SPEED AND SEQUENCING OF MARKET REFORMS: 
THE CASE OF BANKING IN LATVIA

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After gaining its independence from the former Soviet Union, Latvia’s banking sector initiated free market reforms. Initially, several apparent disequilibria existed in the market for banking services. This paper reports on the processes that generated these disequilibria as well as on the events that transpired as the market approached equilibria over time. (JEL L15, P21, P52)

I. INTRODUCTION

In 1991, Latvia withdrew from the Soviet Union and gained its independence as a sovereign state. It quickly embarked on the transition path to a market economy and, especially in the banking sector, initiated “free market” reforms. From 1991 to 1993, Latvia moved from centralized state banking to a market with 61 independent banks. In 1994 and early 1995, 11 banks failed including the largest, Bank Baltija, which held 23% of all deposits. There is no deposit insurance in Latvia, and the failure of some banks to honor their obligations to depositors has generated considerable political pressures on the Latvian government to take a more active regulatory stance. Several legislative proposals to restructure banking in Latvia have included compensating depositors who have lost deposits in failed banks, increasing capital requirements for banks, initiating deposit insurance, and limiting open foreign currency positions.

The difficult experience with market reforms in banking is not limited to Latvia. In the fall of 1995, the two largest banks in Lithuania failed. Together these two banks accounted for 25% of all deposits in Lithuania. Since 1991, 24 private Estonian banks have been closed or have had their operations suspended (Economist, 1/20/96, p. 79). Other republics of the former Soviet Union report similar crises. The future path of market reforms depends critically on the political response to these banking failures.

II. LATVIA’S MARKET REFORMS

Market reforms must ensure that the financial sector “serves industry and trade, not the other way around” (Akyuz, 1991, p. 37). However, no single Western model establishes how to accomplish this. As Akyuz (1991, p. 19) notes, “The experience of industrial countries shows that there is no single way of organizing finance. Consequently, an important issue in financial reform in developing (and Eastern European) countries is what types of financial institutions and markets need to be promoted.” Considerable variation exists in the way successful Western economies organize financial markets. A newly formed country like Latvia, might consider imitating the Japanese “administered, state led” financial system, the American “capital market, company led” system, or the German “negotiated, bank led” system (see Zysman, 1983, chapter 6). Thus, saying that “Latvia initiated market reforms in banking” oversimplifies the matter. One observer suggests that in Latvian banking “structural reform has been rapid and a laissez faire approach has been applied.”

Latvia has relied more on free market processes to reform its financial market than have most other countries. For example, comparing Latvia to other countries analyzed in the World Bank’s Financial Reform Lessons reveals that

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ABBREVIATIONS
CIS: Commonwealth of Independent States
SDR: Special Drawing Rights

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Latvia, more than other country, has initiated “big bang” reforms in banking by deregulating interest rates, privatizing banks, maintaining low reserve requirements, lifting capital controls, and granting “universal” banking powers to financial institutions (see Capio et al., 1993, Table 1).

Especially in banking, the Latvian government implemented market reforms quickly and with a minimum of government regulation. Government created entry barriers (e.g., initial capital requirements) were low. By 1993, 61 independent banks were operating in the Latvian market. Foreign banks were free to operate within Latvia, but by 1995, no foreign banks had exercised this option. Interest rates and exchange rates were market determined from the beginning, and no restrictions existed on international currency flows. More critically, the government did not provide deposit insurance. Given the rapid opening of Latvian financial markets, some observers saw Latvia as positioning itself to become Russia’s Hong Kong (Financial Times, 1995, p. 2).

The reform package sought to create a credible monetary system with a stable currency and low inflation. Figure 1 presents official inflation statistics for Latvia. Inflation dropped from 50% per month to 3% per month as Latvia separated itself from the Russian ruble. Latvia completed the introduction of its own currency (the lat) during 1993. Following its introduction, the lat has appreciated steadily against the dollar (see figure 2). This appreciation partly results from the Bank of Latvia’s pegging the lat to the SDR with the unofficial target rate of 1 SDR = 0.80 lat. The lat smoothly appreciated until meeting this target in early 1994. The remaining variation of the lat against the dollar is due to the dollar’s variation against the SDR (Saavalainen, 1995, p. 3).

The Bank of Latvia has pursued its goals while remaining quite independent from other branches of the Latvian government. As yet, the central bank has not deviated from its goal of maintaining a stable currency despite Latvia’s recent experience with high real interest rates, negative economic growth, and increased imports as foreign currencies responded to the appreciation of the lat. Since 1991, central bank president Einars Repse has maintained control of the central bank despite strong opposition from legislators.

Events in Russia heavily influence Latvian financial markets. The instability of the Russian ruble, high rates of Russian inflation, economic uncertainty, and restrictions on private banking in Russia all have contributed to flows of financial capital out of Russia and into the Latvian financial sector. In addition, the lat emerged as a stable currency, and Latvian banks offered high interest rates for deposits. During the early 1990s, Latvia appeared a safe haven for Russian financial capital, and the Latvian banking system took advantage of non-market pricing policies within Russia in order to facilitate trade with Europe. The large flow of foreign currency into Latvia resulted in excess reserves of foreign currency and induced the Bank of Latvia to buy foreign currency in its efforts to maintain its pegged exchange rate policy.

III. THE ORIGINS OF THE BANKING CRISIS IN LATVIA

In 1991, the Latvian government began implementing market reforms in the banking in-
industry. Three state-owned banks continued to operate, but private banks soon dominated the market. (The government owns only part of the three “state-owned” banks, which are in the process of being privatized.) Figure 3 shows the initial rapid increase in the number of banks operating in Latvia. By 1993, more than 60 independent banks were operating, but by 1995 bank failures began reducing this number. These figures do not reflect the fact that in 1996, in the wake of the banking crisis, the Bank of Latvia allowed only 11 banks to take deposits from individual Latvians. One could argue that only the top 20 banks had a reasonable prospect of surviving because they held approximately 90% of all deposits. Therefore, the analysis here concentrates on these larger banks and focuses in particular on the influential role played by the largest bank, Bank Baltija. Bank Baltija gained market share between 1993 and 1995. In early 1995, Baltija held about 23% of all deposits; 40% of Latvian depositors held their deposits in Baltija. Regulators declared Baltija insolvent in 1995. The Latvian government is unlikely to furnish any funds to repay depositors.

Table 1 shows the interest rates for one-year deposits at the top 20 Latvian banks in October, 1993. (Complete interest rate data exist for these banks for the period October 1993 to June 1995. The analysis here focuses on interest rates for deposits since interest rates on loans generally are not reported and may represent only a portion of the fees charged.) Currency was freely convertible, so depositors could choose to make deposits in lats or in dollars. Western observers will note three unusual points. (i) Considerable between-bank variance existed in interest rates. Competition in a market with a large number of firms normally forces prices to be about the same. (ii) The difference between interest rates on lat and dollar accounts is paradoxical given that the lat appreciated against the dollar by more than 10% between October 1993 and October 1994. In a market that anticipated appreciation of the lat, interest rates on dollar accounts would be higher than on lat accounts. (iii) The real rate of interest was abnormally high. Expected rates of inflation for Latvia may have been high in 1993; however, ex post Latvian annual inflation was 25% to 30% during this period (Bank of Latvia Annual Reports, 1994 and 1995). The rates on dollar deposits also were considerably higher that those offered in world markets at that time.

Time series data show that all three market paradoxes were on the way to being resolved after 18 months (figures 4a, 4b, and 4c). (Saavalainen, 1995, p. 16, presents data that
are broadly consistent with the data presented here.) Interest rates on lat deposits fell dramatically until they stood at about 20% in April 1995 (see figure 4a). Interest rates on dollar deposits also fell and by April 1995 also were about 20% per year (see figure 4b). Figure 4c shows that the difference between interest rates on lat and dollar deposits also fell until April 1995, when the difference essentially disappeared. The variation in interest rates offered by different banks also was approaching zero by April 1995. One thus can argue that equilibria emerged about 18 months after the disequilibria that seemed to exist in October 1993.

The analysis now examines the conditions which generated the initial disequilibria.

A. Cross Sectional Interest Rate Variation

How could a bank like Parex, offering 12% annual interest, attract depositors when Baltija offered 90% annual interest on lat accounts (see table 1)? Both Baltija and Parex gained in market share of deposits during 1994. Perhaps the differences reflect different perceptions of the risk of bank default. That is, depositors perceived Baltija to be more likely to default, and Baltija’s high interest rates represented a risk premium. But if depositors perceived Baltija to have higher default risk, then the risk premium would be reflected in higher interest rates for both lat and dollar deposits. Instead, Baltija offered below average interest rates for dollar deposits.

The risk premium explanation suffers from other shortcomings. The risk of default on deposits is the perceived probability that the bank will become insolvent times the probability that the government will not bail out the bank if it does become insolvent. A popular perception was that Baltija was “too big to fail”—that legislators would not run the political risk of allowing Baltija to fail since 40% of Latvian depositors had deposits in Baltija. Additionally, statistics published in Latvia’s leading newspaper (Diena, November 22, 1993, p. 10) revealed that Baltija had a higher ratio of “own capital” to deposits than did Parex Bank in September 1993. A Diena opinion poll (July 24, 1995, p. 4) posed the question, “Which bank do you trust the most?” Thirty-five percent of the respondents mentioned Bank Baltija while 25% mentioned Krajbanka, a state bank. Thus, the general public did not perceive Baltija to be a risky bank. Furthermore, assuming that risk of bank default explains differences in interest rates between banks raises the question of why this risk difference decreased over time as the interest
rates converged to 20% by the Spring of 1995, just as Baltija was about to fail.

Interviews with Latvian banking officials reveal the two explanations of the between-bank variation in interest rates that existed in October 1993. (i) The banking market was segmented, and banks offered differentiated products. Thus, Parex could expand its market share of deposits despite its low interest rates because it concentrated on servicing clients in Russia and Kazakhstan. Deutch-Lettish Bank successfully competed by catering only to large commercial depositors who demanded service in foreign exchange transactions. Other banks specialized in serving clients in the agricultural sector, the oil sector, or in specific regional markets. Baltija targeted small depositors. As one observer notes, “Baltija was successful in getting all the lats out of the socks and mattresses of the small depositors.” However, this explanation cannot account for the degree to which interest rates varied between banks (i.e., 12% at Pareks versus 90% at Baltija). And why did the between-bank variation in interest rates approached zero by 1995? One would have to argue that banks offered differentiated products in 1993 and that by 1995 this differentiation had largely vanished. Interviews with Latvian banking officials reveal that in 1996 banks increasingly were turning their attention to competing against one another for local business. In part, this has been a response to the exit of banks like Baltija. Some variation in interest rates persist. In May 1996, Pareks Bank offered 10% for one-year deposits in lats while Deutch-Lettish offered 18%. The between-bank variation observed in 1993 has fallen dramatically and may now represent what one would expect, given the degree of differentiation that exists in this market.

(ii) Another explanation offered for the variation in interbank interest rates concerns expectations of the lat’s future value. All banking officials interviewed mentioned that driving the high interest rates offered by Baltija and some other banks was their expectation that the lat would depreciate significantly over the next year, much like the Russian ruble. In October 1993, the lat had just been introduced as the national currency, and expectations concerning the lat’s future value varied. The lat’s future value depended on the future path of market forces as well as on the central bank’s future actions in currency markets. In both cases, there existed little history from which to extrapolate.

But why would banks differ so much in their expectations concerning the lat’s future value? The answer could arise from differ-
FIGURE 4a
Interest Rates for Lat Deposits

Source: Diena

FIGURE 4b
Interest Rates for Dollar Deposits

Source: Diena

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ences between banks in information sets or differences in the models they used to make forecasts. If all banks had access to the same information, then the differences in forecasts arose because the different banks used different models in generating forecasts. An important component of such a forecasting model would be central bank behavior in currency markets. Given the recent formation of the modern Latvian government, one can reasonably argue that no well accepted model existed of the political constraints operating on the central bank in pursuing its stated objective of maintaining a stable currency.

B. Large Differences in Interest Rates for Lat and Dollar Deposits

The Latvian banking community believed that Baltija and other banks expected the lat to depreciate considerably against the dollar after its introduction in 1993. Baltija aggressively expanded its one-year lat deposits by offering 90% annual interest. Baltija did not actively seek dollar deposits. Its interest rate for one-year dollar deposits was 18%, which was lower than the average. By converting the lat deposits into dollars, Baltija was speculating that the lat would depreciate during 1994 and that the conversion would earn foreign exchange profits sufficient to cover the cost of funds. According to one calculation, if the lat depreciated by more than 60% during a year, Baltija would have been able to pay 90% interest on its lat accounts and still earn a profit. (For example, a one year deposit of 100 lats would convert to $164 [lat/$ = 0.61 in October, 1993]. Assuming that dollars could earn 20% during a year, as was possible at several banks in Latvia, at the end of one year, this would be worth $197; if the lat had depreciated to lat/$ = 1.00, the bank would have 197 lats, which is sufficient to pay 90% interest and earn a profit.) In light of the Russian ruble's experience during this period, an expected 60% depreciation of the lat may not have been unreasonable.
At the same time, potential depositors held varying expectations concerning the rate at which the lat would depreciate. In order to attract deposits, banks needed to offer interest rates on lat deposits greater than the rate at which depositors expected the lat to depreciate. Thus, depositors who expected relatively low rates of lat depreciation went to banks that expected relatively high rates of lat depreciation. The net effect (see figure 5) was that total deposits from enterprises and individuals (excluding interbank deposits) rose 64% between October 1993 and January 1995. (Data are from Appendix 1 of the Bank of Latvia Annual Reports for 1994 and 1995.)


This provides a compelling explanation as to why Baltija offered an interest rate on lat deposits that was considerably higher than the interest rate offered on dollar deposits in the fall of 1993. The introduction of a new currency created large variations in expectations concerning the future value of the lat. Banks like Baltija offered an interest rate premium on lat deposits under the expectation that the lat would depreciate. Banks like Parex and Deutch-Lettish offered no interest rate premium under the expectation that the central bank would carry through on its promise to maintain the value of the lat. An interview with officials at Deutch-Lettish Bank supports this hypothesis. In October 1993, Deutch-Lettish reduced its interest rate on lat deposits from 60% to 35%, which is the same interest rate offered on its dollar deposits. This reduction occurred because Deutch-Lettish analysts in September 1993 concluded that the lat would be stable against the dollar over the next year. As time passed and as the central bank gained more widespread credibility for maintaining the lat’s value, expectations adjusted, and the interest rate differential largely disappeared by the spring of 1995.

C. High Real Interest Rates

Analysis of the connection between central bank monetary policy and interest rates reveals
a very weak, (and even positive) contemporaneous relationship between money supply growth rates and changes in interest rates between October 1993 and April 1995. Interest rates dropped considerably and money supply growth rates did not increase during this period. While the existence of lagged linkages between money supply growth rates and interest rates needs closer scrutiny, at least one other study finds the linkage to be obscure: "The link between interest rates and central-bank policy in Latvia is tenuous. Partly this is because financial markets are still in their infancy" (Vanags and Garry, 1995, p. 9).

If banks have a derived demand for deposits, then the high interest rates observed in October 1993 would result from the banks' high expectation of gaining profits from using deposits in either loan or speculative activities. In October 1993, the interest rates on loans in Latvia exceeded 10% per month while by the spring of 1995 interest rates on loans averaged about 5% per month (Saavalainen, 1995, p. 16).

These data contain a paradox. First, the high 1993 interest rates supposedly resulted from a strong demand for loans. However, banks were holding reserves of about 25% when the required reserve ration was only 8% (Bank of Latvia 1994 Annual Report). With interest rates so high, why were banks holding considerable excess reserves? Second, during 1994, the growth rate in the money supply did not increase, interest rates fell, and the total amount of loans increased. Falling interest rates combined with an increase in the total amount of loans suggests that the supply curve of loanable funds increased during this period. What generated this increase in supply? The drop in interest rates coincided with the fall in the average bank reserve ratio. Thus, one might conclude that the high interest rates existing in 1993 generated an excess supply of loanable funds and that the market responded to this excess supply as expected.

D. A Tentative Model

Officials in the Latvian banking community explain these puzzling conditions by conceding that in 1993 they were not operating according to market principles. However, the evolution of the Latvian banking market does seem broadly consistent with models of price competition. Consider three structural features of this market. (i) In 1993, there existed widely varying expectations of the rate at which the lat would depreciate. (ii) Banks offered differentiated products. (iii) Banks engaged in price competition for deposits. Consider a Bertrand model with a differentiated product. In this model, banks reactions to the interest rates offered by other banks would depend upon the degree to which they differentiated their products and upon their expectations of future lat depreciation. Banks engaging in greater product differentiation and expecting a relatively low rate of lat depreciation would offer lower interest rates on deposits. This may fit the case of banks such as Pareks and Deutch-Lettish. Pareks, which offered special services to CIS customers, maintained a low interest rate throughout the period and still was able to gain market share. A market where banks offer differentiated products, hold different expectations of the future exchange rates, and behave as Bertrand price competitors is able to generate between-bank interest rate variability of the sort presented in table 1.

As time passed, bankers updated their expectations to account for the Bank of Latvia's apparent strong backbone and secure political position, and the stability of the lat. In addition, bank officials report that banks moved into each others' markets. Given these structural changes, the Bertrand model predicts that interest rates would decline and that the variation in interest rates offered by different banks also would decline. In general, this result is consistent with the data.

Through 1994 and the spring of 1995, some banks (e.g., Baltija) faced a dilemma; assets were held in dollars while liabilities (e.g., deposits) were in lats, and the lat was continuing to appreciate against the dollar. The banks had attracted one-year deposits at high interest rates, and interest rates were falling so that interest income fell below the cost of capital. Banks facing this dilemma became insolvent by the beginning of 1995. Banks such as Parex and Deutch-Lettish offered lower interest rates in the beginning, did not speculate against the lat, and survived the crisis.

IV. POLICY ISSUES

The events that transpired in the Latvian banking market provide some insights for the debate surrounding the proper speed and sequencing of reforms during the transition from
a planned to a market economy. In June 1996, Bank of Latvia staff and members of the banking community answered the question, “In hindsight, should the market reforms have been conducted differently?” Some common policy questions emerged from these interviews.

1. The timing of bank privatization. Should bank privatization occur at the beginning of the reforms or be delayed until other sectors of the economy have stabilized? An official policy paper from the Bank of Latvia noted, “The first reason underlying the banking crisis in Latvia is that the banking system developed much ahead of the overall economic environment” (Bank of Latvia, 1996). For example, the banking crisis might not have been so severe had the government delayed introducing private banking until after central bank credibility had been established and incorporated into expectations. In the case of exchange rate expectations, the evidence from the analysis here suggests that about 18 months were necessary after the lat’s introduction before expectations adapted to reflect the lat’s stability. In terms of reform sequencing, one could argue that the monetary authority first successfully must reduce inflation and stabilize the currency and that private banks should be licensed to operate one year later. This sequencing does involve a cost. Banks’ rapid entry into the Latvian market did produce some responsible, effective, and progressive banks from the beginning. Delaying entry of such banks imposes significant costs on the economy.

2. Restrictiveness of licensing requirements. Suppose the equilibrium number of banks were 10. Should bank licensing requirements specify high levels of initial capital so that rates of entry are slow and so that the market gradually approaches 10 banks from below? Or, as in the Latvian case, should licensing requirements be low so that there is rapid initial entry and subsequent exit according to market selection criteria until the market approaches 10 banks from above? The low entry barrier approach runs the risk that some banks entering the market will fail. In the Latvian case, officials should have recognized that the market would not sustain 60 independent banks and that a significant risk of bank failure existed. According to the Bank of Latvia (1996, p. 1) policy paper on the banking crisis, the failure of banks “eroded confidence in the banking system. Many households and enterprises withdrew their deposits. Concurrently the lending by banks decreased as well, and the interbank market narrowed notably.” However, the strategy of erecting high entry barriers as a filter to screen out banks with no real prospect of surviving has its costs as well. Filtering will be imperfect. In the Latvian case, three of the largest banks failed and some of the smaller banks have grown and become successful players in the market.

3. Regulation of bank operations. The Bank of Latvia has identified areas where regulation may be desirable during the early stages of the transition. Important among these are tighter restrictions on insider lending. The Bank (Bank of Latvia, 1996, p. 1) suggests that there existed “a certain pressure on behalf of shareholders that resulted in risky insider or connected lending.” Additionally, a new regulation requires the Bank of Latvia to assign a risk classification for each bank’s loan portfolio. Each bank then is required to set aside a specified provision for doubtful loans. Also on the Bank’s list is a tighter restriction on open foreign exchange positions.

Regulations like these may generate a more orderly development of the banking market. However, this approach assumes that enforcement mechanisms are in place and are immune from manipulation. Despite the relatively low level of regulation that existed in the Latvian banking market, existing regulations were routinely violated through falsifying records and money laundering schemes. Some observers believe that the reform did not need more regulations but simply better enforcement of existing regulations.

4. Deposit insurance. This issue has received much attention in the Latvian financial community. All interviews generated the same response: If the reform package takes the approach of (i) early bank privatization, (ii) low entry requirements, and (iii) imperfectly enforced regulations, then the early reform package should not include deposit insurance. In the Latvian case, rapid early entry produced over 60 banks that followed distinctly different strategies. Both large and small banks adopted prudent, conservative polices emphasizing ser-
vicing commercial clients where one long-term goal was to build a reputation for high quality. At the same time, some banks (again both large and small) adopted risky and sometimes criminal strategies and centered their goals around short-term gains. For example, one bank offered high interest rates, which attracted depositors; then the owners transferred the money and vanished. Adopting deposit insurance at the early stages of reform could not possibly adjust premiums according to an experience rating since no history of past performance existed. Thus, banks would be pooled together regardless of the riskiness of their strategies. The attendant moral hazard problems would penalize banks that adopted less risky strategies, and the overall riskiness of the market would increase. A small group of banks that judged themselves to be among the group of banks following prudent strategies engaged in early discussion to privately provide deposit insurance. Due to public choice problems, the plan never was implemented. However, now that the banking crisis has occurred, the remaining members of the banking community are concerned with the perceived riskiness of the Latvian banks and the flight of deposits out of the market. Now that the market has culled the riskier banks, the remaining banks are less concerned that deposit insurance would place them in the same pool with risky banks. Widespread agreement exists that deposit insurance now should be implemented as a means to instill more confidence in the market. The main point here concerns the sequencing of reforms. Implementing deposit insurance is a policy that officials should consider later in the transition rather than at the beginning.

Hindsight provides some reason to argue that the Latvian reform policy should have implemented policies that would have reduced the extent of the banking crisis. However, ample evidence suggests the idea that market reform in banking has worked remarkably well in Latvia. Conditions in the fall of 1993 were inconsistent with the usual notions of a market equilibrium, but within less than 18 months the equilibria were quickly approached. The failure of banks is a normal cleansing process that purges the market of banks that follow inefficient policies. Banks such as Baltija that operated to borrow money from depositors in order to speculate in foreign currency have been forced out, while banks such as Deutch-Lettish that earn most of their income by providing services are prospering. The rapid entry of more than 60 banks provided a large sample, and the market is operating quickly to select those that adopt effective strategies. The "banking crisis" has created a demand for companion institutions, and these are rapidly being supplied. Western auditing firms are now actively supplying services in the Latvian market, and Latvian banks have formed correspondent positions with many European banks to facilitate risk management. Perhaps the most crucial elements contributing to the successes of this particular reform experience are that the Bank of Latvia maintained its stabilization policies until creditability was established and that the Latvian representative democracy did not react to the banking crisis by demanding a return to the past.

REFERENCES


