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BALTIC STATES BANKING SECTOR EVOLUTION

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Abstract

This article gives an overview of the Baltic States banking sector, analysis of the evolution, structure and their perspective. The banking sector was most focused on, as is currently the most important financial intermediation chain, which has the highest weight. The crisis 2008 has highlighted the impact of globalization on the financial sector. The banking industry must take responsibility not only for a profitable business, but also for the banking activities of the possible consequences economy as a whole. This article analyzes the evolution of the banking sector in Baltic States economy recovery; financial stability in Baltic States related to the uncertainty. This paper analyzes the banking sector problems, efficiency indicators and its evolution. Article examines the changes in banking sector with the economic growth, in crisis and after the crisis. It examined the banking sector in different States and its future development, improvement perspective.

Keywords: Banking sector, Economic Development, Finance, Banks

JEL classification: G21, O16

1. INTRODUCTION

The three Baltic States are usually presented as one region. The natural, historic, political and socio-economic development of and business environment in these countries are analogous thereabout. The twenty first century brought major changes in the global financial dynamics.

Global change forced the Europe Union (EU) to review the cornerstones in its economic policy. Information Technology (IT) revolution, the knowledge society development, a political instability and integration trends are common factors which are causing the changes in global finance. Today's situation in international financial markets, the debt problems increased by countries' monetary and fiscal decisions seeking stabilize the economic recession, the effects appear to reflect the complex cross-country relationships and the extent of financial integration (Martinaityte *et al*, 2011).

The financial crisis has caused credit-worthiness, liquidity, and the dramatic downturn in equity markets were affected by the essential sectors of the economy. Financial sector collapse has given a clear signal about the market economy has changed significantly and

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the banking industry must take responsibility not only for a profitable business, but also for the banking activities of the possible consequences economy as a whole (Martinaityte *et al.*, 2011). Due to the said reason, the prevention and management of the crises of financial systems are integral functions of the modern central banks. Experience of foreign countries proves that problems in the financial sector may arise unexpectedly and can spread very quickly. Speed of the crisis spread depends on the level of interdependence between banks and other financial institutions: the faster it is the higher is the likelihood of systemic crisis.

Baltic States and several euro area countries experienced V-shaped gross domestic product development during the crisis, yet in the Baltic States the dive was followed by recovery, while some European countries experience protracted recession. The prevention and management of the crises of financial systems are integral functions of the modern central banks. Only a stable financial system can guarantee efficient reallocation of resources thereby contributing to the long-term price stability and the growth of domestic economy.

Financial stability in Baltic States is primarily related to the uncertainty caused by the European sovereign debt crisis and the poor growth outlook for the euro area. The financial markets have retained their high confidence in the Nordic parent banks throughout the euro area debt crisis and contributed to the strength of the Baltic States banking sector. Furthermore, the great dependence of the parent banks on market-based funding makes them vulnerable to possible unease on the financial markets.

The article research object is the Baltic States banking sector development in 1991 - 2012. It analyzes the evolution of the banking sector, the aggregated parts of the structure.

The first paragraph is dedicated to short overview of the Baltic States banking sector evolution after the restoration of Baltic States independence from 1991 to 2000. The financial sector there as a main driver the banking sector creates the scope of conditions for the country's economy growth. One of the main problems was quality of human resources, the lack of qualifications and knowledge of bank employees.

The second paragraph is dedicated overview of the Baltic States banking sector evolution from 2000 to 2012, analyzes the development main indicators of the banking sector and the aggregated parts of the structure. Process of economic recovery and banking sector development analyzes presented. Information technology advances have changed not only the bank's strategy, but also promoted the evolution of the banking system. The crisis 2008 has highlighted the impact of globalization on the financial sector.

2. BALTIC STATES BANKING SECTOR EVOLUTION FROM 1991 TO 2000

After the restoration of Baltic States independence (Lithuania 1990.03.11; Latvia 1991.08.21; Estonia 1991.08.20), Baltic States did not have own finance sector, it was necessary to solve the banking dependency issue. All credit resources generated by the Baltic States banking system needed to be separated from the USSR (Union of Soviet Socialist Republic) central banks dependency. State banks functioned as instrument for financing central planed economy sectors. It was one functioning state insurance company. No stocks, no bonds, no leasing, no credit union, no Stock Exchange. From 1988 it was a few very new and very small commercial banks registered in Soviet Union Central Bank. Knowledge of market economy and finance was very low. Just few specialists in all state can work with foreign payments and foreign exchange.

Baltic States was still in the ruble zone, the Central Bank's of Baltic States was not able to pursue an active monetary policy, and its main efforts were aimed at preparing for

the introduction of the national currency. However, open the Eastern market, the gap of high inflation led to get huge profits from trading in rubles, vouchers, and other currencies. Banking laws and normative documents were not complete and no one forced to follow them strictly, since the government's allowed banks to operate even in the absence of compliance with the baseline requirements.

Baltic States turned in a way of development liberal market economy. The number of new banks, insurance, brokerage companies grows fast. In 1992 in Lithuania were 27 banks, in Latvia – 61, in Estonia 21bank. The Central Bank's of Baltic States has taken an important step to strengthening the banking sector control. Some banks were closed or their activities were suspended due to liquidity problems, or other irregularities in all Baltic States. Number of banks decrease in all states.

1995-1996 after the banking crisis, the Bank of Lithuania has taken an important step to strengthening the banking sector control. Until the end 1995 the 15 of the registered 27 Lithuanian banks have collapsed or their activities were suspended due to liquidity problems, or other irregularities, now is 20 banks.

Similar situation was in Latvia and Estonia. Latvia in 1993 has 61bank, in 2000 just 22, today 29. Estonia in 1992 has 21bank, now 16.

One of the main reasons was the lack of qualifications of bank employees. The banking analysts, risk management professionals shortage of Baltic States labor market. It was a very important for Baltic States to improve their human resources in the financial sector. Additional support came from the Danish, Norwegian, Swedish, Italian banks, Austrian bankers' college, by inviting the Baltic States banking personnel training.

3. BALTIC STATES BANKING SECTOR EVOLUTION FROM 2000 TO 2012

Information technology advances have changed not only the bank's strategy, but also promoted the evolution of the banking system. Due to the changes in knowledge economy, the finance specialist's profession competence changes as well. A 21st century banking system is no longer able to bring such a success for banks, which would bring up to 2000, because the banks to their customers, competitors enables anytime, anywhere in the world just a computer mouse click to perform most of the banking operations.

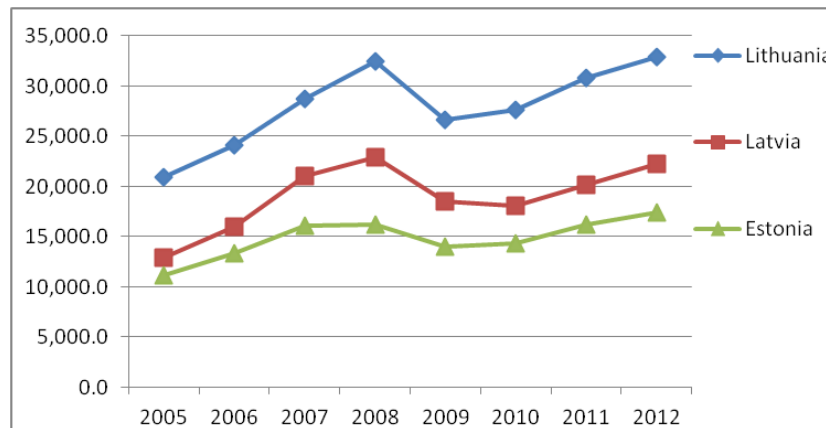
Customers increasingly use digital channels, which over time will entail a new relationship with the bank. Therefore, it can be said that increasing competition between banks for the creation of such banking operations, which are most convenient to the customer. Popularity of electronic commerce, the rapid development of information and communication technology developments have role in enabling of an increasing number of banks in Baltic States started to provide online banking services in the beginning twenty-first century.

The Central Bank's of Baltic States improve supervisory and took an important step to strengthening the banking sector control. When Baltic States became a member Europe Union (EU) in May 2004 and introduce the banking sector modern supervisory system, the banking sector became more stable. Foreign banks buy local banks or open branches of foreign banks. More active Sweden, Finland, Denmark banks.

Baltic States has only few banks problems. Latvia nationalize local bank "Parex" in 2008. Lithuania nationalize bank "Snoras" and closed in end 2011. As consequence in Latvia "Latvijas Krajbanka" affiliated by bank "Snoras" go to bankruptcy. Bank suspension of activities has not the higher impact on the financial system, the banking assets and loans

changes negligible. It is difficult to separate limit of permanent effects of the crisis and on the bank of suspension but it was negligible. Lithuania in 2012 stop bank “Ukio Bankas”, divided in two parts, “good” and “bad”. First was sold, next go to bankruptcy. The recent intervention of “Ukio Bankas” has strengthened financial stability.

The analysis of the Gross domestic product (GDP) evolution in 2005-2013 (Figure no.1) shows how big changes Baltic States had. The particularly strong growth of GDP 2005-2008, when Baltic States joined the European Union (EU) membership.



Sources: Eurostat, Statistics Lithuania

Figure no. 1 – Baltic States GDP 2005-2013 Millions euro

In the autumn of 2008, the Central and Eastern Europe faced a global financial crisis like a fireplace (Aslund, 2011). The new ten European Union (EU) Member States from Eastern Europe faced a huge economic overheating. All new members perceived significantly increased inflation: in Bulgaria, Estonia, Latvia and Lithuania it became double. The financial crisis is already well estimated, it was a great blow on 15 September 2008, and the United States (US) investment bank Lehman Brothers went bankrupt. Suddenly the world decreased financial liquidity, and Eastern Europe faced "sudden stop" – it was left without credit, and liquidity. Although, free monetary policy has been a global phenomenon, so these small and very open economy countries were difficult to prevent.

Baltic States and several euro area countries experienced V-shaped gross domestic product development during the crisis, yet in the Baltic States the dive was followed by recovery (Figure no.1), while some European countries experience protracted recession.

In 2009, GDP fell by more than 18 percent in Lithuania. Latvia lost 21% of its GDP in a short period of time, unemployment tripled, the proportion of bad loans grew to 20%, and real estate market plummeted, whereas the government revenue decreased by almost one third.

Estonia had a little better situation, having some reserves collected in good days, lost 14% of its GDP. The countries which pursued conservative fiscal policies (e.g. Estonia and Poland) were less affected by the crisis.

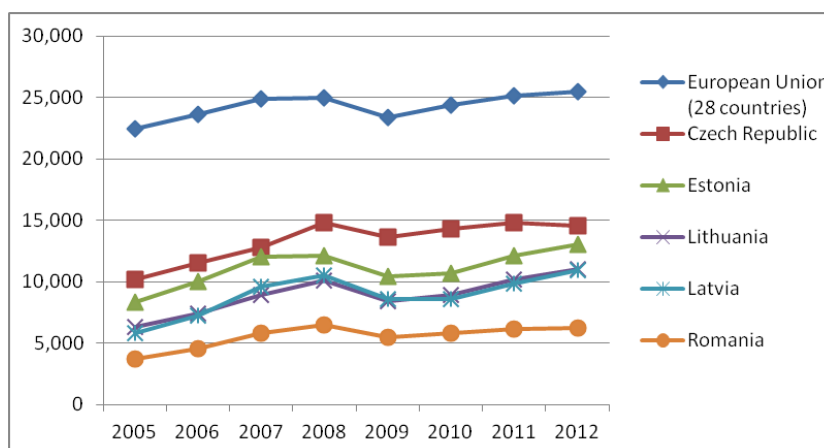
During three years (2008–2010) the overall Latvia GDP decreased per 21.3 percent, and historically it was the largest drop, experienced by some national economy after the Great Depression in the USA where within four years GDP decreased by 29 percent (Skribane I. *et al*, 2013, p.30). Although in 2011 the growth of GDP in Latvia was positive

and reached 5.5 percent. The banking sector's total losses from the year 2009 to 2010 amounted to 1,134.1 million lats (Latvian Association of Commercial Banks, 2011). The largest Latvian debt has reached a level of 44.7% of national GDP due to the nationalization of local commercial bank "Parex" in 2008 (Macys, 2012, p.545).

Lithuania has taken strict fiscal discipline and austerity measures. This has produced results quite quickly, in 2010 GDP grew by 3.4 percent, and in 2011 even 11.5 percent (Chain-linked volume growth 6.0), in 2012 - 3.6 percent.

The Baltic countries today have a significantly better macroeconomic balance and resilience compared with a few years ago. The work done in 2009-2012 to improve credit quality in the lending portfolios and strengthen the capital base in the Baltic States banks has made them more resilient.

To understand better Baltic States place in EU and development let us look at GDP per Capita EU, Czech Republic, Romania, Baltic States 2005-2012 Figure no. 2. Citizens of Baltic States were affected by the crisis more dramatically compared with other EU States, Czech Republic. Baltic States GDP per Capita is approximately two times smaller than the EU 28 countries average. It seems enough place to grow for the Baltic States. It explains the rapid growth of the economy after the crisis period.



Sources: Eurostat, Statistics Lithuania.

Figure no. 2 – GDP per Capita EU, Czech Republic, Baltic States, Romania 2005-2012 (Euro per inhabitant)

The fact that Estonia is the smallest country as compared with two other Baltic countries, the Estonian financial policy really was the most successful. Estonian conservative fiscal policies were less affected by the crisis.

Lithuania's economy is expanding at a healthy pace. Macroeconomic adjustment undertaken after the crisis is paying off with increased resilience, balanced growth, and job creation. Despite these positive developments, Lithuania remains susceptible to risks associated with shocks emanating from trading partners and volatile global financial markets.

The largely foreign-owned financial system is liquid and well capitalized. The Bank of Lithuania's stepped-up supervision of the credit union sector is welcome and should be bolstered by implementation of additional regulatory reforms to strengthen the functioning of this sector.

The banking system's high liquidity and capitalization, alongside declining non-performing loans and the improved economic outlook, should pave the way for healthy credit expansion. In this regard, steps to broaden the mandate of the Bank of Lithuania to include macro-prudential policy are timely and should help ensure that credit growth remains sustainable and does not jeopardize financial stability. Exiting the currency board and joining the euro area is the next logical step for Lithuania on its path towards integration with Europe and will substantially reduce residual exchange rate and liquidity risk.

The Bank of Lithuania has licensed eight commercial banks, 12 foreign bank branches and representative offices. In Lithuania, the banks are major part of the financial system. The banks' assets consists of 75 billion LTL (1EUR=3.45LTL) 21.7 billion EUR, and was 65 percent of GDP, and more than 80 percent of the total financial system assets in August 2013.

The Bank of Latvia has licensed 20 commercial banks, 9 foreign bank branches in 2013. Commercial banks assets consists of 20.29 billion LVL (1 LVL =1.42 EUR) 28.8 billion EUR, and was 129 percent of GDP. In Latvia, the banks are major part of the financial system.

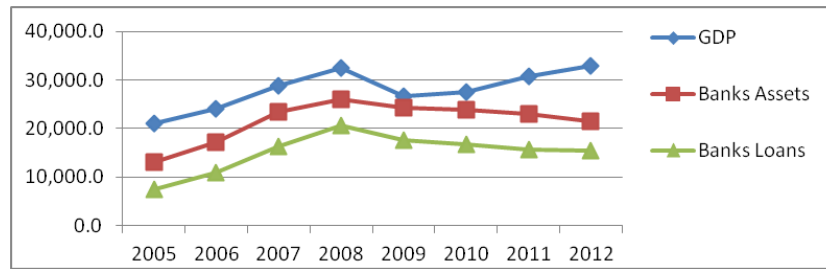
Latvia decided to strike at the root of the problems, choosing internal devaluation instead of currency devaluation. Latvia managed to overcome the crisis, stabilise its fiscal position, implement significant reforms and it returned to the international financial markets already last year. In overcoming the crisis, Latvia focussed on swift response, solidarity and collective action.

Mr. Åslund listed seven lessons (Macroeconomics, 2012) taught by Latvia to the rest of the world, including honest communication of the real situation to the population; early action to restore confidence; implementation of fiscal adjustment; expenditure cuts instead of tax raises; let expenditure cuts drive structural reforms; equity required; get international rescue financing, but with conditions. He also voiced his support to Latvia's journey towards the euro, saying that it would help to avoid a new liquidity freeze. Moreover, concerns about the future of the euro area have diminished considerably at the moment. The situation has stabilised thanks to the latest decisions taken by the European institutions, including about European banking union (Macroeconomics, 2012).

The statement made by Paul Krugman (Krugman, 2010) that Latvia with its two million populations could not be considered reliable proof as to the way how much larger and much more complex economies should act. Some economists who did not have confidence in Latvia's ability to overcome the deep financial and economical crisis and who were unanimously predicting just three years ago that the Latvian economy would collapse and the lats would have to be devalued. The grim predictions by Paul Krugman (Krugman, 2010), Nouriel Roubini (Roubini, 2009) and Lars Christensen about Latvia falling into the abyss have not come true (Macroeconomics, 2012). Latvia has been transformed from the country most painfully hit by the economic crisis into the fastest growing European economy.

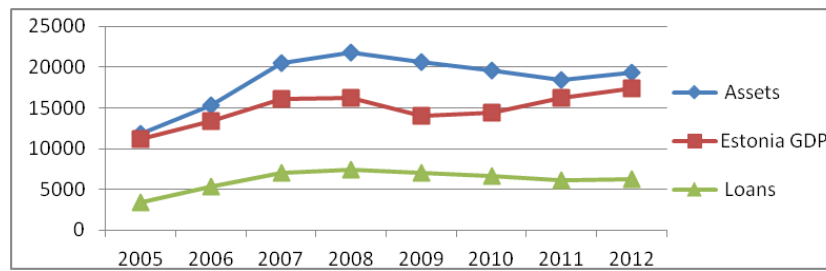
Estonia has 16 commercial banks operating. The Estonian financial sector is financially strong and sound at present. Capitalization in the banking sector is good and rapid deposit growth has provided sufficient funding for gradual increases in credit volumes. The Estonian economy has learned a lesson and has reorganized significantly from where it was earlier.

Let us look at each Baltic State financial sector, banks assets, loans and GDP development in 2005-2012.



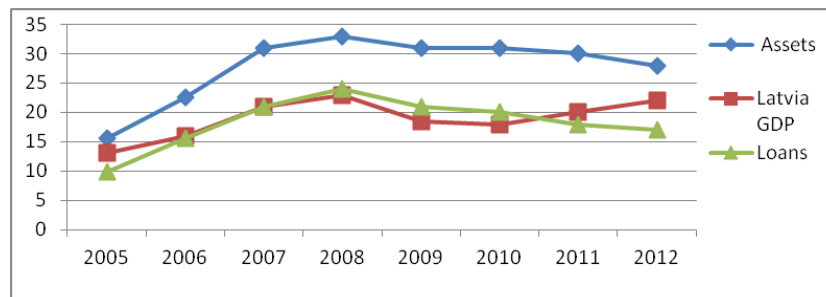
Sources: Eurostat, Association of Lithuania's Banks, Bank of Lithuania.

Figure no. 3 – Lithuania GDP, Banks Assets, Banks Loans 2005-2012, Millions euro



Sources: Eurostat, Bank of Estonia (Eesti Pank).

Figure no. 4 – Estonia GDP, Banks Assets, Banks Loans 2005-2012, Millions euro



Sources: Eurostat, Bank of Latvia, Association of Commercial Banks of Latvia.

Figure no. 5 – Latvia GDP, Banks Assets, Banks Loans 2005-2012, Billions euro

Baltic States banks assets after a global financial crisis is falling to 2007-2006 level (Figure no.3, no.4, no.5). Banks assets curve is similar in Lithuania and Latvia and still falling even when GDP is growing by recovery economy of state. Estonia banks assets was falling in 2010, 2011, but in 2012 started to grow. Banks loans are falling in all states, after crisis and even when GDP is growing. It means what banks loans are not supporting recovery economy of Baltic States.

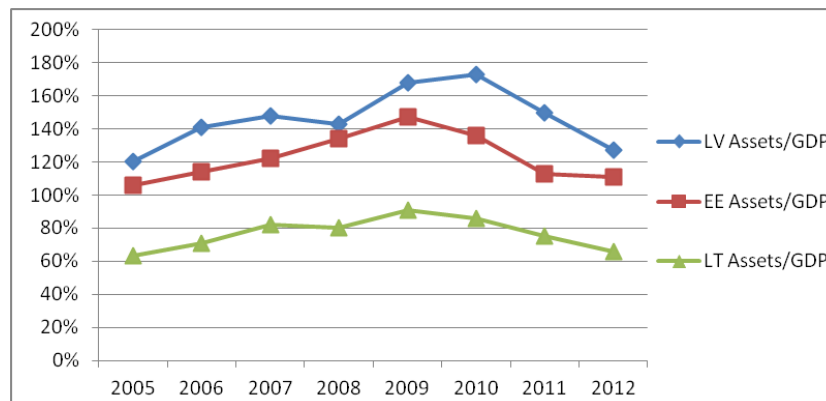
From Figure no.3, no.4, no.5 see what the best developed banking sector, has Latvia, banks assets approximate 1.5 times higher GDP. In EU old members this banks assets to GDP ratio is 1.5-2.6. Estonia banks assets to GDP ratio is 1.1-1.4 in different time. Lithuania banking sector less developed, banks assets to GDP ratio is 0.6-0.9 in different time.

Countries which pursued conservative fiscal policies (e.g. Estonia and Poland) were less affected by the crisis.

The strongest process of economic recovery has begun in Estonia due to handling of special fund stores and regaining in short time the past volumes of export, predominantly in the markets in Finland (Macys, 2012, p. 542).

Economic growth in the course of the financial sector and economic development is best visible in the correlation between the banks loans to GDP, as claimed (Kendall, 2009), but this does not apply at the time of the economic fall (Balkevicius, 2012).

Banks' relative indicators better reflects the weight of the financial sector and the impact on the national economy (Levine et al, 2000). Studying the dependencies (Kendall, 2009) (Zhang et al, 2012) scientists use relative indicators, such as Assets to GDP, or the depth of the financial sector (measured by the ratio of credit to GDP).



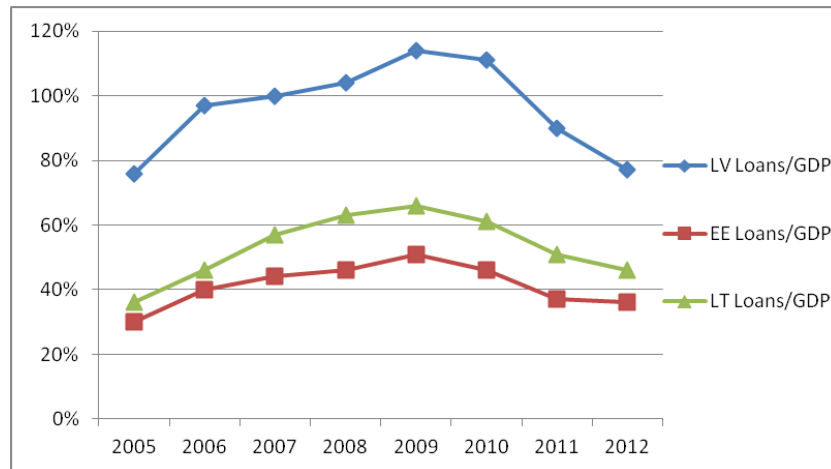
Sources: Eurostat, Association of Lithuania's Banks, Bank of Lithuania, Bank of Estonia (Eesti Pank), Bank of Latvia, Association of Commercial Banks of Latvia and the author's calculations.

Figure no. 6 – Banks Assets/GDP 2005-2012 in Latvia (LV), Estonia (EE) and Lithuania (LT)

We can see that in 2011 Lithuania (LT) and Estonia (EE) banks relative indicators Assets/GDP dropped to 2006 level (Figure no.6). In Latvia (LV) banks relative assets in 2011 have dropped to 2007 level. Analysis Banks' relative indicators show dramatically bad situation in banking sector in all Baltic States to compare with relative indicators before crisis. Banks assets are not adequate to recovery of economy in all Baltic States. Worse situation is in Lithuania, the lowest Assets to GDP ratio. Lithuania GDP is biggest in Baltic States (Figure no.1) it is 1,5GDP Latvia, 2GDP Estonia. But from Figure no. 6 see that Lithuania has smallest relative Assets/GDP. Lithuania banks' are not adequate to economy development to compare to GDP. Banking sector did not support sustainable development of state efficiently.

The fact that Estonia is smallest country as compared with two other Baltic countries, the Estonian financial policy really was most successful.

Relative Loans/GDP (depth of the financial sector) falling in all Baltic States (Figure no.7). This shows how much the financial sector's contribution decreased to economic development.



Sources: Eurostat, Association of Lithuania's Banks, Bank of Lithuania, Bank of Estonia (Eesti Pank), Bank of Latvia, Association of Commercial Banks of Latvia and the author's calculations.

Figure no. 7 – Banks Loans/GDP 2005-2012 in Latvia (LV), Estonia (EE) and Lithuania (LT)

The largely foreign-owned financial system is liquid and well capitalized in Baltic States. But still wait for healthy credit expansion. Relative loans/GDP (depth of the financial sector) in 2012 is still at 2006 level in all Baltic States (Figure no. 7). Usually increase of banks loans in state economy leads increase in GDP (Kendall, 2009). In Baltic States loans falling, but GDP increase. Banking sector did not support efficiently recovery of economy in Baltic States.

Let imagine how fast growth of economy can be in Baltic States with efficient finance support.

From one hand is good to have foreign-owned banks and Nordic Parent banks in crisis period stable, from other hand after crisis period banks assets and loans decrease, have assets flow back to Nordic Parent banks.

It is important to create a harmonious development of banking sector and whole economy. Sustainable economic development and transformation of the financial system must go together. Harmonious development must support National sustainable development under globalization conditions, what is goal of state.

4. BALTIC STATES BANKING SECTOR TODAY AND IN THE FUTURE

The Baltic States foreign-owned banking sector's high liquidity and capitalization, alongside declining non-performing loans and the improved economic outlook, should pave the way for healthy credit expansion. In this regard, steps to broaden the mandate of the Central Banks of Baltic States to include macro-prudential policy are timely and should help ensure that credit growth remains sustainable and does not jeopardize financial stability.

Baltic States economy is expanding at a healthy pace. Macroeconomic adjustment undertaken after the crisis is paying off with increased resilience, balanced growth, and job creation. Despite these positive developments, Baltic States remain susceptible to risks associated with shocks emanating from trading partners and volatile global financial markets. Key policy priorities are to cautiously manage the 2013 budget, implement a

credible 2014 budget that targets further fiscal consolidation and is underpinned by high quality measures, and build on the recent improvements to strengthen financial sector stability.

The economy in the euro area has started to grow, but the recession there has impaired the quality of the assets of the euro area banks markedly. In order to restore confidence in the banking sector, the European Central Bank and the financial supervision authorities across the euro area are assessing the balance sheets of all the biggest banks in the euro area and carrying out stress tests. If the results of the stress tests are that some European banks need additional capital, those banks will first need to raise it from the private sector, with governments only stepping in as a last resort. If there is a shortage of capital, the ability of the European banking sector to support economic recovery by lending will be restricted.

The Estonian financial sector is financially strong and sound at present. Capitalization in the banking sector is good and rapid deposit growth has provided sufficient funding for gradual increases in credit volumes. Despite the weaker external demand, the still buoyant economic activity has supported corporate revenues and stimulated the labour market. The financial position of Estonian households and businesses has also improved further, as their indebtedness has declined and their financial assets have increased. As a result, the Estonian economy has become more resistant to potential external shocks and has gained a solid foundation for balanced credit growth.

The forecast shows that many of Estonia's economic indicators are close to balance, though that balance could easily be disrupted. For this reason the main goal of Estonian economic policy for the years ahead should be to maintain and build the confidence already shown in the economic environment. Confidence in the Estonian economy will facilitate investment and create a base for sustainable economic growth. Equally, an overly-rapid expansion of credit caused by low interest rates should be avoided. The general government budget for 2014 will be close to nominal balance. Given the economic circumstances, the budget should have reached balance or surplus by 2013, as was planned in the 2011 state budget strategy.

The outlook for growth in the Estonian economy is good, the commercial banks operating here are well-capitalized and loan servicing ability of bank customers remains good. The main risks to financial stability are the lower quality of loans in the euro area banks and risks to the banking groups operating in Estonia stemming from Nordic real estate markets. Additional risks could also arise if the banks operating in Estonia were to abandon their conservative stance on real estate lending. The parent banks of banks operating in Estonia have borrowed funds on better terms than other big banks in Europe. However, it should be noted that the financing model of Swedish banks continues to be based in large part on short-term funding from the financial markets.

This 2013 year Lithuania's economic growth is mainly driven by domestic demand. Having accelerated in the beginning of the year, domestic demand should continue to grow noticeably in the entire projected period. Economic growth is particularly related to private consumption, which is affected by the improved financial situation of households due to an increase in labour and property income. The real GDP growth only slightly differs from the projected growth, so the growth prospects for both 2013 and 2014 is unchanged. Real GDP is projected to grow by 2.8 percent this year and 3.5 percent next year (The Bank of Lithuania, 2013).

As Lithuania has set itself a target to adopt the euro as of 2015, the country's preparedness will be assessed next spring according to the following five convergence

(Maastricht) criteria: price stability, general government deficit, government debt, exchange rate stability and long-term interest rate stability. Moreover, the country must comply with these criteria on a sustainable basis. Exiting the currency board and joining the euro area is the next logical step for Lithuania on its path towards integration with Europe and will substantially reduce residual exchange rate and liquidity risk. Yet, being a member of a currency union also requires appropriate supporting policies.

According to the Bank of Lithuania forecasts, next spring, when the country's preparedness for the adoption of the euro will be assessed, inflation in Lithuania will stand at 1 percent and will not exceed the projected Maastricht criteria — 1.9 percent. Lithuania is also likely to meet the general government debt, exchange rate stability and long-term interest rate criteria.

As from the beginning of 2008, commercial banks in Lithuania are subject to new capital adequacy calculation requirements elaborated according to directives of the European Union. According to these requirements, banks not only calculate the regulatory capital requirement, but also make an assessment of the internal capital adequacy (The Bank of Lithuania, 2013).

The Bank of Lithuania established the requirements for the public disclosure of information by commercial banks. Such information is useful for commercial bank customers, investors and other parties concerned in the assessment of a bank's performance, its operations and risk management processes. On the other hand, a higher degree of transparency also encourages commercial banks to assess and control the assumed risks more accurately.

Latvia has been transformed from the country most painfully hit by the economic crisis into the fastest growing European economy.

During the initial stage of the crisis, the main tasks of the government were to avoid default and restore the confidence of the financial markets in Latvia. The first step in managing the crisis is to achieve financial stability and after that the focus can be shifted to measures fostering growth. Solution for the crisis included the achievement of financial stability and restoration of growth. Precisely in that particular order: stability and then growth, as in the absence of financial stability banks would not resume lending and businesses would not make investments. For that reason, its role cannot be overestimated, especially in a small economy.

Latvia's macroeconomic indicators continue to outperform the forecasts and the budget outturn is also bound to be better than expected. The government budget results could also turn out better than expected and the next year's budgetary deficit could slide below 1% of gross domestic product. In 2014 and 2015, Latvia will already have balanced budgets or even surplus budgets. The targeted budgetary deficit of this year is 2.5% of gross domestic product, yet the real deficit will be considerably lower, possibly even below 1.5% of gross domestic product. Latvia's GDP growth rate reached 4.4% in the second quarter 2013 and was again the highest rate in the EU. GDP growth forecast for 2013 remains unchanged 4.1% (The Bank of Latvia, 2013).

On 1 January 2014 Latvia will become the 18th member of the euro area.

In overcoming the crisis, Latvia changed the structure of its economy by focussing more on exports, already over the pre-crisis level at the moment. Exports were one of the most important factors ensuring the economic recovery of Latvia and Lithuania.

The euro implementation will ensure stability, growth and investor confidence and it is also important for Latvia and Lithuania to have a common currency with its main trade partners.

In a modern global environment, financial markets cannot be cheated by promises, as they keep a close watch on government decisions, particularly those affecting the financial area. This is true not only for such small economies like Baltic States.

7. CONCLUSIONS

Baltic States financial sector is very small. At the moment banking sector is the most important. Information technology advances have changed not only the bank's strategy, but also promoted the evolution of the banking system.

The fact that Estonia is smallest country as compared with two other Baltic countries, the Estonian financial policy really was most successful. Estonia pursued conservative fiscal policies were less affected by the crisis.

Latvia all time has best developed banking sector, more assets in banking sector, banks assets approximate 1.5 times higher GDP, as well as highest banks number between Baltic States.

The grim predictions by Paul Krugman (Krugman, 2010), Nouriel Roubini (Roubini, 2009) and Lars Christensen about Latvia falling into the abyss have not come true (Macroeconomics, 2012). Latvia has been transformed from the country most painfully hit by the economic crisis into the fastest growing European economy (Macroeconomics, 2012).

The lessons taught by Latvia to the rest of the world, including honest communication of the real situation to the population; early action to restore confidence; implementation of fiscal adjustment; expenditure cuts instead of tax raises; let expenditure cuts drive structural reforms; equity required; get international rescue financing, but with conditions (Macroeconomics, 2012).

Banks relative indicators better reflects the weight of the financial sector and the impact on the national economy. We can see that in 2011 banks relative indicators dropped to 2006 level.

Relative loans/GDP (depth of the financial sector) falling in all Baltic States. This shows how much the financial sector's contribution decreased to economic development (Balkevicius, 2012). Relative loans/GDP in 2012 is still at 2006 level in all Baltic States.

The economic crisis has intervened in the banking system and has been surviving until now. Banking sector did not support efficiently recovery of economy in Baltic States.

Banks assets and loans are not adequate to recovery of economy in all Baltic States.

Today Baltic States are the fastest growing economy in the EU. They have new challenges for the financial sector harmonious development.

Harmonious development of banking sector and whole economy must support National sustainable development under globalization conditions, what is a goal of state.

The euro implementation will ensure stability, growth and investor confidence and it is important for Latvia and Lithuania to have a common currency with its main trade partners.

In a modern global environment, financial markets cannot be cheated by promises, as they keep a close watch on government decisions, particularly those affecting the financial area. This is true not only for such small economies like Baltic States.

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