Ilmars Rimsevics: General economic developments and banking in Latvia

Notes by Mr Ilmars Rimsevics, Governor of the Bank of Latvia. Overview in December 2002.

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General Economic Developments

In November 2002, Latvia's sound macroeconomic development was acclaimed on an international scale. The invitation to begin accession talks to join NATO is politically significant and homage to Latvia's security and stability, and this, no doubt, will be a positive stimulus for economic growth, as Latvia's membership will reinforce its security, fostering inward flows of investment.

As Latvia's integration into the European Union (EU) is seen as an irreversible process and a significant constraint on eventual risk probability, for the first time since 1997 the international rating agency *Moody's Investors Service* upgraded Latvia's credit rating from Baa2 to A2 with regard to long-term loans in foreign currency and Latvia's eurobonds and from Prime2 to Prime1 with regard to short-term liabilities in foreign currency.

In its autumn report on economic developments in the accession countries, the European Commission retained for Latvia the highest annual GDP growth projections, at 5% in 2000 and 5.5% in 2003, among the accession countries.

As projected, economic growth was more pronounced in the third quarter than in the first half of the year. Higher economic indicators were a result of the sustained high level of domestic demand and a more pronounced increase in external demand. The output indicators of manufacturing, construction and trade increased at a more rapid pace than at the beginning of the year, showing year-on-year increases in the third quarter:

- 7.9% in the manufacturing sector, owing to a considerable increase in new orders;

- 8.4% in the output of the construction sector (at constant prices);

- 20.9% in retail trade turnover (at constant prices);

- a continued decline was observed in the transit of oil and oil products (by rail and by the oil main) and turnover at the Ventspils port in the third quarter. Nevertheless, in October transit by rail, including the transit of oil products, grew rapidly (by 29.1% year-on-year). The decrease in turnover at the Ventspils port, which is the largest in Latvia, slowed, whereas turnover at the ports of Riga and Liepāja continued to show marked increases. Hence, the decrease in total turnover at the ports of Latvia was considerably lower in October (6.5%) than in the past months.

GDP growth is expected to be more rapid in the latter half of 2002 than in the first one, at 5.6% to 5.7%. The principal contributors are likely to be manufacturing, construction, trade, a number of other areas of the service sector, and transport, storage and communications, of which the latter has shown significant improvements over the third quarter. Real GDP growth is likely to be about 5% in 2002.

Inflation remained low. In November, consumer prices were 1.6% higher than the year before and 0.8% higher than in October. The November pick-up in consumer prices was mostly a result of increases in food prices. The core inflation rate was 1.3% in November. The inflation rate for 2002 is projected at 2%.

In the first nine months of 2002, Latvia's exports and imports of goods showed year-on-year growth of 10.0% and 12.6%, respectively. Exports to the EU member states rose by 6.9%.

Higher export growth observed in the recent months was partly attributable to the low level of exports in the corresponding period of 2001, when demand in Europe, along with exports, dramatically fell, and this year's significant increase in new orders.

The growth in exports was mostly effected by higher exports of prepared foodstuffs, wood, metals, furniture, and appliances and equipment. The most rapid growth was observed in exports to the United States, Sweden, Russia and Lithuania.

According to preliminary data, the current account deficit (about 8.6% of GDP) declined in the third quarter compared with both the previous quarter (by 9.3%) and the third quarter of 2001 (by 10.3%), because exports of goods increased more rapidly than imports, and the current transfers surplus increased substantially.

In the first nine months of 2002, the services surplus was 12.0 million lats higher than the year before. Although transportation services rendered to non-residents decreased significantly, the services surplus increased as proceeds on travel services were higher (mostly due to the increasing number of foreigners visiting Latvia) and the other services balance improved. In the first nine months of the year, the services surplus covered 40.5% of the goods deficit.

Due to qualitative changes in collection of balance of payments statistics, the current transfers surplus increased by 88.6 million lats in the first nine months of 2002, covering 18.8% of the goods deficit.

The current account deficit continued to be covered largely by foreign direct investment (in the amount of 75.5% in the first nine months of the year).

Provided the internal and external economic environments do not deteriorate significantly at the end of the year, the current account deficit is likely to be 8.5% of GDP in 2002.

The country's fiscal position was better than in the past year. In the first ten months of 2002, fiscal deficit in the general government consolidated budget totalled 32.1 million lats. (Fiscal deficit was 1.4 times or 46.0 million lats higher in the corresponding period of the past year.)

Nevertheless, there are grounds to expect that the fiscal deficit in the 2002 general government consolidated budget will remain at the level of 2001, not exceeding 2.0% of GDP.

The Cabinet of Ministers has basically accepted the projections for budgetary revenues for 2003, according to which revenues in the central government basic budget will be 7.3% higher than those projected for 2002. No agreement over expenditures projections has been reached.

The Bank of Latvia has highlighted the importance of tight fiscal policy in ensuring a balanced development in the national economy. Under the fixed exchange rate regime, achieving fiscal discipline is of particular importance. The Bank of Latvia encourages the Government to draw up the state budget for the next year so as to keep the deficit below 2.0% of GDP. In case tax revenues grow in excess of projections, the expenditures, which are not included in the next year's budget, could be revised.

Developments in the Banking System

Interbank market rates on lats transactions continued to follow a downward trend in November. The overnight RIGIBOR dropped from 4.0% at end-October to 3.0% at end-November, while the six-month RIGIBOR, to which interest rates on lats loans to domestic enterprises and private persons are usually fixed, fell from 4.2% to 4.1%, respectively.

In October, interest rates on loans in lats and the OECD currencies granted to domestic enterprises and private persons fell, reaching a record low. This downward trend was promoted by a gradual decrease in money market rates on lats transactions of longer maturities and escalating competition.

The weighted average interest rate of short-term loans in lats dropped to 6.42% and that of short-term loans in the OECD currencies was down to 5.59%. At the same time, the weighted average interest rate of long-term loans in lats declined to 7.43%, and that of long-term loans in the OECD currencies fell to 6.16%.

A slight month-on-month increase in October notwithstanding, deposit rates remained rather low. Basically, lending and deposit rates have followed a falling trend since the beginning of the year.

The weighted average interest rate of short-term deposits in lats was 2.97% (2.71% in September), and that of long-term deposits was 5.44% (4.53% in September). The weighted average interest rate of short-term deposits in the OECD currencies was 2.19% (2.05% in September), while that of such long-term deposits declined from 5.19% to 3.20%.

The demand for cash continued to rise, and currency in circulation grew by 9.6 million lats (by 7.2 million lats in October), amounting to 585.8 million lats.

In October, loans to domestic enterprises and private persons increased by 4.2% (a year-on-year increase of 46.4%), totalling 1 734.3 million lats.

Loans to domestic enterprises increased by 38.5 million lats, and loans to domestic private persons grew by 31.6 million lats.

In October, the largest growth was observed in long-term loans (by 62.5 million lats). At the same time, short-term loans increased by only 7.6 million lats.

The development of the real estate market and a downward trend in lending rates fostered further rapid growth in mortgage loans, which rose by 25.1 million lats in October. The year-on-year growth in mortgage loans was 81.9%. Significant increases were recorded also in commercial credit and industrial credit, which are related to the development of the trade and industrial sectors (21.5 million lats and 13.3 million lats, respectively).

At the end of October, loans granted by banks totalled 1 989.5 million lats (4.2% higher than at the end of September).

Deposits with banks rose 9.3% in October, amounting to 2 954 million lats.

Deposits by domestic enterprises and private persons (1 261 million lats) were 2.2% higher than in September and 22.9% higher than in October 2001.

In October, banks' assets (excluding trust assets) increased by 4.6% (by 27.5% over October 2001), totalling 4 147 million lats.

Banks' equity capital grew by 0.9% in October, reaching 369 million lats at the end of the month (a year-on-year increase of 29.4%).

Banks' profit for the first ten months of 2002 was 44 million lats (a year on-year increase of 34%).

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 and the Payment System

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 64.3% of total share capital in Latvian banks at the end of the second quarter of 2002. 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 7.9% of banks' total share capital as at the end of the second quarter of 2002). 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. The prudential requirements that foreign banks wishing to establish representative offices or branches in Latvia 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 the strengthening of the role of exports to the EU: in the first nine months of 2002, 60.3% of total exports went to the EU member states.

Although the 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 with most of them.

- In November, consumer price inflation was 1.6%.

- Gross government debt was only 11.9% of GDP at the end of the first half of 2002.

- 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 (5.38% for 5-year Treasury bonds in September 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.