The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

No Free Parking in Latvia

By Todd Wood

January 26, 2014

Since the Cypriot "bail-in," foreign deposits in Latvia have grown to about 50 percent of Latvian bank funding. Although that level may not yet be a bubble, Russian depositors would do well to be cautious.

Parking money in Latvia has plenty of benefits. Since the country is now part of the eurozone, money transfers can be made to other euro countries with minimal red tape. But the flip side of that convenience is that it may very well be attracting "dirty money" looking to wash itself all over the continent in mainline European banks.

A big risk for Russian depositers in Latvia is a repeat of the 2009 real estate crisis. Already, a real estate bubble may be forming.

There is also the added perk of Latvian residency obtained by depositing at least 300,000 euros ($410,000) for five years, allowing depositors to move freely around the Schengen area. Add to that the tax exemptions for nonresident depositors, and Latvia's status as a tax haven is confirmed.

All of these benefits make Latvia a natural home for Russian wealth. In fact, Latvian nonresident deposits have grown almost at the exact level of Cypriot non-resident withdrawals. It is fairly obvious that funds are being transferred from one offshore jurisdiction to another.

Russians moving money to Latvia may seem like a no-brainer. Yet any savvy business person must also look closely at the risks. The most obvious potential problem is the level of nonresident funding for Latvian banks. The current level of 50 percent is higher than the 40 percent that Cyprus was at prior to the Cypriot banking crisis, which saw bail-ins and the nationalization of one of the country's largest banks. Russian depositors took a hit as they were forced to share in the losses.

This level of offshore funding is also causing concern among regulators in the eurozone. There are calls from many corners asking for tighter oversight of Latvian deposits. These worries stem not just from fears of a nonresident deposit bubble, but from concerns over money laundering, terrorist financing, and other organized crime.

The risk to the Latvian economy is also a burden. The deposit level of the banking sector versus gross domestic product is relatively low at 128 percent compared to more than 300 percent, the norm throughout the rest of Europe. However, as the Latvian economy recovers and more foreign deposits arrive, this percentage could grow and increase the chances of a problem arising.

There also does not seem to be much concern over where Latvian banks are placing these deposits to earn returns. Cypriot banks notoriously leveraged their offshore funds by investing in extremely risky Greek bonds, which led to a significant under-capitalization when the Greek debt crisis hit.

But as the nonresidence deposits grow, so will the pressure to find a good return. Competition among offshore jurisdictions is fierce and eventually there will also be financial institutions looking for higher returns to attract capital. Depositors should seek to stay informed of where their money is being invested.

Perhaps the biggest risk is Latvia repeating the real estate crisis of 2009. As Swiss money flowed into the country in the first decade of the new millennium, real estate prices shot up dramatically. This caused a massive real estate bubble that spectacularly popped when the European debt crisis hit in 2009. Latvian GDP shrank by double digits and unemployment skyrocketed. Today, the economy has rebounded mostly thanks to austerity and other reforms put in place by the Latvian government. Yet, the memory is still quite fresh in everyone's mind.

With Russian capital now flowing into the country, there is a very real risk of a new real estate bubble forming. Investors are incentivized to place capital in the country in the form of cash deposits or real estate. Housing prices in the Baltic republic have already started to rebound after the economic crisis, which also saw the real estate market shrink considerably.

All in all, depositing money in Latvia may hold many benefits for Russian investors, but there are scores of reputable offshore financial centers around the world with good long-term reputations for asset protection and tax avoidance. You should employ the age-old tactic of diversification to spread the risk and not concentrate your funds, as there is a very real possibility of new bubbles forming in Latvia.

If Latvia experiences another financial crisis, the bail-in model would likely be implemented to insure depositors shared in the losses.

Todd Wood, formerly director, emerging market debt capital markets at Cantor Fitzgerald in New York, is author of "Currency" and other historical fiction novels.

The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.