up to a fixed amount for mortgage borrowers whose income is below an income threshold, as in the case of the *Prêt à taux zéro* programme in France (OECD, 2023^[74]).

Although ALTUM's loans to enterprises partly ease collateral requirements for SMEs, more could be done to ease borrowing conditions for smaller firms. Surveyed companies indicate that ALTUM loans, which are top-up loans subordinated to bank loans, are granted with relaxed collateral requirements, but usually for small amounts and at a higher interest rate compared to more secured bank loans. As smaller SMEs, particularly those operating in rural areas, have difficulties to pledge valuable real estate as collateral, these top-up loans could also accept machinery and other movable assets as collateral. In addition, the interest rates on such loans could be set below the corresponding bank lending rate, which would reduce the overall cost of credit. ALTUM also plans to offer loans with a capital discount for medium or large companies to foster large-scale investments in technology-intensive sectors. The capital discount will be granted after the project meets specific performance criteria, which will be monitored by the LIAA. With around EUR 423 million (1.1% of GDP) foreseen for these loans until 2026, it is crucial to ensure effective management and monitoring procedures.

Development finance should also play a more active role in improving the collateral framework for innovative start-ups. Innovative start-ups have difficulties to raise external finance because lenders are often unable to evaluate their intangible assets or the future cash flows of their projects (OECD, 2022^[1]). This hampers innovation and productivity growth (Demmou and Franco, 2021^[75]). Based on the Korean experience, ALTUM, in partnership with LIAA and universities, which are currently running business incubator programmes for science-intensive business ideas, could provide the service of intangible asset valuation for SMEs, while loans continue to be provided by commercial banks. The existence of US and European patent rights for companies could also be used as a first proxy for the valuation of intangible collateral (Box 5). Experiences from the valuation of intangible assets in many European countries, such

as Austria, Belgium, Luxembourg and Germany, should also be used for improving policy design, as in these countries development finance institutions have tried to fill the collateral valuation gap through guarantees for intellectual property financing (Brassell and Boschmans, 2022^[76]).

The establishment of the IPO Fund as a joint initiative with the Lithuanian government will help deepen capital markets in Latvia. In June 2023, the Latvian government approved the establishment of the Baltic SME IPO Fund, co-financed by ALTUM, and the Lithuanian Investment and Business Guarantee Agency, INVEGA. The total financing of the fund is EUR 50 million, with each of the two development finance institutions contributing EUR 20 million and the remainder to be raised by the fund. The fund will support initial public offerings or private placements on Nasdaq Baltic and the alternative market First North and invest in Baltic SMEs in the pre-listing phase to guide them through the listing process over a period of approximately 12 to 18 months. The average investment will be up to 50% of the listing price. The IPO fund will increase the visibility of the recipient companies and contribute to the development of the stock market in Latvia. It may also help attract VC funds to Latvian start-ups by providing more viable exit strategies.

Box 5. Facilitating the pledging of intangible assets as collateral: The case of Korea

Legislation enacted in 2012 allowed the pledging of intangible assets, opening the way for increased lending secured by intangibles in Korea. Based on the legislation, a certificate can be issued for high quality and technology assets pledged by companies with a low risk of insolvency. If the valuation of the asset is successful but the quality is less certain, the lending institution is provided with a guarantee of between 85% and 100% of the loan granted. These procedures are overseen by the Korea Invention Promotion Association (KIPA), a subsidiary of the Korean Intellectual Property Office, which is responsible for developing and promoting IP valuation tools and accrediting valuers.

Guarantees are often provided by the Korea Technology Finance Corporation, which specialises in assessing the technology of SMEs. To date, KOTEC has completed around 700 000 ratings for 80 000 companies. KIPA has also provided tools for lenders to attach credit scores to some patents where company portfolios include US and European patent rights.

In December 2018, the Financial Services Commission of Korea and KIPO issued an announcement reviewing policy achievements and setting targets for the future. The announcement prioritised the targeting of companies at relatively early stages of IP commercialisation and included case study results showing that companies that received IP finance achieved sales growth of 16.5% and increased employment by around 6.5 employees on average. The future targets included increasing the share of valuations performed by the private sector from the historical norm of around 10% to 50% by 2022. Since 2019, Korean companies have been able to choose from four modular valuation models, which allows them to reflect heterogeneities in their IP asset type, maturity and associated loan amount.

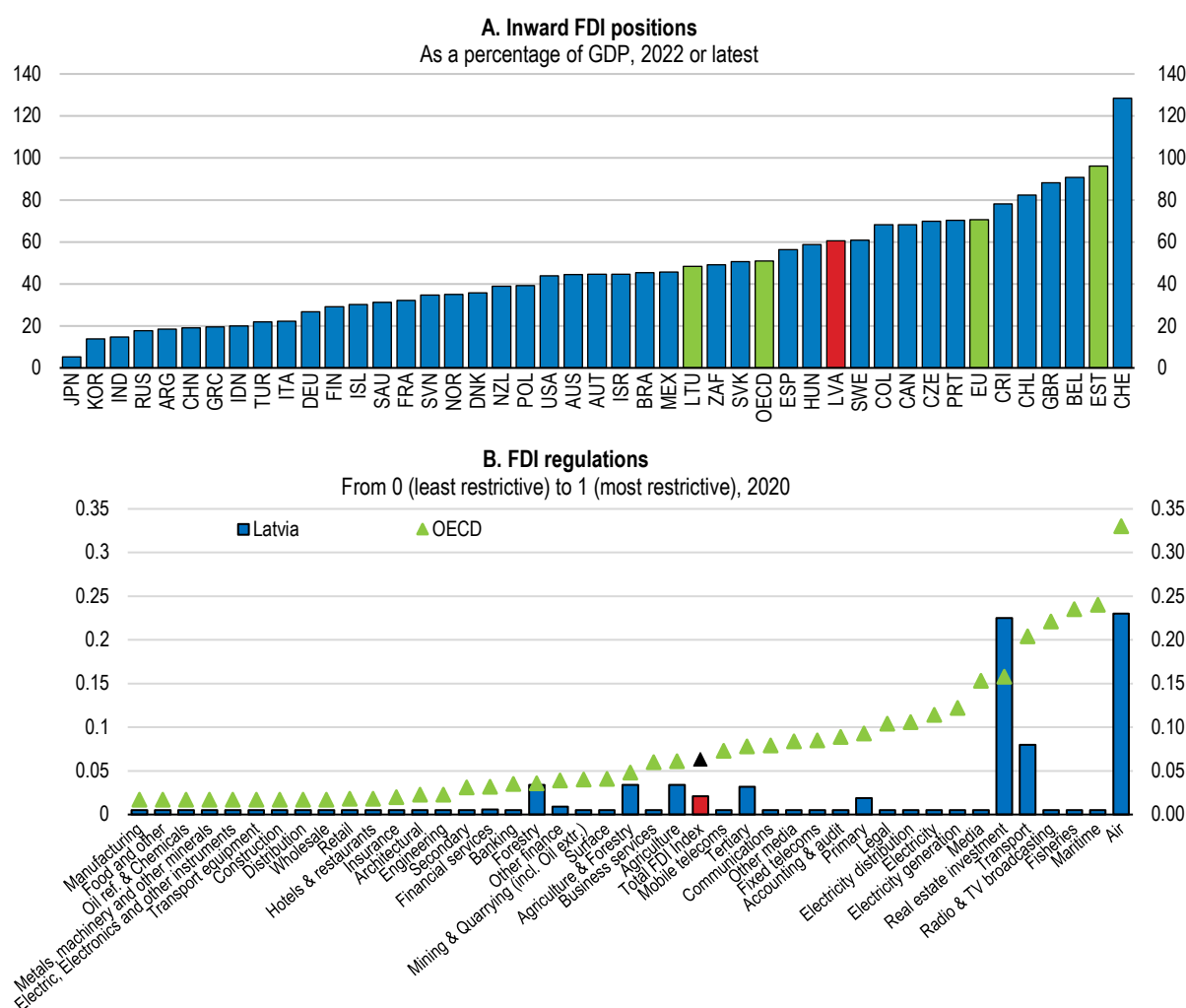
Source: OECD SME and Entrepreneurship Papers No. 33 (2022^[76]).

Improving the business environment to raise investment demand

An appropriate combination of less restrictive FDI regulations and investor-friendly policies has made Latvia an attractive destination for FDI. Inward FDI into Latvia is higher than in the average OECD country, as investors have benefited from access to the EU market, decreasing administrative burden, generous corporate tax incentives and an improving digital infrastructure (Figure 31). Proximity to Russia and Belarus poses a downside risk to FDI inflows, but the reduction in flows from sanctioned investors has so far been compensated by inflows from other investors, mainly from Sweden and especially in technology-intensive industries (OECD, 2023^[77]).

Rising FDI flows have benefited the Latvian economy, but room for improvement exists. FDI has positive spillover effects as it helps domestic suppliers to vertically integrate into global value chains and enhances domestic capabilities through knowledge exchange and the adoption of new technologies (Andrenelli et al., 2019^[78]). However, the number and deal value of cross-border mergers and acquisitions remain low in Latvia, limiting vertical integration into global value chains (OECD, 2021^[79]). Restrictions on foreign entry and competition in air and rail transport are high and should be reduced to facilitate investments (Figure 31). Moreover, skill shortages discourage potential foreign investors, which should be addressed by facilitating skilled migration, improving VET and the quality of basic and tertiary education to reduce skill mismatch in the labour market (OECD, 2022^[1]).

Figure 31. Latvia has attracted large FDI flows thanks to low FDI restrictions



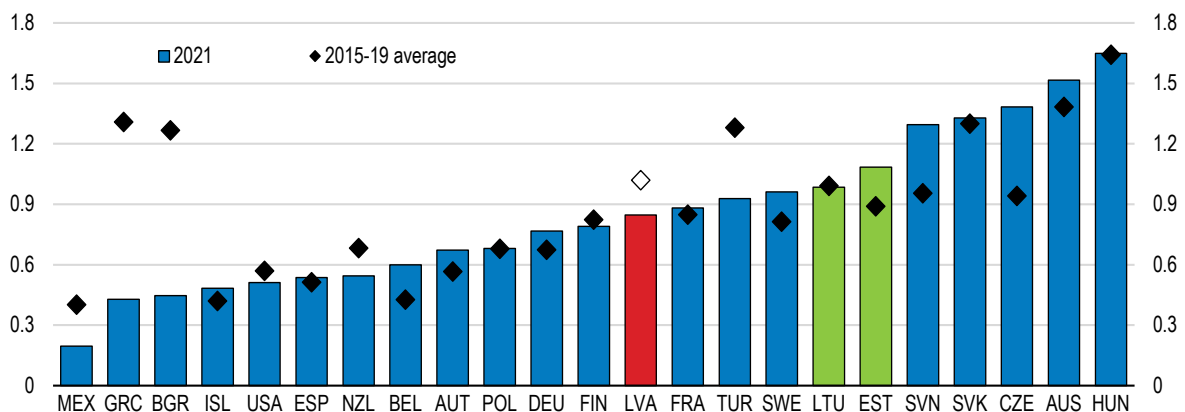
Note: Countries such as Ireland, Luxembourg and the Netherlands with an FDI position above 250% of GDP are excluded from Panel A. Source: OECD International Direct Investment Statistics database; and OECD FDI Regulatory Restrictiveness Index database.

Attracting more FDI in the current geopolitical context requires large investments in transport infrastructure to better connect Latvia to the EU market. Funds from the Recovery and Resilience Plan have been used to build and improve 210 km of state regional and local roads, but the quality of inland transport infrastructure is well below the EU average and investment to improve it remains low (Figure 32) (OECD, 2022^[1]). Only 14% of all existing railway lines are currently electrified, reducing the potential for emissions reductions in the transport sector. Funds from the Recovery and Resilience Plan will be used to increase the coverage of electrified railways in the Riga metropolitan area by 2026, but some infrastructure projects

have been delayed due to planning uncertainty regarding the replacement of diesel trains. In the past, transport infrastructure investments have focused on facilitating freight traffic with Russia, rather than passenger transport. In this respect, the Rail Baltica project, a greenfield investment to connect the Baltic states to the rest of the European rail network, provides ample opportunity to fill large investment gaps in the transport infrastructure, including accompanying investments in potential inland, airport and seaport connections, and the digital infrastructure, such as the fibre optic cable line along the railway. The Rail Baltica project will also contribute to the development of a dual-use transport infrastructure, including passenger transport. Boosting infrastructure investment planning capacities, making land acquisition more flexible, and improving public procurement procedures is key to raise high quality public investment and would also help crowd in more private investment. In this respect, the government's aim to promote public-private partnerships in infrastructure works is a step in the right direction and could help to reduce efficiency gaps in the management of these projects. Facilitating construction permit procedures and the migration of workers, such as civil engineers and crafts occupations, would lower construction costs and facilitate the implementation of much needed infrastructure investment (OECD, 2021^[79]).

Figure 32. Investment to improve the low quality of transport infrastructure could be higher

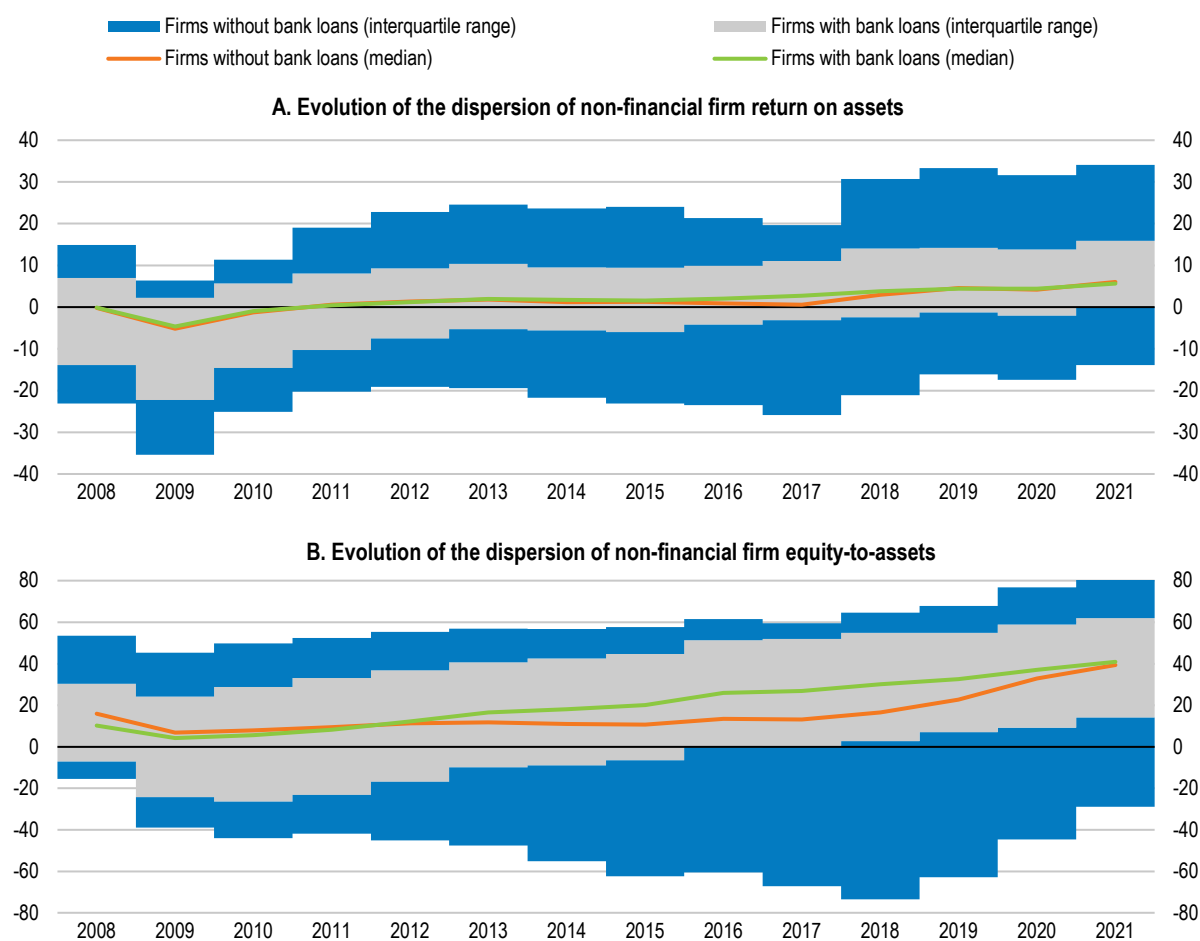
Total inland transport infrastructure investment per cent of GDP



Source : OECD Transport Infrastructure indicators database.

To reinvigorate Latvia's income convergence process, domestic investment should accompany FDI inflows. An important reason for the historically weak domestic investment demand is that many domestic firms are reluctant to borrow. Although non-bankable firms with a negative net worth – about one-third of all non-financial firms – contribute to low aggregate corporate leverage, many firms with high profitability and strong capitalisation choose not to borrow (Figure 33). Cultural and demographic factors may also play a role in this behaviour, with first-generation owners reluctant to cede discretion over their firm's decisions to external lenders (Karahan, Pugsley and Şahin, 2019^[80]).

Figure 33. Many firms with stronger balance sheets do not rely on bank loans



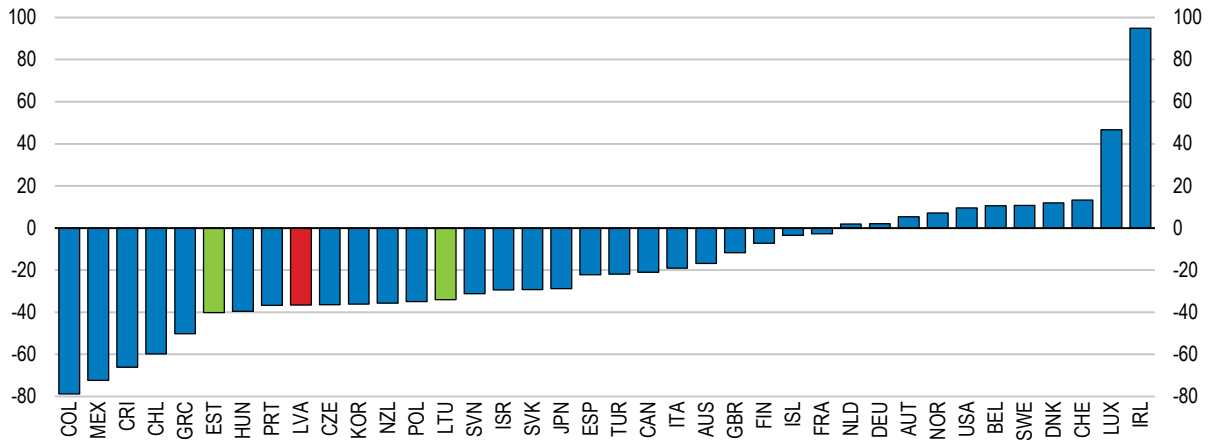
Source: Bank of Latvia Calculations using firm-level data at the State Revenue Service.

Promoting efficient resource allocation to increase investment demand

Despite high profit margins and healthy corporate balance sheets for some larger firms, investment returns have been relatively low on average, leading to low average capital intensity in production (University of Latvia, 2023^[8.1]). The labour productivity gap with the best performing OECD countries remains large (Figure 34). As unit labour costs have risen faster than productivity over the past decade, especially in the manufacturing sector, the competitiveness of Latvian firms has deteriorated, weighing on net exports. To raise productivity and exports it is key to foster business dynamism, innovation, and digital adoption, facilitate the reallocation of production factors to more productive firms and improve the skills of the workforce.

Figure 34. Labour productivity is still weak

Gap in GDP per hour worked against 19 richest OECD countries, PPPs, population weights, in %, 2022

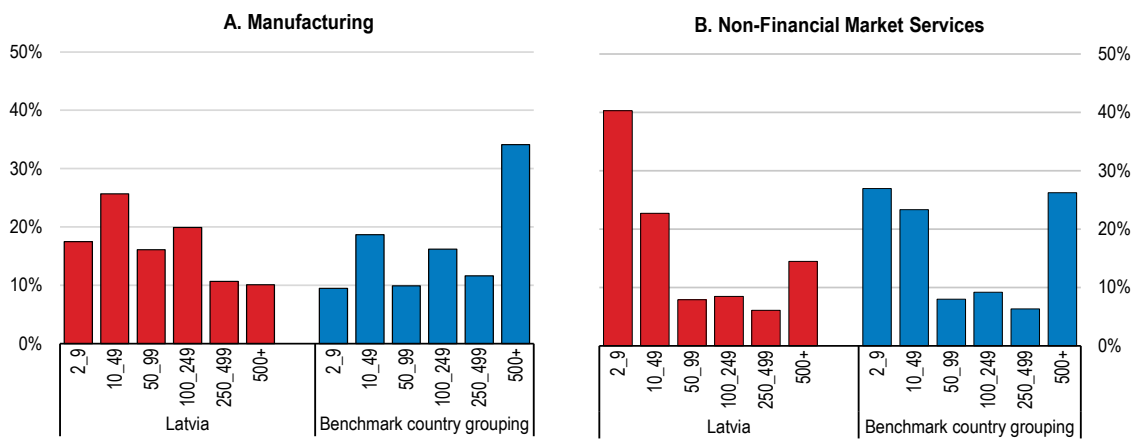


Source: (OECD, 2023^[82]), Economic Policy Reforms 2023: Going for Growth, OECD Publishing, Paris.

Although firm entry rates are high due to the low administrative burden of starting a business, many firms in Latvia remain small (Figure 35, Figure 36) (OECD, 2019^[3]). This weighs on aggregate productivity as many small firms have lower productivity due to weaker management skills, low access to finance, lower digital adoption and innovation and less training provision for workers.

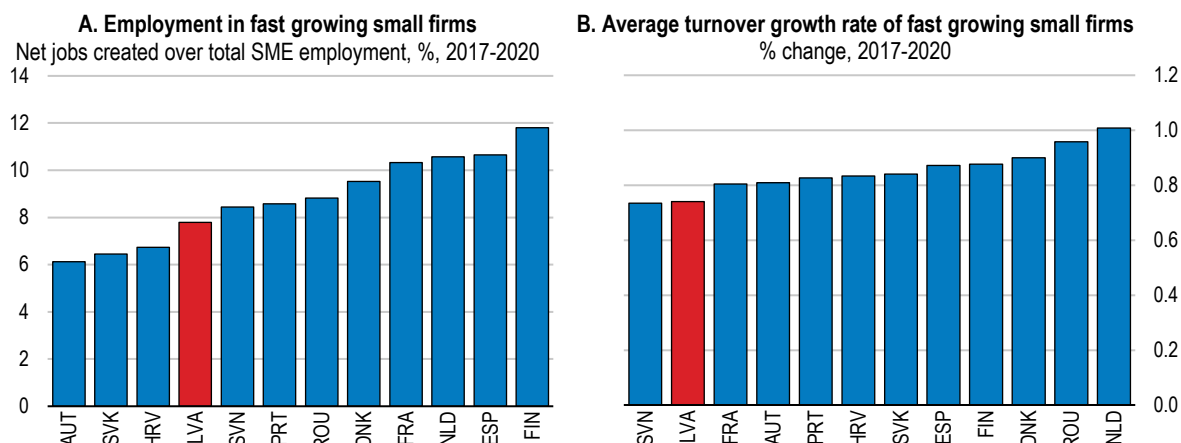
Figure 35. Employment is concentrated in small firms

Share of total employment by firm size, average over 2013-17



Note: The benchmark country grouping includes Belgium, Finland, Hungary, Croatia, Slovenia and Sweden.
Source: OECD DynEmp database.

Figure 36. Small firms grow less than in other countries

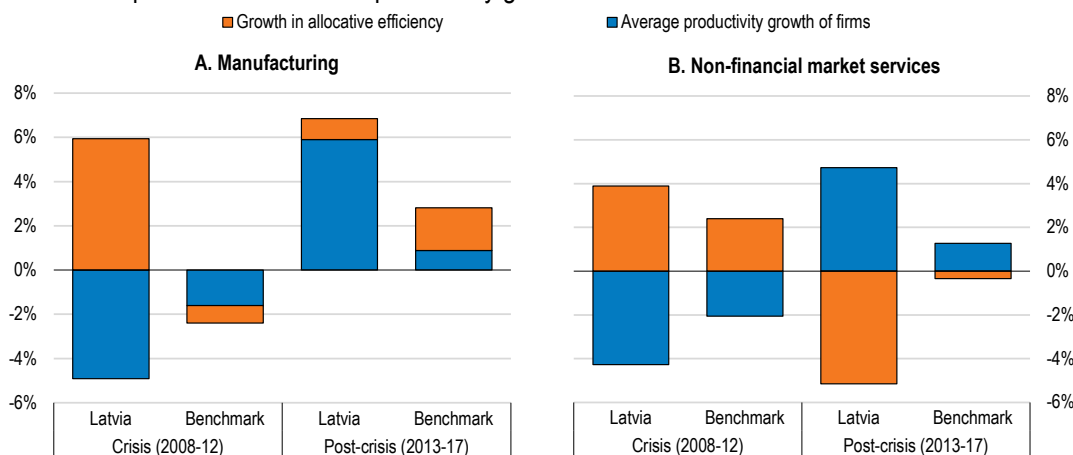


Note: Fast growing small firms are defined as SMEs with at least 10 employees that grow in employment or turnover by at least 10% per year, on average, over 3 consecutive years.
Source: OECD CFE Database on Scalers.

Inefficient and costly insolvency procedures and specific tax regimes for small firms have acted as barriers for the reallocation of production factors to more productive firms with high labour shortages, which weighed on productivity growth, particularly in services (Figure 37). Aggregate productivity growth in an economic sector depends on how fast the average productivity of firms grows and whether production factors can be efficiently reallocated from less productive to more productive firms, which can be measured by allocative efficiency (Olley and Pakes, 1996^[83]; Andrews and Cingano, 2014^[84]). Decomposing productivity growth into these two components suggests that a strong deterioration in allocative efficiency has led to declining productivity growth in services sectors after the global financial crisis (Figure 38). This is related to the introduction of the microenterprise tax regime in 2010, which has incentivised firms to stay small and even split up to benefit from generous tax reductions, particularly in labour-intensive services sectors (World Bank, 2017^[85]). Although its conditions have been made less generous, this special tax regime still exists and its design should be evaluated to ensure that it does not hinder the reallocation of resources to more productive firms. Re-training micro-enterprise owners who exit the market could help to reduce labour shortages in more productive firms.

Figure 37. Resources are trapped in low productivity firms, particularly in services

Olley-Pakes decomposition of multi-factor productivity growth



Note: The benchmark country grouping includes Belgium, Finland, Hungary, Croatia, the Netherlands, Portugal, Slovenia and Sweden.
Source: OECD MultiProd database.

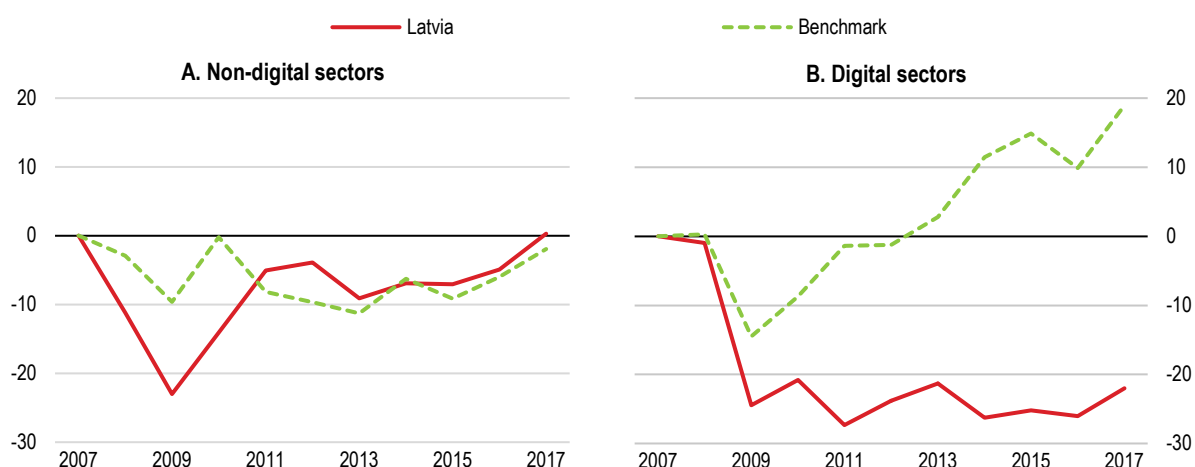
Improving restructuring procedures and reducing barriers to exit is key for increasing allocative efficiency. About one-third of non-financial firms have negative equity, and although these firms represent a small share of total corporate assets, they lock up labour and capital inputs that could have been used by more productive and viable firms (Bank of Latvia, 2023^[4]). In 2022, only around 10% of restructuring applications were concluded, which reduces the chances of viable companies facing financial distress to survive and lowers the liquidation value of failing companies, resulting in low debt recovery (Adalet McGowan and Andrews, 2018^[86]). Aligning restructuring procedures with the EU Restructuring and Insolvency Directive 2019/1023 is key to better differentiate between viable and failing firms early on and achieve a more efficient allocation of productive resources. Further reducing barriers to market exit, such as relatively high costs to file insolvency, would help ensure the smooth liquidation of unprofitable small firms (see above). For many of these firms, the distinction between corporate and personal balance sheets is relatively narrow and many owners use their firm's income to finance their living (World Bank, 2017^[85]). Therefore, the liquidation of these firms may lead to their personal insolvency and should be accompanied by targeted social protection and active labour market policies to facilitate the move to new jobs in more productive firms (Demmou et al., 2021^[87]). In line with the EU Directive on Insolvency and Second Chance, reducing the personal costs for failed entrepreneurs and the time to discharge, which have both remained stable over 2016-22 according to the OECD insolvency Indicators, would further help exiting firms during the transition.

Informality acts as another barrier to efficient reallocation and formal firm growth and is particularly high in construction and services sectors, such as retail and hospitality (Sauka and Putnins, 2023^[88]). Informal firms are reluctant to grow, have weaker access to finance, lower digital adoption and training investments and are generally less productive than formal firms (OECD, 2019^[3]). Moreover, by under-declaring income and wages these firms reduce their costs to compete with larger more productive formal firms, which in turn has negative consequences on profitability, innovation incentives and investment of formal firms (Amin and Okou, 2020^[89]). This unfair competition can even act as a market entry barrier for foreign firms, which cannot compete with the prices set by informal domestic firms, for example in the construction sector. Corruption is equally harmful as it helps well-connected incumbent firms to remain in the market and acts as a barrier for young, innovative and more productive firms. Therefore, tackling informality by stepping up tax enforcement, lowering labour taxes for low-income earners and raising the quality of public services while continuing to fight corruption and raise the trust in institutions is key to level the playing field and raise business dynamism and innovation.

Slow digitalisation in small firms and a lack of reallocation of resources to more productive firms in the services sectors has hampered the adoption of digital technologies and productivity growth (Figure 38). Productivity growth in sectors that show a high degree of digitalisation in OECD countries, mainly services sectors, has stagnated in Latvia since the financial crisis, while it strongly increased in benchmark countries. This is due to a lack of adoption of digital technologies in many smaller firms, which do not have sufficient scale to shoulder the required fixed investments, have weak access to finance, are often informal, and miss the necessary management and workforce skills. Improving the reallocation of production factors to more productive firms is key to raise digital adoption and productivity growth. Moreover, high barriers to competition have contributed to weak innovation and productivity growth in smaller firms, particularly in services sectors, and should be reduced.

Figure 38. Productivity has stagnated in sectors that are intensive in digital technologies

Percentage change in multi-factor productivity compared to 2007 (2007=0)



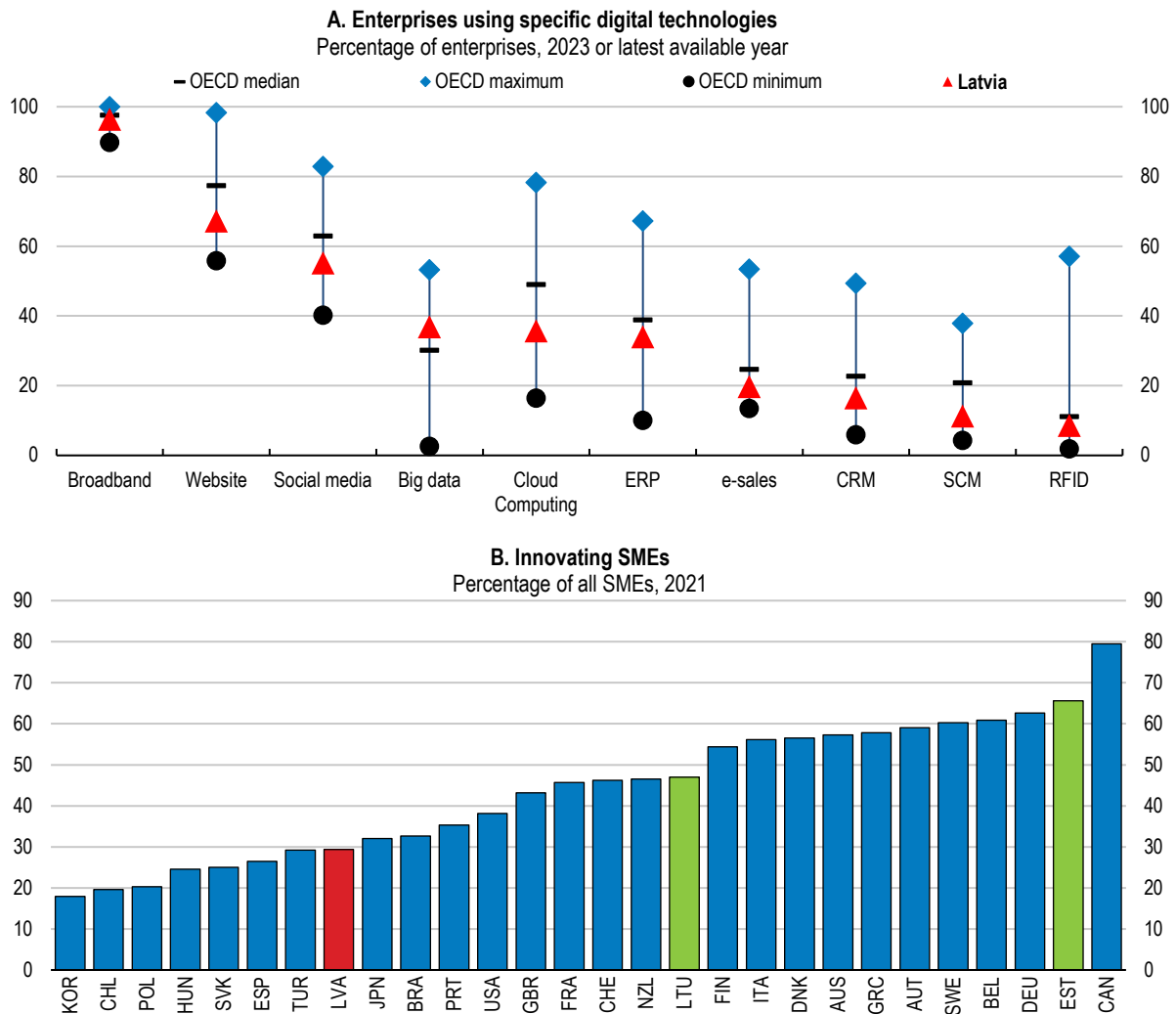
Note: The graph shows average multi-factor productivity of firms, normalised to zero in 2007. The benchmark country grouping includes Belgium, Finland, Hungary, Croatia, the Netherlands, Portugal, Slovenia and Sweden. Digital sectors are defined as sectors that are intensive in digital technologies and have a high share of ICT occupations on average across OECD countries.

Source: OECD MultiProd database.

Fostering innovation and digital adoption

Although many formal firms use the internet and software, for example for human resource planning, there is room to improve adoption of more sophisticated digital technologies (Figure 39). One key policy lever is digital infrastructure, which has improved in recent years, although regional disparities remain (OECD, 2021^[90]). Providing high-performance network connections to businesses is key to raise the adoption of more sophisticated digital technologies, such as cloud computing or the use of big data. Using financing from the Recovery and Resilience Facility and the European Regional Development Fund, the fibre optic network is planned to be extended to regions where private investors are not expected to provide such infrastructure over the next three years. Improving digital infrastructure in homes and public buildings such as schools and hospitals is also part of the EU funding plans and will facilitate financial inclusion of households and the digitalisation of public administration and public services in municipalities.

Figure 39. There is scope to improve the adoption of more sophisticated digital technologies



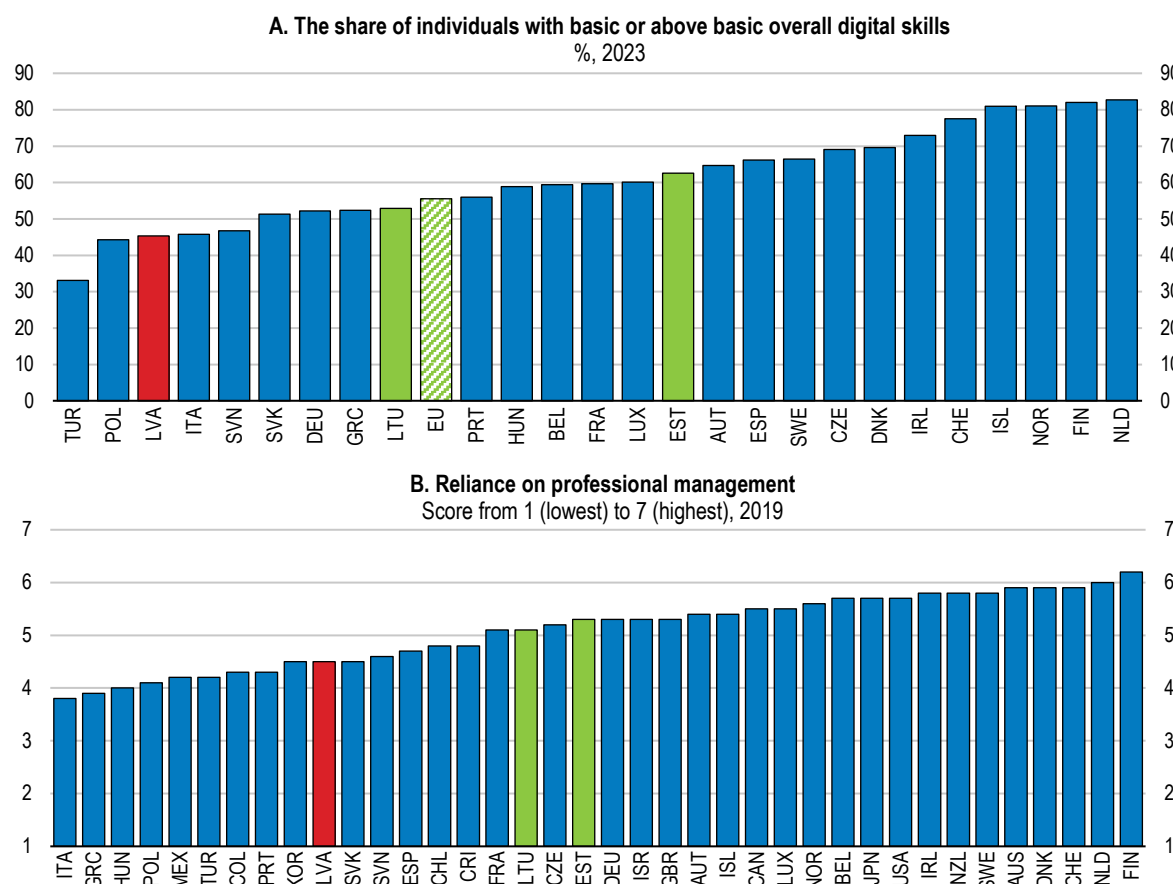
Note: In Panel A, data correspond to the share of businesses with ten or more employees with broadband connection (fixed or mobile); with a website or home page; using social media; using Enterprise Resource Planning (ERP) software; using Customer Relationships Management (CRM) software; purchasing cloud computing services; receiving orders over computer networks; sharing electronically information with suppliers and customers (SCM); using Radio Frequency Identification (RFID) technology; and having performed big data analysis. Panel B: Innovating small and medium-sized enterprises are those introducing product, process, marketing or organisational innovation.

Source: OECD ICT Access and Usage by Businesses Database; OECD 2021 Survey of National Innovation Statistics; and Eurostat Community Innovation Survey.

Improving digital and management skills is key to raise the adoption of digital technologies and innovation (OECD, 2022^[1]; European Commission, 2022^[91]). Basic digital skills, such as navigating the internet and using the internal communication tools, as well as advanced digital skills, which require quantitative and technical proficiency, are relatively weak among Latvian workers (Figure 40). Management skills, such as ensuring efficient teamwork and communication between and within teams, also need to be improved to raise digital adoption (Pisu et al., 2021^[92]). As part of its Recovery and Resilience Facility plan, Latvia is developing the Individual Learning Accounts, an EU initiative that aims to facilitate access to online learning opportunities to improve adult skills. Moreover, the Ministry of Economy will provide grants of EUR 30 million covering up to 70% of the total training costs, to improve the digital skills of the employees of more than 4 200 entrepreneurs over the period 2021-29. The grants will support programmes to improve basic digital skills, online courses on the use of digital business solutions, high-level training on cybersecurity, and AI and high-performance computing. However, the strong dependency on EU funds for these

programmes introduces uncertainty about their continuation as well as issues related to spending efficiency (OECD, 2019^[3]). Raising domestic resources to ensure continuity and expand measures that have proven effective is key.

Figure 40. Digital and management skills are weak



Note: Scores shown in Panel B are based on responses to the question: "In your country, who holds senior management positions in companies? [1 = usually relatives or friends without regard to merit; 7 = mostly professional managers chosen for merit and qualifications]".

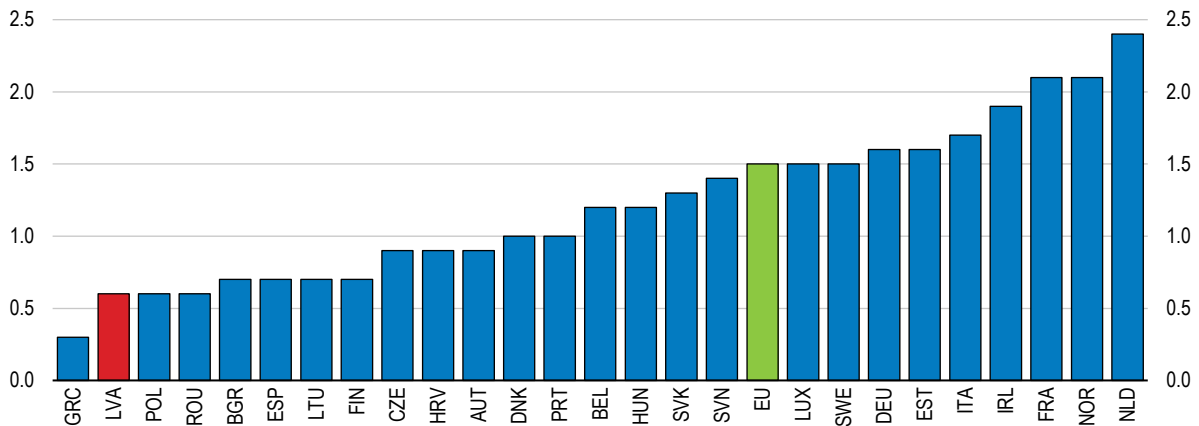
Source: Eurostat; World Economic Forum (2019), The Global Competitiveness Report 2019.

While the various public programmes to strengthen digital skills are welcome, it is also important to further improve incentives for firms to expand training of their workforce. Training investments of firms as a share of total labour costs are among the lowest in the EU (Figure 41). This is related to the large number of small firms, who lack management skills to implement effective human resource practices or do not have sufficient resources to provide training. Moreover, severe skilled labour shortages exacerbate the problem of poaching of skilled employees by other firms, which reduces incentives to invest in training of employees (Acemoglu, 1997^[93]). This is particularly problematic as coordination across firms is weak, as only about half of firms are members of an employer organisation, which is far less than the EU average (OECD, 2022^[94]). Better cooperation among firms of the same economic sector is necessary to coordinate initial and continued vocational education and training (VET) including with training providers and public VET institutes, which could be facilitated by establishing a training fund as recommended by the previous OECD Economic Survey of Latvia (OECD, 2023^[95]). This is particularly important for sectors with many smaller firms, as coordination is more complicated. Training funds are planned to be piloted in three sectors starting in 2027 but given severe skilled labour shortages and weak training investment of firms the piloting should be accelerated. The recent decision to expand payroll tax exemptions for training provision of firms to also

include support for higher education is welcome but should be accompanied with further measures to improve coordination in training provision among the government, firms and workers.

Figure 41. Firms need to step up training

Spending for continuing vocational training (CVT) courses, % of total labour cost of all enterprises, 2020



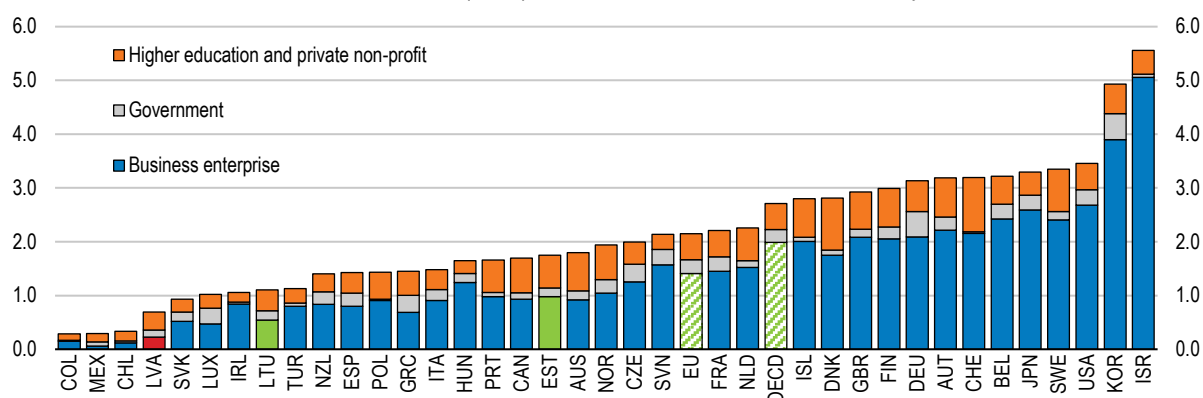
Source: Eurostat, Continuing vocational training survey (CVTS) 2020.

Low spending on research and development (R&D), in particular by businesses, hampers innovation and productivity growth (Figure 42). There are no specific corporate tax incentives for R&D, which are used by many countries to stimulate private sector innovation (OECD, 2022^[11]). Instead, the government focuses on grants and financial instruments to support innovation and the digital transformation of enterprises. However, the governance of innovation policy can be improved, as responsibilities are shared by several ministries and agencies. Many different small-scale programmes exist with different application procedures and requirements and a lack of comprehensive and centralised impact evaluation. In this respect, the transfer of some research management functions from the State Education and Development Agency to the Latvian Council of Science in 2022 is a welcome step. Further centralisation of innovation support in a single agency would help to reduce the administrative burden on applicants and conduct a comprehensive evaluation and consolidation of existing programmes. Effective programmes should then be scaled up and expanded.

Moreover, a better cooperation and coordination between universities, research institutes and the private sector is needed to foster innovation. Plans to consolidate universities and create specialised research clusters are welcome, as the low number of researchers is dispersed across a relatively large number of universities, hampering knowledge spill-overs and effective coordination with the private sector (OECD, 2022^[11]). Making funding for universities more performance based, in particular, regarding innovation outcomes and successful cooperation with the private sector, would help to foster knowledge transfer and innovation. Increasing the representation of the private sector in university councils would help to strengthen links with the private sector and better update study content according to skill needs of firms. As the previous Economic Survey of Latvia has argued, increasing the share of royalties of patents that researchers receive could help increase the incentives to innovate, invest and commercialise innovative ideas. Better using synergies between specialised research institutions and creating research clusters, as for example done by the Riga Technical University, can help to improve cooperation with research institutions in other EU countries and increase visibility to attract funding and cooperate with innovative start-ups.

Figure 42. Low spending on Research and Development holds back innovation

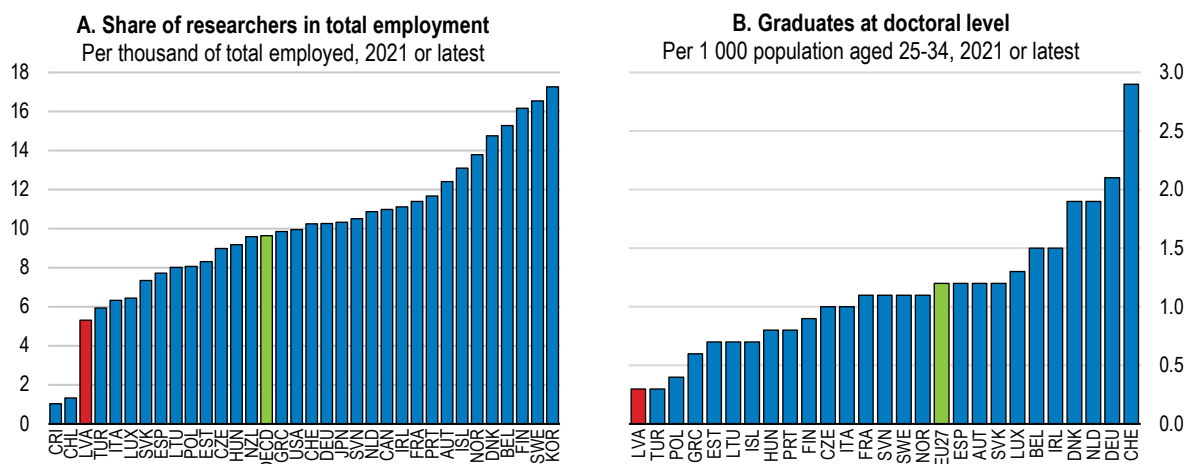
Expenditure on Research and Development (R&D) % of GDP, 2021 or latest available year



Source: OECD Main Science and Technology Indicators database.

A relatively low number of researchers and STEM graduates holds back innovation and digital adoption (OECD, 2022^[1]). Latvia has one of the lowest numbers of researchers per employed person in the OECD (Figure 43). This is linked to the low share of tertiary and doctoral graduates among the 15-29 year old due to high dropout rates, particularly in STEM and ICT fields (OECD, 2023^[96]). The government has raised the share of tuition fee waivers in STEM and ICT studies to above 80% of study places, which increased incentives for secondary graduates to choose these subjects in university. However, severe skilled labour shortages in the booming ICT sector and low funding for living costs lead many successful students to take job offers and dropout before graduation. Other students struggle due to weak quantitative and language skills, which calls for improving the quality of STEM and language education in schools. Moreover, the allocation of university funding should encourage higher graduation rates, while controlling for quality standards, to incentivise universities to provide sufficient support for struggling students. Data on labour market outcomes of graduates and alumni surveys should be used to evaluate the quality and regularly update the content of study programmes. To improve the financial situation of students, the existing means-tested financial support to cover living costs for students should be further increased.

To increase the number of researchers and doctoral graduates, funding for doctoral students and working conditions for researchers as well as links between teaching and research need to improve (OECD, 2022^[1]). Plans to introduce professor positions with reduced teaching requirements can help to attract researchers to university teaching, improve working conditions and increase the exposure of students to frontier research topics. Providing sufficient funding for living costs for PhD students is crucial to reduce dropouts and should be combined with better cooperation with the private sector to allow for joint research projects, which could provide additional income for PhD students and foster knowledge spillovers. Moreover, attracting foreign and diaspora researchers through specific funding programmes, more flexible language requirements and better working conditions would help to raise knowledge transfers, facilitate international research cooperations and raise the quality of research.

Figure 43. The research workforce is small

Source: OECD Main Science and Technology Indicators database; Eurostat.

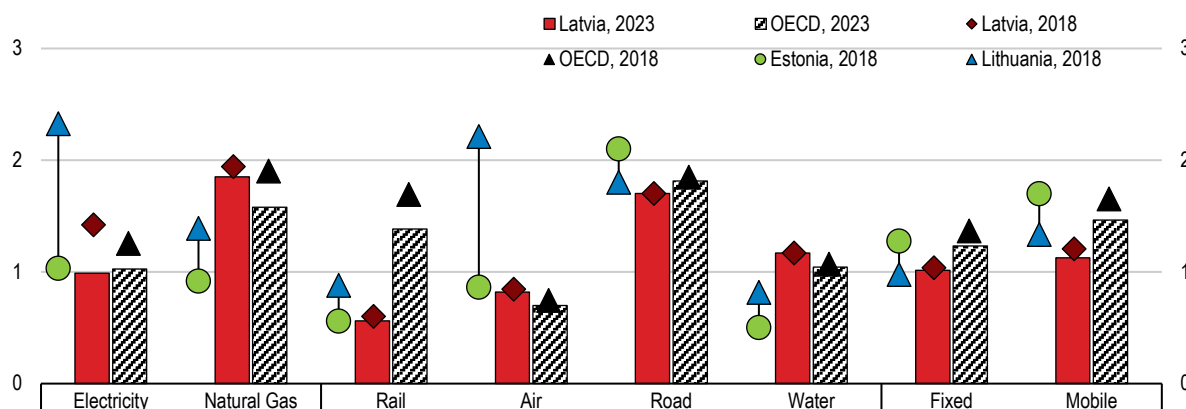
Improving competition enforcement

Competition enforcement is key to ensure that markets are competitive and conducive to firm innovation and productivity growth. Safeguarding a level playing field ensures that innovative market entrants can challenge incumbents, which need to innovate and improve their products and services or free up resources to allow more innovative and productive firms to grow. The independence and capacity of the Competition Council of Latvia to enforce competitive markets have been strengthened since 2020. The Competition Council retains the exclusive right to enforce competition laws and its decisions can only be challenged in court. Its budget has been separated from the Ministry of Economy and is submitted directly to the parliament's Budget and Finance (Taxation) Committee, in line with the previous recommendations of the OECD Economic Surveys of Latvia and the implementation of the EU's ECN+ Directive as of 2020. Resources have increased by about 22% in inflation-adjusted terms over the last two years, mainly for employee remuneration, resulting in an increase in the number of staff from 47 in 2020 to 59 in 2023 and a decrease in the staff turnover rate from 32% in 2019 to 12% in 2022. An IT laboratory was established to improve data analysis, including the pilot of an automated cartel screening and a merger report submission tool. Amendments to the Competition Law in June 2022 further strengthened the capacity of the Competition Council by increasing the number of representatives in its decision-making body from three to five and establishing a new unit to enforce the 2022 law on the prohibition of unfair trading practices. A separate unit of six economists has also been created within the Council to improve analysis to support damage claims and evaluate the benefits of the council's interventions. In 2022, the conclusion of legal proceedings on previously imposed fines has led to the collection of fines amounting to more than EUR 9 million, which is more than four times the allocated budget of the Competition Council.

However, significant challenges remain, particularly in services sectors where competition remains weak (Figure 44). High entry barriers and a strong presence of national and local SOE's pose challenges to new entrants in some network sectors, such as road and air traffic as well as energy and heat production and distribution. This weighs on business dynamism and innovation and may reduce the quality and raise prices of services for consumers and firms that use these services as production inputs. Mark-ups have also been relatively high in other services sectors with a strong presence of SOEs, such as in arts, entertainment and recreation, real estate activities, and health and social work, pointing to weak competition (OECD, 2019^[3]; Statistical Institute Latvia, 2023^[97]). Moreover, according to the 2023 OECD PMR Indicators market entry barriers remain high in many professional services, such as lawyers, architects and civil engineers, as well as in retail sale of medicine, contributing to high prices.

Figure 44. Barriers to competition remain high in some network services

OECD Indicators of Product Market Regulation (PMR), index scale of 0-6 from least to most restrictive, 2023 (higher values indicate worse performance)



Note: OECD average includes all OECD countries, apart from Belgium, Hungary, Mexico, the Netherlands, and the United States for which data collection is still ongoing. PMR values for Estonia and Lithuania for 2023 will only be released in Summer 2024.

Source: OECD (2023), Product Market Regulation Database (forthcoming).

In 2020, the principle of competitive neutrality was introduced following the implementation of the EU's ECN+ directive to prevent market distortions caused by SOEs or regulations, but its enforcement should be improved (OECD, 2022_[11]). A pre-condition for competitive neutrality is to clearly separate the management of SOE's from other functions of the public administration such as regulating markets, conducting public procurement or designing laws and regulations. Moreover, to strengthen the enforcement of competitive neutrality, the Competition Council should receive the power to initiate market investigations and challenge decisions of public bodies, in case certain administrative decisions, regulations, institutional arrangements or SOE practices hamper competition (Motta and Peitz, 2021_[98]; OECD, 2021_[99]). So far, the council only has an advisory role and can only start evaluations when asked by market participants or the public body. In this respect, Latvia can learn from the example of the UK, where the Competition and Markets Authority (CMA) can even impose remedies following market investigations, which conclude that competition is being restricted (Whish, 2020_[100]). The remedies sought by the CMA are binding orders for future conduct, such as to supply goods or services or to divest or not to acquire a business, among others, which are not sanctions to punish any past wrongdoing. Legislation in Greece, Iceland, Romania and Mexico also provides competition authorities with market investigation powers similar to those of the CMA (OECD, 2016_[101]).

The large number of SOEs and relatively weak data transparency at the municipal level poses a challenge for monitoring abuse of dominance in markets where SOEs and private companies compete. In line with the OECD Ministerial Council Recommendation on competitive neutrality, requiring all SOEs to apply high standards of transparency, accounting separation and disclosure for activities that pursue public policy objectives, including those of statutory natural monopolies, and their commercial activities, which compete with private market players, is key to facilitate investigations on unfair practices of cross-subsidisation (OECD, 2021_[102]). The Competition Council should receive sufficient resources to regularly monitor this accounting separation and assess whether SOEs are cross-subsidising their commercial activities. For example, the Australian Competition and Consumer Commission provides comprehensive guidance for SOEs to assess cross-subsidisation and monitors its implementation (ACCC, 2014_[103]). Listing of SOEs can also help improve transparency and accounting separation.

There is also scope for strengthening the enforcement of the competition law. The time allowed for investigations over merger control is too short. The investigations must be completed within 4 months and the Competition Council does not have stop-the-clock powers during an ongoing review, which creates

incentives for firms under investigation to withhold information and reduces the quality of assessments. The Competition Law should be aligned with the EU Merger Regulation to allow the Competition Council to suspend reviews until essential missing information requested from the merging parties is provided (European Commission, 2004_[104]). The Competition Council also does not have legal tools to assess the acquisition of minority shareholdings, which may harm competition due to common ownership. In Germany, for example, acquisitions of minority shares of 25% or more have to be notified and can be subject to merger control under certain conditions (OECD, 2017_[105]). The investigative capacity of the Competition Council should be expanded to enable tracking concerted practices involving the exchange of sensitive commercial data that could be used to prove concurrence of wills in tacit collusion cases (OECD, 2017_[106]; OECD, 2020_[17]). For example, investigations by the Portuguese competition council of email exchanges between bank employees allowed to prove collusion in a case against major banks coordinating in setting mortgage rates (see above) (OECD, 2020_[17]). Finally, further raising resources for staff training and IT equipment and software to improve the IT laboratory and the capacity to carry out regular ex-post evaluations is key to guide future investigations and decisions based on past experiences and rulings.

Concluding remarks

This paper examines the obstacles to higher investment growth in Latvia, which have derailed Latvia's convergence to the living standards of the best performing OECD countries. The paper finds that limited credit supply due to banks' high risk aversion, weak competition in the financial sector and shallow capital markets have weighed on investment in Latvia. To improve access to finance, it is key to foster competition in financial markets by raising transparency on deposit rates, commissions and fees, reducing switching costs for bank customers and strengthening competition enforcement. Listing minority stakes in large SOEs, providing low-cost creditworthiness information on smaller firms and fostering financial literacy would help increase the supply of securities traded in capital markets. Facilitating greater exposure of second-pillar pension funds to domestic securities would then help to deepen capital markets. The paper also shows that, high informality, barriers to competition, and skilled labour shortages weigh on business dynamism, innovation and investment demand in Latvia. Increasing incentives to formalise work, reducing barriers to firm exit, improving coordination between firms and training institutes to provide workers with the skills needed by firms, and strengthening competition enforcement would increase allocative efficiency, foster business dynamism and increase investment demand in Latvia.

MAIN FINDINGS	RECOMMENDATIONS (Key recommendations in bold)
Improving credit provision	
Banks have not passed on lower funding costs to lending rates due to a market practice of setting a zero lower bound for the base rate for lending. Common ownership among banks, and between banks and other financial market institutions, is weakening competition in the financial system.	Strengthen the legal and investigative powers and tools of the Competition Council to monitor anti-competitive behaviour in financial markets. Introduce a mandatory notification of minority shareholdings for financial market participants.
Low customer mobility related to high fees and information asymmetries is reducing competitive pressures on banks. The household saving ratio is low and few households save in time deposits, partly due to low deposit rates.	Extend the platform on payment account commissions to include information on bank deposit rates as well as other fees, such as minimum fees charged for refinancing loans, and provide standard switching packages and contract templates for loans.
Regional disparities in access to banking services remain high. Information on borrowing activity and access to banking services is only available at the nationwide level.	Collect information at the municipal level on the availability of banking access points and services. Incentivise online banking by reducing information asymmetries on fees and contract conditions and improving cyber security.
High AML risk aversion by banks increases barriers to market entry and costs for FinTech firms.	Grant FinTech firms direct access to the national payments system, while maintaining security and consumer protection in line with the EU Payment Services Directive 2.
High AML risk aversion by banks has increased the administrative costs of loans and led to unwarranted de-risking.	Better define low-AML risk cases in line with the EBA guidelines and assess the degree of de-risking. Provide regular training to the relevant staff and require AML/CFT compliance officers in the financial sector to undergo additional training where necessary.
Regulatory and supervisory functions are centralised in the central bank, which could lead to prioritising financial stability over the effective functioning of financial markets.	Maintain current separate reporting, budget lines and staffing arrangements for different functions and monitor risks to the governance of financial sector policies.
Deepening capital markets to foster alternative sources of credit	
Stock market capitalisation is very small and none of the large SOEs are listed in the stock market, in contrast to other Baltic countries.	Accelerate current plans to list large SOEs.
For smaller companies, the administrative burden and costs of listing are high, preventing them from entering stock markets.	Simplify listing procedures and provide direct or indirect financial support for advisory fees associated with listing. Design mechanisms for companies listed in the Secondary List to transfer to the Main List.
Corporate bond issuance remains very limited, which is related to the high costs of obtaining creditworthiness information as well as low financial literacy, particularly among smaller firms.	Consider using data from the credit registry and the State Revenue Service to provide low-cost creditworthiness information on smaller firms and continue to improve the financial literacy of smaller firms.
Investments of pension funds, mostly in foreign assets, have yielded low returns, while many domestic firms have difficulties in accessing financing through domestic capital markets.	Raise investment and concentration limits of second-pillar pension funds for single issuer assets, real estate and private investment funds, while ensuring appropriate risk management and governance processes.
Common ownership between pension funds and banks is weakening competition and reducing asset returns for clients. Pension fund operating expenses are high.	Further improve the design of key information documents and provide a single point of access to aggregated information on investment performance and fees across all existing pension funds.
Application and reporting requirements for Venture Capital (VC) support programmes for start-ups are very stringent, resulting in a heavy administrative burden.	Simplify registration and reporting requirements for venture capital funds in line with EU regulation to reduce the administrative burden.
Exit strategies for start-ups are scarce due to shallow capital markets, which reduces access to VC finance.	Implement plans to introduce the public IPO fund.
Improving contract enforcement and insolvency procedures	
Insolvency proceedings remain long on average. The establishment of the Economic Court in 2021 has improved the efficiency of judicial proceedings concerning complex commercial disputes and large economic-crime, money laundering and corruption cases.	Expand the remit of the Economic Court, while raising its resources.
Insolvency procedures are costly and burdensome, discouraging low-income small business owners from filing for insolvency and hampering the reallocation of resources to more productive firms.	Increase the income threshold for the eligibility for legal aid of natural persons. Reduce the cost of filing insolvency to eliminate upfront barriers faced by debtors, while compensating insolvency administrators.
Property registries do not exist for machinery, creating uncertainty for leasing companies. Leasing of machinery is scarce.	Introduce a deed register for all leased assets to facilitate leasing as an alternative source of credit.

Strengthening innovation and digital adoption	
A lack of digital and management skills holds back digital adoption and innovation. Firm-provided training is weak due to poaching concerns and a lack of cooperation with VET institutes and training providers.	Establish a tri-partite training fund and improve cooperation in training design and implementation among firms and training providers.
Governance of innovation support programmes is weak and the administrative burden is high. Many small-scale programmes exist without a comprehensive impact evaluation.	Further centralise innovation support in a single agency, evaluate existing programmes and scale up the most effective ones.
The low number of researchers and PhD graduates weighs on innovation performance.	Continue to improve funding for PhD students and working conditions for researchers, while strengthening the links between research and university teaching.
Dropout rates in tertiary education are high, particularly in STEM fields. Funding for students to cover living costs is low.	Incentivise increased graduation rates through university funding allocation while controlling for quality standards. Increase the means-tested financial support scheme to cover living costs for students.
Improving competition enforcement	
Monitoring abuse of dominance in markets where SOEs and private companies compete is hampered by weak data transparency at the municipal level.	Require and dedicate the necessary resources to monitor the implementation of accounting separation between activities pursuing public policy objectives and commercial activities by all SOEs.
Time limits for merger control investigations are too short and the absence of stop-the-clock powers creates incentives for investigated firms to withhold information reducing the quality of assessments.	Align the Competition Law with the EU Merger Regulation to allow the Competition Council to suspend reviews until essential missing information requested from the merging parties is provided.
Although IT capacity of the Competition Council has improved, resources are not sufficient to regularly conduct ex-post evaluations of interventions to guide future investigations and decisions.	Further raise resources of the Competition Council for staff training, IT equipment and software to improve ex-post evaluations and expand its IT laboratory.

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