Mr Repse describes general economic developments and banking in Latvia

Notes delivered by Mr Einars Repse, Governor Bank of Latvia, at the 5th Annual International Conference and Exhibition “Banking and Finance in the Baltics 99”, held in Riga on 13-15 October 1999.

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General economic developments

Since 1996 and until the third quarter of 1998 Latvia experienced a period of accelerated economic development.

It was characterised by:

- High GDP growth - 8.6% in 1997 and the same level of growth in the first half of 1998.
- Continuously declining inflation - 2.8% at year end 1998.
- Growth in exports and orientation of trade increasingly towards the European Union (EU).
- This has been a continuous and sustainable trend backed by sound and responsible economic policies of the government. No budget deficit - even a surplus was recorded in 1997 and 1998. Public borrowing in mid-1998 was just around 10% of GDP.
- These policies were and continue to be strongly supported by the tight monetary policy pursued by the Bank of Latvia. For more than 5 years, the cornerstone of this policy has been and continues to be exchange rate stability. The national currency has been pegged to the SDR (the IMF basket of currencies) since February 1994, and its value against the SDR has remained unchanged.
- Macroeconomic stability, improving investment climate and continuing structural reforms have all contributed to increasing investor confidence. Foreign direct investment (FDI) attracted in 1996-1997 more than doubled and in 1997 constituted 9.3 % of GDP, covering the current account deficit.
- However, unfavourable external developments, first and foremost the Russian crisis, caused a considerable slow-down in Latvia’s economic growth in the second half of 1998 and at the beginning of this year.
- The budget for 1999 originally adopted by the central government was balanced. Under current circumstances, however, a fiscal deficit of 3-3.5% of GDP is planned for this year. It is important to stress that this was an extraordinary measure. The government has every intention to reduce the deficit to a minimum next year, and a balanced budget remains its objective for the near future.
- Despite the unfavourable external conditions, the Latvian economy already shows signs of recovery. After the first six months of 1999, there has been a visible upward trend of economic activity, particularly due to a much stronger performance in the service sector. Substantial number of Latvia’s export-oriented businesses have made concerted efforts to find new markets, and the geography of Latvian foreign trade has expanded as a result. Currently, more than 60% of Latvian foreign trade is with the EU countries, and new export partners have been found in Latin America, Middle East and other regions.
- FDI still remains the main source of financing for the current account deficit. Denmark, USA, Sweden, Germany, Russia and the United Kingdom are at the top of the investor’s list.

- These positive developments allow us to forecast a moderate GDP growth of roughly 1% in 1999, with annual inflation remaining low at approximately 2.5%.

The Central Bank

The main objective of the monetary policy of the Bank of Latvia, as defined by law, is price stability.

Independence of the Bank of Latvia is guaranteed by law and ensured in practice. No institution or person can influence the Bank of Latvia's decisions. The Governor and members of the Board of Governors are appointed by the parliament for a six-year term and cannot be dismissed, thus their personal independence is ensured. The central bank's budgetary independence is also secured.

The Bank of Latvia has adopted the full set of indirect, market-based monetary policy instruments in use at the European Central Bank. Currently we are in the process of fine-tuning these instruments and increasing their efficiency.

Capital movements

Both current and capital account transactions have been fully liberalised from the first days of Latvian independence. There are virtually no restrictions on cash and capital flows to and from Latvia.

Banking sector development

At present there are 25 commercial banks in Latvia, including a branch of the French Société Generale and subsidiaries of the German Vereinsbank, Finnish Merita Nordbanken and Estonian Hansabank. Important foreign banking institutions are major shareholders in several Latvian banks.

The restructuring of the banking sector is practically complete: the industry is almost entirely in private hands. Only one medium-sized bank (Mortgage and Land Bank) remains state-owned, and another one (Latvian Savings Bank) has the state as an important shareholder (41%).

At end-September 1999, total assets of the banking sector reached Lats 1.73 billion (around USD 3 billion), and total equity - Lats 169 million (around USD 290 million).

Stable growth from 1996 to the first half of 1998; impact of the Russian crisis after August 1998

The banking sector reported particularly rapid growth starting with the second half of 1996. It was stable, orderly and controlled growth that went hand in hand with positive developments in the real economy and occurred within the tight framework of banking regulations and strengthened supervision.

In 1996-1997, the annual increase in the banking sector's main indicators (assets, equity and deposits) was in the range of 50-60%. This growth, which continued during the first half of 1998, was very much fostered by considerable improvement in the economic and legal environment in Latvia.

The Russian crisis of 1998 held the development back somewhat: some contraction of the banking sector took place in the last quarter of 1998.

Most banks proved able to withstand the external shock and re-orient their investment and lending policies rapidly. The first 9 months of 1999 witnessed stable growth of 10% to 15% in all major banking indicators (assets, equity, deposits and credits). The total profit of the Latvian banking industry reached Lats 17 million in the first three quarters of 1999.

Bank lending

Development has been most pronounced in the area of bank lending, and it has continued despite the Russian crisis. The remarkable increase in bank lending was not accompanied by deterioration of credit portfolios - on the contrary, the quality of bank assets has improved considerably since 1996.

Most of the loans - more than 90% - are issued to the private sector.

A gradual shift towards medium- and long-term lending normally associated with lending to the productive sector of the economy has been ongoing and currently accounts for 63% of total loans.

Loan loss provisions

At the end of September 1999, the share of non-performing loans in total loans for the whole banking sector was 6% (bad or "lost" loans 1%). This indicator has considerably improved since the end of 1996.

In our opinion, these figures indicate realistic credit risk assessment and, in a transition economy, can scarcely be provided any lower that proper evaluation methods are used. Our loan-loss provisioning scheme is very tight (tighter than in western economies) and strictly enforced, so that non-performing loans do not pose any threat to the stability of the banking system.

Banking sector: legislation and supervision

General

The legislative framework for banking meets EU requirements and in some respects exceeds them. International Accounting Standards (IAS) have been fully introduced; annual reports are prepared in accordance with IAS and audited by internationally recognised auditing firms. Practical supervision is very tight and bank inspections are more frequent than in EU countries.

Licensing

Required minimum initial capital to establish a bank is 5 million euro. There are no restrictions for foreign banks to establish subsidiaries or branches in Latvia except for prudential requirements, which are the same for domestic and foreign banks.

Legislation

The principal basis - the Law "On Credit Institutions" - was adopted in 1995 and incorporates subsequent amendments. The Bank of Latvia regulations make the requirements set by the law more specific. The whole set of regulations normally used by a supervisory authority is in place and corresponds to EU standards. The regulations apply to minimum initial capital, own funds, capital adequacy ratio, liquidity requirements, large exposures, open foreign exchange positions, loan classification and provisioning.

The law against money laundering came into effect on 1 June 1998. The law fully conforms to the respective EU directive: it requires customer identification, keeping records on all transactions, defines suspicious transactions and obliges banks to report them to a special control institution (Disclosures Office).

Law on deposit guaranties came into effect on 1 October 1998. Presently deposits are guaranteed up to the rather moderate level of Lats500, however, the law sets a timetable for increasing this amount to the level required by the EU directive. Initially the law will cover only natural person deposits, and later on we will apply to legal persons as well.

Remaining tasks

We are currently working on the implementation of two more advanced EU directives, relating to consolidated supervision and capital adequacy. This means that by the end of 1999 the regulatory framework for banking activities in Latvia will be completely harmonised with EU requirements.

Practical supervision

Banking supervision in Latvia is well advanced and among the strictest in Central and Eastern Europe. The Bank of Latvia has been invited by the EU Tacis (Technical Assistance to CIS) programme to participate in a major project aimed at bank restructuring in Ukraine.

Currently there are 55 staff members in our Credit Institutions Supervision Department. A number of them deal with on-site banking inspections, others with off-site analysis. Our inspection teams visit each commercial bank 2 to 3 times per year, in addition to regular audits by external auditors. In 1998, 95 on-site inspections by the Bank of Latvia took place in Latvian commercial banks. Compared to western practices, these figures are very high. Due to the improvement of analytical skills of our staff, in the future more emphasis, as elsewhere, will be put on off-site analysis, and the frequency of on-site inspections will obviously decrease.

As a result of all this work, we have been able not only to set regulations for banks, but also to fully enforce their compliance.

Bank of Latvia's policies and the introduction of the euro

Our policy responses to the euro are based on the general objectives set by our country. Accession to the EU is a strategic aim for Latvia, and we see entry in the European Monetary Union as a part of this task.

We have adopted the fulfilment of Maastricht convergence criteria as a medium-term target, and will be able to meet all of them in 4 to 5 years. Latvia already complies or is close to complying with most of them:

- the public debt is much lower than Maastricht requirements, i.e. 13% of GDP;
- there has been no budget deficit in 1997 and 1998; the fiscal situation in 1999 was strongly influenced by external factors, and the government intends to reduce the deficit in 2000 below Maastricht requirements;
- the Lats has been pegged to the SDR at a constant exchange rate since 1994, and, in principle, we are meeting the currency stability criteria;
- inflation has declined to a stable level below 3%, close to the Maastricht targets;
- government bond yield rates, while still high, are on the downward trend, and we expect to be able to meet the requirements in the medium-term.

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 the set of monetary policy instruments are fully in line with those defined for the European System of Central Banks.

During the pre-accession period, the exchange rate peg of the Lats to the SDR will be maintained. This peg has served us well and has ensured less exchange rate fluctuation than a 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 USD being the major component in both.

However, we are closely monitoring the new European currency. We hope that the euro will become a stable currency and anticipate its wider use in world trade. If this happens, we will have all the necessary economic grounds for joining the European Monetary Union after Latvia's accession to the EU.