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FINANCIAL MARKETS IN THE BALTIC STATES IN THE CHANGING ENVIRONMENT

Ramona Rupeika-Apoga, University of Latvia, Latvia[1]

Abstract. Many agreed that in recent years the economic environment has changed very quickly, dramatically, and thus, creating new challenges for financial market development. But behind this too often scanned claim, almost everything else about this phenomenon is the subject of intense debate.

The **object** of this paper is the Baltic financial markets.

The **purpose** of this research is by analysing Baltic financial markets from international competiveness perspective to find how Latvia's financial market can benefit under changing environment.

To achieve the purpose the following **tasks** were conducted:

1) to identify the main characteristics of financial market soundness in the changing environment;
2) to assess Baltic financial markets from international competition prism;
3) to analyse access to finance through loans in the Baltic states financial markets;
4) on the basis of the author's findings to put forward offers, how Latvia's financial market can to benefit in the changing environment.

The study results highlight the need to recognize that countries require sound and well-functioning at the same time financial markets. Only in that case financial markets can provide recourses for investments as sound banking loans, properly regulated securities exchanges, venture capital, and other sources.

During development of the paper the generally accepted qualitative and quantitative **methods of economic research** were used including comparative analysis and synthesis, graphical illustration methods.

Key words: *financial markets, competiveness, Baltic States*

JEL code: G10

Introduction

Changing global economic environment has made it more important than ever to identify and contribute the qualitative as well as the quantitative aspects of financial markets growth, integrating such concepts as social and environmental sustainability to provide a fuller picture of what is needed and what works.

[1] Corresponding author – e-mail address: ramona.rupeika-apoga@lu.lv, telephone: +371 67034625

Financial markets all over the world face a number of significant and interrelated challenges that could prevent a real growth after an economic crisis as in the most advanced economies as in the developing markets as well. The remaining financial difficulties in the euro zone have led to a long-lasting sovereign debt crisis that has now reached the highest point. Scientists together with governments are looking for cooperation and management of the current economic challenges while preparing their economies to perform well in an increasingly difficult and changing environment. Financial markets activities mostly focused on the short-term crisis management, remain critical for countries to establish the fundamentals that contribute to economic growth and development in the long run.

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The structure of the paper is as follows. Chapter 1 explores the main characteristics of financial market soundness in the changing environment, by emphasizing in what directions we need to work to improve financial market efficiency: macroeconomic policy and data transparency; supervision and regulation of financial intermediaries and institutional and market infrastructure. Chapter 2 assesses Baltic financial markets from international competiveness perspective, paying attention to access to finance and trustworthiness and confidence of financial markets. Finally, in Chapter 3 the author looks for solutions how Latvia's financial market can to benefit in the changing environment taking into account our neighbour countries achievements, by analysing the main recourses of finances: loans.

The study results highlight the need to recognize that countries require sound and at the same time well-functioning financial markets. Only in this case financial markets can provide resources for investments as sound banking loans, properly regulated securities exchanges, venture capital, and other sources.

To analyse access to finance is a multifaceted task, the authors of the paper in this research have mostly concentrated on the main sources of finance- loans, as one of the main characteristics of financial market soundness.

During development of the paper the generally accepted qualitative and quantitative **methods of economic research** were used including comparative analysis and synthesis, graphical illustration methods.

1. Characteristics of financial market soundness

The recent economic crisis has emphasized the need of efficient financial markets. Efficient financial markets that are sound and well-functioning play the vital role for countries development. A characteristic of efficient financial market is that it channels funds from the ultimate lenders to the ultimate borrowers in a way that the funds are used in the most socially useful manner.

In the 1970s Eugene Fama defined an efficient financial market as "one in which prices always fully reflect available information" (Fama E., 1970). Financial markets allocate the resources saved by as local as foreign citizens to their most productive uses. Financial markets are more profit oriented than politically, that is why they transfer resources to those projects with the highest expected rates of return rather than to the politically connected. In the analysis of financial markets the examination of efficiency assumes an informational dimension, the existence of which may well be related to that of Pareto or productive efficiency, but the meaning of which is quite distinct (Leighton, 2005).

While most scientists believe the markets are neither fully efficient, nor fully inefficient, many disagree where on the efficiency line the world's markets fall. In reality a financial markets can't be considered to be extremely efficient, or completely inefficient and are a mixture of both, sometimes providing fair returns on the investment for everyone, while at other times certain investors will generate above average returns on their investment. In this research the author of the paper are not arguing about the market efficiency in general terms, but looking for key factors how Latvia's financial market can to benefit taking into account turmoil financial markets development in recent years.

Backed by solid empirical evidence, development practitioners are becoming increasingly convinced that efficient, well-functioning financial systems are crucial in channelling funds to the most productive uses and in allocating risks to those who can best bear them, thus boosting economic growth, improving opportunities and income distribution, and reducing poverty.(Fama E., 1991; Mankiw G., Phelps E. and Romer P., 1995; Clas W., 1990; Berger Allen N., Hunter William C., Timme Stephen G., 1993; Aghion P., Howitt P. and Mayer-Foulkes D., 2005).

To improve financial market efficiency we have to work in three directions: macroeconomic policy and data transparency; supervision and regulation of financial intermediaries and institutional and market infrastructure.

1. First of all on <u>macroeconomic policy and data transparency:</u> macroeconomic policy divides to monetary and financial policies and fiscal policy.
   To achieve transparency on monetary and financial policies we need to identify and develop:
   - what are the main responsibilities and targets of central banks and financial agencies, and their role in the market;
   - how to formulate and report monetary policy decisions by the central bank and of financial policies by financial agencies;
   - public access to information on monetary and financial policies;
   - responsibility and assurances of integrity by the central bank and financial agencies.

IMF in the Code of Good Practices on Transparency in Monetary and Financial policies (MFP) identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies. For purposes of the MFP, transparency refers to an environment in which the objectives of policy, its legal, institutional, and economic framework, policy decisions and their rationale, data and information related to monetary and financial policies, and the terms of agencies' accountability, are provided to the public on an understandable, accessible and timely basis. The code is currently under review (IMF (a)).

To achieve transparency on fiscal policy we need to identify and develop:

- clearness of government structure and functions to the public;
- fiscal policy intentions;
- public sector accounts;
- fiscal projections.

Fiscal transparency by strengthening responsibility and increasing the political risk can therefore enhance credibility. As a result companies will receive access to finance with lower borrowing costs and in general stronger support for sound macroeconomic policies by a well-informed public.

IMF have been designed the Code of Good Practices on Fiscal Transparency. The code contains transparency requirements to provide assurances to the public and to capital markets that a sufficiently complete picture of the structure and finances of government is available so as to allow the soundness of fiscal policy to be reliably assessed. Code is currently under review in line with the recent IMF Board paper on Fiscal Transparency, Accountability, and Risk, which proposed a set of revisions to existing international fiscal transparency standards and monitoring arrangements (IMF (b)).

2. Secondly, supervision and regulation of financial intermediaries, emphasising the banking and insurance sector supervision and securities regulation. Last year problems in banking sector activities have highlighted the necessity of structural reforms in banking sector regulation and supervision all over the world. That is why the Basel Committee on Banking Supervision revised Core principles for effective banking supervision, underling the difference between what supervisors do and what they expect banks to do. New revised principles address supervisory powers, responsibilities and functions, focusing on effective risk-based supervision, and the need for early intervention and timely supervisory actions. The principles cover supervisory expectations of banks, emphasising the importance of good corporate governance and risk management, as well as compliance with supervisory standards.

In addition, the review has taken account of several key trends and developments that emerged during the last few years of market turmoil:

- the need for greater supervisory intensity and adequate resources to deal effectively with systemically important banks;
- the importance of applying a system-wide, macro perspective to the microprudential supervision of banks to assist in identifying, analysing and taking pre-emptive action to address systemic risk; and
- the increasing focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of a bank failure. (BIS, 2012)

The regulatory and supervisory system must address the increasing presence in the market of insurance groups and financial conglomerates, as well as financial convergence. The importance of the insurance sector for financial stability matters has been increasing which has implications for insurance supervision as it requires more focus on a broad set of risks. Supervisors at a jurisdictional and international level must collaborate to ensure that these entities are effectively supervised so that policyholders are protected and financial markets remain stable; to minimise the risk of contagion from one sector or jurisdiction to another; and to reduce supervisory gaps and avoid unnecessary supervisory duplication. The Insurance Core Principles (ICPs) are the highest level in the hierarchy of IAIS supervisory material and prescribe the essential elements that must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of consumer protection. (IAIS, 2011)

Efficient security market requires:

- investors protections;
- ensuring that markets are fair, efficient and transparent;
- reducing systemic risk.

The International Organization of Securities Commissions (IOSCO) has published its revised Objectives and Principles of Securities Regulation (Principles) to incorporate eight new principles, based on the lessons learned from the recent financial crisis and subsequent changes in the regulatory environment, which are designed to strengthen the global regulatory system against future crises. (IOSCO, 2010)

3. Thirdly, institutional and market infrastructure. Managing institutional and market infrastructure to ensure financial markets efficiency we need to concentrate on:

- Crisis resolution and deposit insurance;
- Insolvency and creditor rights;
- Corporate governance;
- Accounting and auditing;
- Payment, clearing and settlement;
- Market integrity.

A well-considered and proper assessment of macroeconomic policy and data transparency; financial regulation and supervision; institutional and market infrastructure as well are the key ingredients of a sound financial market. As a result countries require sophisticated and well-functioning at the same time financial markets. Only at that case financial markets can provide recourses for investments as sound banking loans, properly regulated securities exchanges, venture capital, and other sources. To accomplish all those functions, financial markets regulation has to be sustainable and well-functioning. Financial regulation and supervision has to be confident and reliable, available to protect market participants from external and internal shocks.

In the next chapter the author assesses the Baltic States financial markets through the prism of international competiveness, by emphasising availability and affordability of financial services.

2. Baltic financial markets analysis through the prism of international competiveness

The authors of the paper relied on "The Global Competitiveness Report" of the World Economic Forum, by assessing development of the financial markets of the Baltic States from international competiveness perspective.

This forum has, for more than thirty years, provided detailed assessments of the productive potential of nations worldwide. The Report contributes to an understanding of the key factors that determine economic growth, helps to explain why some countries are more successful than others in raising income levels and opportunities for their respective populations, and offers policymakers and business leaders an important tool in the formulation of improved economic policies and institutional reforms.

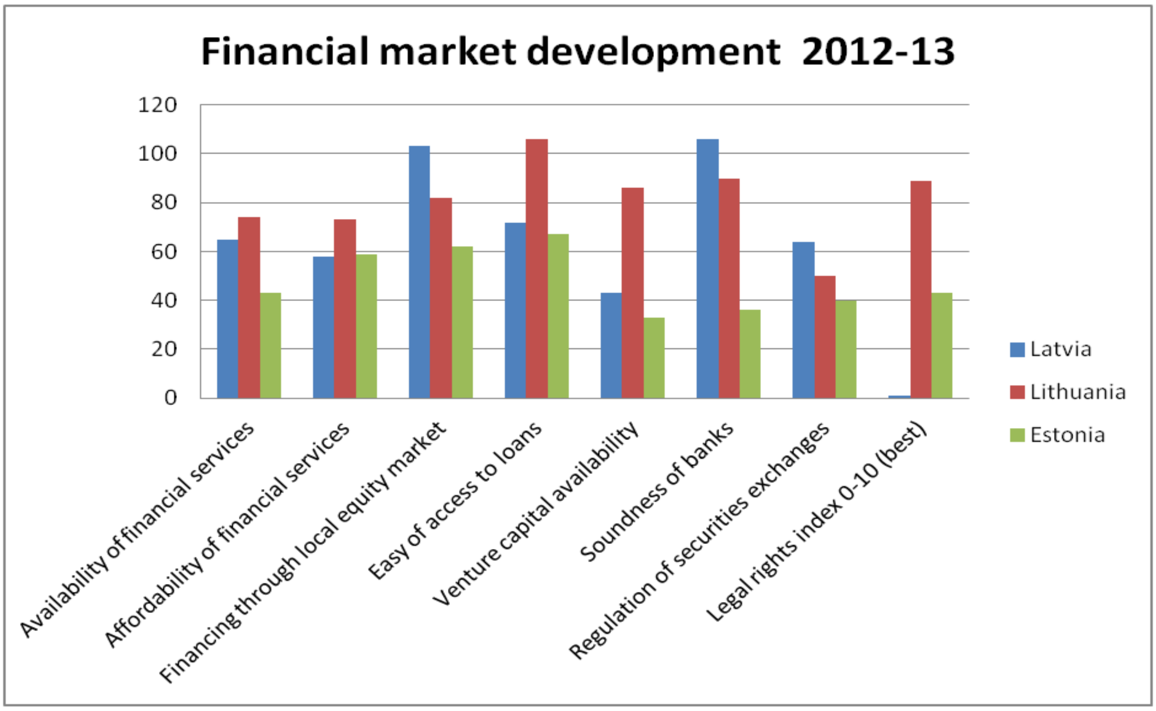

Fig. 1. **Global Competiveness Index 2012-13 of financial market development for the Baltic States, World Economic forum' report (Rank/144 countries) (World Economic Forum, 2012)**

In accordance with World Economic forum's report financial market efficiency can be characterised by following factors:

- Availability of financial services;
- Affordability of financial services;
- Financing through local equity market;
- Ease of access to loans;
- Venture capital availability.

Factors characterising trustworthiness and confidence are following:

- Soundness of banks;
- Regulation of securities exchanges;
- Legal rights index

In figure 1 are reflected the main determinants of financial market development in the Baltic States in accordance with World Economic forum's report. As we can see all efficiency determinants correlate with access to finance. In recent years access to finance has been considered one of the main obstacles to successful financial market development (Peachey S. and Roe A., 2004; Beck T. and Demirguc-Kunt A. 2006; ECB, 2012).

The results from the Feasibility study on new forms of EU support to Member States and Regions to foster SMEs Innovation Capacity report have highlighted the shortage of financial resources and access to finance as one of the main barriers to SMEs innovation capacity (Pro Inno Europe, 2011).

This same conclusion has been reached by European Central Bank survey results:

- European Central Bank Consultation: among 7,532 firms, of which 6,941 had less than 250 employees:
  - Access to finance was second ranked most pressing problem faced by SMEs in the Euro Area. (ECB, 2011)
- Public Consultation on the effectiveness of innovation support in Europe:
  - 1,000 companies (of which a large majority were innovative micro and small enterprises) and 430 innovation intermediaries found that:
    - Lack of access to finance is viewed by enterprises as the main factor hampering innovation activities.
    - Lack of access to finance is considered by institutional stakeholders as the principal barrier hampering enterprises bringing innovations to the market. (EC, 2009)

Access to finance can be analysed from different aspects:

- How available are financial services for companies and individuals in general?
- Who can afford financial services in general?
- What are the main recourses of financing: loans, securities and venture capital?

Analysing availability of financial services in the Baltic States in general, the authors concluded that in Estonia companies and individuals have better access than in Latvia and Lithuania, ranking Estonia in 43rd place (2012), within 45 best countries, at the same level as Slovak Republic and Czech Republic, and not far from Japan's and Israel's levels. Whereas Latvia's and Lithuania's positions are 65 and 74 respectively, placing Latvia at the same level as Jamaica and Colombia, and for Lithuania - Uganda and Zambia.

Whereas access to finance is significantly better in Estonia, the affordability of financial services is rather similar in the all Baltic countries, placing Latvia and Estonia in 58 and 59 places out of 144 countries, and Lithuania in 73rd place. By evaluating the positions of the Baltic States in the world countries ranks, Latvia shows an improved affordability of financial services when compared with access to services, whereas in Estonia the situation is opposite, as for Lithuania in both determinants situation is the same.

3. Main recourses of finances: case of the Baltic states

To better understand why in Estonia access to finance is easier, lets analyse the main recourse of finances: loans.

In figure 2 we can see two different approaches to loan access in the Baltic States: the first in Latvia and Lithuania, and the second in Estonia. The period from 2004 to 2007 was marked by buoyant growth of the Baltic States economies and banking sector, characterised by investment inflows, lending boom and a very low exposure to non-performing loans in the loan portfolios. In 2006-2007 all three Baltic States were actively working on the introduction of the euro and were trying to reduce too high inflation, for example Latvian government was forced into action to set up a working group on inflation which published an anti-inflation plan in early March 2007. As a result if in the beginning of 2006 access to loans in Lithuania and Estonia was at the same level and significantly better than in Latvia, after government reforms Latvia and Lithuania worsened their positions equally. Whereas Estonia continued to strengthen financing possibilities for companies and individuals till 2008.

Starting from the third quarter of 2008, the first signs of growing stress became apparent mainly as a result of the shrinking economic activity, drying-up lending and an ever accelerating fall in real estate prices. In the second half of the year, access to loans worsened against the background of the collapse of Lehman Brothers and the subsequent liquidity squeeze and deterioration of the external economic environment. In Latvia situation was complicated with the take-over of JSC Parex banka in 2008 and the government turning to international donors for assistance. Despite the fact that Lithuania didn't use international aid, the problems in the country were very similar to Latvia's, as a result Lithuania's access to credits was only slightly better than the Latvia's. Only starting from 2010, the situation can be assumed to normalise, yet the high provisions ratio, significant losses of the banking sector and shrinking loans still suggest that the availability of loans remains problematic.

After 2010 Latvia showed significant improvements in crediting and almost reached the level of Estonia, at the same time in Lithuania the improvement of credit availability was moderately stable.

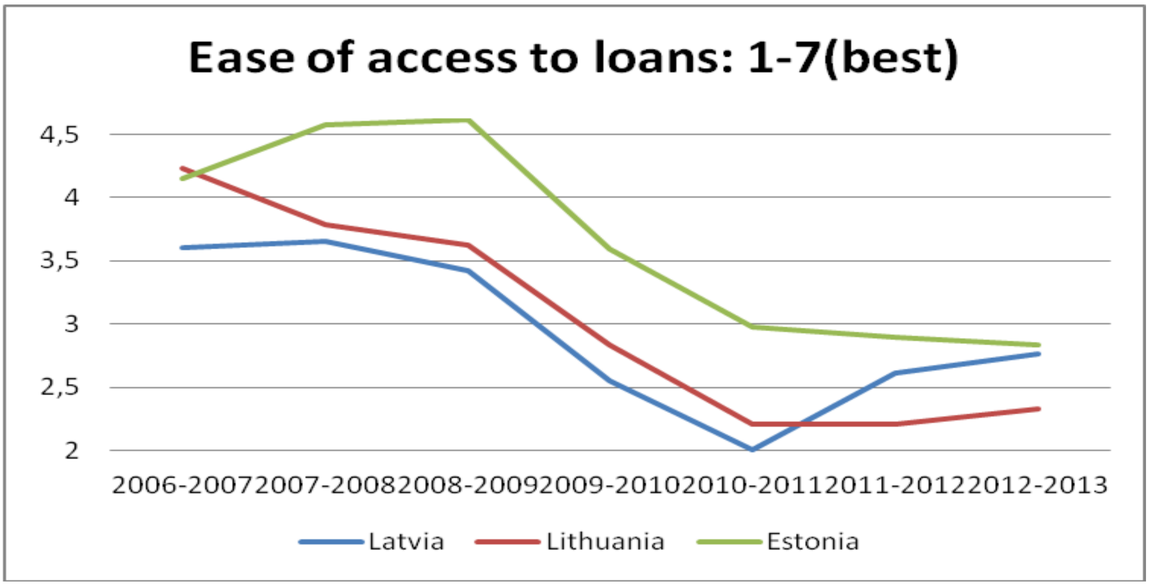

Fig. 2. **Ease of access to loans from 2006-2013 in the Baltic States: 1-7 (best) (World economic forum data base)**

The crisis affected Latvia's market more severely than others, as during 2 crisis years the drop of availabilities of loans was 41% compared with 38% and 35% in Lithuania and Estonia respectively.

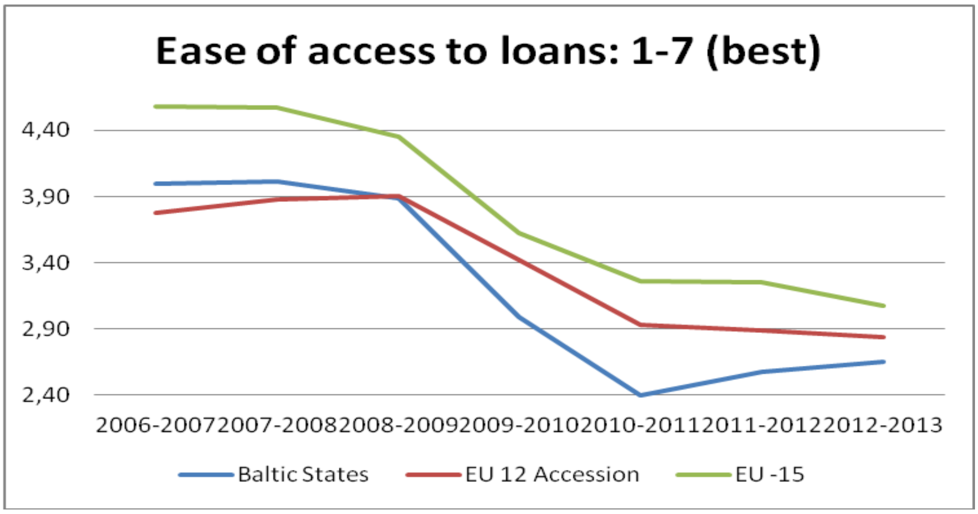

Fig. 3. **Ease of access to loans from 2006-2013 in EU economic groups: 1-7 (best) (World economic forum data base)**

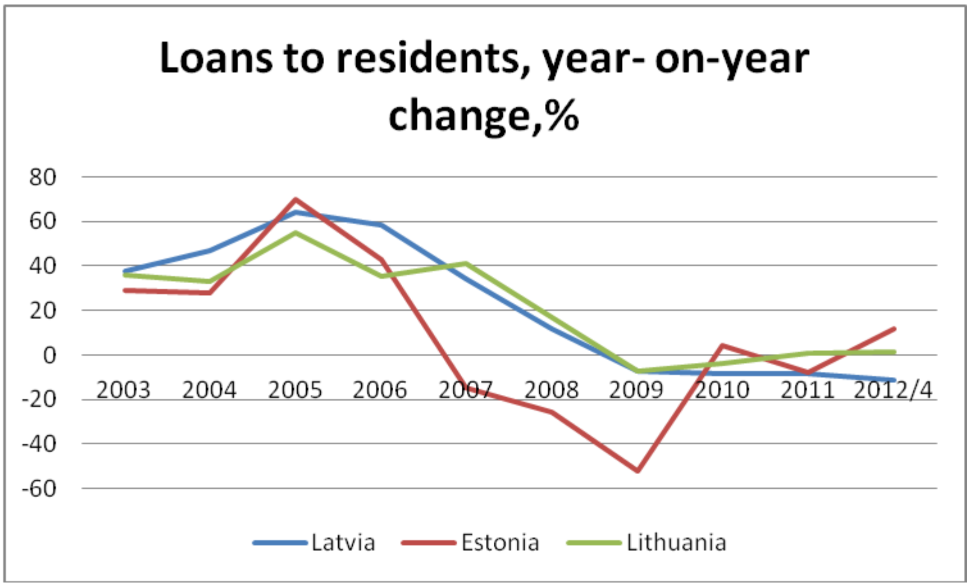

Fig. 4. **Loans to resident financial institutions, non-financial corporations and households in the Baltic States (author calculations based on central banks statistics)**

It is interesting to compare the performance of the Baltic States as a group with other EU groups. The crisis had similar effect on all economic groups, but the effect was stronger in the Baltic region, when during 2 years the availability of loans decreased by 38%, whereas in EU-12 (Accession) and EU-15 only by 25%. The author positively values that after the crisis recovery was more dynamic in the Baltic region, when access to loans improved by 10%; at the same time in EU-12 and EU-15 it decreased by 3% and 6% respectively.

Comparing the Baltic financial markets with EU-12 and EU-15 the author concluded that our markets were not as stable, as fluctuations in the access to financing are significantly higher than average for the EU.

The differences in government and central bank -implemented credit policies can be observed in figure 4. Estonia started to implement restrictive crediting policy more actively, more aggressively than Latvia and Lithuania, as a result the Estonian financial market was more prepared for crisis, and recovery in Estonian market started from 2009, whereas in Latvia we still see negative credit growth.

By analysing availability and affordability of financial services in the Baltic States the author concluded that the best access to finance is in Estonia, the most problematic in Lithuania, while situation in Latvia is average.

Conclusions, proposals, recommendations

1. Backed by solid empirical evidence, development practitioners are becoming increasingly convinced that efficient, well-functioning financial systems are crucial in channeling funds to the most productive uses and in allocating risks to those who can best bear them, thus boosting economic growth, improving opportunities and income distribution, and reducing poverty.
2. Improvement of financial market efficiency needs the revaluation of:
   - macroeconomic policy and data transparency;
   - supervision and regulation of financial intermediaries;
   - institutional and market infrastructure.
3. Macroeconomic policy and data transparency by strengthening responsibility and increasing the political risk can therefore enhance credibility. As a result companies will receive access to finance with lower borrowing costs and in general stronger support for sound macroeconomic policies by a well-informed public.
4. In recent years the problems in financial intermediaries' sector activities have highlighted the necessity of structural reforms in this sector regulation and supervision all over the world :
   - the need for greater supervisory intensity and adequate resources to deal effectively with systemically important system participants;
   - the importance of applying a system-wide, macro perspective to the microprudential supervision of financial intermediaries to assist in identifying, analysing and taking pre-emptive action to address systemic risk;
   - the increasing focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of the intermediaries failures.
5. In recent years access to finance has been considered as one of the main obstacles to successful financial market development; as a result availability and affordability of loans, as loans are the main resource of financing within the Baltic States.
6. In Estonia companies and individuals have better access than in Latvia and in Lithuania, placing Estonia in 43rd place (2012), within 45 best countries, at the same level as Slovak Republic and Czech Republic, not far from Japan's and Israel's levels. Whereas Latvia's and Lithuania's positions are 65 and 74 respectively, placing Latvia at the same level as Jamaica and Colombia, and for Lithuania - Uganda and Zambia.

7. In assessment of loans availability the author divides data to before and after the crises:
   - in the begging of 2006 access to loans in Lithuania and Estonia was at the same level and significantly better than in Latvia, than after government reforms in 2007-2008 Latvia and Lithuania worsened their positions equally. Whereas Estonia continued to strengthen financing possibilities for companies and individuals till 2008.
   - the crisis had similar effect on all economic groups, but the effect was stronger in the Baltic region, when during 2 years the availability of loans decreased by 38%, whereas in EU-12 (Accession) and EU-15 only by 25%. The author positively values that after the crisis recovery was more dynamic in the Baltic region, when access to loans improved by 10%; at the same time in EU-12 and EU-15 it decreased by 3% and 6% respectively
   - Estonia started to realised restrictive crediting policy in 2005 more actively, more aggressively than Latvia and Lithuania, as a result the Estonian financial market was more prepared to the crisis, and recovery in Estonian financial market started from 2009, whereas in Latvia we still see negative credit growth.
   - Taking into account that loans are only one part of the finance recourses, in the future researches, will be necessary to analyse security market, venture capital and other resources availabilities in the Baltic States.

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