Ilmars Rimsevics: General economic developments and banking in Latvia

Speech by Mr Ilmars Rimsevics, Governor of the Bank of Latvia, Riga, November 2002.

*   *   *

With Latvia's economic indicators confirming sustained stability in the national economy, economic growth is likely to be balanced in 2002. Amidst somewhat weak economic activity in the external sector and downward adjustments of global economic growth projections for 2003, Latvia continues to report economic growth that is largely driven by domestic demand.

The performance of the Latvian economy has also been recognized internationally: in November, the rating agency Moody's Investors Service upgraded Latvia's credit rating. In its Regular Report on Latvia's Progress Towards Accession, the European Commission has acknowledged Latvia's macroeconomic stability and positively evaluated reforms undertaken to enhance the country's competitiveness. The European Commission has nominated Latvia among the ten countries ready for accession to the European Union in 2004.

Inflation remains low: in October, consumer prices rose 1.6% year-on-year and 0.8% month-on-month. The pick-up in consumer prices was largely a result of seasonal increases in food, and clothing and footwear prices. Core inflation was 1.3% in October. The inflation rate is projected to be around 2% in 2002.

Increasing economic growth rates observed in the third quarter can be attributed to the sustained high level of domestic demand and new orders from external markets. Strong production indicators in some of the sectors, marked growth in the retail trade sector, and increases in non-financial investment and lending are all evidence to this.

With more orders placed with the manufacturing sector, its real output rose in July and August (8.1% and 3.1%, respectively). The most pronounced growth of non-financial investment and loans was observed in the manufacturing and construction sectors, as well as some areas of the service sector, mostly in trade, the financial sector, commercial and other services.

Retail trade turnover continued to increase at a rapid pace in August (by 22.5% year-on-year), as population's income and loans granted grew and the size of the shadow economy in the retail trade sector declined.

Although growth in oil product transit by rail accounted for the September increase in cargo traffic by rail, oil transportation by oil main to the Ventspils port continued to decline. Thus declining transit of oil and oil products restrained a more rapid economic growth. In September, cargo turnover at the Ventspils port decreased, while the other ports of Latvia performed well.

Vibrant economic activity allows us to project that GDP growth will be higher in the latter half of 2002 (5.5%-5.7%) than it was in the first half of the year; and therefore, real GDP is expected to grow by 5% in 2002.

The year-on-year growth of 10.0% in Latvia's exports that was observed in the first nine months of 2002 despite weak global economic growth should be noted as a positive development. In the country breakdown, exports grew in all groups, with most rapid growth reported in exports to the United States, Sweden, Russia and Lithuania. Exports to the principal trading partner, the European Union, rose 6.9%. The principal contributors to the growth were exports of prepared foodstuffs, wood, furniture, machinery and mechanical appliances, electrical equipment, and base metals and articles of base metals. With domestic demand remaining high, imports were up by 12.6%.

As Latvia's exports rose more markedly, deficit in the balance of payments current account decreased substantially in July and August. In September, the current account deficit increased again, as imports of goods rose.

In the first nine months of 2002, the services surplus was 12.0 million lats higher than the year before. The increase in the services surplus resulted from rising exports of travel and other services and lower imports of other services. The transportation services surplus declined largely because of a low cargo turnover at the Ventspils port. In the first nine months of 2002, the services surplus covered 40.5% of the goods deficit.

The current account deficit continued to be adequately covered with foreign direct investment (in the amount of 75.5% in the first nine months of 2002). If the external and internal economic environment does not deteriorate at the end of the year, the current account deficit for 2002 is likely to remain at 8.5% of GDP.

The country's fiscal position was still better than the year before. In the first nine months of 2002, fiscal deficit in the general government consolidated budget was 19.8 million lats (2.2 times higher than the year before, when the deficit amounted to 43.6 million lats). The general government consolidated budget was affected by an increase in the local government consolidated budget fiscal deficit, which amounted to 20.3 million lats. Nevertheless, according to the preliminary data released by the State Treasury, the fiscal position continued to improve also in October: the central government basic budget reported the highest monthly revenues this year. As tax and non-tax revenues have exceeded projections and expenditures are likely to remain lower than projected until the end of the year, the budget deficit for 2002 is expected to be below 2.0% of GDP.

Developments in the banking system

In October, liquidity conditions in the Latvian money market tightened slightly. In the interbank market, interest rates on transactions of shorter maturity (up to three months) rose, owing to stricter monetary policy followed by the Bank of Latvia in the latter half of the month and the end of the reserve maintenance period. However, the behaviour of interest rates on lats interbank market transactions of longer maturity (over six months) – they continue to drop, reaching historical lows – confirm that the tightening of liquidity conditions is only temporary.

At the end of October, the overnight RIGIBOR rose to 4.0%, while the six-month RIGIBOR, to which interest rates on lats loans to domestic enterprises and private persons are usually fixed, dropped to 4.2%, promoting further decreases in interest rates on lats loans.

Falling money market rates and escalating bank competition fostered a decline in interest rates on lats transactions by domestic enterprises and private persons. In September, interest rates on loans in lats fell to a record low. The weighted average interest rate of short-term loans in lats dropped to 6.52%, below that of short-term loans in the OECD currencies, which was at 7.89%. Likewise, the weighted average interest rate of long-term loans in lats fell (to 8.13%), though it still remained higher than that of long-term loans in the OECD currencies (6.30%).

The weighted average interest rates of short-term and long-term deposits made in lats declined, down to 2.71% and 4.53%, respectively. The weighted average interest rate of short-term deposits in the OECD currencies decreased to 2.05%, whereas that of such long-term deposits rose to 5.19%.

The downward trend of lending rates and several sizeable loan projects in the trade, wood processing and transport sector promoted lending in September. Higher growth rates, however, have not impaired loan quality. The share of non-performing loans in total shrank to 2.2% at end-September.

In September, loans to domestic enterprises and private persons rose 4.3%, reaching 1 664.2 million lats. This was the most rapid monthly increase in loans this year (annual growth was 43.0%). Loans to enterprises grew in excess of loans to private persons (increases of 49.7 million lats and 19.5 million lats, respectively). An increase of 73.3 million lats was recorded in long-term loans, whereas short-term loans declined slightly.

The increase of 19.4 million lats in mortgage loans was the largest increase in loans. This can be attributed to the fact that the real estate market deepens and people increasingly start construction of housing and repairs of dwelling they own. Commercial and industrial credit, which are related with the development of the trade and industrial sectors, increased considerably (by 18.9 million lats and 9.6 million lats, respectively). The most rapid annual increase was recorded in mortgage loans (95.2%).

At the end of September, loans granted by banks totalled 1 909.7 million lats (a month-on-month increase of 3.7%).

In September, total deposits decreased by 2.8% (to 2 702.1 million lats), but deposits received from domestic enterprises and private persons (1 234.6 million lats) rose 0.5% over August and 23.0% over September 2001.

In September, banks' assets (excluding trust assets) grew by 0.6% (a year-on-year increase of 26.4%), reaching 3 963.4 million lats.

Banks' equity increased by 1.8% in September, totalling 365.9 million lats at the end of September (a year-on-year increase of 37.8%). Banks' profit for the first nine months of 2002 was 39.3 million lats (a year-on-year increase of 35.8%).

The most significant event in the Latvian securities market was the new issue of 10-year mortgage bonds by the state joint-stock company *Latvijas Hipotēku un zemes banka*. These securities have the longest maturity of all Latvian securities. Mortgage bonds were successfully auctioned on the Riga Stock Exchange and all bonds supplied (3 million lats) were sold at the average yield of 5.98%.

In September, broad money M2X grew by 0.5% month-on-month and 18.8% year-on-year, totalling 1 736.2 million lats.

As in the past months repayments were made under currency swap arrangements, in October the Bank of Latvia's net foreign assets declined by 47.0 million lats, while the backing of the national currency with the Bank's net foreign assets remained high at the end of October, at 110.2%.

In October, the demand for cash continued to increase, and currency in circulation grew by 7.2 million lats (by 6.5 million lats in September), reaching 576.2 million lats. At the same time, no major changes were observed in banks' deposits with the Bank of Latvia. Hence, the monetary base rose 7.6 million lats over its September level (to 665.5 million lats).

At the end of October, the exchange rate of the US dollar against the lats, 0.606, was unchanged from end-September, while the exchange rate of the euro, 0.595, was up slightly. At the end of October, exchange rates of the above currencies as quoted by banks equalled official rates set by the Bank of Latvia.

Bank of Latvia

The main objective of the Bank of Latvia, as defined by the Law "On the Bank of Latvia", is to implement monetary policy by controlling the amount of money in circulation with the aim of maintaining price stability.

The independence of the Bank of Latvia is guaranteed by the Law "On the Bank of Latvia" and ensured in practice. The Bank also meets all prerequisites, as established by the European Monetary Institute, for independence of the central bank. No institution or person can influence the Bank's decisions. The Governor is appointed by the Saeima of the Republic of Latvia. Likewise, upon the Governor's recommendation, it appoints members of the Board of Governors. All the above officials are appointed for a six-year term. The Governor, the Deputy Governor and members of the Board of Governors may be discharged before their term of office only if they have tendered their resignation, if a court decision on sentencing any of them for a deliberate crime has taken legal effect, or the Governor, the Deputy Governor or a member of the Board of Governors is not able to officiate for a period exceeding six successive months because of illness or some other reason.

The Law prohibits the Bank of Latvia from granting direct credit to the Government for the needs of covering budget deficit. In addition, the Bank of Latvia does not have the right to buy government securities on the primary market.

The Bank of Latvia has developed and is using the full set of the same indirect, market based monetary policy instruments that are used by the European Central Bank.

On May 18, 2000, the Bank of Latvia was assigned quality management ISO 9002 certification.

Movement of capital

Both current and capital account transactions have been fully liberalised in Latvia. There are virtually no restrictions on cash and capital flows to and from Latvia. The Bank of Latvia ensures the convertibility of the lats by buying and selling unlimited amounts of the SDR basket currencies to banks at their request.

In 2000, the Bank of Latvia introduced the interbank automated payment system (SAMS), which is a real-time gross settlement system. It conforms to the relevant requirements of the European Central Bank and may be joined in the TARGET system.

Brief description of the banking sector

Currently, financial services are provided by 22 banks and one branch of a foreign bank (Riga Branch of Nordea Bank Finland Plc). A representative office of Dresdner Bank AG (Germany) operates in Latvia, but it has no right to render financial services.

According to the Financial and Capital Market Commission, foreign shareholders owned 67.8% of total share capital in Latvian banks at the end of 2001. In 10 banks, foreign shareholders held over 50% of share capital.

The restructuring of the banking sector has been completed: the industry is almost entirely in private hands (the state owned only 4.5% of banks' total share capital as at 31 December 2001). The state is the owner of only one bank, the state joint-stock company *Latvijas Hipoteku un zemes banka*, and holds 32% of interest in the joint-stock company *Latvijas Krajbanka*.

Banking legislation

General. The legislative framework for banking meets the EU requirements in full, and in some areas the requirements are even more rigorous. International Accounting Standards (IAS) have been fully introduced; banks' annual reports are prepared in accordance with IAS and audited by internationally recognised auditing firms. Practical supervision is very tight and bank inspections are conducted more frequently than in the EU member states.

Licensing. The required minimum initial capital to establish a bank is 5 million euros. Foreign banks that want to establish representative offices or branches in Latvia face no restrictions. The prudential requirements that they must meet are the same as for domestic banks.

Legislation. The principal relevant law, the "Law on Credit Institutions", has been in force since October 24, 1995, and it has been amended on several occasions. The regulations of the Financial and Capital Market Commission and the Bank of Latvia detail the requirements set by the Law. The whole set of regulations normally used by a supervisory authority is in place and corresponds with the EU standards.

The Law "On the Prevention of Laundering of Proceeds Derived from Criminal Activity" came into effect on June 1, 1998. The Law fully conforms with the relevant EU directive: it requires customer identification and keeping records on all transactions, defines suspicious transactions and obliges banks to report them to a special control institution (Disclosures Office).

The Law "On Natural Person Deposit Guarantees" came into effect on October 1, 1998. From January 1, 2002 until December 31, 2003, deposits will be guaranteed up to the level of 3 000 lats. This applies to all deposits made with banks that are subject to this Law, regardless of the day a deposit was made. The Law prescribes a schedule for increasing this amount to the level required by the EU directive (13 000 lats) in six years. As of 2003, the guarantees will also be applied to deposits of legal persons.

As of July 1, 2001, the financial sector is supervised by a single supervisory authority, the Financial and Capital Market Commission, the successor, in this area, to the Bank of Latvia. Hence, the financial sector will continue to benefit from the supervision framework that is among the strictest in Central and Eastern Europe.

Latvia's integration in the European Union and the introduction of the Euro

The Bank of Latvia's policy responses are based on this country's strategic goal, which is accession to the EU, and the task of the Bank of Latvia is to prepare the country for joining the Economic and Monetary Union. In light of its commitment to joining the EU, Latvia is aiming towards both nominal and real convergence with the EU member states. Real convergence is a long-term objective, but Latvia is well on its way of achieving it.

Since 1996 real GDP growth in Latvia has exceeded GDP growth in the EU (except in 1999), thus narrowing per capita income differences.

The structure of Latvian GDP is in line with that of the developed countries: the shares of agriculture and manufacturing in total value added declined from 10% in 1995 to 4% in 2001 and from 22% to 13%, respectively, while the share of services increased from 56% to 63%.

Latvia's export structure by trade partner indicates expansion in the share of exports to the EU: 61.2% of total exports in 2001 went to the EU member states.

Although accession countries are not required to meet the Maastricht convergence criteria, we have set fulfilling the Maastricht convergence criteria as a medium-term target in the area of nominal convergence. Already now Latvia complies or is close to complying with most of them.

– In October, consumer price inflation was 1.6%.

– Gross government debt was only 15.0% of GDP at the end of 2001.

– There was no budget deficit in 1997 and 1998. In 2000 and 2001, the budget deficit was below the Maastricht ceiling, i.e., 3% of GDP.

– Yields on government bonds, while still higher (5.54% for 5-year Treasury bonds in July 2002) than the Maastricht criteria, are on a downward trend and their maturity continues to increase. We expect to be able to meet the requirements in the medium term.

– The lats has been pegged to the SDR basket of currencies at a constant exchange rate since 1994. Latvia has thereby shown that it is ready and able to meet the currency stability criterion.

During the pre-accession period, the exchange rate peg of the lats to the SDR will be maintained. This peg has served the Bank well and has ensured narrower exchange rate fluctuations than a possible peg to any single currency. In addition, the composition of Latvia's foreign trade by settlement currencies closely resembles the composition of the SDR basket, with the US dollar and the euro being the major component in both.

The Bank of Latvia will be prepared to join the European System of Central Banks at the time of Latvia's accession to the EU. The structure and objectives of the Bank of Latvia, the degree of its independence and its set of monetary policy instruments are fully in line with those defined for the European System of Central Banks.