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Evaluating the Interrelationship between Actions of Latvian Commercial Banks and Latvian Economic Growth

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Abstract

This paper aims to evaluate the existence of the interrelationship between Latvian commercial banks' operations on the economy, based on economic theory and the analysis of banks' retained earnings, credit growth and economic growth trends.
The existence of this interrelationship was tested using Granger causality and Johansen cointegration tests. The analysis was based on quarterly data from 2001 to 2015. The study reviewed several indicators for banking developments to establish their relevance for GDP growth: credit to non-banks, non-bank deposits and bank retained earnings. This paper finds that the empirical link between bank retained earnings and GDP growth is more robust that between credit growth and GDP growth, although this does not mean that credit growth is not important. The relationship is bidirectional – GDP growth has a significant effect of bank retained earnings and vice versa. The implication for banks is to continue optimizing their asset and liability structure and adjust to both current unprecedented monetary accommodation and its eventual unwinding.

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Keywords: Latvian commercial banks, operating results, economic development, regression model

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1. Introduction

The link between the financial sector and the real economy as an object of theoretical analysis has returned to prominence in the aftermath of the financial crisis. In Latvia a sharp contraction in credit after 2008 as external financing became scarce had shown that banks can not only promote growth, but also endanger it. Safeguarding the stability of the financial system and minimizing the risks of negative spillovers from the banking sector to the rest of the economy is the key objective of bank supervision, which has recently been strengthened in the euro area with the introduction of the Single Supervisory Mechanism, which covers Latvian banks as well.

However, even in the aftermath of the Single Supervisory Mechanism, Latvian commercial banks continue to struggle with the consequences of prolonged period of deleveraging that affect their operating results, which, in turn, can affect economic growth. On the other hand, GDP growth can affect the profitability and stability of the banking industry. Thus the interrelationship between commercial banks' operations and economic growth in Latvia is a highly relevant topic for both bank supervisors as well as macroeconomic policymakers in general.

Some of the earliest analysis of the link between economic and financial development dates back to Schumpeter (1934), who argued that the services offered by the financial sector – attraction of deposits, resource allocation, providing a payment system and managing risks are the main preconditions for technological progress and economic development. McKinnon (1973) argued that if the financial system is fragmented and agents have to rely only on their own savings for investment, a country will not be able to mobilize resources to switch to more productive technologies and hence development prospects would suffer.

Other authors, however, saw financial development as more of a consequence rather than a cause of economic development, for example, Robinson (1952), or Lucas (1988), who argued that the development of financial institutions has been over-stressed as a factor for economic development. Greenwood and Jovanovich (1990) develop a theoretical model that synthesizes the two views, where financial intermediation and growth are inextricably linked. Financial intermediation promotes growth because it increases the return on capital, while growth enables ever more sophisticated financial intermediation.

Early empirical research on the link between financial and economic development focused on growth, for example Goldsmith (1969) establishes a close empirical relationship between financial development and economic growth. Using the data for 80 countries over thirty years (1960 to 1989) King and Levine (1993) conclude that financial development can be a good predictor of long-run growth, which suggests that financial development is not merely a consequence of economic development, yielding support for Schumpeter's views.

In most emerging markets, in particular in Europe and Latvia, financial development is primarily a bank based process. Thus many authors focus on the interrelationship between banking sector developments and economic growth. The most obvious link is via lending and there is a large amount of literature linking credit and economic growth. Beck and Levine (2004) find that bank credit (as well as stock market depth) positively influence economic growth and that these findings are robust to the possibility of simultaneity. Beck *et al.* (2005) find that financial intermediation (measured as private sector credit to GDP) exerts a large positive impact on total factor productivity and GDP growth. More recently, in the aftermath of the financial crisis and as econometric techniques have become more sophisticated, the conclusion has become more nuanced. Law and Singh (2014) find that finance exerts a positive influence on GDP growth only until a certain threshold. A similar conclusion has been reached by Cecchetti and Kharroubi (2012), who focus on the sample of developed and emerging economies.

Besides the credit channel, Mwenda and Mutoti (2011) find that improvements in bank cost efficiency and strengthening of regulatory and supervisory financial frameworks are significant determinants of economic growth. Greenwood *et al.* (2013) summarize the channels of transmission from financial development to economic growth as *capital deepening*: when lower interest rate spreads lead to higher capital to GDP ratio, which in turn leads to a greater level of GDP per capita and *reallocation effect:* the fact that lower interest rate spreads are associated with higher TFP growth rates.

However, the causality in the relationship between financial sector and the economy is not linear – not only do banking sector developments affect economic growth, but banks and other financial intermediaries are sensitive to growth itself. Albertazzi and Gambacorta (2009) find that the positive relationship between bank profits and economic growth is mainly due to the effects of growth (the business cycle) on net interest income (via lending