# Developing Government Debt Securities System: The Case of Latvia

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**Abstract:**

Developing countries are in need to attract additional resources. Reasons causing this action vary: i) to increase the speed of countries development, ii) lack of financial resources to settle government liabilities, iii) solve social requests of society like hospitals, schools, concert halls and infrastructure.
The object of the research is government debt securities in Latvia with the aim to analyse improvements to increase demand on them. To achieve the target statistical data analyses and grouping analyses methods are used. With respect to Latvia starting from December 1993 there have been a lot of issues of government securities and consequently maturities, however there is a lack of result in country's development or solutions in social projects. During 18 years from 1993 till 2011 the government debt has grown from 0% till 38% of GDP.
Overall results of the research will show the logical development of the debt maintenance system and the need for improvements in it. There will be given highlight of weak points in system and suggestions of the way to reduce further increase of the total debt amount, e.g., by introducing improvements in the current system and attracting additional amount for smaller percentage payments.
Current system is attractive for professional investors like banks, insurance companies, pension and investment funds, but not so attractive for households. The author believes that country with strong economy must rely on their resident households and should attract additional investors from household sector.

Key words: borrowing, government debt, securities system.

**The System**

The first issue of government debt securities in Latvia took place in December 1993. There were offered government debt notes for the period of one month. The main reason for it was to develop government debt market. The trade place and infrastructure for trade was developed and maintained by the Bank of Latvia. As the Bank of Latvia provides money settlements and controls the amount of reserves, it was possible to settle debt securities system and maintain it.
For the first 6 years it was only possible for banks and other special entities to take a participation in primary government debt market. As there were no stock exchanges for these securities, no households could buy any government debt security. That resulted in situation in which banks had a role of intermediaries. From liability side banks took deposits from households, but from asset side they were lending the money to government for better percent rate. Since 1999 it was possible for banks or investors with more than 140 thousand EUR equivalents to participate in primary market, but household and non-finance companies with less than 140 thousand EUR equivalents could make investments using secondary market.

After several years, the barrier of 140 thousand EUR equivalents has been taken off, but the problem remains the same. Starting from August 1999, the change in debt law made the State Treasury responsible for debt maintenance and as the technical provider of system was chosen NASDAQ OMX Riga. As it is seen in the image No.1, all the information and responsibilities for technical provision of the issue, settlements and maintenance lays on the NASDAQ OMX Riga and it's daughter company – Latvian Central Depositary, that is 100% owned by NASDAQ OMX Riga(NASDAQ OMX Group, 2012).

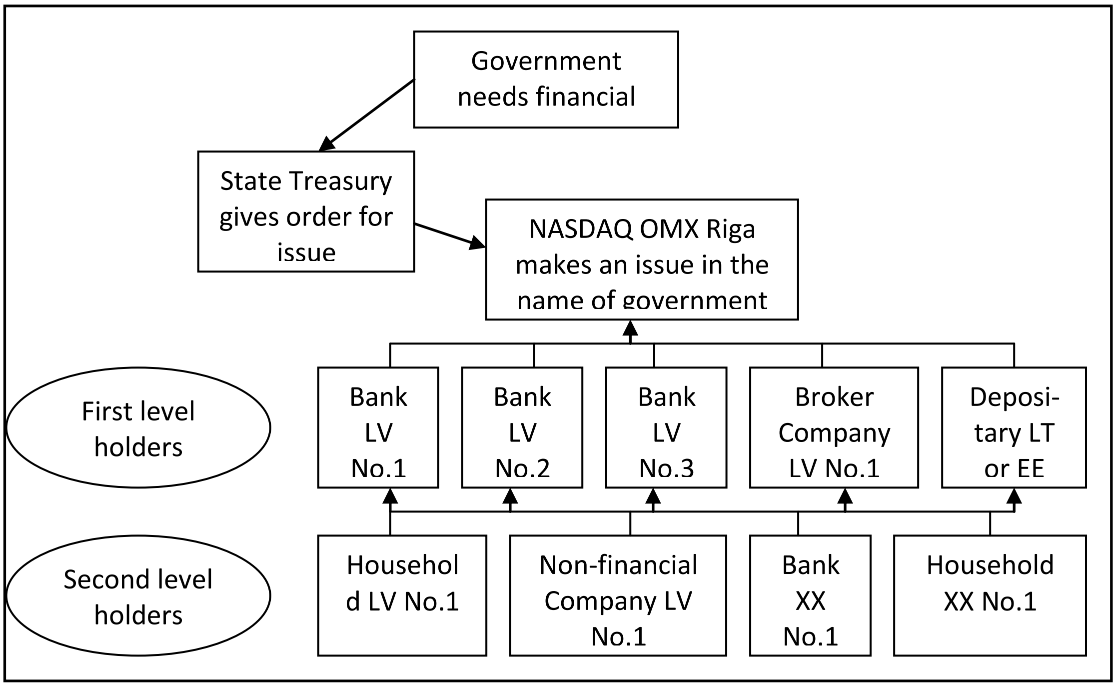


Image No.1 The turnover of internal government debt securities in Latvia 2011
Source: Image made by the author using resources from [www.nasdaqomxbaltic.com and www.kase.gov.lv]

The image No.1 shows that it is impossible to buy any government debt securities without using NASDAQ OMX Riga services. Additionally for household, non-financial companies and investors that are not banks or broker companies it is not possible to buy government debt securities without intermediaries who charge extra fee.

**The Potentials Amounts**

To understand the total amount of possible investments in government debt securities by non-financial companies and households Chart No.1 shows the statistical data accessible of the total amounts held by the above mentioned sectors according to the positions in the MFI (Monetary Finance institutions) balance sheet.

**Chart No.1**

Liability positions of MFI balance sheet excluding the Bank of Latvia in million lats

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| **Overnight deposits** | 584,7 | 804,9 | 1210,5 | 1804,1 | 1652 | 1385,2 | 1114,9 | 1662,7 | 1821,3 |
| · Financial institutions | 6 | 17,8 | 13,7 | 31,5 | 42,3 | 51,3 | 38,8 | 106,2 | 47,1 |
| · Public non-financial corporations | 36,5 | 37,6 | 54,5 | 115,6 | 117,1 | 111,9 | 70,4 | 87,1 | 166,8 |
| · Private non-financial corporations | 255,5 | 372,8 | 537,8 | 744,1 | 705,8 | 556,4 | 448,2 | 698,8 | 782,2 |
| · Households | 286,7 | 376,8 | 604,4 | 912,8 | 786,8 | 665,6 | 557,5 | 770,5 | 825,1 |
| **Time deposits** | 421,8 | 532,6 | 630,6 | 765,5 | 979,7 | 1141,8 | 1119,6 | 1031,3 | 722,2 |
| · Financial institutions | 28,4 | 42,3 | 61,4 | 69,3 | 141 | 230,1 | 296,6 | 283,7 | 146,7 |
| · Public non-financial corporations | 42,3 | 47,8 | 51,8 | 73,5 | 175,8 | 167,1 | 200,9 | 155,2 | 87 |
| · Private non-financial corporations | 104,1 | 137,3 | 160,3 | 138,4 | 150,9 | 171,2 | 117,9 | 165,5 | 103,2 |
| · Households | 247 | 305,2 | 357,1 | 484,3 | 512 | 573,4 | 504,2 | 426,9 | 385,3 |
| **Households and non-financial corporation's total** | 972,1 | 1277,5 | 1765,9 | 2468,7 | 2448,4 | 2245,6 | 1899,1 | 2304 | 2349,6 |

Source:The Bank of Latvia. Accessible: [http://www.bank.lv/images/stories/pielikumi/statistika/MFI_bilances_un_monetara_statistika/Table9a_9b_MFI_kopsavilkuma_bilance.xls] last seen on 14.03.2012

At first steps of development by issuing debt securities the main reason for government was to attract money. In the year of 1993 it was considered that the main sector with resources is custodian banks which accordingly became the main security holders. By the end of 2011 the savings of the capital by non-financial companies and households, as it is shown in the Chart No.1 in overnight deposits and time deposits are 2,3 billion lats that in total makes 3,3 billion EUR. From one point of view those are commercial activities of the banks to attract resources from liability side and to provide these resources to interested parties on better interest rates from asset side. However, from other point of view it could be possible for the government, to attract resources directly on its own. In that case at least some part of 3, 3 billion EUR could be used without paying fees to intermediaries.

**Classifications**

All the government debt securities issued by the Latvian government can be classified by using 5 main indicators: by issue, by turnover facilities, by distribution, by maturity and by income payments, as it is shown in the image No.2.

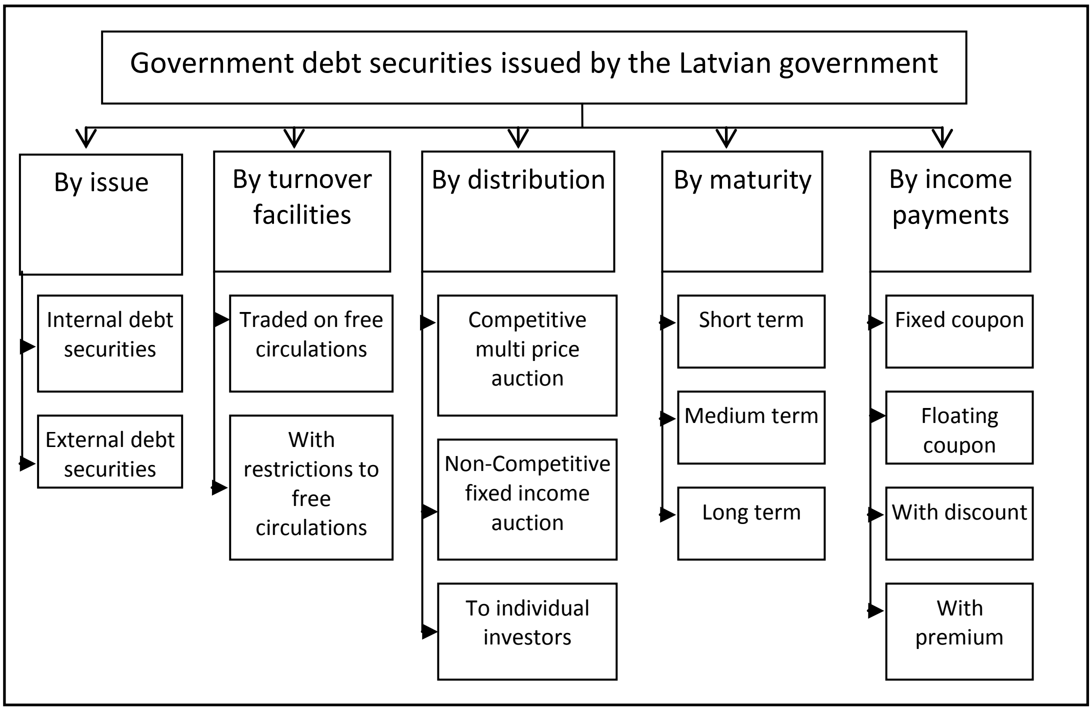


Image No.2 Classification of government debt securities issued by the Latvian government from 1993 till 2011

Source: Image made by the author using resources from [www.nasdaqomxbaltic.com and www.kase.gov.lv]

Analysing the Image No.2 referring to the section "By income payments" author can conclude, that there is a lack of index-linked income payments for government debt securities in Latvia. However, e.g., countries, like Canada (Department of Finance Canada, 2012) and USA (Treasury Direct, 2012) are offering debt securities for households with interest rate and/ or nominal linked to inflation rate. Having regard of this,to author's consideration that brings to need for improvement of different types of government debt securities in Latvia, by adding, for instance index-linked coupon type.

**International Requirements and Issues**

In parallel to issuing internal government debt securities, during 1999 Latvia made the first international issue or Eurobonds in total amount of 150 million EUR for 5 years. It was the result of long preparation work. At the moment of issue of Eurobonds, the main reason of doing it was to reduce interest rates in internal market and to take first steps to join the European Union. As Latvia was planning to join the European Union and the European Monetary Union, there was a need to start to comply with euro convergence criteria (also known as the Maastricht criteria). In general there are five main criteria which shall be met (Economic and financial affairs, 2012):

- Annual government deficit must not exceed 3%;
- Gross government debt to GDP must not exceed 60%;
- There should be exchange-rate mechanism under the European Monetary System for two years;
- Inflation rate should be less than 1,5 percent points than the average of three best performing Member States of the European Union;
- The nominal long-term interest rate must be less than 2 percentage points higher than in the three Member States with the lowest inflation rates.

Simultaneously in 1999 the economy of Latvia was just developed and the main trading partners were connected to Russian market. At that moment the Russian financial crises started having impact on the economy of Latvia. In 17.08.1998 the Russian government devaluated their currency ruble, defaulted on domestic debt, and declared a moratorium on payment to foreign creditors (Abbigail and Michael, 1998). The above mentioned action affected newly developed Latvian economy. As a result majority of export has been stopped and there was a need for the government to increase its

expenditures. As the effect of the crises started only in the middle of 1999 and also the first issue of Eurobonds took place at the same time, the internal debt was not reduced as initially planned and the crises effected Latvia less than in case no additional resources would have been attracted.
The total amount and times of issues of government securities is indicated in the subsequent

**Chart No.2**

External issues/ borrows by the Government of Latvia from 1993 till 2011

| Issue/ borrow data | Amount in millions EUR | Interest rate according to IRR method | EURIBOR 6 month interest | Difference between interest rates (a-b) | Credit long term rating Fitch/ Moody's/ Standard&Poor's |
|---|---|---|---|---|---|
| 14.05.1999 | 150 (issue) | 6.55% | 2.586% | 3.964 | BBB/Baa2/BBB |
| 06.10.1999 | 75 (issue) | 6.78% | 3.379% | 3.401 | BBB/Baa2/BBB |
| 27.11.2001 | 200 (issue) | 5.64% | 3.292% | 2.348 | BBB/Baa2/BBB |
| 02.04.2004 | 400 (issue) | 4.29% | 2.018% | 2.272 | A-/A2/A- |
| 29.02.2008 | 400 (issue) | 5.53% | 4.383% | 1.147 | BBB-/A3/BBB- |
| 29.12.2008 | 600 (borrow) | 2.352% | 3.037% | -0.833 | BBB-/A3/BBB- |
| 25.02.2009 | 1000 (borrow) | 3.125% | 1.951% | 1.174 | BB+/Baa3/BB |
| 27.07.2009 | 1200 (borrow) | 3.125% | 1.168% | 1.957 | BB+/Baa3/BB |
| 31.08.2009 | 200 (borrow) | 2.352% | 1.082% | 1.27 | BB+/Baa3/BB |
| 03.09.2009 | 100 (borrow) | - | 1.076% | -1.076 | BB+/Baa3/BB |
| 04.11.2009 | 200 (borrow) | 3.03% | 1.002% | 2.028 | BB+/Baa3/BB |
| 19.02.2010 | 200 (borrow) | 2.559%* | 0.965% | 1.594 | BB+/Baa3/BB |
| 11.03.2010 | 500 (borrow) | 3.375%* | 0.957% | 2.418 | BB+/Baa3/BB |
| 16.06.2011 | 500 USD (issue) | 5.49% | 0.395% (LIBOR) | 5.095 | BB+/Baa3/BB |

* - interest rates are approximate, according to analytical information (Latvian official law portal, 2012)

Source: Latvia State Treasury. Accessible: [http://www.kase.gov.lv/uploaded_files/2010/FRD/izsolu_rezultati_2011_04_15.xls] last seen on 06.05.2012 and Euro Interbank Offered Rate. Accessible: [http://www.euribor-ebf.eu/euribor-org/euribor-rates.html] last seen on 01.05.2012

As it is seen in the Chart No.2 there has been 6 issues (5 initial and 1 additional) of external government debt securities. The difference between interest rate that is for government debt securities and the interbank term deposits shows that only in 2008, just before the crises, it was less than 2 percent. From one point in total it is not higher than 6 percent, but from other point it would be higher if there were no loans from the European Union and international organisations in the time period from 2008 till 2010.

As regards loans, the difference between the loan rate and interbank term deposit rate is lower and sometimes the borrowing rate is even lower than interbank term deposit rate. That concludes that if there is an option to borrow from the international organizations, such an option is more preferable in comparison to issuing government debt securities and should be used. However, if there is an option to borrow by higher interest rate than it is possible by issuing government debt securities, then securities should be issued.

It is hard to analyse how international credit rating and its changes affect interest rates. From 1999 till 2004 the interest rates were reducing while credit rating was increasing. According to theories (AAA Oligopoly, 2008) the higher the rating is, the lower the interest rate is. In 2008 the interest rate for debt securities increased and meanwhile EURIBOR rate increased as well, as a consequence of decrease of the rating. However, the difference between interbank term deposit rate and interest rate for government debt securities has decreased. It shows that prior borrowing it is important to calculate difference between the interest rate for government and interbank term deposit rate. In this case, there was no logical reason for decrease in difference, if only the calculations were made by not giving better priority to government due to mortgage crises and possibility that all banks could have problems to repay their loans.

The last issue was made when the government had its worst rating which consequently resulted in the highest interest rate difference.

The lack of government bond issues from the end of 2008 till the middle of 2010 is connected to the international loan program, provided to Latvia by the European Union and the International Monetary Fund. The Latvian crises (2008-2010) was impacted and started from the global financial crisis in 2008-2009. The crisis was generated when an easy credit market burst, resulting in an unemployment and bankruptcy of many companies. As the rating went to non-recommendable for investment, the situation could develop in a way that in the worst scenario no resources could have been granted by regional and international organisations.

The plan for an emergency bailout loan of 7, 5 billion EUR was excellent, but there was no need for such amount to be borrowed for Latvia at that time. This is the reason why only 4 billion EUR were transferred to Latvia. Consequently, not all of the borrowed financial resources have been used, however that gave stability to international debt market.

Therefore, by the author's point of view, it is logical that smaller amounts of debt are attracted to internal market and when there is a need to refinance the debt on better interest rates, then international resources on lower interest rates should be attracted.

The only problem is that during some issues deposit interest rates are much lower than interest rates to be paid for the debt. That gives to author additional confidence that there is a need to increase household lending to government. Choosing this scenario, there would be an option to decrease the total debt amount by paying smaller percentages to households and non-financial companies then to financial intermediaries.

Moreover, to author's consideration there is a need for various type of securities apart from those depending on issue, turnover, distribution, maturity and income payments. Additional securities could be introduced for purposes like large project financing, guaranty of safe haven to part of household savings and non-financial company savings.

Since its development in general the system of internal debt securities issues in Latvia works well, and if there is a need for additional resources to be attracted for state financing purposes it is possible for the government to attract them at any time by issuing debt securities. However, there are several risks to be evaluated prior government debt securities are to be issued, e.g. risk of not buying all securities offered at particular date. Also there is a risk that banks can ignore opportunity to acquire government debt securities due to other than economical reasons. Particular risks on several occasions are not analysed by the government. Therefore, to author's consideration, particular aspect should be improved in the future in order to eliminate the risks and respective consequences. However as long as Latvia is the Member State of the European Union there is a persuasion that in urgent issues financial support from the outside resources will be granted.

## Findings

- Internal government debt securities settlement and maintenance system has developed as it should, and it was logical that by the time when it was developed in 1993, the main participants to the system and lenders to the government were custodian banks and other professional investors.
- When in 1999 the internal government debt settlement and maintenance system was started to be maintained by NASDAQ OMX Riga, it was natural way of development that no important changes have been made so that everything could be continued in the way as initially started.
- The external government debt issues in 1999 were as next steps for development of government debt security system. Short and medium term issues are recommendable to be made in the country. Whereas for a longer period and lower interest rate international issues abroad should be made where more financial resources are circulated.
- During all the time the system is accessible only for the major participants of the financial sector in a role of the lender. Non-financial companies and households have not been given an opportunity to participate. These sectors are keeping in their bank account more than 3,3 billion EUR, and some part of the money could be used for reduction of government external debt.

IEGULDĪJUMS TAVĀ NĀKOTNĒ

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