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DEVELOPMENT OF LONG-TERM SAVINGS SYSTEM IN LATVIA

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Abstract. This paper documents that in Latvia long-term savings are not particularly widespread both in the form of bank deposits as well as investment assets. Indirectly, this contributed to the 2009 balance of payments crisis, because it encouraged overreliance on foreign financing sources. Low levels of financial literacy may be one of the contributing factors to the low level of long-term savings along with low levels of disposable income and the demographic situation. The paper suggests some proposals and recommendations to further facilitate the development of the system of long-term savings.

Key words: *long-term savings, deposits, pension plan assets*

JEL code: E21

Introduction

Savings and their dynamics are concepts of fundamental macroeconomic significance. In countries with a sustainable market economy accumulated savings are invested and therefore become the driver of economic growth. Sustainable economic growth further increases a country's level of wealth, which enables economic agents to save more, establishing a positive feedback loop. Furthermore, imbalances between savings and investment levels in open economies are associated with current account deficits, which played a definitive role in the run-up to the 2008-2009 crisis in Latvia. If investment levels exceed the levels of saving, the gap is closed by foreign capital inflows, which can stop or reverse suddenly. Historically, such reversals have had a negative effect on growth that goes beyond their direct effect on investments (Edwards, 2004).

The link between the processes of saving and investment is established by financial markets. Financial markets and relationships not only underpin the majority of economic transactions, but also aspire to a leading role in the modern economy. Beck et. al. (2010) document that financial markets have generally deepened over time measured by increases in market development indicators (especially in high income countries) and became more globalized measured by the volume of cross-border transactions. The level of development of financial markets is a key indicator of the social and economic development, while the level of the financial literacy of the population determines whether the potential of financial market to execute their man function of facilitating productive investment can be unlocked.

A high level of the financial literacy enables a person to manage his money savings more efficiently, contributing to the formation of active saving and investment behaviour (Lusardi and Mitchell, 2011a). All of this, in turn, facilitates financial market development and provides the basis for the growth in prosperity of the population and of the country. A positive link between financial market development and growth has been shown, for example, by Enisan and Olufisayo (2009), as well as Guiliano and Ruiz-Arranz (2009).

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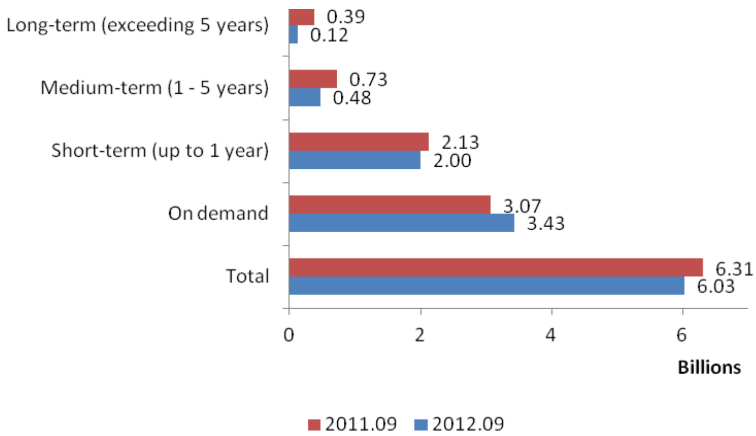
The problem of promoting financial literacy and encouraging responsible saving by the population has been highlighted by Lusardi and Mitchell (2011b), who show that financial illiteracy is widespread when financial markets are well developed as in Germany, the Netherlands, Sweden, Japan, Italy, New Zealand, and the United States, or when they are changing rapidly as in Russia. They also argue that financial literacy is critical to retirement security.

Only a proper level of the financial literacy of the population leads to the rise in the standard of living of citizens, development of economics and improvement of social welfare. A sufficiently high level of the financial literacy facilitates the inflow of cash into the economy thereby strengthening its financial stability. As globalization encourages faster and more uniform processes of economic development across many emerging markets, the problems of improving financial literacy acquire particular relevance.

In this paper the authors document the trends in the development of long-term savings system in Latvia, by highlighting the dynamics of its main forms – term bank deposits and pension plans. The authors propose a theoretical framework for classifying savings based on different incentives to save and consider the reasons for rising importance of financial literacy and how they apply to Latvia, as well as certain other considerations, such as demographic trends. Finally, the authors conclude with recommendations on improving financial literacy and the operation of the long-term saving system overall.

Long-Term Savings in Latvia

The long-term savings system in Latvia offers several venues for savers: long-term bank deposits, contributions to pension funds, and life insurance being the primary ones. Immediately, certain idiosyncratic circumstances become apparent.



Source: Authors' calculations based on Financial Capital and Markets Commission data[2].

Fig. 1. **The term structure of deposits in the Latvian commercial banks in 2011-2012 (billions LVL)**

For example, the share of deposits made by the population is comparatively small. According to the respective national banks' data, in 2012 total deposits of residents in the banking system amounted to around 37% of GDP, whereas in neighbouring Estonia they were around 60% of GDP. One possible explanation could be that the average disposable income in Latvia is low relative to the EU average, and lower than in Estonia.

[2] See http://www.fktk.lv/lv/statistika/kreditiestades/ceturksna_parskati/2013-02-07_banku_darbiba_latvija_20/

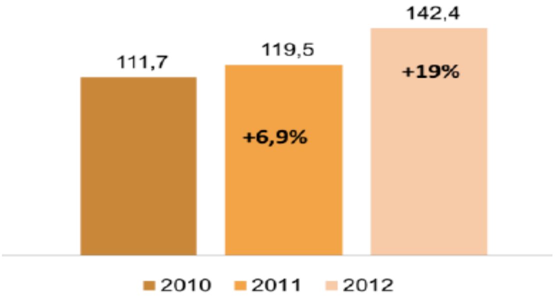
Recent evidence shows that low levels of disposable income can be especially damaging to the likelihood of saving – having income below the household reference level decreases the likelihood of saving, while having income above the household's reference level does not have a significant effect on the likelihood of saving (Fisher and Montalto, 2011). Another explanation could be the lack of saving habits.

The analysis of the Latvian banks data on long-term savings also shows that in the 3rd quarter of 2012 only 2% of the general savings fall to the share of long-term savings in the banks (deposits for a term exceeding five years and more), long-term savings if compared to 2011 decreased by 68%. The proportion of medium-term (1-5 years) and short-term savings (up to 1 year) has decreased as well by 34.2% and 6.2% respectively. The changes occurred not only in the term structure of deposits, but also the level of deposits in the banking system has decreased by 4.48%.

The decrease in the amount of long-term savings in the form of bank deposits can be explained by lowering of bank interest rates on fixed-term deposits and by the growing popularity of alternative deposits in private pension schemes, which can be considered investment savings.

Having analyzed the trends shaped up in 2010-2012, one can conclude that decrease in the volumes of bank long-term and short-term deposits was partially compensated by the growth of assets in private pension schemes (Figure 2), which can be explained both by their average profitability (Table 1), and by a possibility to get additional profitability through recovery of personal income tax from the contribution amount not exceeding 10% of gross income.

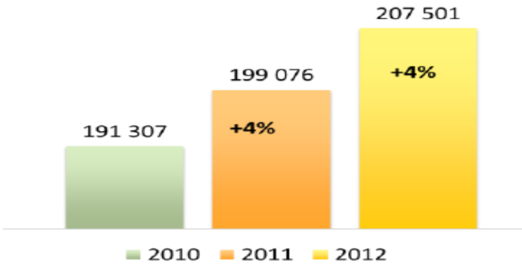
In 2012 in Latvia there were 7 private pension schemes – 6 open and 1 closed pension scheme.



Source: Pensiju fondu apskats, No. 4, 2012, http://www.bankasoc.lv/lv/pdf/Apskats_2012_gads.pdf

Fig. 2. **Pension plan assets in Latvian private pension schemes in 2010 - 2012 (million LVL)**

In 2012 the pension plans in private pension schemes had a 142.4 million lats in assets, up 19% compared to 2011.



Source: Pensiju fondu apskats, No. 4, 2012, http://www.bankasoc.lv/lv/pdf/Apskats_2012_gads.pdf

Fig. 3. **Number of members in Latvian private pension funds in 2010-2012, pers.**

In general, in Latvia 207501 members participate in the third level of pension plans, or 17 percent of the number of members of the 2nd level participants (Fig. 3). In 2012 the number of members increased by 4 percent, the average age of the members is 45 years, confirming that the members are of the active working age.

Table 1

Average return of private pension plan as at 31.12.2012, in percentage terms

	Balanced Plans				
	1 year	**2 years***	**3 years***	**5 years***	**Since Inception**
Average Return	8.23%	3.29%	4.84%	4.08%	4.72%
	Active Plans				
	1 year	**2 years***	**3 years***	**5 years***	**Since Inception**
Average Return	9.19%	2.84%	4.59%	1.62%	4.88%
Average Return of All Plans	8.80%	3.02%	4.69%	2.62%	4.82%

***** *Average annualized return*
Source: Pensiju fondu apskats, No. 4, 2012, http://www.bankasoc.lv/lv/pdf/Apskats_2012_gads.pdf

The main advantages of these types of savings are that it is possible to change the amount and timing of contributions easily. In addition, according to the current tax legislation contributions to the third pillar of the pension system are tax deductible, allowing the saver to recover part of the income tax paid each year. In addition, Table 1 shows that the profitability of these pension plans has been higher than the average deposit interest rates, which can explain their rising popularity on account of declining popularity of long-term deposits.

Another form of long-term saving is a form of life insurance, which simultaneously combines both the life insurance function as well as accumulation of capital. Insurance becomes current with the first contribution, which means that if the saver dies, the designated beneficiary will receive the full amount of the insurance policy together with the accumulated premiums and income on those. Otherwise, the policy will expire and the saver will receive all of the premiums paid, together with interest. Current tax legislation makes contributions to these life insurance policies tax deductible as well.

Theoretical Classification of Savings

It is well-known that the presence of certain incentives or lack thereof contributes to the economic agent’s decision on whether to save and, if yes, then to what extent. Based on the incentives for saving, the following types of household savings can be distinguished:

- current savings – for the purchase of durable goods (typically in the form of bank deposits);
- contingency savings and savings for old age (often in the form of bank deposits);
- investment savings (including investment in private pension schemes).

Current savings are replenished regularly by diverting some of the income to that purpose. When the income is used for current consumption purposes current savings are depleted. Such savings are usually short-term and are accumulated in highly liquid forms, including physical cash.

Savings for the purchase of durable goods are built-up when the price of a planned purchase exceeds the current income of a potential buyer. In order to make the purchase the consumer must accumulate the necessary amount, unless he or she is willing to take a loan. In fact, the durable goods itself may serve as collateral for a loan. Fernández-Villaverde and Krueger (2011) show that in a model with interaction of consumer durables and endogenous borrowing constraints durables accumulation is predicted early in life and higher consumption of nondurables and accumulation of financial assets is predicted later in the life cycle. Accumulation of the said amount implies the delay of consumption in time, whereas the longer delay the more time is required to accumulate the amount necessary for the purchase.

Contingency savings and savings for old age are by nature long-term savings. The decision to spend the funds saved in this category implies the occurrence of a special case: disease, disablement, old age etc. Such savings might be less liquid until completion of the process of their accumulation.

Investment savings refer to a special type of savings, which is not simply deferred consumption. The main objective of such funds is investment in assets that generate returns. The volume of such savings depends upon the general living standards of the society and upon the level of income of individuals. The majority of savings of this type is invested in different investment tools. The funds from which investment savings are formed can be short-term and long-term.

The long-term savings manifest the source of financial assets on the capital markets or long-term assets. The short-term savings come on the money market or commercial paper market. The degree of liquidity of investment savings depends upon the liquidity and return on assets, in which the funds were invested.

The level of savings can depend upon many factors, reflecting the presence of different social and economic reasons of building-up thereof in different people, manifested as certain saving motivations. These factors are considered by the family economics, as well as personal finance, which refers to a special area of scientific study and cognition. Historically, it has been identified as moral economics or humanitarian finance, where the defining role is played by a subjective factor, i.e., human psychology. Humanitarian finance is a cross-disciplinary line formed at the junction of economics, psychology, financial science and sociology. The problems, related to the household finances and management thereof, have not been researched substantially by the Latvian financial science. The savings initially stand for the result from the decision of households as regards the use of monetary income, at the same time they represent one of the components of the economic relationship system. For the society the availability of savings means development opportunities in the future.

The Concept and Impact of Financial Literacy

Having reviewed the dynamics of long-term savings system in Latvia and the theoretical classification of savings, one can now turn to the concept of financial literacy. The OECD offers the following definition of financial literacy: "*knowledge and understanding of financial concepts and risks, and the skills, motivation and confidence to apply such knowledge and understanding in order to make effective decisions across a range of financial contexts to improve the financial well-being of individuals and society and to enable participation in economic life*" (OECD, 2012).

Thus, one of the ways in which the impact of the low level of financial literacy can manifest itself, is the lack of knowledge about financial services on offer, as well as the lack of trust in the offered financial instruments for saving – universal life insurance and investment in private pension schemes. These explanations may be as important in accounting for the dynamics previously described as the scarcity of funds available for saving.

Economic agents may need incentives to save. The large levels of debt accumulated by variously both private and public sectors in most of the advanced countries testify to lower incentives to save in those countries and higher incentives to consume. In many countries there are incentives for building up savings and there are mechanisms enabling to accumulate and efficiently apply savings in economic activity. At the moment, the culture of savings in Latvia is in its incipient stage, and economic agents may not have enough knowledge of the offered avenues for saving.

On the other hand, the development of lending industry and lighter terms of borrowing, driven by the temporary influx of resources from abroad, resulted in the considerable widening of the circle of consumers of credit products, as well as in the emergence of borrowers, incapable to evaluate objectively their capacity to meet the assumed obligations.[3] In crisis situations this problem becomes aggravated and occasionally requires interference of government institutions, with potentially high overall social costs. Loans taken without due consideration and problems with their repayment, another possible manifestation of low levels of financial literacy, adversely affect the disposition of the population to make savings or exclude such possibility at all.

However, even economic agents free of debt may not necessarily concern themselves with building up savings. The polling of one thousand individuals taken by the *SEB bank* in cooperation with the SKDS Public Opinion Research Centre in 2012 showed that one person out of six saves up cash, while only one out of ten has savings in a bank. A mere one percent of the respondents invest in securities or jewellery, while four percent of respondents chose another type of accumulation of money or tangible resources. Only three percent of the respondents invest in pension or insurance saving funds, while the overwhelming majority (69 percent) declared that they did not have any savings at all. Thus, approximately two – thirds of the country population does not have any savings for the future, for education, for improvement of their living conditions. These facts support the notion that a more sustainable long-term savings system needs incentives, which can, in part, be supplied by improvement in financial literacy.

Demographics

Another area of concern for the sustainability of the long-term savings system is the demographic situation. In Latvia one can observe a trend of reduction of employable population and of population in general (Table 2).

Table 2

Latvian population and natural growth in 2011-2012

Population (at the beginning of the period), thousand												
	I	**II**	**III**	**IV**	**V**	**VI**	**VII**	**VIII**	**IX**	**X**	**XI**	**XII**
2011	2074.6	2072.3	2070.4	2066.8	2062.7	2059.3	2056.0	2052.9	2049.8	2047.9	2045.0	2043.4
2012	2041.8	2040.4	2038.7	2036.9	2035.4	2034.4	2033.6	2033.0	2032.4	2031.7	2030.6	2029.4
Population natural growth, pers.												
	I	**II**	**III**	**IV**	**V**	**VI**	**VII**	**VIII**	**IX**	**X**	**XI**	**XII**
2011	-1179	-982	-940	-990	-848	-531	-442	-523	-589	-856	-839	-996
2012	-1090	-1320	-1110	-800	-680	-490	-320	-280	-490	-830	-880	n/a

Source: http://www.csb.gov.lv/dati/iedzivotaju-skaits-un-dabiskas-kustibas-galvenie-raditaji-30070.html

[3] This was matched by imperfections in asset management on the part of the banking system.

Reduction of employable population and the potential increase in the size of the shadow economy increase the risk of poverty for people of the older generation and jeopardize the long-term viability of the pension system, as well as the system of long-term savings. In addition, poor demographic prospects mean that population is likely to become older and older generations as a rule tend to spend what was saved previously rather than save themselves. Implementation of structural reforms in the field of stimulation of savings and of the pension system can help to ease these trends and mitigate their adverse economic affect.

The problem of ageing and reduction of population can weaken the creation of business environment aimed at vigorous and long-term growth, sophisticated and realistic regional planning, support of childbirth and realistic approach to the immigration policy. For mitigation of negative demographic trends it is necessary to stimulate not only childbirth, repatriation of immigrants, skill-based migration, but also increase in employment of population and rise in labour productivity.

Conclusion

This paper had considered the dynamics of the long-term saving system in Latvia, offered a theoretical classification of savings based on the underlying incentives and suggested that one of the reasons for the lack of sustainable domestic savings may lie in the low levels of financial literacy of the population. Lack of financial literacy is by no means the problem unique to Latvia; high levels of financial illiteracy have also been documented by Lusardi (2008) in the U.S. and Van Rooij et. al. (2011) in the Netherlands. However, in Latvia the problem is complicated by poor demographics and low level of population trust in the institutions in general. This makes the task of improving financial literacy even more urgent.

Because low levels of financial literacy may be a concern, the government and the financial industry should more actively facilitate encouragement of responsible financial behaviour and literacy of the population. The financially literate part of the population, who respond to incentives such as higher profitability of pension plans, will save more once the macroeconomic situation in the country is improved. To that end the government must take steps to preserve macroeconomic stability and create a tax environment that is conducive for saving and investment. Finally, the demographic trends highlighted in the paper should be reversed by stimulating the return of migrant workers and adopting pro-natal policies. This will result in growth of the number of economically active population, who will create more long-term savings in the future.

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