Lithuania's financial sector: an overview

Tomas Garbaravicius and Raimondas Kuodis

Bank of Lithuania

I. Size and structure of the financial sector

As in other financial systems in their early stages of development, the commercial banking sector represents the most important part of Lithuania's financial system. In 2001, bank assets constituted 32% of GDP and nearly two-thirds of those of the overall financial system, while other financial intermediaries (credit unions, insurance, investment, leasing and other financial companies) have only recently been gathering momentum.

The size of the securities market, as measured by the capitalisation of listed stocks and bonds, is 2.3 times smaller than the total assets of the banking sector, and its importance for financial intermediation is not yet significant. In terms of absolute volume, the financial sector is rather small by international standards – at the end of 2001 bank assets and the capitalisation of the securities market amounted to €4.35 billion and €1.92 billion, respectively.

In 2001, the share of financial intermediation in real Gross Value Added (GVA) amounted to 3.2%, which is also relatively low by international standards. However, financial intermediation expanded much more rapidly than GDP during the period 1999-2000, partly owing to the influx of foreign strategic investors and a relatively low starting base. In 2000, the banking sector created 60% of real GVA in financial intermediation, the central bank accounted for 23%, insurance generated 14% and the remaining 3% came from activities in the securities market.

Table 1: Financial sector structure
(in % of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Assets of:									
Commercial banks	30	31	25	19	22	25	26	29	32
Insurance companies	-	-	-	-	1	1	2	2	2
Leasing and factoring companies[1)]	-	-	-	-	1	1	1	2	3
Investment holding companies[2)]	-	-	-	-	1	0	1	0	0
Capitalisation of:									
Listed stocks	0	1	3	11	18	10	11	14	10
Bond market	0	1	3	3	4	4	3	3	4
Total	31	34	31	33	46	41	43	50	51

Source: Bank of Lithuania (BoL), Department of Statistics, National Stock Exchange of Lithuania (NSEL), State Insurance Supervisory Authority

1) Leasing and factoring portfolio

2) Net (own) assets

II. Banking sector

The first commercial banks were founded in 1989 and at that time their operations were governed by the laws regulating corporate entities, until the adoption of the separate Law on Commercial Banks in 1992. Early developments in the banking sector mirrored experiences of other transition economies. Initially the number of banks soared up to 27 in 1993, followed by a major shake-up of the banking system in 1995, which was caused by imprudent and sometimes fraudulent management activities, as well as the lack of regulation and relevant skills. As a result, the number of banks shrank to 13 in 1996. The fiscal costs of cleaning up the banking system through the special state-owned asset management company amounted to around 2.5% of GDP (USD 300 million) and were rather moderate due to the small size of the banking system and its early stage of development.

As an alternative to bank financing, the first credit unions (co-operative banks) were established in 1995 and their number rose to 41 at the end of 2001, although their assets amount to less than 0.2% of bank assets.

Foreign ownership in the banking sector has increased dramatically in recent years, because strategic investors from Sweden (SEB and Swedbank) acquired the two largest banks, while the last state-owned bank, with 12% of the banking sector's assets, was sold to a German bank (Nord/LB) in the first quarter of 2002. After full privatisation, foreign investors own more than 50% of the registered capital in 7 out of 9 banks. Foreign banks started opening their branches in 1997 and there are 4 branches at the moment (one from Poland, one from Finland and two from Germany).

The banking sector is highly concentrated – the three largest banks control almost 80% of the market. Challenges related to this high degree of concentration are the increase of systemic risk of "too big to fail" as well as lower competition. At least 4 banks accept deposits and grant loans in each county's centre, while elsewhere in the counties only 2-5 banks compete for deposits and loans. However, branches of foreign banks have intensified competition recently, but mostly in the loan market, since they do not dispose of a branch network and operate only in the capital. Their weight is growing quite rapidly – at the end of 2001 their market share in terms of assets, loans and deposits increased to 7%, 10% and 3% respectively up from 4%, 5% and 2% at the end of 2000.

The problem of a rather high concentration in the banking sector may be further intensified by the dominant position of banks in the entire financial system, as their subsidiaries are very active in other segments of the financial sector. All commercial banks and one branch of a foreign bank own a leasing company, and these leasing subsidiaries control almost the entire

Table 2: Ownership of the banking sector
(end of 2001)

	Domestic institutions			Foreign banks				
	State-owned[1)]	Private-owned	Total domestic	Foreign-owned[1)]	Foreign-controlled	Branches	Total foreign	Total
Number of banks	1	1	2	6	1	4	10	13
% of registered capital	10	3	13	76	3	8[2)]	87	100
% of banking assets	12	2	14	78	1	7	86	100

Source: Bank of Lithuania
[1)] A state-owned bank (foreign-owned) is defined as a bank with more than 50% of the registered capital in the government's (foreign investors') hands
[2)] Funds, received from headquarters

Table 3: Profitability and soundness of the banking sector
(in %)

	1996	1997	1998	1999	2000	2001
ROE[1) 2)]	-	-15.8	10.8	1.1	4.0	n.a.
ROA[1)]	-	-1.0	1.0	0.1	0.4	n.a.
Capital adequacy ratio (10%)[3)]	10.5	15.3	23.8	17.4	16.3	15.6
Liquidity ratio (30%)	55.7	65.5	58.7	45.4	49.7	48.0
Net loans to assets	46	39	42	46	40	41
Non-performing loans to:						
Total loans	32	28	13	12	11	7
Capital	300	215	46	47	43	34
Provisions to:						
Total loans	20.7	18.5	5.9	4.5	3.7	2.6
Non-performing loans	64	66	48	38	35	34
Provision expenses to:						
Net banking income[4)]	30	31	8	18	11	n.a.

Source: Bank of Lithuania, published audited annual accounts of commercial banks
1) 13 end-of-month averages
2) Funds received from headquarters were taken as a proxy for equity in the case of branches of foreign banks
3) Without branches of foreign banks
4) Net interest and net non-interest income

leasing market. Three out of nine life insurance companies and four out of 22 non-life insurance companies belong also to commercial banks, although their market share is not as important as in the case of leasing. Furthermore, banks are major players in the securities market as well.

Banks are well capitalised and comply with all prudential requirements. However, traditional profitability ratios (ROE, ROA) indicate insufficient profitability, which cannot be explained only by the credit risk issues. Other factors include: a low share of non-interest income (in 2000, non-interest income accounted for only 42% of net banking income and less than 30% of gross income), which makes banks vulnerable to interest rate competition; a high portion of non-interest bearing assets (reserves and tangible assets); and high general operating expenses, making up 79% of net banking income in 2000.

At the end of 2001, only 5 out of 9 banks and none of the branches of foreign banks had assets in excess of EUR 100 million, which means that smaller banks cannot reap even minimal benefits from economies of scale.

High operating expenses are partly attributable to the over-branching and overstaffing in some (usually formerly state-owned) banks. Although the average number of inhabitants per branch (4,305 including customer service sub-branches) is more than twice as high as the euro area average (1,800), at least several banks need to reconsider their branching policy in order to be well prepared for the technological innovations threatening traditional banking.

Bank credit to the private sector has remained at a rather low level and constituted 13.1% of GDP in 2001, while funds were mostly redirected to the public sector and foreign assets during the last few years. The slowdown might be explained by cautious lending behaviour following the banking (1995) and the Russian crisis (1998) as well as a general scarcity of lending opportunities. Furthermore, structural changes with regard to the three largest commercial banks – the largest commercial bank absorbed a smaller bank, whereas the

Table 4: Domestic credit

Stocks in % of GDP	1993	1994	1995	1996	1997	1998	1999	2000	2001
Domestic credit and net foreign assets of domestic banks									
Credit to private sector	13.9	17.7	15.4	10.9	10.0	10.5	11.7	10.8	13.1
Corporate sector	12.3	15.5	13.7	9.6	8.4	8.2	9.1	8.4	9.9
Households	1.6	1.6	1.0	0.8	1.0	1.2	1.6	1.3	1.5
NBFI[1)]	0.0	0.1	0.2	0.1	0.4	1.0	1.0	1.1	1.6
Net credit to public sector[2)]	-7.3	-5.2	-4.7	-2.2	0.0	1.1	1.4	3.1	4.8
Credit to public sector	3.5	3.8	3.1	3.2	5.3	5.4	4.9	5.9	6.6
Liabilities to public sector	10.8	9.0	7.8	5.4	5.3	4.3	3.5	2.9	1.8
Net foreign assets	2.3	0.3	0.5	1.2	0.8	-1.1	-0.7	1.7	1.3
Foreign assets	2.6	2.3	2.0	3.6	3.7	2.7	3.9	6.1	6.3
Foreign liabilities	0.3	2.0	1.5	2.4	2.9	3.8	4.6	4.5	5.0
Foreign credit to private non-banks[3)]	-	-	-	5.3	8.8	8.4	8.0	8.1	7.7
Loans	-	-	-	5.3	7.2	7.9	7.8	7.9	6.9
Bonds	-	-	-	0.0	1.6	0.5	0.2	0.2	0.8

Source: Bank of Lithuania, Department of Statistics

1) Non-bank financial institutions

2) Public sector does not include monetary authorities

3) Foreign credit includes cross-border loans and bonds held by foreign investors, but excludes trade credit and intercompany loans by foreign (parent) company

second and third largest banks were prepared for privatisation – made them reluctant to extend new credits.

As far as the demand for credit is concerned, the borrowing side appears to be constrained by relatively high lending interest rates caused by insufficient competition among banks and their inflexibility to adapt to client demands, in particular to those of SMEs. In 2001, the stock of foreign credit to private non-banks was lower than the ratio of domestic bank credit to private non-banks by more than 5% of GDP. Although the economy has returned to positive growth, domestic bank lending still lags behind, as the recovery in 2001 is partly attributable to the abolishment of corporate profit tax deductions for reinvestments from 2002.

After a spike in 1998 and 1999, the growth of foreign liabilities slowed down in 2000 and 2001, since local commercial banks cannot use locally even domestic resources (mainly household deposits), which have been expanding strongly during 1999-2001.

At the end of 2001, enterprises constituted only 11% (individuals 88%) of bank borrowers, but their debts accounted for 78% (individuals 11%) of the total bank loan portfolio. The majority (81%) of corporate credit recipients owed less than USD 125,000. 27% of them owed even less than USD 5,000. On the other hand, corporate loans above USD 125,000 accounted for 91% of credits to enterprises and 71% of the total loan portfolio value. These figures explain why banks make a lot of effort to attract large corporate clients, but competition may also force them to look more closely at SMEs.

Loans to the manufacturing, trade, energy and transportation sectors account for 23%, 22%, 7% and 6% respectively (at the end of 2001) and dominate the loan portfolio of commercial banks. Leasing companies are becoming an important lending channel for banks, as the share of loans to non-bank financial institutions, mostly to subsidiary leasing companies, has been expanding quite rapidly and amounted to 10% at the end of 2001. The breakdown of the credit portfolio by sector corresponds roughly with the structure of GDP, although loans to transportation, construction and agriculture are slightly underweight.

III. Non-banking sector

1. Money market and foreign exchange market

Unsecured deposits are one of the most prevalent money market instruments in Lithuania, although banks also use collateralised loans and deposits and government debt securities. Sell buy-back and repo markets do exist, but the activity in this market segment is partly constrained by legal uncertainties related to collateralised lending and the absence of respective open market operations. Interbank rate fixings exist for maturities of up to 12 months.

The relative importance and development of FX instruments is attributable to the currency board arrangement, an early capital account liberalisation and to the openness as well as the dollarisation of the economy. FX swaps are as popular as unsecured deposits, also partly due to their limited credit risk. Starting from a low base, the volume and number of forwards has been augmenting impressively as well.

Domestic banks and branches of foreign banks are major players in the money and foreign exchange markets, although liquidity and efficiency was greatly enhanced by Scandinavian participants, namely parent banks from Sweden and Finland. However, the efficiency of the litas money market, as evidenced by money market spreads, is still rather low, albeit gradually improving.

Notwithstanding the small market size and an insufficient number of market participants, a further reason for high interest rate spreads relates to the legacy of the banking crisis in 1995, after which banks became used to relying only on themselves for liquidity management. This practice of self-reliance is further reinforced by the high degree of concentration, where the three largest banks control almost four-fifths of the market and, in the case of substantial

Table 5: FX and money market statistics

	Annual turnover, USD billion			Average daily turnover, USD million			Average daily number of transactions		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
Foreign exchange market	25	21	32	99	82	127	-	-	-
Spot	22	17	24	87	68	97	-	-	-
Forward	0	0	1	1	2	4	2	3	5
Swap[1)]	3	3	6	10	10	24	7	8	12
Options	0	0	1	2	2	3	0	1	1
Interbank loans & deposits	25	35	52	99	138	205	28	39	47
in LTL	2	2	3	6	9	13	9	10	13
in foreign currencies	24	33	49	93	129	192	19	29	33
between local banks	2	1	2	6	5	8	8	6	8
in LTL	1	1	2	3	4	7	5	4	7
in foreign currencies	1	0	0	3	1	1	3	2	2
with non-resident banks	24	34	50	93	133	197	20	33	38
in LTL	1	1	2	3	5	6	4	6	7
in foreign currencies	23	32	48	90	128	191	16	28	32
Treasury securities	0	0	0	1	1	1	7	5	6

Source: Bank of Lithuania, NSEL

1) Only second (long) leg of the transaction

liquidity swings, face the constraints of the shallow domestic money market. The local money market would greatly benefit from the abolishment of the anchor currency conversion costs charged to banks by the central bank, enabling an instantaneous link with international markets and more effective liquidity management. Levels of more than 10% of excess reserves can be viewed as a clear symptom for the rigidities of the domestic money market.

2. Stock and bond markets

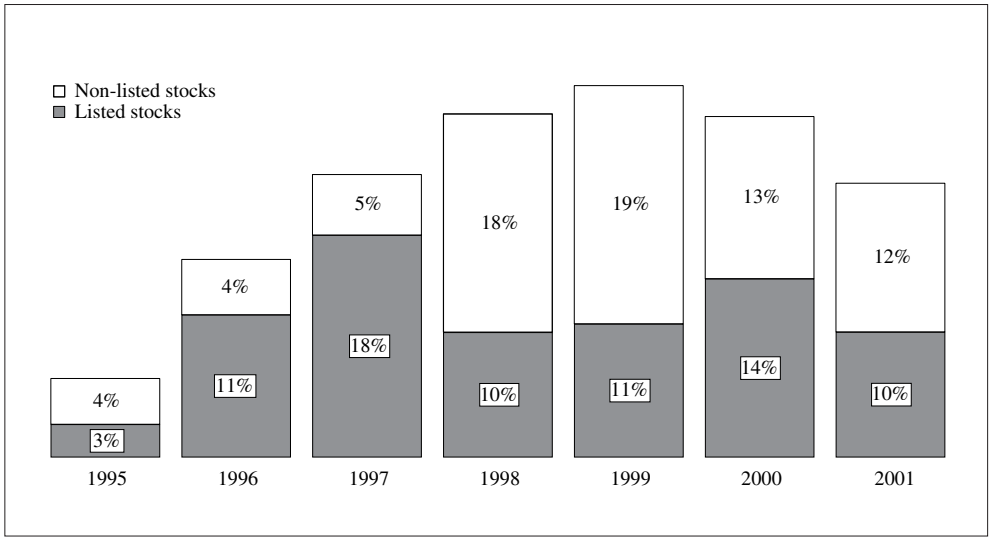
A marked and still ongoing consolidation phase has significantly decreased the number of market participants in the Lithuanian capital market. At the end of 2001, there were 20 brokerage houses and 8 brokerage divisions of commercial banks in Lithuania. A low demand for asset management and consulting services has resulted in only a few firms ready to provide related services. The first, and as yet the only, index fund was launched in 2000, while only 11 investment holding companies managed to carry on with their operations after the boom of such companies during the mass voucher privatisation.

Listed stocks constitute only 10% of GDP and, therefore, do not constitute a vital pillar for the financial intermediation process in Lithuania. The official list comprises only 6 companies. Telecom's capitalisation makes up 2.1% of GDP, 60% of the capitalisation of the stocks in the official list and more than 20% of the capitalisation of all listed stocks, while the top five listed stocks account for more than 60% of the listed stock capitalisation.

The outstanding stock of domestic debt instruments (capitalisation above 4% of GDP) is dominated by treasury securities, whereas corporate debt securities are negligible. The rationale for the relatively low level of development of the local debt market is linked to the, in general, low public debt burden and its high share of foreign currency-denominated debt. The latter restrains the local bond markets' development in combination with the prohibition

Chart 1: Stock market capitalisation

(in % of GDP)



Source: NSEL, Department of Statistics

Table 6: Stock market indicators

Number of:	1997	1998	1999	2000	2001
Listed stocks	53	62	54	54	46
Official list	5	6	7	6	6
Current list	48	56	47	48	40
Non-listed stocks	1,120	1,100	1,044	981	895
Government debt securities	38	46	47	55	47
T-bills	35	43	32	22	10
T-bonds			3	12	19
Retail bonds			9	14	11
Special purpose T-bonds[1)]	3	3	3	7	7
Corporate bonds	11	6	3	8	9

Source: NSEL, Securities Commission, Ministry of Finance, Central Securities Depositary of Lithuania
[1)] For bank recapitalisation and restructuring after 1995 banking crisis

to issue debt securities denominated in foreign currencies domestically. Other non-supporting factors include the lack of institutional investors and a rather limited number of potential larger corporate issuers.

Debt instruments other than plain fixed-rate bonds – such as floating-rate, inflation-indexed or exchange-linked debt securities – are non-existent in the Lithuanian market. In 1999, the government tapped the market for T-bonds for the first time and since then the longest maturity of issued bonds has been 10 years. The first 10-year bond was issued in March 2002. The weighted average maturity of treasury securities outstanding exceeded 22 months at the end of 2001. By extending the yield curve, the government has established benchmark securities, thereby paving the way for corporate bonds with longer maturities.

Liquidity in the stock market, as measured by the ratio of turnover to capitalisation, is rather moderate and trading in the central market is thin, since block trades account for more than four-fifths of the stock trading volume. Lower liquidity may stem from the fact that local companies are rather small and foreign strategic investors prefer to buy up large proportions of share capital, thereby reducing free-float capitalisation to less than 15% of the total listed stock capitalisation. As for the bond market, liquidity of the treasury securities market is higher (2.2% of GDP, €289 million, or 59% of the average of two year-end capitalisations), albeit far from the levels common in the EU countries. The growing liquidity of treasury securities is also derived from the fact that turnover of government debt securities exceeded stock market turnover for the first time in 2000.

As indicated by the international investment position (IIP), in 2001 foreign portfolio equity investors held approximately 8% of the total listed stock capitalisation or more than a half of the estimated total free-float capitalisation. The influence of foreign investors appears quite substantial, although the estimated minimum foreign share of equity turnover remains rather modest.

The absence of pension funds, the lack of mutual funds as well as other institutional investors result in an insignificant role for the securities market. The securities market still awaits the implementation of the pension reform, which is scheduled to take place in 2004. Other explanations may also relate to the lack of an investment culture, the low knowledge of financial markets within the society, the long bear trend and a still low level of savings. Enterprises cannot rely on the stock market in their funding decisions, as indicated by

the latest statistics. Over the last three years the majority of equity issues were private placements and in 2001 constituted a mere 1% of GDP.[1]

IV. Functioning of the financial sector

1. Capital account liberalisation

Lithuania liberalised its capital account at the outset of economic reforms. The free movement of capital, coupled with the currency board arrangement introduced in 1994, was believed to foster the inflow of foreign investment and to fill the gap between domestic savings and the capital needed to restructure the economy. So far, the results have justified such an early liberalisation, as evidenced by the successful track record of FDI inflows.

Debt-creating flows have not threatened macroeconomic or financial stability yet, and the vulnerability to sudden capital outflows is minimised by the favourable profile of external debt liabilities. By the same token, equity portfolio flows do not pose any major risks either. It seems that the small market size shelters the economy and the financial sector from sizeable capital movements.

2. Stock of financial savings

As for the supply side of the intermediation process there are, generally, five major financial assets available for retail investors (households and enterprises): cash, debt securities, stocks, deposits and life assurance contracts. Table 7 summarises the size and the distribution of the present stock of financial savings. Naturally, the table does not contain data for cash in

Table 7: Stock of financial savings

Holdings at the end of 2001, in % of GDP	Cash in litas	Domestic securities market		Bank deposits	Life insurance[3)]	All financial assets
		Government securities[1)]	Stocks[2)]			
Residents		4.5	2.9	21.2	0.2	28.7
Households		0.3	0.7	13.0	0.2	14.7
Corporate		0.6	1.6	6.3		8.5
Non-residents		0.0	2.5	3.1		5.6
Total	5.8	4.5	5.3	24.3	0.2	40.1

Source: Bank of Lithuania, Department of Statistics, Central Securities Depositary of Lithuania, State Insurance Supervisory Authority

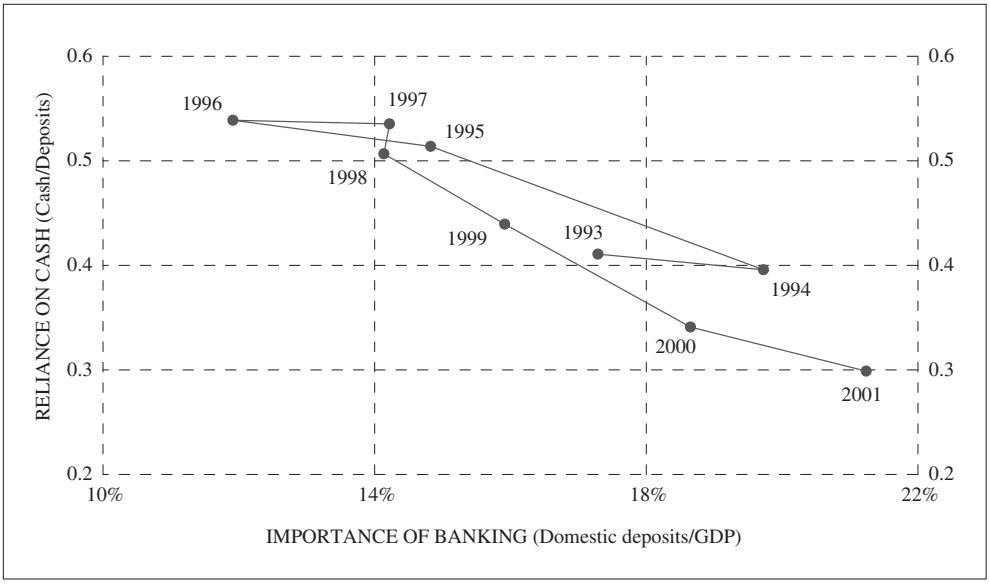
1) At par value

2) In the accounts of brokerages

3) Technical provisions of life insurance companies at the end of September 2001

[1] Insurance companies, which have become the second largest (next to banks) domestic institutional investor, still pursue a rather conservative investment strategy, preferring fixed-income instruments to stocks. Indeed, domestic government securities and term deposits constituted 63% and 6% of their investment portfolios respectively at the end of 2001. Investments in shares, corporate bonds and mortgage loans accounted for only 10% of total investments. Therefore insurers do not represent an important source of funds for the corporate sector yet.

Chart 2: Banking deposits vs. cash holdings



Source: Bank of Lithuania, Department of Statistics

foreign currencies, but it is reasonable to assume that households hold a significant amount of this – according to some estimates up to 10% of GDP.

Banks have been becoming increasingly important in mobilising domestic savings, as the ratio of domestic deposits to GDP has been rapidly increasing at the expense of regular cash holdings. The significance of cash will be further reduced by the expected expansion of electronic payments, as the number of payment cards (credit, debit, prepaid) amounted to only 23% of the total population at the end of 2001. Bank depositors with credit balances in excess of USD 10 amounted to less than half of population (end of 2001), while only 0.5% and 0.2% of the population invested in stocks and government debt securities (mostly retail bonds) at the end of 2001.

It has to be stressed that banks dominate the financial intermediation process at the expense of the securities market, as the stock exchange is not very successful in transferring funds from savers to investors. Although there is no clear evidence that loan-based or securities-based intermediation performs better, a more balanced structure would be desirable, as each of these intermediation forms offers complementary advantages. An over-reliance on banks may lead to costlier crises and could likely disrupt the entire intermediation process.

3. Allocation of funds to the corporate sector

The predominance of internal funding sources (depreciation and retained profits) over external funding sources indicates the huge potential for the financial sector to contribute more actively to the corporate sector's funding. The ratio of domestic commercial banks' new net lending to the corporate sector (i.e. the change in the stock of credit to the corporate sector) to gross fixed-capital investment (GFCI) (see Schardax, 2001) declined rapidly from

Table 8: External corporate funding
(relative to gross fixed capital investment (GFCI))

Changes in stocks in % of GFCI	1993	1994	1995	1996	1997	1998	1999	2000	2001
Domestic sources					11.3	12.8	13.4	4.0	20.0
Bank credit to corporate sector	41.1	30.9	12.2	-3.6	1.8	2.9	3.8	-1.0	10.5
Equity issues[1)]	-	-	-	-	9.4	8.1	10.0	2.6	5.0
Leasing	-	-	-	-	-	1.8	-0.4	2.4	4.5
Foreign sources	-	-	-	-	31.9	5.1	1.6	10.4	9.5
Intercompany loans	-	-	-	-	3.9	4.2	1.1	4.5	3.0
Bank Loans	-	-	-	-	11.6	6.2	-0.8	2.7	-2.6
Bond issues	-	-	-	-	6.4	-3.7	-1.3	0.0	3.3
Trade credit	-	-	-	-	9.3	-0.9	1.9	1.9	5.6
Other liabilities	-	-	-	-	0.6	-0.7	0.7	1.3	0.2

Source: Bank of Lithuania, Department of Statistics, Securities Commission
1) Flows

1993, hovered around zero from 1996-2000 and picked up in 2001 (11% of GFCI), as corporate profit tax deductions for reinvestments were abolished from 2002. Adding up equity issues and even rapidly expanding leasing finance instruments still results in a rather low level of external corporate funding domestically (20% of GFCI).

4. Funding of the public sector

A preference for foreign financing over domestic financing characterises the funding of the public sector, mostly because foreign funds were cheaper and available in greater amounts. The public sector on aggregate also preferred bond financing to loans. In 1999, after the turmoil in Russia, the public authorities not only increased the overall funding but were also forced temporarily to switch to foreign funding, as domestic costs were too high.

5. Foreign exchange exposure

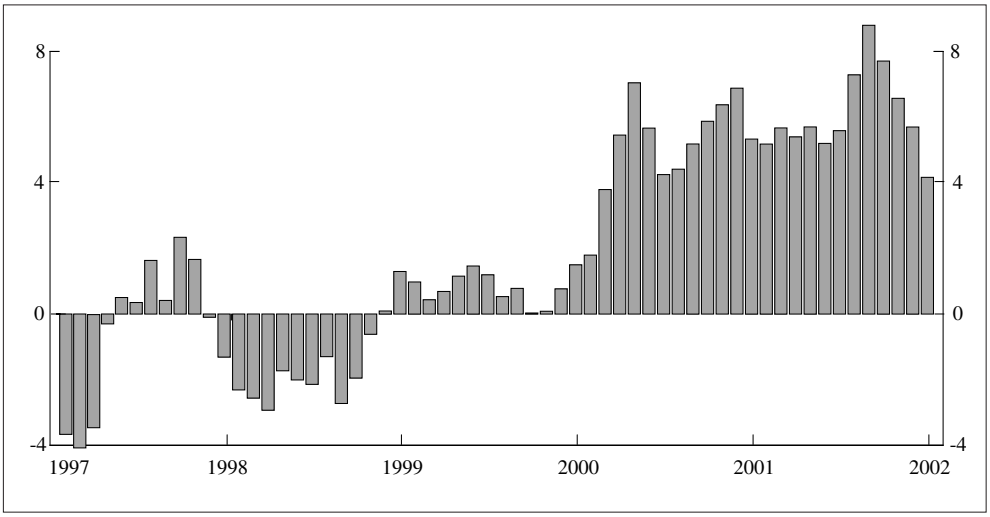
The banking sector displays a small currency mismatch between its overall assets and liabilities due to the prudential requirement concerning open foreign exchange positions. Balance sheet assets in foreign currencies exceed foreign currency liabilities, i.e. banks have a short litas balance sheet position, which is also a consequence of the limited availability of suitable litas investment opportunities. This mismatch is covered with off-balance sheet instruments.

At the end of 2001, 62% of total bank credits to the corporate sector were denominated in foreign currencies and this share has been gradually increasing during 1995-2000, despite the currency board arrangement. As normally enterprises are net debtors towards the banking system, they have a short foreign exchange position towards domestic banks, and their foreign currency liabilities to banks exceed their claims to banks in foreign currencies. Relations with non-residents augmented the corporate sector's total net short foreign exchange position to 19% of GDP in 2001.

Not all companies match their foreign currency liabilities with foreign currency assets or receipts, as corporate customers base their borrowing decisions almost exclusively on the

Chart 3: Difference between banking sector's balance sheet assets and liabilities in foreign currencies

(in % of balance sheet assets)



Source: Bank of Lithuania

interest rate level and do not attach particular importance to their currency risk, despite bank efforts to promote "plain-vanilla" hedging tools. In 2000, the share of euro denominated loans increased from 8% to 17% of the total loan portfolio and to 20% in 2001, reflecting lower euro interest rates than US rates as well as expectations of a further euro depreciation. While part of the advance was clearly attributable to the natural hedge in the light of changing trade patterns and the repegging of the litas from the US dollar to the euro on 2 February 2002, companies focusing exclusively on the domestic market also used euro loans.

In contrast to the corporate sector, the household sector is a primary provider of funds to commercial banks, preferring to keep assets in foreign currencies. The phenomenon of unofficial dollarisation is still widespread in Lithuania, albeit almost non-existent in daily life. Almost two-thirds (65%) of household time deposits and more than half of total household deposits are denominated in foreign currencies, while credits denominated in foreign currencies are not as intensively used as in the corporate sector. Therefore households have a significant net long foreign exchange position against banks – 6.2% of GDP at the end of 2001. Cash holdings denominated in foreign currencies further increase this net long foreign exchange position of households.

The currency breakdown of domestic credit provides some interesting information on the exposure of certain sectors to currency risk when viewed against the background of the repegging of the litas from the US dollar to the euro. Enterprises with dollar loans and litas or euro income will need to adjust the currency composition of their liabilities either directly or with derivative instruments. In addition, loans issued in litas but bearing a clause that indexed payments to the dollar/litas exchange rate will also be affected by currency risk. However, loans with such a clause have become less common on account of greater credibility for the currency board arrangement, increased competition in the banking sector and some concern among banks that it may not be legally enforceable.

Table 9: Foreign exchange positions
(against domestic banks and non-residents)

in % of GDP	1993	1994	1995	1996	1997	1998	1999	2000	2001
Corporate sector									
Foreign assets[1)]	-	-	-	7.5	7.8	6.6	8.2	6.2	6.4
Foreign liabilities[2)]	-	-	-	-15.3	-20.4	-19.4	-19.9	-20.7	-21.4
Net foreign exchange position against non-residents[3)]	-	-	-	-7.8	-12.6	-12.8	-11.7	-14.5	-15.0
Bank credit to corporate sector	-12.3	-15.5	-13.7	-9.6	-8.4	-8.2	-9.1	-8.4	-9.9
of which in foreign currencies	-5.1	-5.9	-5.1	-3.7	-3.5	-4.9	-5.9	-5.8	-6.1
Bank liabilities to corporate sector	4.7	5.0	5.0	4.7	5.4	4.5	4.1	5.0	5.7
of which in foreign currencies	1.6	1.9	1.7	1.5	1.3	1.1	1.4	1.5	1.6
Net foreign exchange position against domestic banks	-3.6	-4.0	-3.4	-2.2	-2.2	-3.7	-4.5	-4.3	-4.5
Households									
Bank credit to households	-1.6	-1.6	-1.0	-0.8	-1.0	-1.2	-1.6	-1.3	-1.5
of which in foreign currencies	-1.1	-0.7	-0.2	-0.1	-0.1	-0.2	-0.5	-0.6	-0.7
Bank liabilities to households	5.4	8.5	7.6	5.1	5.7	6.8	9.2	11.0	13.0
of which in foreign currencies	1.8	3.3	3.4	2.4	2.5	3.2	4.7	6.1	6.8
Net foreign exchange position against domestic banks	0.7	2.6	3.2	2.3	2.4	3.0	4.3	5.5	6.1

Source: Bank of Lithuania, Department of Statistics
1) Including intercompany loans by domestic (parent) companies, intercompany claims to foreign (parent) companies, trade credits and other debt obligations
2) Including intercompany loans by foreign (parent) company, intercompany liabilities of domestic (parent) company, trade credits and other debt obligations
3) Assuming that all foreign assets and liabilities are denominated in foreign currencies

Private individuals have the greatest net foreign exchange position and were therefore highly affected by the change of the base currency of the CBA, as roughly 90% of foreign currency deposits and a substantial share of loans are in dollars. Individuals receive their income and make expenditures in litas and do not have the motivation and/or sophistication to hedge their foreign currency exposure. Therefore the Bank of Lithuania has been trying to increase public awareness of the potential impact on their savings denominated in dollars.

6. Efficiency of the banking sector

The equilibrium between savings and investment is – in addition to taxes and transaction costs – affected by the difference of returns to savers and financing costs for investors arising from bank interest spreads. In the case of Lithuania, financial funds are still provided at comparatively high cost as a consequence of the relatively high interest rate spreads, although the downward trend in interest rate spreads over time is apparent. There appear to be two main technical factors making interest rate spreads wider than in EU and some EU accession countries, such as higher reserve requirements and deposit insurance.

Recently the Bank of Lithuania started a long-term strategy of lowering the minimum reserve requirement by reducing the requirement ratio from 10% to 8% in October 2000 and to 6% in March 2001 (2% in the euro area). The high level of reserve requirements in Lithuania is mainly the result of liquidity concerns, while initially it also served as a tool for curbing credit growth and inflation. However, the improving expertise of individual banks as

well as the strengthening supervisory capacity of the Bank of Lithuania diminish liquidity concerns and should allow further reductions towards the euro area level. As reserve requirements account for more than 5% of assets, and are not remunerated, they sustain wide interest rate spreads.

Costs related to the setting-up of a deposit insurance regime represents another factor that contributes to the wide interest spreads.[2] Already in 2000 deposit insurance premia paid by banks amounted to €12 million or 10% of net interest income or 7% of operating expenses.

Although interest spreads are one of the basic indicators for the efficiency of financial intermediation, some researchers look at the net interest margins as well. The difference between the two indicators reveals the magnitude of losses on non-performing loans. In the case of Lithuania the difference is gradually diminishing, indicating that the banking sector has been recovering from the long-lasting effects of the banking crisis and is decreasing the burden of non-performing loans.

7. Monetary transmission mechanism

Due to the US dollar-based currency board arrangement, the Bank of Lithuania did not conduct an independent monetary policy and therefore imported US monetary conditions until the repegging of the litas to the euro on 2 February 2002. Thereafter, ECB monetary actions have started to influence domestic monetary conditions. Nevertheless, the following analysis is based on the past, looking therefore at the interdependence between the Lithuanian and US money markets.

A visual inspection of the Fed Funds target rate and the 1-month VILIBID dynamics reveals a strengthening of links over time between key central bank interest rates and money market rates. The correlation coefficient of the respective non-lagged daily time series was equal to 0.83 in 2001 and was the same for a lag of one day. One-month money market rates were taken because they should be free from the factors related to the fulfilment of the minimum reserve requirements.

Monetary impulses seem to feed through to commercial bank lending rates with a lower intensity. Interestingly, rates on lending to residents in litas were more affected by fed funds target rates than USD lending rates in 2001, while almost no impact of ECB rates on euro lending rates was observed.

An analysis of the monetary transmission mechanism needs to include also interest rates on household time deposits, as deposit rates influence saving and consumption decisions, too. Until end-2000/early 2001, USD and EUR household time deposit interest rates did not move in line with key Fed or ECB interest rates and were sticky upwards, raising doubts about insufficient bank competition. However, the banks' behaviour started to alter and more frequent changes of household time deposit rates have brought this segment more in line with international developments, thereby improving the transmission of monetary impulses. Further progress could be made with the introduction of floating interest rates on household time deposits.

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[2] As from 27 February 2001 banks have to pay 0.45% per annum of covered deposits. However, the present maximum compensation level of €13,033 probably is too high for Lithuania, since it is more than three times higher than nominal GDP per capita, necessitates speedier accumulation of the Deposit Insurance Fund and thereby means higher current costs for banks.

Table 10: Impact on deposit and lending rates

Correlation coefficients[1]	(Monetary transmission)							
	Household term deposit rates				Lending to residents rates			
	Lag-0		Lag-1		Lag-0		Lag-1	
	2000	2001	2000	2001	2000	2001	2000	2001
Fed funds target rate[2]								
with LTL rates	-0.02	0.49	-0.23	0.22	-0.19	0.37	0.17	0.44
with USD rates	-0.26	0.36	-0.15	0.40	-0.37	0.16	-0.20	0.22
ECB rate[2]								
with EUR rates	-0.14	0.38	0.29	0.61	0.12	0.21	-0.50	-0.07

Source: Bank of Lithuania

[1] First differences of the monthly time series were taken in order to remove the non-stationarity of the data

[2] Monthly averages

V. Trends in the financial sector in view of the integration into the EU

Lithuania has volunteered to participate in the Financial Sector Assessment Program (FSAP). Reports from the World Bank and the IMF will help to understand, assess and address key risks, vulnerabilities and inefficiencies in the financial sector that may impede a fast convergence and smooth integration into the EU.

The Bank of Lithuania intends to proceed with its policy of a gradual reduction of minimum reserve requirements until full harmonisation with ECB requirements with respect to scope and level. The practice of calculating and fulfilling minimum reserve requirements has already been harmonised in March 2002. Nevertheless, closer links with euro area markets and improvements in banks' risk management systems will lessen the importance of minimum reserve requirements as a liquidity buffer and pave the way for a speedier reduction of this wedge between savers and investors.

While there are no plans for the foreseeable future to reduce deposit insurance premiums paid by banks and credit unions, the Law on Deposit Insurance envisages an upper limit on the funds accumulated by the Deposit Insurance Fund equal to 4% of covered deposits.

After the successful repegging of the litas in February 2002, the issue of foreign currency usage is being reconsidered. Before the repegging, only banks and credit unions were allowed to extend credits in foreign currencies, thereby sheltering them from the domestic bond market competition and hampering the development of the entire bond market.

As EU integration proceeds at a fast pace, the future of the shallow domestic stock market will become uncertain. Therefore, mergers with the Warsaw Stock Exchange or Scandinavian Stock Exchanges should be seriously considered.

Relaxation of the still valid foreign investment limits would allow a wider range of domestic financial institutions to acquire experience, contacts and relevant skills of transactions in the euro area and other foreign markets, allowing them to become well prepared for the integration into EU financial markets.

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