SEIIA LAINELA – PEKKA SUTELA

The Baltic Economies in Transition

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SEIIA LAINEILA – PEKKA SUTELA
with contributions by
Inkeri Hirvensalo and Inna Shteinbuka

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Foreword

The Baltic states’ transition towards a market economy has proceeded rapidly. In a few years’ time the countries have achieved considerable results in liberalizing and stabilizing their economies. Estonia has become something of a model case for transition, due to its strict commitment to reform policies, but also in Latvia and Lithuania progress has been impressive.

Although the Baltic states have much in common, e.g. the economic structures inherited from the Soviet era and the main principles of their present transition policies, closer scrutiny reveals that they are far from being a homogenous group. They have, among other things, different historical backgrounds, and there are clear differences in their current political and economic development. The results of these differences are observed in the transition processes in the Baltics, and although these differences will probably not affect the general aims of transition they may have some influence on the speed of reform.

What are the factors that have brought about the success of the Baltic transition under extremely difficult economic circumstances — probably among the worst in the former socialist countries? And what are the future challenges which the Baltic states will face? Although the short-term results of transition have been impressive, there will be problems looming as concerns long-run development. These are some of the questions on which this book aims to shed some light.

The book offers a survey of current economic conditions in the Baltic states, examining the problems that these countries are facing as well as their achievements to date. It begins by analyzing the initial conditions for transition in the Baltic states and the current economic situation. Macroeconomic stabilization is the cornerstone of a successful transition to the market economy, and therefore monetary and financial developments are central to the book. The discussion begins with a survey of one of the greatest success stories of the Baltic transition, the introduction of national currencies. Next, the fiscal and monetary policies pursued in these countries are studied, and Latvian fiscal policies are presented as a special case. Estonia has advanced the farthest in the development of the banking sector, and so Estonian experiences in this area are analyzed thoroughly. The book concludes with a wider theme: a discussion of the development of private initiative and its prerequisites in the Baltic states.
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Kalevi Sorsa
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Overview

The Baltic countries only reappeared on the maps less than three years ago. Since then, they have come to be widely regarded as the appropriate economic and also political models for the other former Soviet republics (or FSU). The Baltic countries have not only re-established internationally recognized legal independence, but they have also succeeded in recreating many of the economic and political preconditions of independence. In particular, the Baltic currency reforms have been a veritable success contributing to some of the lowest inflation rates among post-communist countries. This would not have been possible without responsible monetary and fiscal policies widely supported by the electorate. Indeed, together with the Czech Republic, the Baltic countries are prime examples of how politically popular stabilization policies can be. The reorientation of foreign trade, general economic liberalization and the growth of the private sector are among the other generally acknowledged Baltic successes. The difference between Estonia and Latvia, one to one hand, and their eastern neighbours is evident to any visitor, and studies seeking to explain the Baltic success story are beginning to appear.

Still, the Baltic countries share many of the well-known problems of the post-communist world. The decline in statistically recorded production has been particularly pronounced, among the steepest in the region. As it has not been accompanied by large-scale open unemployment, recorded productivity has collapsed. Budget balance is maintained, but on a lower level of revenue than would be needed to maintain many traditional budgetary expenses. The inevitable and often simply necessary cuts in expenditure have seldom been accompanied by the much-needed structural overhaul of the public sector. Policy making is not always as cool-headed and professional as one might wish. Political consensus may be fragile, especially in those countries with large minorities. Many Russians in Russia see the Baltic countries as a historically given part of their sphere of influence.

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1 There is a terminological problem here beyond the usual ones. The Baltic countries rightly disapprove of any notion that might imply that they have been willing parts of the USSR. Still, the usual conventions of "former USSR", "Former Soviet Union" (FSU) and "former Soviet republic" have to be followed until a proper substitute is found. For questions of linguistic correctness in the Baltics see The Baltic Independent, 12–18 August 1994.
As economies in transition, the Baltic states can be compared both with the former Soviet republics (FSU countries) and with the Central and Eastern European countries (CEECs). In comparison with the latter countries, one feature is especially peculiar to the Baltics. The Baltic states had formed an integral part of the former Soviet economic, political and security system. Before becoming independent the Baltic states did not have any control over their national economies.

The big difference compared with the former Soviet republics is well known. The Baltic states have a tradition of national independence. They never joined the USSR voluntarily, the goal of independence was generally shared among the population, and there has been no hesitation concerning the grand goal of transition: to become full-fledged European states.

The Baltic countries, as a part of the Soviet Union, were tightly bound to the Soviet economy. Concerning production, the Baltics were almost totally dependent on raw materials from other parts of the USSR. The Soviet Union also constituted practically the only market for their products. Secondly, the Baltic states did not possess institutions, such as central banks, to handle the basic economic functions. In addition to building a market economy the Baltic countries have been building the essential political structures of an independent country. Thus, for this reason also, the task facing the Baltic countries is larger than that facing the Central and Eastern European countries, where state structures have long been in existence.

The Baltic states took the first steps to reform their economies in 1989—1991, while still belonging to the USSR. The reform measures were made possible by the agreement on 'economic independence', concluded between the Baltic republics and Moscow authorities in late 1989. The true implications of this partial sovereignty always remained unclear, and this episode is best seen as a crucial step in the dissolution of the Soviet Union. The re-establishment of true Baltic independence in August 1991 allowed the Baltics to initiate a genuine transition process, which has been moving forward ever since. Estonia was the best prepared for independence of the Baltic states, as the drawing up of blueprints for an independent economy had been underway already for several years.

One should always keep in mind that the Baltic countries are far from being the homogenous entity often perceived by distant viewers. They are divided by history (Lithuania has been a great regional power, contrary to the others), religion (Lithuania is Catholic, the others Lutheran), culture (Estonia and much of Latvia once belonged
to Sweden), industrial tradition (strong in Estonia and especially in Latvia), foreign exposure (northern Estonia, which always used to watch Finnish TV, is linked to Finland with about 10 daily ferry connections) as well as by current political differences (Lithuania has a leftist government, the others are right of centre). \(^2\)

These differences have a bearing on the way in which the Baltic countries perceive each other. Though this is not always appreciated and seldom admitted, even in the countries involved, there is little real interest in or historical basis for practical economic cooperation among the Baltic states. Thus, although there is a Baltic free trade agreement, it has been inspired primarily by the logic of parallel negotiations with the European Union. But neither should one jump to conclusions and overlook the fact that these small countries do share a common recent history and current problems. Therefore, they do form a common subregion, and even though current domestic policies often seem even to be pushing them further apart, their common position vis-à-vis cooperation in the Baltic Sea region and beyond that in Europe as a whole will continue to maintain a degree of pressure for subregional cooperation.

The Baltic free trade agreement process highlights both the communalities and differences between the countries. Following the traditional imperial trade pattern — common to the Ottoman and Habsburg empires as well as to both the USSR and the CMEA — the Baltic countries used to trade heavily with Moscow and very little with each other. While the (now) FSU share in Baltic foreign trade was around 90 per cent, intraregional trade was for decades almost negligible — just a few per cent of the total value of trade. Since independence, the relative importance of Western trade has risen quickly, while intra-Baltic trade has perhaps even declined; certainly, it has not increased to the degree that might have been expected. \(^3\)

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\(^2\) Lieven (1993) gives a vivid introduction to the mosaic called the Baltics.

\(^3\) Statistics are unreliable, but there does seem to have been a decline, especially when re-exports are excluded. The most obvious exception to this trend is energy trade, which has recorded notable growth. Even here, cooperation is overshadowed by attempts at self-reliance. Thus, in the face of outside advice to the contrary, Lithuania is planning to build a coastal oil terminal to diversify the supply for its Mazeikiai oil refinery now dependent on deliveries from Russia. The underutilized Latvian oil harbour of Ventspils is just on the other side of the border.
As already mentioned, the Baltic free trade agreement of September 1993 is largely due to outside European pressures. After it had been signed, an Estonian government official publicly commented on the divergent policies pursued by the three countries in trade negotiations with the European Union (Priit Kolbre, cited in The Baltic Independent, 19–25 November 1993, p. B1). Estonia’s policy, he argued, was more liberal and open, and her government had given up protectionism.\textsuperscript{4} "Latvia wants to protect its agricultural producers from European competitors, while Lithuania strives at a gradual transition to a market economy and wants to preserve import restrictions and quotas".\textsuperscript{5}

As such, these comments are accurate enough. But in the Latvian and Lithuanian view, no doubt, they are simply following the well-established asymmetry principle in European foreign trade liberalization by removing their import protection at a slower pace than the developed market economies are doing. A Russian observer might furthermore point out that Latvia’s approach of taxing agricultural but not industrial imports actually amounts to a consumption tax on town-dwellers. In their ethnically structured society, almost all farmers are Latvian, whereas Russians are dominant in many of the towns. Russians are also arguably underrepresented in the policy process.\textsuperscript{5} While the ethnic dimension of the impact of divergent economic policies has not yet openly come to the fore, disagreements on foreign trade liberalization had a central role in the Latvian political crisis of summer 1994.

These examples hopefully convey some of the political economy complexities beyond Baltic macroeconomic policies and underlying developments. The economics of transition is complicated enough. Seldom does it become as complex as in the Baltic mosaic. This complexity is not nearly sufficiently appreciated, often for the simple reason that it is not known. Furthermore, learning to appreciate Baltic peculiarities is not easy. Though Baltic statistics are probably better

\textsuperscript{4} A World Bank report agrees: "Estonia is without question the most successful of the newly independent states in terms of establishing a highly liberal external trade regime with virtually no tariff or non-tariff barriers". Estonia: Trade (1993), p. III.

\textsuperscript{5} Another argument which has become somewhat of a favourite in Moscow asks why Estonian and Latvian stabilizations have succeeded while that in Russia has failed. The alleged answer is simple: in all three countries Russian workers carry the burden of stabilization, but only in Russia are they eligible to vote. — Needless to say, this argument is seriously misleading, concerning both the concept of the stabilization burden and the distribution of the burden among the population.
than those in the FSU in general, they still leave much to be desired. The small size and traditional provincialism of these countries is visible in the meagre amount of analytical economic and political economy studies available. The outside observer is therefore limited to making hypotheses and conjectures to a larger extent than is normally deemed appropriate.

The Baltic states' experience with transition confirms the importance of an uncompromising commitment to reform by the country’s political leaders. Another important factor is national consensus on transition policies, which makes it possible to take painful reform measures with the approval of population. This requires that people trust their leaders and are confident that better times are coming.

Here the Baltic states offer a very good example: without wide national support it would not have been possible for them to carry out their stringent stabilization policies. The political independence that the countries regained at the same time that they started the economic transition served as motivation and the first payoff on the difficult road to a market economy. In Estonia the introduction of a national currency the next year was also a clear sign of the reform progress and was welcomed with great enthusiasm and pride.

However, there are differences between the Baltic states regarding support for reforms. In Lithuania the goals of economic transition have never been as clearly defined as in Estonia, and this may have affected the results of the parliamentary elections in 1992, which brought the former communists back to power in place of the nationalistic Popular Front. In Latvia a centrist minority government was formed following the 1993 parliamentary elections, but it was compelled to resign after a year, in summer 1994. The reform-oriented Latvian Way party, however, continues to be the leading force also in the new government.

Estonia also has suffered from government crises, and the government headed by the rightist Fatherland party had to resign in autumn 1994. Though there has been no serious danger of a reversal of transition policies in any of the Baltic countries, these developments serve to remind us that support for reforms is not self-evidently permanent. What is important for support is how the Baltic economies and living conditions of the population develop.

The Baltic experience also confirms another issue concerning economic transition, namely that it is far more complicated and time-consuming to carry out structural changes and privatization than to stabilize and liberalize the economy. Privatization of medium and large-scale enterprises is only beginning in Latvia, and in Estonia
about 150 companies have been privatized during the past two years. Lithuania has proceeded the fastest, but mainly by transferring ownership of companies to the workers and management, a method which may not bring about the most efficient ownership structure.

Changes in the economic environment are essential for the normal operation of privatized and new private enterprises. These developments have also — for understandable reasons — come quite slowly in the Baltics. The financial system is not yet functioning properly and a large part of the crucial economic legislation is either still being formulated or its implementation is hampered by the lack of trained personnel. For instance, there may be a danger that the Baltic states will become major centres for money laundering in Europe, unless the appropriate legislation and control mechanisms are established soon. These problems will persist for some years and will hinder the development of the private sector. The role of foreign investment and technical assistance will be important for educational purposes and for introducing new methods of operation.

Although the economic transition has thus far proceeded without a major backlash, future development of the Baltic economies may entail risks. One of them is the relatively high inflation which has continued in the Baltic states despite restrictive monetary and fiscal policies. It remains to be seen whether the current account deficits which have emerged recently will suffice to check the increase in foreign reserves and money in circulation.

Another major uncertainty lies in the Baltic states’ relations with Russia. Estonia in particular has been very quick to reorient its trade towards Western countries, but Latvia and Lithuania have also increased the share of Western countries in their foreign trade. There have been some complaints in the Baltic countries about the fast turnaround. Critics feel that the Baltic countries would have been better off by trying to maintain as much as possible of their trade with Russia. The Baltic countries would for instance benefit greatly from becoming a major transport link serving Russia’s foreign trade, if only the political relations would allow it.

The clear aim of all the Baltic states is to 'return to Europe' and become an integral part of Western Europe. The Baltic states were very swift in attaining free trade agreements with the EU, which will come into force in the beginning of 1995. Immediately after concluding these negotiations the countries started negotiations for associate membership in the union. The final goal is full membership, which the Baltic states hope to achieve even before some of the Central and Eastern European countries. The threat felt from the side
of Russia is one important factor behind the Baltic states’ eagerness to join the EU. In the Baltics, the question of losing some national sovereignty if they join the EU has hardly been discussed.

This book highlights economic transition in the Baltic states, policy choices that these countries have made and their implications for the future. The current stage of transition is presented, as well as possible threats and problems that may lie ahead. The chapters discuss progress in several areas of economy, but the main emphasis is on monetary and financial developments, which are crucial preconditions for the success of transition.

The first chapter offers an overview of the starting conditions which the Baltic states were facing as they regained their independence and discusses the subsequent economic developments. A deep slump in production and the continuing threat of inflation form the economic surroundings in which the Baltic states are pursuing the transition to a market economy. Open unemployment, on the other hand, is intriguingly small.

A decisive step in the Baltic states’ economic independence was taken in 1992, when they left the Russian rouble zone and established their own independent monetary systems. These events are discussed in chapter 2, together with a discussion of the arguments for introducing national currencies and aspects of choosing monetary policy and exchange rate regimes. The differing solutions applied in the three countries are analyzed. The conclusion is that escaping from the rouble zone has not only been possible and desirable but that there is also more than one way of doing it. The chapter also discusses the comparative efficiency of the different routes to monetary independence that have been taken by the Baltic countries.

Chapter 3 continues this discussion by presenting current developments in monetary and fiscal policies in the Baltic states and the achievements to date in macroeconomic stabilization. The chapter also includes a case study of the development of fiscal policy tools in Latvia, written by Dr Inna Shteynibuka, Head of Department in the Latvian Ministry for Finance, and a former Visiting Researcher at the Unit for Eastern European Economies of the Bank of Finland.

To continue further the theme of monetary developments, chapter 4 describes the evolution of the Estonian banking system. This chapter illustrates the legal and institutional changes which have taken place in the banking sector, as well as the activities of the banks. Estonia has the most developed banking system in the Baltics, and the country has even gone through the first series of bankruptcies of commercial banks. The chapter was written by Inkeri Hirvensalo.
The last chapter broadens the discussion again by presenting an overview of the development of the private sector in the Baltic states. The chapter addresses the development of preconditions for the emergence and advancement of private activity and reviews the current stage of the respective private sectors. Privatization of state owned enterprises and the role of foreign investment are also discussed.
1 Production, Employment 
and Inflation

1.1 The inherited economic potential

Joint work by Finnish and Estonian researchers has recently confirmed the widely-held interpretation that the immediate pre-war development levels of the two countries were roughly similar (Lugus – Vartia, eds., 1993). This conclusion follows whether one looks at industrial wages on a purchasing power parity basis, export performance, or the level and structure of consumption. Similarly detailed comparisons are not available concerning the other Baltic countries. An educated guess might be that Latvia’s development level was roughly similar to or probably higher than Estonia’s. The predominantly agricultural Lithuania probably lagged in income and productivity.

Whether the Baltic countries had matched or surpassed Finland’s growth in the absence of Soviet occupation remains an open question. First, this test is exceptionally tough, as Finland was in 1900–1990 one of the fastest growing economies of the world. Second, though the evidence is sketchy, it may be that in 1900–1938 Finland already grew faster than Estonia and thus improved its relative position. Third, the relative specialization of Finland in forestry exports in the inter-war period may have predetermined better growth prospects than the specialization of Estonia and Lithuania in agriculture and Latvia also in heavy industries.

These conjectures necessarily remain speculative. What is clear is that the decades of Soviet industrialization from the late forties to the late eighties were in the case of Estonia and Latvia based on an inflow of labour – which was not needed in Lithuania as rural labour was still abundant – much trade and production dependence on the USSR as well as hugely inflated statistics. A measure of economic dependence is that – according a calculation based on input-output table (Lugus – Vartia, eds., 1993, p. 87) – Estonia’s import share of GNP in 1989 was at 38.3 per cent almost double that of Finland’s. As already mentioned, almost all of this trade was with the USSR. The share of the USSR in imports was about 85 per cent and in exports about 95 per cent. A measure of inflated statistics is that Estonia’s official growth was recorded as having in 1939–1988 almost doubled Finland’s. Still – and contrary to such statistics – in 1988 the real
Estonian consumption level was actually a fraction — perhaps just over a tenth — of Finland’s (Vartia – Lugus, eds., 1993, p. 301–332).

But within the USSR, the Baltic countries were the best pupils of an admittedly very bad class. Baltic living standards and productivity levels were by almost any measure the highest among the Soviet republics. According to provisional World Bank estimates, Estonia’s per capita income in 1991 was USD 3700, Latvia’s USD 3410 and Lithuania’s USD 2700. These figures compare with a former Soviet Union average of USD 2600 for the same year (Estonia, 1993; Latvia, 1993; Lithuania, 1993). The range of World Bank estimates is naturally open to debate, but the rank ordering of the countries corresponds with anecdotal evidence and visual observation. So also does the small distance between Lithuania and the FSU average.

The dependence of the Baltic industries on USSR labour, resources and markets was formidable. Essential plants were naturally under direct all-union (meaning Moscow) subordination. In the case of defence plants, domestic authorities did not necessarily even have access inside plant walls. The oil shale power stations of North-Eastern Estonia, parts of Latvian engineering and the Ignalina atomic energy plant in Lithuania are just some examples of true Soviet Russian appendices within the Baltic countries. A gas main from the North-Eastern Estonian oil shale works to Tallinn was introduced only several years after a similar one to Leningrad had become operative.

Data on transactions between FSU and the Baltic countries is naturally partial and fragmentary. All the relevant items can probably never be added together. As calls for republic autonomy and sovereignty became vocal in the late 1980’s, Russian economists soon came forward with calculations showing that due to relatively underpriced Russian energy and raw materials, on world market prices the Baltic countries would run huge trade deficits with the FSU. Later in a path-breaking study Senik-Leygonie and Hughes (1992) estimated that all the Baltic countries had a higher than the FSU average share of industries with negative value added. Indeed, in their calculations Latvia came out as the worst short-run case of all of FSU republics, while Lithuania and Estonia have the dubious honour of heading the list of worst long-run cases. Estimating the impact of inter-republican trade on national income in FSU republics, Senik-Leygonie and Hughes could find no solution for Latvia which yields positive national income and is consistent with the assumed decline in trade volumes. The Baltic countries, importers of energy and raw materials, exporters of manufactures and food to the FSU market, really looked like basket cases in the light of such calculations.
Most of old Soviet industries in the Baltic countries are probably of no economic value under the new set of circumstances. Consequently, though the situation varies across countries, in most cases inherited industrial plants either vegetate on state subsidies and/or are being closed down, while valuable units are being privatised. A few years into independence, almost the only examples of adaptation of old state-owned enterprises to changing environment seem to come from subcontracting, primarily in Estonian and other textile industries. This is an example of exploiting the most conspicuous relative advantage of the Baltic economies, that of cheap and relatively well educated labour force. This is naturally an advantage shared with other post-communist economies. The Balts — primarily Estonia and Latvia — have the added advantage of close geographical position to the Nordic countries. According to Estonian statistics, Finland has become the main trading partner of Estonia. A substantial share of this trade consists of subcontracting flows. There are also thousands of Estonians working in the grey labour market of Finland.

Another asset left by Soviet rule is the Baltic transportation infrastructure (Van Arkadie — Karlsson 1992). If future Russian developments were positive and if Russian-Baltic disputes could be regulated, the ports and East-West railroads and pipelines of the Baltic countries might prove to be a major asset to be exploited for transit. Naturally, these are no negligible ifs. Consequently, the popularity of thinking about the Baltic countries as future "Hollands of the Baltic Sea" — as it is sometimes put — has had its ups and downs among Baltic policy planners and decision makers. Currently, Estonian and possibly also Latvian thinking on Russian future is dominated by somewhat apocalyptic views of coming dissolution, collapse and chaos. Perhaps needless to say, these perceptions are often accompanied by a conviction that the Balts are the only ones really to understand Russian developments. "The Nordic and Western countries should be obedient when we speak of what is going on in Russia. The Baltic states know Russia much better than Washington, Paris or Bonn", said Estonian President Lennart Meri while commenting the Russian parliamentary elections of December 1993 (The Baltic Independent, 24 December 1993 — 6 January 1994). Therefore, any ideas of Baltic gateways as a feasible long-range strategic alternative have among the policy makers of these countries currently only little topicality.

This naturally does not prevent taking all available short-run advantage of trading Russian resources as long as that remains possible. Long-range thinking on these matters in Lithuania may be somewhat different from that in Estonia and Latvia, reflecting the
generally greater willingness of the current Lithuanian administration to cooperate with Russia.

An awkward aspect of the Soviet heritage are the minorities so much boosted in Estonia and Latvia by immigration. Many of the issues involved are well-known and need no elaboration here. One might however add the probably less-understood detail that the propensity of minorities to involve themselves in entrepreneurship seemingly varies across countries. Thus, in Estonia most new businesses are probably ethnically Estonian. The same is not necessarily true in Latvia. An at least potentially important issue of ownership and control arises, as it may be that interlinking Baltic-Russian business interests may become of great importance. The prospect raises all kinds of queries in these countries. Though our knowledge of the extent of this phenomenon is scarce, one should never forget that in the Baltic case, foreign direct investment quite often means Russian investment. This is a further reason why the Balts are often less than enthusiastic about the ideas of East-West gateways. They in most cases do not want to become Russian bridgeheads in the West.

1.2 Production: collapse and recovery

As Figure 1.1 shows, Baltic production — as officially recorded — declined in three years from 1990 to 1992 by a rough average of one half. The decline is among the deepest recorded in FSU republics. In 1993, production levels by most measures continued to decline, though the decline clearly slowed down in all the three countries.

Naturally, all the usual caveats in post-communist national accounts apply. There is certainly no reason to think that Baltic statistics would give a true picture of welfare generated by production. Still, the fact of fast production decline until 1993 should be in no doubt. Neither should one jump into the conclusion that all disappearing production was unnecessary or detrimental.

The Estonian case illustrates the problems of Baltic national accounts. Already during 1993, the Institute of Economics of the Estonian Academy of Sciences estimated that gross domestic product (GDP) declined in 1993 by 5.1 per cent (Rajasalu 1993). On their interpretation, recovery probably started in the second half of the year, and it was forecast by the Institute that GDP will grow in 1994 by 4.9 per cent and in 1995 by 3.3 per cent.
This, however, is just one of the available preliminary estimates. The Bank of Estonia has published the most optimistic figures, showing a 3 per cent growth in GNP in 1993 (BBC Monitoring, Summary of World Broadcasts, Third Series SUW/0316). The Statistical Office, on the other hand, recorded a 7.8 per cent decline (Kaubaleht, 9–16 May 1994). IMF has opted for a 3 per cent decline (Estonia, 1994). Such discrepancies in preliminary estimates are rare even for an economy in transition. They are due to the difficulty of keeping track of exactly those sectors that are now growing in Estonia. Towards the autumn of 1994, the best consensual estimate of Estonian GDP change in 1993 was 0±2 per cent.

The current Estonian recovery is based on foreign trade, the service sector and new entrepreneurship. During 1993, Estonian exports grew from EEK 5.5 bn to EEK 10 bn, and the value of services surged from EEK 2.3 bn to EEK 4 bn (8 EEK = 1 DEM) (Kaubaleht, 23 December 1993 – 3 January 1994). As Figure 1.2 shows for all Baltic states, the picture in manufacturing is a different one. In Estonia, production has declined in all industrial branches.
Engineering has been particularly badly hit. Thus, during the first nine months of 1993, the output of electric motors was only about 15 per cent of the 1991 level. Large segments of traditional Estonian industrial production have been practically wiped out. This is true of most forestry production and large parts of chemical industry. Both branches have been characterized by outdated capacities and serious environmental problems. In 1993 previous decline became steeper in textile industries, which are severely constraint by the unavailability of FSU raw materials. Against this background, the official forecast for 1994 is optimistical. Total Estonian industrial output is expected to grow by 6 per cent (Äripäev, 24 December 1993).

Given huge price shifts and the currency reform of summer 1992, no reliable estimate on change in investment in 1992 is available. It is probably safe to guess, however, that the decline in investment in 1991–1992 must have been more than a half. Given this background the currently expected growth in Estonian investment — if it were to materialize — is a hugely positive sign. The real level of investment is on one count expected to have doubled in 1993 — while other sources see a stagnant level of investment in 1993 — and a similar growth is confidently forecast by the Institute of Economics of the Estonian Academy of Sciences for 1994 (Kala — Vitsur 1993). Even more remarkable is that almost three fourths of these investments seem to be in newly established enterprises, primarily in equipment and
machinery. Construction investment is of secondary importance. Services and transport invest more than manufacturing and the energy sector, and an overwhelming 74 per cent on investment is financed by enterprise resources.

These are basically positive characteristics. Necessary structural change seems to be well underway. Unfortunately, this is not the whole picture. The data also tell that bank credits are only little used for investment. They only finance 8 per cent of all investment, and the problem is more in the lack of financable investment projects than in any lack of resources (chapters 3 and 4). The Estonian financial market still concentrates on short-term finance. And whatever the change of investment from previous year, neither should the absolute volume of current investment be exaggerated. The total amount forecast by Kala and Vitsur (1993) for 1994–1995 is about DEM 1 bill. To put the absolute amount in perspective, this is perhaps double the cost of a modern pulp and paper plant.¹ Finally, the optimistical investment forecasts quoted above received a cold shower when the Statistics Department released its figures for the third quarter of 1993 (Baltic News Service, 28 December 1993). True, the Estonian GDP seemed to be growing at a rate of 6.4 per cent, but the growth is led by foreign trade and consumption, not investment. Total investment actually declined by 1.7 per cent relative to second quarter. The Estonian recovery may therefore have a weaker base than one would hope.

During the first half of 1994, moods have clearly shifted in Estonia. The spring upsurge in inflation — discussed below — lead the Bank of Estonia to warn about an imminent overheating of the economy. The competitive edge offered by low cost level is eroded by inflation, especially in the closed sector. The economy now needs to adjust towards quality- and productivity-based competitiveness. This is the next great economic challenge not only for Estonia but for the other Baltic states as well.

The collapse of investment in Latvia and Lithuania in 1990–1992 was recorded to be steeper than in Estonia, around 60–70 per cent. In Latvia, GDP continued to decline in 1993 by about 12 per cent. There is no firm evidence of a upturn in investment, though the authorities are relatively hopeful on this. They are counting on using foreign cre-

¹ The comparison is not totally arbitrary, as the collapse of earlier industry makes Estonia (or perhaps Latvia) a potential site for a modern forestry plant. The possibilities have been studied by the Nordic forestry corporations, with no results so far. One of the reasons for disappointing results must be the fact that as long as future owners of forests are not known, there is no way of forecasting their timber supply behaviour and thus the cost level of a potential plant.
dits for domestic investment. It may anyway be that the bottom of production has been reached in Latvia as well as in Estonia. The Latvian authorities confidently forecast that the economy is starting to grow, perhaps as fast as by 5 per cent annually in 1994 (Baltic News Service, 29 December 1993).

The situation is probably gloomier in Lithuania. The decline in production has been even steeper than in Latvia, and according to IMF information it continued in 1993 by 16.2 per cent (see Figure 1.1). Statistically recorded industrial production was a whopping 46 per cent lower than in previous year (Figure 1.2). Domestic politicians are however upbeat concerning a gradual upsurge. Industrial production is expected to grow by 1.2 per cent in 1994. The actual basis for optimism must however be judged to be weak. Existing investment seems to be mostly in residential construction, a form of asset protection under high and variable inflation. The share of industrial products in non-FSU exports declined further in 1993.

1.3 The reasons for output decline

As in other countries in transition, part of recorded output decline in the Baltic countries is illusory, as resources are shifted to badly recorded small-scale production and services, in particular in the emerging private sector. The usual index number problems due to price liberalization are also present (Osband 1992). But there are also other reasons for output decline, ones that are more interesting in the particular context of the Baltic countries. In this section, we look at four such explanations: credit contraction, institutional uncertainty, demand constraint and finally trade collapse with the FSU (for a taxonomy see Williamson 1993). The discussion is largely speculative, as there is little reliable data and almost no analytical research from the countries concerned.

It has been controversially argued that undue restriction in the availability of credit may have contributed notably to production decline in Poland in the first phase of the stabilization programme (Calvo — Coricelli 1993). The argument is that the withdrawal of subsidies coupled with massive devaluation and severe limits on credit expansion implied that the enterprises no longer commanded the credit needed to continue production at former level of output. Consequently, the enterprises resorted to increased levels of inter-enterprise credit — something the authorities also attempted to prevent.

Though any enterprises will almost always complain of what they see as being insufficient availability of credit, there is little evidence
that this would have been recently — with the obvious exception of only short-term credit being available — a major problem in Estonia or Lithuania. Under the Estonian modified currency board system interest rates in principle freely equilibrate the demand and supply of finance. Though forward looking real interest rates are always difficult to define under nominal price level uncertainty, the Estonian interest rates — though sometimes positive in real terms — have never been excessively high.\(^2\) The situation may have been quite different in 1992, when the introduction of the currency board led to a temporarily severe credit squeeze which also contributed to the first Estonian banking crisis. It is generally interpreted that Estonia did have a liquidity crisis in 1992 and beginning of 1993.

In Lithuania the real volume of credit seems to have remained almost constant over a period of time when production declined (Bulletin of the Bank of Lithuania 1993:1, pp. 38–47). This is also no evidence of a credit squeeze.

The situation is different in Latvia where stabilization has been especially in 1993 accompanied by huge positive real interest rates, ranging — deflated by current inflation — up to about 100 per cent annually. This is in contrast with 1991–1992, when real interest rates were strongly negative due to high inflation. Shteinbuka (1993) argues that though there were no quantitative restrictions on credit in 1991, state enterprises used credit for boosting incomes and investories, not for investment. This is probably a measure of the degree of uncertainty at the time.

There is — as will be discussed in chapter 2 — uncertainty concerning the reasons for high Latvian interest rates. On one interpretation, favoured by the Bank of Latvia as well as the international financial organizations, recent interest rates may reflect the level of profitability available in short-term commercial activities, particularly in trading commodities originating from the FSU area. If this is so, real interest rates in Latvia may remain too high for long-term investment as long as many commodity prices remain subsidized in FSU states. This is an obvious impediment to investment-based Latvian growth, but one that the domestic authorities can do little to alleviate, though they are naturally aware of the possible consequences of current interest rates.

\(^2\) With a nominal rate of interest about 30 per cent in late 1993, Estonian banks still preferred to invest either abroad or in government CD’s with a 6 per cent interest rates. This given a measure of risk perceived in Estonian money markets. See Ross — Sutt (1993).
On another interpretation, to be further discussed in chapter 2, high Latvian interest rates are due to risk generated by floating exchange rate and liberal policies towards the banking sector. If this judgment were true, high interest rates would largely be due to suboptimal policy decisions.

The role of institutional uncertainty in the Baltic countries is great. Some of the originally perceived uncertainty concerning the viability of the three countries as independent entities still remains. Currently of greater importance is the political uncertainty concerning both the future position of Russian-speaking industrial labour force — in Estonia and Latvia — as well as future economic policy lines in general. Much uncertainty concerning future relations with the FSU naturally remains. The level of domestic political stability was until summer 1994 somewhat paradoxically perhaps the greatest in Latvia. This is paradoxical, as the country was governed by a minority coalition government. In the end the government fell due to policy disagreements, and the country currently seems poised for a lengthy period of greater political uncertainty.

The Estonian political scene is plagued by increasing passivity among the population as well as by continuous infighting. The situation cannot be remedied before new parliamentary elections due in spring 1995. The Lithuanian leftist government is strong in the parliamentary sense, but more generally the country has unfortunately been characterized by institutional uncertainty, winddrift policies and recurring scandals. Neither the liberal Estonians nor the more interventionist Latvians and Lithuanians have been able to outline any consistent and credible framework of future industrial policies. Given the importance of Russian-speaking industrial workers, an announcement of laissez faire would probably make disastrous ethnic politics in Estonia and Latvia. This adds a twist to the new economic challenge outlined above.

Another source of uncertainty are the peculiarities of Baltic privatization policies to be discussed more fully in chapter 5. Because of the nationality issue, restitution has been given an exceptionally prominent role in Baltic privatization. At the same time it has tended to increase uncertainty on ownership claims, and as the example of forests given above shows, the issue remains in certain branches a serious impediment to investment. In large-scale privatization, the three countries have chosen divergent paths. Estonia follows quite successfully a German-type privatization programme by sale. Investment plans are one argument used by prospective buyers in their offers. On the other hand privatization by sale is inevitably a slow path to restructuring. There is little interest in investment in those
plants that remain state-owned. In many cases, the intention seems to be to let them die a slow death by attrition, as competent labour force emigrates to the emerging private sector.

Latvia originally opted for a decentralised privatization scheme where industrial ministries were supposed to divest state-owned plants. The approach failed to deliver almost any privatization, and the country is in the process of creating the institutions needed for a centralized privatization programme. Ownership uncertainty thus remains. While most industries remain state-owned, the state is hardly capable of investment-based industrial policies. Budget-financed investment is negligible, around 1 per cent of GDP.

Lithuania has taken a voucher-based fast track to privatization. Most industrial enterprises should be privatized by the middle of next year. The authorities wish that this would give a steady basis for future economic growth. One may have doubts on that, however, as the practice of Lithuanian privatization is characterised by insider worker privileges, closed auctions and an important role given to almost non-supervised investment funds. The corporate control mechanism to appear is therefore quite unclear. Observers also point out that the Lithuanian privatization programme, because of its complexity, leaves much room for corruption and directly criminal activities. The state in many cases clearly wants to maintain controlling shares.

The third explanation for output contraction to be discussed is demand constraint. In principle, as we know, a totally credible stabilization programme might have no impact on output. In practice it has, in particular on that part of output which is best captured by post-communist statistics. The balancing of budgets cuts directly into public demand, while an eventual end to subsidization will increase prices to realistical levels and will therefore depress both household and — assuming hardened budget constraints — enterprise demand. Any attempt to impose tax discipline will force part of production and exchange beyond the taxman’s and statistician’s scope.

Interviews of Estonian enterprises indicate that they moved from a supply-constraint regime to a demand-constraint regime very fast in the summer of 1992 (Sepp 1993). In March 1992 90 per cent of enterprises cited the shortage of production inputs as an obstacle to the growth of production. By autumn 1992 the percentage declined to 40. At the same time the share of enterprises citing lack of demand as a problem rose from less than ten to 70 per cent. This partly reflects loss of foreign markets, but the impact of domestic stabilization — probably aggravated, as seen above, by a liquidity crisis — is also evident.
Though detailed analytical studies are not available, it is taken for granted that stabilization policies have also contributed to output decline in Latvia (Shteinbuka 1993). This might not be the case in Lithuania, were stabilization efforts have been less successful, at least until 1993.

Finally we have to focus on the impact of trade on production. It is generally interpreted that collapse of Baltic trade with the FSU was the main short-run reason for output decline, especially in 1990–1992. This had both supply- and demand-size aspects. On the demand side, the deterioriation of the Soviet economy hit Baltic exports badly. True enough, terms of trade first moved in the favour of Baltic exports, as the prices of manufactured goods were liberalised sooner than those of raw materials and energy. When the terms of trade shock finally came in 1992–1993, it was a heavy one. The calculated impact of the shock may have reached 50 per cent of GDP. At the same time, the independence and currency reforms of the Baltic states necessitated new institutional and payment arrangements in trade with the FSU. In the short run, this also contributed to trade decline. Finally, there was the issue of Baltic exchange rates vis-à-vis the rouble. Exporters in Latvia in particular complained that the rate originally chosen was overvalued and therefore tended to unduly depress export volumes. Some of this criticism is probably justified in the sense that the Baltic authorities saw no reason to continue maintaining the then-existing trade dependence upon Russia. Still, there should be no doubt that all the currencies were initially strongly undervalued. This left much room for real appreciation, which in the Latvian case at least may already have brought exchange rates close to purchasing power parity levels (chapter 3).

Supply side effects were important as well. The unavailability of FSU energy and raw materials created various bottlenecks and possibly important secondary effects. Finally, the sudden liberalization of Western trade certainly shifted demand from domestic to imported goods, especially in consumption. In spite of the undervalued currencies, it also created competitive pressure in many sectors. Not surprisingly, agricultural imports have become — as already noted — a fiercely debated issue in all the three countries.

In the light of the discussion above, the priority of foreign trade disruption in explaining output decline in the Baltic countries seems self-evident. Countries just cannot undergo terms of trade losses amounting to several tens of per cent of GDP without a steep decline in production. Still, the factual evidence available is rather less than perfect. Our picture of Baltic dependence on the FSU is still imperfect, and inflation, relative price changes, rate of exchange fluctuations as
well as incompletely recorded physical flows together with changes in statistical practice make any data-based attempts at decomposing the various existing impacts largely arbitrary. The foreign trade statistics of the Baltic countries are clearly the best in FSU, but even they can be useless or misleading. Trade flows with the FSU are most probably understated, but Western trade statistics also have their problems. It for instance seems that there is a major discrepancy between Swedish imports of nonferrous metals from Estonia — as recorded in Swedish statistics — and similar Estonian exports to Sweden as recorded in Estonian statistics. This is an addition to the well-known problem that Estonian statistics show much more metal exports than imports in spite of the country having no production of its own. Here, underreported imports, sales by withdrawing Soviet army as well as domestic thefts all play their role, as admitted by Estonian authorities (Neumann 1993). Still, the problems of Estonian trade statistics are minor compared with Lithuania, where all transit and re-export seem to be excluded.

Clearly, much work still remains to be done before we can claim to have a comprehensive picture about the reasons for production decline in the Baltic states.

1.4 Maintaining employment

In spite of the output collapse, Baltic unemployment has not risen to Western European levels. In Lithuania recorded unemployment was in autumn 1993 only 1.5 per cent and it has remained stable since. In the other countries unemployment has been somewhat higher and rising in Latvia, but the available figures still imply a huge drop in productivity.

The Estonian labour market is considered relatively flexible, and the average official unemployment has recently fluctuated around 2 per cent. The trade union movement is weak, and a law on collective bargaining was only passed in 1993 (Bolz — Lenzner 1993, pp. 52–57). Pensions are state-funded and do not link people to their current jobs. Still, official unemployment figures varied in 1993 from 0.4 per cent in the overheated Tallinn area to 6.7 per cent in Võru (Southern Estonia) and 5.9 per cent in Narva (russified North-Eastern Estonia). Lack of a proper housing market is clearly one of the reasons for such regional disparities, as it restricts mobility of labour. In Estonia as elsewhere, housing privatization has proved both relatively neglected and complicated.

Unemployment has risen steadily to some 6.5 per cent in early-to-mid 1994 in Latvia (The Baltic Independent, 5–11 August 1994).
is so far more slowly than earlier expected. Latvian labour officials expected 20 per cent unemployment already in 1993 (Polkowski 1993, p. 48). For 1994 unemployment has been expected to reach as much as 15 per cent. As in Estonia, regional variation in unemployment is great. It is sometimes claimed to reach 40 per cent in certain smaller towns. Latvia is changing its welfare system to a means-tested direction, and that together with the planned cuts in unemployment benefits — as of late 1993 90 per cent of minimum wages — might be expected to increase labour market flexibility. There is no formal incomes policy outside the public sector and no collective bargaining.

Again, the situation may be different in Lithuania. Though privatized enterprises have in principle full autonomy in employment and wage decisions (Pissulla 1993, p. 36), the still paternalistic instincts of the Lithuanian administration, together with the remaining role of the state even in privatized enterprises, mean that traditional state paternalism still prevails. As noted, there is consequently almost no open unemployment.

Small numbers of open unemployment hide existing levels of underemployment, short working weeks, involuntary vacations and wage arrears. Estimates of such practices necessarily vary, but a "gross" unemployment figure of at least 10 per cent might give a truer picture than those officially recorded. On the other hand, in numerous cases official employment is only nominal. Tax avoidance is the primary reason why people might want to have a nominal state sector job while actually earning in the private sector. This is another facet of the death of the state sector through attrition referred to above.

Companies finance excess employment primarily through a decline in statistical real wages (see Figure 1.3). This is particularly true in Lithuania, where state sector real wages declined from 1991 to mid-1993 quite steadily by 60 per cent. In Latvia, on the other hand, state sector real wages dropped from 1990–1991 to 1992 by approximately only 20 per cent. Since that they have remained basically on the same level, with even a clear upward trend in 1993. It is thus not surprising that Latvia is the Baltic country with the largest open unemployment. Estonian real wages collapsed by 40 per cent in early 1992. Since that they have remained stable with some growth in 1993.

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3 For Estonia the EMOR research institute has estimated a gross unemployment figure of 7.9 per cent for the third quarter of 1993. Interestingly the estimated unemployment figure has declined from 9 per cent in early 1993. This reflects the development of Estonian entrepreneurism. See Kaubaleht, 23 December 1993 — 4 January 1994.
Other adjustments to collapsing productivity have been probably of less importance, though wage arrears, tax avoidance, tax arrears and mutual non-payments have all appeared, though to different degree across countries and over time. Anecdotal evidence also tells of wage payment in unsold goods produced. State administrations in all the three countries are weak, and the impression is created that officials are not always overly anxious to impose financial discipline over enterprises in cases where employment is seriously threatened. The situation is further complicated by the relative importance of Russian-speaking labour force in Estonia and Latvia. On one hand they have very little policy input; on the other governments have to be careful not to antagonize them excessively.

1.5 Inflation

The Baltic success in stabilization is well known. Estonia’s modified currency board system and Latvia’s dirty float — both of which are discussed in some detail in chapter 2 below — have both been accompanied by strict fiscal and monetary policies so that by the end of 1993 monthly inflation in both countries was down to low single digits
(Figure 1.4) and the values of domestic currencies stable. These states have possibly the best post-communist stabilization outcome in — with the exception of the war-torn countries — probably the worst circumstances. Lithuania, which had been earlier characterised by strict fiscal but slack monetary policies also succeeded in 1993 in getting inflation under a much better control by a notable tightening of monetary policies (chapter 3).

The Balts have had the somewhat peculiar habit of debating whether the Estonian currency board solution or the Latvian dirty float with slow appreciation of the currency is "the" right way of stabilization. Actually, both paths have proved feasible and highly successful, when they have been accompanied by prudent economic policies (chapter 2). During the first half of 1994 Latvia, with an inflation of 15 per cent, outperformed both Lithuania — almost 23 per cent — and Estonia — almost 27 per cent. The outcome in all of these countries remains excellent relative to former Soviet republics, and no great importance should be attached to small variation across countries.

Figure 1.4 Monthly inflation, per cent
The main attraction of the Estonian solution is its high resistance to pressure to reflate. Therefore, Estonian achievements should be sustainable. Due to nominal rigidity and the continuing need for relative price shifts the country does not, however, plan for zero inflation. The Latvian solution lacks similar institutional guarantees and is therefore much more dependent on the stamina of policy makers. The under-development of financial markets in Latvia also means that policy makers have only one instrument — interventions in foreign exchange markets — for pursuing two goals, low inflation and exchange rate stability. The policy-makers must therefore increasingly pay attention to developing markets through which to transmit their policies.

The Estonian currency board may not be a suitable long-term arrangement. Currency boards elsewhere have developed toward classical central bank systems, and the probability that Estonian policy makers would like to forego the possibilities of monetary policy forever is not high. Estonia’s great economic policy challenge is how to move towards a central banking system without endangering the credibility and stability reached. In terms of average dollar wages (Figure 1.5), the current Estonian rate of exchange (8 EAK = 1 DEM) should remain feasible for some time more.

Figure 1.5  
Average monthly wages in USD

<table>
<thead>
<tr>
<th>Month</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/92</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>5/93</td>
<td>20</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>3/94</td>
<td>120</td>
<td>140</td>
<td>160</td>
</tr>
</tbody>
</table>
Lithuania moved to a currency board solution in spring 1994. This may seem surprising, as in 1993 Lithuania seemed able to start to learn the nontrivial art of prudent monetary policies in a floating currency environment. Obviously, the longer-term success of the Lithuanian currency board will depend on the ability to maintain reasonable economic policies. In spite of the improvement in policy record during 1993 recent Lithuanian policy performance is such that a repetition of the Estonian success story is far from being self-evident. The short-term preconditions for a currency board, a nearly balanced budget and sufficient currency reserves (Hansson 1993a) are available.
2 The Introduction of Baltic Currencies

2.1 Why sovereign currencies?

New currencies were introduced in the Baltic states during the summer and autumn of 1992. Estonia was the first of them to introduce its own currency, the kroon. Latvia and Lithuania left the rouble zone a little later when they declared the parallel currencies that had been circulating alongside the Russian rouble to be the sole legal tender. These interim currencies were to be replaced with true national currencies, the lats in Latvia and the litas in Lithuania. The introduction of the lats was started in March 1993, and the litas followed in summer 1993. This was largely seen as a technical operation involving the exchange of banknotes — and changing price scales — without any fundamental change in the monetary system as this had already taken place when the Russian rouble was abandoned. As the Estonian experience shows, one should though not underestimate the socio-psychological importance of finally having the "real" national currency in circulation. Also, the new notes are much better protected against counterfeiting than those of the parallel currency had been.

The Baltic currencies, as the monetary authorities of these states would be the first to emphasize, are not entirely new in the sense that all three states had their own sovereign currencies between the World Wars. In Estonia the currency was initially the markka and subsequently the kroon, in Latvia it was the lats and in Lithuania the litas.

There are several valid economic arguments for the introduction of national currencies in countries which were formerly part of the rouble zone (see, for instance, Fieleke 1992, Hansson 1993b). 1) A national currency allows the pursuit of a more independent economic policy, while at the same time underlining the responsibility of national decision-makers for the development of their own economies. 2) There is no reason for thinking of the rouble zone as an optimal currency area. The resource endowments, probable exogenous shocks, institutions and policy goals of the former Soviet republics vary hugely. Having different currencies is therefore a more natural arrangement than the rouble zone ever was. 3) The rapid depreciation of the rouble has made it necessary for these countries to buffer themselves against the rouble crisis. 4) Particularly during the early
months of 1992, the rouble zone suffered from a simultaneous excess supply of deposit roubles and a shortage of cash roubles. Supplementary currencies were duly introduced in several of the former Soviet republics for transactions purposes. There was a likelihood that regional or enterprise-based monies would have appeared in the Baltic countries without the introduction of sovereign currencies. That would have greatly complicated the conduct of economic policy. 5) The existence of a national currency also introduces the possibility of garnering government revenue in the form of seigniorage.

Apart from such economic considerations, Baltic currencies were also viewed from a wider perspective. A national currency has great importance as a symbol of national independence. The enthusiasm shown by the Baltic states for their own currencies is easy to understand and should also be respected from this point of view. Evidently, the endogenous population of countries like Estonia and Latvia, where stringent stabilization policies have proved very popular in the voting sense, has been willing to accept greater hardship in the name of defending the value of one’s own currency than would ever have been possible under a different monetary arrangement. National feelings, a seemingly irrelevant factor in economic policy making, may thus have had great importance in widening the sphere of the feasible in economic policies.

Outside understanding for the Baltic currency plans was rather less than complete in 1992. The International Monetary Fund (IMF) and the European Community (EC) are understood to have urged the Baltic states to be cautious in introducing their own currencies. In the Baltic states this was widely, even if incorrectly, interpreted as opposition in principle to national currencies. Hansson and Sachs (1992) argue that the IMF "tried at first to delay the introduction of Estonia’s currency, arguing that the country was not yet ready". Only after having seen that the Estonian authorities "proceeded on their own", did the IMF provide them "with some last-minute technical support". They would seem to be well placed to make the comment, as Hansson was a member of the official three-member Estonian Currency Reform Committee at the time the kroon was introduced.

Still, the IMF has protested this interpretation vehemently (Odling–Smee 1992). The Fund does not try to deny that — as evidenced by Hernandez–Cata (1992) — it originally took a highly cautious attitude towards the introduction of national currencies in the former Soviet Union. The Fund at that time argued that "certain key elements would need to be in place to improve the chances for success, including, inter alia, completion of the price liberalization
process and a balanced budget". Not all such preconditions were present when the kroon was first introduced. The difference in the monetary reform schedules implied is partly explained by the fact that the Fund seems to have been thinking along the lines of establishing fully-fledged central banking, while Estonia basically chose to pursue the shorter and narrower road of a currency board.

To a degree at least, differing philosophies of transition were also involved. Traditionally, the IMF and many others have tended to see the convertibility of currencies as the end-result of a many-sided process, during which several preconditions of convertibility are established (for a discussion see Sutela 1992). The Polish experience of 1990–1991 however showed that the almost overnight establishment of convertibility is feasible and can contribute in an important way not only to economic opening up, but also to stabilization by providing a nominal anchor. The Estonian case was heavily influenced by the Polish example, and the mode of currency reform chosen was the one that could deliver convertibility fastest. This was not only deemed important on technical economic grounds. At least as important was to see the convertibility of the kroon as the crucial step in integrating Estonia with the world economy. This was a case of both escaping from the rouble and entering the Western markets.

As such, the IMF naturally never questioned but emphasized the right of Estonia to choose its path. The introduction of a national currency is a matter for sovereign decision-making in each independent country. What has changed since early 1992 is the emphasis given to national currencies as policy instruments. While the IMF recommended careful consideration to the Baltic countries in early 1992, the Fund was already by early 1993 understood to be pushing such unwilling former Soviet republics as Belarus and Kazakhstan towards the introduction of national currencies as a condition for full-scale Fund support (see also Hernandez–Cata 1993). Indeed, if the technicality of having notes printed is satisfied, there is no economically acceptable reason for not introducing a national currency in any former rouble zone country. The example of Ukraine perhaps shows that it is possible to manage the monetary system on one's own even worse than has been the case in the rouble zone, but that is not really a valid argument against national currencies. As pointed out above, the existence of a national currency not only creates new policy instruments, but also highlights the responsibility of domestic authorities. This is obviously a good thing in itself.

The Baltic states are only now in the process of developing institutions and instruments for the pursuit of monetary and foreign exchange policies. This process will inevitably take some time, as
experience, know-how and other resources remain scarce. On the other hand there is no reason to mystify this process. The Baltic authorities have surely proved fast enough in learning the trade of central banking, and market participants can hardly be accused of a lack of the entrepreneurial spirit.

In 1992, the IMF and other foreign advisors also stressed the need to negotiate payment arrangements with the rouble zone countries before the introduction of national currencies so as to prevent the dislocation of trade between these countries. In negotiations, Russia was forthcoming concerning the technical issues of exchanging kroons for roubles, but trade issues proper have been repeatedly bogged down by various economic and political conflicts of interest. All Baltic states have seen a collapse in their trade with the rouble zone countries, especially Russia. However, trade had already started to decline before these countries left the rouble zone. Thus the Baltic states’ own currencies were not a decisive factor in this regard, although they did give rise to some technical difficulties and payment delays. Russian monetary and economic disorder has surely been a more serious trade obstacle.

Opinions differ in the Baltic states concerning the pace at which foreign trade could and should change from almost complete dependence on Russia to a more balanced geographical distribution. It is generally accepted, however, that there is a need to continue trading with Russia and other CIS states. Payment arrangements between these countries have been agreed on. Much of the actual trade between the countries is conducted outside official channels, often using barter or mutually acknowledged convertible currencies. Consequently, not all of this trade is recorded in statistics.

It is widely held in the Baltic states that the decline in the trade with Russia is mainly due to the serious economic situation in Russia as well as to political measures taken by Russia that are regarded as being anti-Baltic. On the other hand, the outcome of the parliamentary elections in Lithuania in the autumn of 1992 demonstrated that, at least in that country, people already early on felt that their own government could also do more to maintain and develop traditional trade relations.

Currency substitution, the parallel use of foreign currencies in domestic circulation (dollarization), can be interpreted in different ways. Under certain circumstances, it may be the only possible path to monetary stability. At the same time, it transfers seigniorage abroad and removes money supply from among the instruments of economic policy. As a rule, governments usually seek to avoid currency substitution if only possible. In this respect, the introduction of
national currencies and the consolidation of their position have been most successful in Estonia, where the kroon has replaced practically all roubles and convertible currencies in circulation. The Estonian kroon immediately enjoyed the confidence of the population, as is evident in the extensive exchange of cash convertible currencies for kroons and the increase in kroon deposits since the currency reform.

Convertible currencies can still be used in Latvia and, until August 1993, they could be used in Lithuania as well. In Latvia, for a lengthy period after the currency reform, a large share of transactions were made in convertible currencies. This presumably still remains the case. There have been also Russian roubles in circulation. The Latvian monetary authorities sometimes deny seeing this as a problem. In a Hayekian vein, they argue that there should be a choice of monies on the basis of market criteria. Corresponding information is not available concerning Lithuania, but it seems probable that the position of the national currency has not been any stronger there.

The stability of the new currencies in the longer term is difficult to assess at this point. The Estonian kroon has from the beginning been pegged to the deutschmark and as a result of the general European currency turmoil the kroon has strengthened along with the deutschmark. The Latvian currency floated until spring 1994, but the central bank was quite active in the markets, and the exchange rate against the dollar strengthened steadily. In Lithuania the national currency was floating until April 1994, when the Parliament decided to peg it to the dollar. Before that, also in Lithuania the value of the national currency appreciated or remained stable after readjustments in monetary policy in the spring of 1993.

Against the background of Russia's stubborn monetary disorder, the introduction of the Baltic currencies stands out as a crowning achievement. In 1993, the yearly rates of inflation in the Baltics varied between 35 percent (Estonia and Latvia) and 190 percent (Lithuania), as contrasted with a rate of inflation of 840 per cent in Russia. Even at worst, monetary reform could hardly have made the situation in the Baltic states any worse than it is in Russia. That escaping from the rouble zone was the wise thing to do became more and more evident during the course of 1992 and 1993. The uphill struggle to stability and beyond that to prosperity is, however, still in its early phase. The credibility of the new currencies could still be discredited by reckless policies. A remainder of the risks involved was given when Estonian inflation temporarily peaked in early 1994.

While stabilization policies will determine the worth of the new currencies in the short run, the ability of the Baltic economies to earn foreign exchange is of crucial importance for the stability of the new
currencies in the longer term. Structural reforms in the economy and the reorganization of production are therefore important tasks. The countries' own resources will not be enough for this, however, and external financial support will most probably remain necessary in the coming years.

It is sometimes assumed that the size of a country correlates positively with the possibilities of establishing the necessary credibility of new currencies (see Bofinger et al. 1993). The Baltic experience does not support this hypothesis. It may actually be that small, compact countries with a high degree of homogeneity and commonly shared goals are in a better position in this respect than large countries with deep divisions. The relatively small exchange reserves needed may be easier to mobilize and certainly some of the technicalities of transition are much simpler in a small setting.

2.2 The Estonian kroon

2.2.1 Background

Discussion of a national currency started in Estonia in 1987 when a group of four high-ranking government officials and scholars published the so-called IME programme, aimed at securing Estonia's economic independence (for background see Misiunas — Taagepera 1983; Van Arkadie — Karlsson 1992; Hansson 1992a; and Kallas — Sörg, 1993). A national currency was part of this programme. The economic and political obstacles to the introduction of Estonia's own currency were, however, insurmountable as long as Estonia was part of the Soviet Union. In spite of this, preparations for the introduction of the kroon got under way in 1990 when the Estonian central bank, Eesti Pank (Bank of Estonia), commenced operations. When Estonia gained political independence in August 1991, the way was open for the introduction of the country's own currency.

As already mentioned above, the IMF closely followed the preparations being made for the Estonian currency reform in spring 1992. The IMF had earlier supported the idea that the rouble should be retained in the republics of the former Soviet Union but later in the spring relaxed its opinion and in the final stage assisted in the practical issues involved in the introduction of the kroon. The Russian government also changed its attitude towards the introduction of national currencies in the former republics in the course of the spring. Because of the uncontrolled monetary policies pursued in some of the
republics, the Russian government now felt that a shrinking rouble zone was in Russia's interest. For this reason Estonia and Russia found it fairly easy to reach agreement on the technical issues related to the introduction of the kroon.

The introduction of the country's own currency was strongly supported in Estonia for both economic and political reasons. It may not be too much of an exaggeration to conclude that almost magical efficiency-enhancing properties were attached to sovereign currency among segments of the public at large. In the longer term such expectations could have turned out to be a problem if they had remained unfulfilled. Two years after the currency reform, however, Estonia is already seemingly firmly on the path of economic growth.

2.2.2 Estonia's currency system

In introducing the kroon, Estonia basically adopted the currency board system. A currency board is arguably the most simple, credible and pressure-resistant way to introduce a national currency in undeveloped monetary conditions. It is an arrangement whereby the introduction of the currency is the responsibility of a currency board, an independent monetary authority either distinct from the central bank or at least separate from the central bank's other activities. The currency board undertakes to convert all the national currency offered to it at a fixed rate into the currency chosen as the reserve currency. The domestic currency in circulation is fully backed by foreign exchange and can only change according to changes in the foreign exchange reserves. Monetary policy is not exercised; rather, the supply of money is endogenous to the market (Osband — Villeneuva 1992, Walters 1987).

The aim of the currency board system is to achieve currency convertibility and a fixed exchange rate and thereby help to stabilize the economy, bring about structural change and integrate the country into the world economy as quickly as possible. As the currency board is a technical arrangement which is not associated with any economic or political discretionary power it ensures that the fixed exchange rate is adhered to. Political pressures, to which a conventional central bank is exposed, cannot affect a currency board. Indeed, if they do, the arrangement collapses. For the same reason, inflationary financing through central bank lending to the government cannot take place, either. The government can only run budget deficits if it is able to finance them in the money market. As a country like Estonia lacks well-developed markets where the government might raise deficit
financing, a currency board and a balanced budget become natural companions.

Paradoxically however, over a longer term a currency board system might actually help to pave the way to the abandonment of balanced budgets by enhancing the credibility of the government so as to make market-based deficit financing feasible. In the Estonian case, this phase may already have been reached.

A currency board's strength and weakness thus lie in the fact that it completely ties the hands of the currency issuing authority. In so doing, it economizes on scarce policy resources and in a limited sense borrows the credibility of the reserve currency chosen. On the other hand it subjects possible economic policies to stringent constraints.

The great advantage of the currency board system is that it is simple to operate and does not require experts in monetary policy. This is particularly important in former socialist countries, where the ways and means of the market economy are generally less than perfectly understood.

It is essential for the success of a currency board that it be credible, i.e. that the market shows confidence in its ability and will to exchange currency at a fixed rate. The country issuing the reserve currency may choose to support the currency board country here, as too may international organizations and other countries. Foreign support may become crucial in countries with a low capacity to earn foreign exchange and large variations in its foreign exchange earnings. Without support, such fluctuations would be directly reflected in the domestic money supply, which might be impossible to accept for cyclical reasons.

The currency board model in a post-communist country is naturally also open to different kinds of criticisms. It may be judged as too harsh a solution for an economy in the process of adjustment because the only way to increase the supply of money is by attracting foreign exchange into the country, either through exports or capital investment. When inflationary financing is impossible and the exchange rate is not flexible, other factors — domestic interest rates, prices and wages — must adjust. Softening adjustment by inflation and money illusion is impossible as a policy line. This puts the functioning of the economy and the political acceptability of the currency board to a severe test. Perhaps not surprisingly, currency board solutions have proven unacceptable to large countries. There are also examples of failed currency boards. They are thus neither sufficient nor necessary for successful stabilization. Most stabilizations have been achieved without a currency board.
Currency board arrangements have been applied in various parts of the world, mainly in former British colonies where the mother country's currency has been the reserve currency. More than 70 such boards once operated. Among the best known examples of countries which still have a currency board of some kind are Hong Kong and Singapore. In both of these cases, however, the currency board has developed a long way towards being an ordinary central bank over the years (Fieeleke 1992, pp. 20–21). Argentina adopted the currency board principle in spring 1991 and it has succeeded in curbing its high inflation rate and bringing down interest rates.

Before the currency reform in Estonia, there were doubts about the applicability of the currency board model in Estonia, as it lacks the foreign exchange earning capacity typical of the countries cited as examples. It was suspected that the money supply would become a random process in an Estonian currency board. So far at least, such fears have proven to be unfounded.

In May 1992, the Estonian Parliament passed three laws: the currency law, the law on backing the Estonian kroon and the foreign exchange law (see Eesti Pank, 1992). These laws lay down the principles of Estonia’s currency system. As they make the running of the Estonian currency board the task of the central bank, which also retains the possibility of pursuing monetary policies, the Estonian case is best characterized as a hybrid form of currency board (Bennett 1992).

The Estonian currency board was in the end adopted almost unanimously. Still, it may have been almost a historical accident that the country decided upon this particular arrangement. The amount of monetary expertise in Estonia was not particularly plentiful, and it is probable that many decision makers did not quite grasp the issues involved. The currency board may have won the day primarily because there was the will to pursue a fast currency reform, a currency board is simple to establish, and it was also the only monetary arrangement for which plans were readily available.

The fact that the Estonian case is one of a modified currency board has given rise to peculiar discussions. On the one hand, such prominent supporters of the currency board principle as Hanke, Jonung and Schuler (1993) argue that the Estonian case should not be characterized as a currency board at all. On the other hand, Fieeleke (1992) points out that no "pure" currency boards currently seem to exist. The purist argument therefore looks suspiciously like an attempt to make a principle immune to criticisms from the real world.

Because of historical interest, this chapter describes in some detail also such early features of Estonian currency arrangements that are no longer directly relevant.
According to the above-mentioned Estonian laws, the kroon is fully backed by gold and foreign exchange. The Bank of Estonia can change the amount of notes and coin in circulation only to the extent that there are changes in the gold and foreign exchange reserves. The Bank of Estonia undertakes to convert all kroons offered into foreign currencies. In the early stages of the currency reform the central bank operated in only one currency, the deutschmark. This arrangement was applied because of its simplicity. After some time the central bank shifted to the normal practice whereby it operates in several convertible currencies.

The exchange rate of the kroon is fixed and the kroon is pegged to the deutschmark (1 DEM = 8 EEK). The exchange rate is allowed to fluctuate within margins of 3 per cent. The Bank of Estonia quotes an official exchange rate for the kroon against the deutschmark and unofficial rates against other currencies.

Right after its introduction, the Estonian kroon was convertible within the country as regards current account operations, i.e. the convertibility covered the current foreign exchange transactions of Estonian enterprises and individuals. According to the Bank of Estonia’s instructions, the kroon was convertible into foreign currencies when the customer could present documentary evidence of a journey abroad or of an import transaction. In practice, however, these documents were not always requested. Foreign exchange earnings had to be surrendered within two months of their receipt. Enterprises engaged in foreign trade could, however, obtain the Bank of Estonia’s permission to keep foreign exchange in foreign banks for a longer period.

During 1993 these restrictions were gradually lifted, and Estonia moved closer to total convertibility of its currency, also concerning capital account transactions. In March 1994, the last restriction prohibiting private persons from opening foreign currency accounts was eliminated.

There are no restrictions on the transfer abroad of dividends or foreign capital invested in Estonia. The permission of the Bank of Estonia is required for raising foreign loans.

The core of Estonia’s foreign exchange reserves consists of the gold reserves which the country had deposited in Western central banks before 1940. During 1992, Western countries returned these reserves, totalling about 11.3 tonnes, to Estonia either in the form of gold or foreign exchange. A decision was also made in Estonia on the possibility of using the country’s forest reserves to back the kroon, if necessary, but the practical implementation of this decision is likely to be difficult. The Bank of Estonia is required to publish information once a month on the gold and foreign exchange reserves and the amount of notes and coin in circulation.
2.2.3 Implementation of the currency reform

Technically, Estonia's currency reform was a notable success. A reform whereby the entire amount of notes and coin in circulation is changed at one time requires very complex practical arrangements. In the practical exchange of one currency for another, a large number of volunteer workers assisted at conversion points in different parts of the country. The aim was to make sure that the rules and arrangements were as unambiguous as possible so as to minimize the scope for discretionary decisions and abuse. In a small country with an educated population, the authorities were able to implement the change in a speedy and orderly fashion.

In carrying out the currency reform there was the risk that large sums of roubles might flow into the country from Russia for the conversion. This danger was avoided by restricting the amount of cash that each inhabitant could exchange and by separately investigating all unusually large transfers made between bank accounts before the conversion. It may also be that in the end the possessors of large amounts of rouble notes decided not to place their trust in the new currency of a small nation.

The currency reform was carried out between 20 and 22 June 1992. The rouble ceased to be legal tender in Estonia with immediate effect on 20 June and the only legal tender since then has been the kroon. All persons residing in Estonia who had registered their names for the conversion were allowed to exchange 1 500 roubles at a rate of 1 kroon per 10 roubles in the period from 20 to 22 June. The amount was equivalent to about 12 dollars. Larger amounts of roubles could be converted into kroons at a rate of 1 kroon to 50 roubles in the period from 26 to 30 June. After this the roubles could no longer be converted into kroons. Apparently, the Tallinn authorities believed that Estonians would use any remaining surplus roubles for shopping in Russia. The central bank of Russia, however, forbade the import of roubles from Estonia to Russia after the currency reform. The unenforceability of such restrictions is not a major problem in the case of such a small state as Estonia. This fact helped to make the reaching of agreement between the Tallinn and Moscow authorities easier than in case of Ukraine, for instance.

Bank deposits made by residents were also converted into kroons at the rate of 1:10. The only exception was deposits of more than 50 000 roubles made after the beginning of May. The conversion of such deposits was decided on a discretionary basis. Roubles held by enterprises were also converted into kroons at the rate of 1:10. As soon as the currency reform began, stores marked their prices in
kroons and, for example, all hard currency stores started to sell their goods in kroons only.

Foreign currency accounts held by enterprises or individuals remained valid and foreign currencies in such accounts could be used until the end of 1992. The accounts were, however, closed as regards new foreign currency entries, which had to be converted into kroons. Beginning from 1 March 1993, Estonian firms were again allowed to open settlement accounts in foreign currencies in authorized Estonian banks. According to the Bank of Estonia, this measure was made possible by the strengthened position of the kroon.

Since the introduction of the kroon, the official exchange rate quoted by the Bank of Estonia has been 1 deutschmark = 8 kroons. The exchange rate between the kroon and the deutschmark was set at the level of the so-called market rate of the rouble at the time of the currency reform. This meant that the kroon was undoubtedly undervalued. The rouble’s market rate was determined in interbank auctions and, because of the scarcity of currencies offered and abundance of roubles, the rouble’s rate was undervalued. The undervaluation of the kroon follows the example of many other currencies at the time of abrupt opening up of the economy. It should facilitate economic development by promoting exports and protecting home markets from import competition. On the other hand it is one possible explanation for the continuation of Estonian inflation.

A crude way of assessing the feasibility of the current exchange rate over a longer period of time is to look at Estonian competitiveness in terms of wage levels. In summer 1994 average Estonian wages were approximately USD 120 per month, having risen from USD 80–90 per month in late 1993. Taking the Polish level of over USD 200 per month as the benchmark, Estonia could still almost double its cost level while maintaining the current exchange rate.

This comparison also gives a crude but useful way of assessing the original undervaluation of the kroon. As the Estonian cost level has almost tripled since June 1992, the original undervaluation may have been as large as 1:6.

Altogether about 2.2 billion cash roubles were converted into kroons (Hansson 1992b). The amount is about the same magnitude as estimates of the amount of roubles in circulation in Estonia at that time, on which no accurate data were available. It would seem that only small amounts of roubles were converted into kroons during the second stage of the conversion at the more unfavourable rate.

The implementation of the currency reform required discussions with Russia beforehand on practical arrangements related to the issue of the kroon. The Bank of Estonia agreed to return the roubles
collected during the conversion to the central bank of Russia without compensation. Because of problems connected with payment arrangements, this was never done. Due to high Russian inflation, and particularly after the rouble note reform of August 1993, the whole issue became academic and seemed to have been dropped. It was announced in September 1994, however, that not all had been as simple as earlier believed. Estonia had actually sold the notes involved at a low market price to an unknown buyer, believed to be the rebel Russian republic of Chechenya.

2.2.4 After the reform

The currency reform can also be considered to have succeeded well in achieving goals other than technical ones. This is indicated by the fact that the kroon immediately became the only currency in circulation. Since the currency reform, significant amounts of foreign exchange have flowed into the Bank of Estonia. During the first months after the currency reform the foreign currency converted into kroons consisted mainly of cash held by residents, and the magnitude of these sums came as a surprise to the authorities.

Later on, enterprises also started to repatriate their foreign exchange funds. In July, the Ministry of Economy estimated that Estonian companies held foreign exchange in foreign bank accounts to the value of USD 65 million (Baltic News Service, 24 July 1992). Other estimates put the sum as high as USD 100 million. Currency was evidently transferred abroad at an accelerating pace prior to the currency reform because companies were uncertain as to how foreign currency holdings would be treated.

On 16 July 1992, the Bank of Estonia published its balance sheet for the first time. It showed foreign exchange reserves of USD 98 million. By the end of 1993, the reserves had already increased to USD 362 million. Developments in the Bank’s balance sheet are shown in Figure 2.1. As can be seen, the kroon is actually overbacked relative to the currency board principle adopted. Such accumulation of reserves by the central bank may still prove highly useful in the case of various possible disturbances.
Criticism of Estonia’s currency reform came mainly from economists and spokesmen for the business sector. The level at which the kroon’s exchange rate was fixed aroused criticism. It was argued that the undervaluation of the kroon makes imports too expensive, with the result that a large part of production becomes unprofitable (Rajasalu 1992). It should be noted, however, that this criticism was not levelled at the choice of a currency board as such.

The criticisms of enterprises and banks referred to problems caused by the practical arrangements associated with the conversion and the new exchange rate system. Large companies engaged in trade with Russia were unhappy about the obligation to convert all of their roubles, as this hampered their trade with Russia. Altogether, companies exchanged 700 million cash roubles into kroons in connection with the reform.

It is probable that Estonian authorities willingly accepted the problems caused by the currency reform to trade with Russia. The underlying goal, after all, was not only to escape from the rouble but also to integrate Estonia more closely with Western markets.

As regards commercial banks, problems were caused in the beginning by the central bank’s practice of operating only in the deutschmark and not in other foreign currencies. Commercial banks had to convert other currencies deposited in accounts with them into deutschmark before presenting them to the Bank of Estonia for conversion into kroons. The operation took time and weakened banks’
liquidity as they nevertheless had to pay the corresponding amounts in kroons immediately to their customers (Otsason 1992).

2.2.5 Impact of the reform on the foreign trade sector

As the degree of rouble convertibility remained long unclear, the Bank of Estonia has been unwilling to quote an exchange rate for it. According to the banking agreement between Estonia and Russia, payments between the two countries may be effected either in roubles, kroons or other currencies ('Estoniya', 1992). The aim is to have payments related to trade with Russia handled by commercial banks. Accordingly, Estonian banks have been authorized to open correspondent accounts in Russian banks. Some Estonian banks have rapidly developed their ties with Russian banks and can now execute currency conversions involving CIS states in a matter of a few days ('Politika', 1994).

Trade between Estonia and Russia has declined sharply over the past few years. Difficulties have been encountered in importing goods from Russia as well as in receiving payments for export deliveries. Hence the introduction of Estonia's own currency has not been crucial for trade with Russia, although apparently the new payment arrangements have not functioned quite smoothly. It is obvious that a substantial part of trade between Estonia and Russia that is excluded from official statistics is based either on barter or convertible currencies.

Payments with other CIS states are effected through correspondent accounts kept in the central banks and commercial banks. It has been the intention of the Bank of Estonia that commercial banks gradually take over all these arrangements. Currently, the role of the central bank is quite limited in payment transfers. In practice, trade is now partly conducted in cash convertible currencies as well. It has been agreed that payments between the Baltic states are made in convertible currencies.

2.2.6 Implications of the reform for other sectors

In connection with the currency reform, the turnover tax in Estonia was raised from 8 per cent to 18 per cent, the corporate income tax was raised by 10 percentage points to 35 per cent and personal taxation was tightened. Wage rises were also restricted. These measures were part of the economic stabilization programme which
the Estonian authorities drew up together with IMF experts. The stabilization programme is based on restrictive monetary policy and tight fiscal policy aimed at improving the budget balance.

As a result of these measures, living costs went up by almost a quarter between June and July 1992. For the whole of 1992, the rate of inflation was 953 per cent. In 1993 the annual inflation came down to 35 per cent, which is a remarkable achievement. However, it seems that Estonia has not been able to bring its inflation completely under control. During the first six months of 1994, consumer prices increased by 27 per cent.

There are several possible explanations why the currency board did not immediately bring about price stability. One contributing factor to the rapid rate of inflation after the currency reform has been the larger-than-expected inflow of currencies into the Bank of Estonia. This turned into a rapid increase in the amount of currency in circulation. These currencies came both from larger-than-expected original cash reserves and from exports, including the reportedly very profitable trading of metals and other commodities imported from Russia, at least part of which may be reflected in currency reserves. The share of exports in the economy has thus at least temporarily been larger than expected. Performance on the real side of the economy has, however, remained weak, and output fell continuously until at least 1993 (chapter 1). The rapid rate of inflation has reduced the substantial original undervaluation of the kroon, which has also allowed the existence of inflation. Finally, one should note that Estonian price liberalization has been to a degree stepwise. This has also continued to feed inflation in spite of the balanced budget.

The unexpected inflationary peak of early 1994 will be discussed in chapter 3.

The application of the currency board system in the Estonian situation over the longer term will involve special problems. As already mentioned, the foreign currency reserves have grown faster than expected both because the size of domestic foreign currency cash funds was larger than expected and because export earnings had been boosted by receipts from trading. In theory it is possible that export earnings will continue in the future to increase at a faster rate than domestic production, in which case the currency board system could turn into a mechanism for sustaining inflation. Even though the currency board naturally only determines the upper limit of the money supply, a continuous accumulation of reserves by the authorities — as so far is the case with the Bank of Estonia (see Figure 2.1) — might well become difficult to sustain under certain circumstances.
Perhaps partly in recognition of this danger, the central bank, which is responsible for currency board operations in Estonia, has also retained some monetary instruments at its disposal, although they do not have a significant role. In principle, however, a potentially unstable combination of a currency board and a central bank pursuing monetary policy might be emerging. It is very probable that the currency board principle will be regarded as too strict in the coming years, as the credibility of the kroon will no longer be a problem and politicians increasingly come to love budget deficits, also for good economic reasons. The transition from the present arrangement to something much more like an ordinary central banking system is a question which will perhaps soon be occupying Estonian policy planners.

A more probable outcome than oversized export revenue will be the drying up of income from trading Russian commodities on international markets. In such a case adherence to the currency board would lead to a contraction of the money supply in an economy which has already undergone a (statistical) downturn of some 50 per cent in production. This might be the time for the Tallinn authorities to gradually abandon the currency board, which at least some among them have always understood to be a temporary vehicle for creating credibility and borrowing time for the development of central banking instruments and policies proper.

The Banking Department of the Bank of Estonia has already intervened strongly in the banking system. Several banks, among them three of the largest, had to be liquidated or consolidated in a first round of post-socialist banking crisis (chapter 4). These moratoria following insolvency translated into illiquidity were due to general incompetence, unduly high inflationary expectations and the loss of currencies in the Moscow VEB debacle, when the Soviet foreign trade bank collapsed and depositors, also from Estonia, lost their money. It was not yet a case of a bank crisis induced primarily by bad loans. That may still be waiting in the wings.

2.2.7 Estonia: concluding remarks

Hanke, Jonung and Schuler (1993) cite three criteria for a genuine currency board. The monetary base must be fully backed by foreign exchange reserves, the currency must be fully convertible and the exchange rate fixed. In their view the Estonian case fails on two counts. At the time they wrote the article, kroon convertibility was not complete even for current-account transactions, and the kroon was not convertible for capital-account purchases by Estonians. Also, in their
view, the kroon exchange rate is not fixed but pegged; it can be changed.

There is no doubt that the Estonian case is not that of a pure currency board. But, as Fieleke (1992) argues, it seems impossible to find a pure currency board anywhere. Also, it seems that Hanke and others may exaggerate the ease with which the kroon exchange rate can be changed. Finally, their case is weakened by their insistence that 'when the pegged exchange rate of the Estonian monetary system is altered, as we believe will occur in the near future, the currency board system should not be blamed, since Estonia does not have that'. As all good utopians know, the only way any system can remain beyond failure is to define it in such a way that it would never be subject to empirical judgment.

Still, as the above discussion should make clear, though they were wrong about the timing, Hanke and others are very probably right in seeing the current Estonian monetary arrangement — whatever one decides to call it — as being transient.

Fieleke (1992) tends to judge the adoption of a currency board by economies in transition as being in a sense superfluous. If the authorities can commit themselves to reform, why would they require so drastic a remedy? If they remain inclined to inflate, why would they agree to a currency board?

But surely, as we have already indicated, the alternatives are not that simple. First of all, the Baltic countries are clearly cases where the authorities have not reformed themselves. It is a question of genuinely new authorities, quite possibly with genuinely new frames of mind. Second, and more important, the most important lesson that may be drawn from the Estonian case seems to be that money is indeed not only money but also a crucial national symbol. It is highly improbable that the Estonians would have accepted the balanced budget as stoically as they did were it not for the sake of maintaining the value of the kroon. The currency board principle made possible 'The Only Stable Currency in the North of Europe' — as Estonians liked to characterize the kroon during the European currency volatility of autumn 1992 — and national pride helped to make drastic stabilization policies feasible.
2.3 The Latvian rouble and the lats

2.3.1 Implementation of the currency reform

Latvia’s intention of introducing its own currency was first made public in the first economic reform programme drawn up by the government in 1990. The Latvian currency reform is not as well known abroad as Estonia’s. This might be because roubles were gradually replaced by the national currency in Latvia, and initially this took place through the introduction of an interim currency. In Latvia there was no single conversion operation that might have attracted a lot of publicity. Contrary to Estonia, the Latvians opted for a stepwise reform. The introduction of Latvia’s true national currency, the lats (divided into 100 santimi), was only started in March 1993.

The issue of the interim currency, the Latvian rouble or "rublis", was started in May 1992. Latvian roubles were introduced alongside roubles at the exchange rate of 1:1. The immediate reason for the introduction of Latvia’s own currency was a severe shortage of rouble notes, a shortage which was felt throughout the entire rouble zone, especially in the early part of 1992.

After May 1992, wages were paid in Latvian roubles. The position of the Latvian rouble gradually strengthened during the summer. In July, retail stores started to give change in Latvian roubles only, and the Savings Bank of Latvia started to take deposits from individuals in Latvian roubles only. Russian roubles could still be withdrawn from savings accounts, however. The Bank of Latvia exchanged cash roubles for Latvian roubles until mid-July at a rate of 1:1.

As from 20 July, the Latvian rouble became the only legal tender in Latvia. Bank deposits of both enterprises and individuals were automatically converted into Latvian roubles at the rate of 1:1. At the same time the Russian rouble became a foreign currency and regulations regarding foreign currencies also applied to it. The use of foreign currencies inside the country was not forbidden altogether but all prices had to be stated in Latvian roubles and, because of their legal tender status, Latvian roubles had to be accepted for payment. Wages could still be paid in foreign currencies. According to the sparse information available, enterprises — particularly the all-Union ones formerly subordinated to Moscow — continued to use Russian roubles to a large extent in their payments. Accurate data on the scope of the use of Russian roubles and convertible currencies are not available, but the Riga authorities have cited figures claiming that at the end of 1992 half of all transactions — according to other
information one third — were still in convertible currencies and perhaps some 15 per cent in roubles. As Latvian inflation was lower than Russian inflation, many preferred to use the Latvian rouble for savings and the Russian rouble for payments.

Hard currency shops were obliged to start selling their goods in Latvian roubles as well. However, shops effectively circumvented this obligation by pricing their products so high in Latvian roubles that it paid customers to exchange their roubles for foreign currency in exchange offices and pay for their purchases in foreign currency. Exchange offices — Polish-style kontors — are plentiful and competitive. They became a Riga landmark. Central bank officials refer to the freedom of markets and claim ignorance of the volume of the Riga cash market. It is believed to be probably the largest in the former Soviet Union.

The practical implementation of the currency reform in Latvia was successful, although for reasons very different from those in Estonia. Latvia chose a very simple method of gradually replacing Russian roubles with the new currency. This method nevertheless entails certain dangers: with bad luck, Latvia could have been faced with a flood of roubles from Russia and other former Soviet republics. The value of the new currency would then have collapsed. Fortunately for Latvia, there was obviously little confidence in the new Latvian currency outside the country, and thus foreigners were not interested in acquiring Latvian roubles.

The Latvian rouble was always intended as an interim currency before the lats would be introduced. According to the authorities, the lats should have been issued as soon as inflation had been brought under control and the exchange rate stabilized. But in the autumn of 1992 the governor of the central bank asserted that this would possibly take place in the latter part of 1993 (as cited in Estoniya, 9 September 1992). Considering that the original plan was to introduce the lats in 1992, it is evident that, somewhat unexpectedly, the Latvian roubles temporarily lost their interim nature and became relatively permanent. This also created a serious technical problem as the Latvian rouble notes were easy to forge.

The announcement of the gradual introduction of the lats was made — after much speculation — in early March 1993. The official reason given was that as the economy had been stabilized, the time for the lats had come. Remembering what was said above about the socio-psychological importance of the kroon in Estonia, there is also some reason to wonder whether the June 1993 elections were not a contributing factor. Finally it seems clear that the flow of counterfeit Latvian rouble notes was much bigger than expected.
The rate of conversion of Latvian roubles into lats was 200:1. The first banknotes denominated in lats, which were put in circulation on 5 March, were five lats notes. Latvian roubles were gradually phased out with the further issuance of lats notes. By June, already two-thirds of currency in circulation was in lats. From July, all prices had to be in lats, and all taxes and duties were also collected in the new currency. Latvian rouble bank accounts were converted into lats, but foreign currency accounts remained untouched. The use of foreign currencies is still permitted. The last Latvian rouble notes were withdrawn from circulation in October 1993.

The Latvian and Russian authorities did not reach a final agreement regarding the Russian roubles that had accumulated in the Latvian central bank in connection with the currency reform. Latvia agreed to keep the roubles in its custody at the central bank. There were some unresolved issues between the countries regarding debts, and Latvia was interested in linking them to the return of the roubles to Russia. As in the Estonian case, the Russian note reform of August 1993 changed this situation. A total of 1.5 billion roubles accumulated in the central bank of Latvia during the currency conversion (Baltic News Service, 9 October 1992). Their value has since been decimated by Russian inflation.

Like Estonia, Latvia also recovered the gold reserves it deposited with Western central banks before 1940. The gold reserves were, in late 1992, estimated to amount to a meagre 7 tonnes (Financial Times, 19 December 1992).

Despite heavy domestic criticism, the Bank of Latvia, which enjoys a high degree of independence, remains committed to tight monetary policy. Due to that, the yearly rate of inflation which in 1992 was 959 per cent, slowed in 1993 to 35 per cent, the same figure as in Estonia. In the run-up to the June 1993 parliamentary elections, these achievements were in danger as the Bank of Latvia seemed to be almost the sole domestic defender of stabilization policies. In the end, however, stabilization policies proved perhaps even surprisingly popular in the elections. In May 1993 Latvia was the first transition country to record a decrease in consumer prices in spite of the fact that the central bank increased liquidity through currency intervention. During the first half of 1994, it seemed that Latvia has been the most successful of the Baltic countries in bringing down the rate of inflation.
2.3.2 Exchange rate system

The officially announced exchange rate system in Latvia is very liberal. This could at least partly be due to incomplete foreign exchange legislation and the undeveloped state of monetary institutions and instruments, but on the other hand, the Latvian authorities long seemed to be strictly committed to the continuation of this liberal regime. The lats is freely convertible as regards both current and capital transactions. Enterprises are not obliged to repatriate foreign currency earned abroad but the state taxes foreign exchange earned by enterprises and individuals. There are no restrictions on the repatriation of either capital or dividends by non-residents.

A special feature of Latvia is the existence of private foreign exchange offices, which have been set up in large numbers in a short period of time. The best known of these is Parex, which controls the major part of the market. Officially at least, in the beginning neither the banks nor the central bank were very active in controlling the foreign exchange market. This was mainly due to the undeveloped state of the banking sector and lack of resources. Later on, the involvement of the central bank has become more apparent.

Until February 1994, the exchange rate of the lats floated both against convertible currencies and the Russian rouble. Actually, however, it seems that the floating of the Latvian rouble was not clean at all. Originally, the Latvian rouble was clearly undervalued, and the monetary authorities have announced that they consider exchange rates based on purchasing power parity to be the proper ones in the longer term (Repsē 1993). Therefore the appreciation of the rublis (and lats after that) against the dollar has also been an intentional consequence of tight monetary policies.

Over the shorter term, developments have also been informative. During the latter half of 1992 the Latvian rouble was notably stable against the dollar (see Figure 2.2). After the period of turbulence connected with the introduction of the lats, this stability has continued, this time most clearly against the deutschmark. It is of course most improbable that such stability might have existed without central bank intervention in the currency market. In fact, the Bank of Latvia has rather consistently bought dollars from the banks to soften the appreciation of the national currency. 'De facto pegging, officially called floating in the face of uncertainty concerning the authorities' ability to defend the rate of exchange originally chosen', may be an apt characterization of actual Latvian policies. The accumulation of dollar reserves by the central bank was also necessary because of the meagre level of initial reserves.
Exchange value of the US dollar (domestic currency / USD)

Bank of Estonia

Bank of Latvia

Bank of Lithuania

Quotations are shown for the end and middle of each month.
In February 1994, the central bank finally introduced an informal peg of the lats to the SDR. It remains to be seen how strongly this peg would be defended in case of a major attack.

As already mentioned, the Riga market for cash roubles and convertible currencies has since 1992 been very active. Initially, Latvia was considered to be the only former Soviet republic where obstacles to the exchange of non-cash roubles for cash and vice versa had in principle been removed (‘Valyutnoe’ 1994). The size of the rouble-foreign currency market is unknown, and there is no attempt to determine the origin of the convertible currencies traded on it. Despite efforts to develop Riga into the biggest money market centre in the Baltic region, the alleged lack of controls could still turn out to be a major problem.

2.3.3 Impact of the reform on the foreign trade sector

Prior to its withdrawal from the rouble zone, Latvia held negotiations with Russia on new arrangements for payments and settlements between the two countries. Accounts have been opened in the central banks of both countries, through which payments are made. Latvian commercial banks may open correspondent accounts in Russian banks and transfer companies’ payments through these accounts.

With the aim of protecting its economy against a possible flood of roubles from the former Soviet republics, the Bank of Latvia introduced differentiated exchange rates in August 1992 for non-cash roubles transferred from different republics. According to the first quotation, roubles originating from Ukraine had the lowest value with a buying rate of 0.3 Latvian roubles. The highest rates were for roubles coming from, inter alia, Russia and Lithuania, with a buying rate of 0.9 Latvian roubles (Baltic News Service, 14 August 1992, 16 August 1992).

Latvian enterprises were highly critical of the central bank’s new system, as their export earnings were significantly reduced because of the new rates. In early 1993, the Bank of Latvia stopped exchanging CIS currencies for Latvian roubles. It continues to quote their rates of exchange but now wants banks and exchange offices to do the trading. It is understood that this decision was prompted by the accumulation of rouble assets in the central bank.

As markets between the roubles — and later on the various national currencies — of different republics were initially somewhat slow to emerge, the central bank in making quotations regulated the market and divided it into segments according to republic, which
could nevertheless be circumvented through the use of convertible currencies. Markets for roubles and other national currencies now seem, however, to have developed quite rapidly and currently Riga is considered the prime trading centre for these currencies in the former Soviet Union.

2.3.4 Latvia: concluding remarks

We pointed out above that the underlying specific problem for Estonian monetary policy in coming years will be an orderly transition from the current modified currency board arrangement to something closer to ordinary central banking. In the case of Latvia, three specific questions seem to stand over and above others.

First, noble as the general Latvian goals of an independent central bank, zero inflation and purchasing power parity exchange rates may be, low inflation levels have been bought at a very high price. Open unemployment is much higher than in the other Baltic states (chapter 1), and interest rates have remained very high.

Second, the laissez faire attitude of the authorities is not sustainable. The risks involved are evident. The country has already had its share of financial scandals, and much supervision and possibly also controls will be needed to make Riga a respectable financial centre.

Finally — and in particular against a Finnish background — one may ask whether the declared libertarian stance is in fact credible, given the possibilities for implicit agreements and backroom deals in any small society. A general clarification of the rules of the game might be in order.

2.4 Lithuania: coupons and the litas

2.4.1 Implementation of the currency reform

The Lithuanian parliament passed an act on the introduction of a national currency at the end of 1991. At the same time, a currency reform committee was set up. After that, the introduction of the lithuanian currency, the litas — divided into 100 centai — was widely expected throughout 1992. As, however, there were diverging views on how this should be done and the appropriate timetable, Lithuania became the last Baltic country to escape from the rouble zone.
After much debate, Lithuania — accepting the views of the central bank — decided to follow Latvia in embarking upon gradual monetary reform. The necessary conditions for a true national currency, including payment agreements with neighbouring countries, were deemed to be absent, and under the pressure of a rouble note shortage, Lithuania introduced an interim currency in May 1992. It had no proper name but was simply called the coupon, "talonas" in Lithuanian. The coupon was valued at par with the rouble. Initially, 40 per cent of incomes were paid in coupons. They were accepted as payment in the same way as roubles.

Somewhat later, towards the end of September 1992, the authorities began to withdraw roubles from circulation. Rouble notes and bank deposits held by the population were converted into coupons at the rate of 1:1 for one week until 1 October. After that, the use of roubles in trade was forbidden. Convertible currencies could still be used with special permission. Roubles were regarded as foreign currency and could be exchanged in commercial banks at the market rate.

The sudden withdrawal of roubles was motivated by a large inflationary inflow, especially from Ukraine. Declaring coupons the sole legal tender was judged to be the quickest solution. This was contrary to expectations, as the original intention had been for there to be a changeover from roubles to litas. There were also technical, but politically sensitive, problems in printing the litas notes.

In June 1993 the authorities finally announced that the litas would be put into circulation beginning from 25 June at the rate of 1 litas = 100 coupons. On the same date, bank deposits were also converted and all prices had to be given in litas.

The coupon was not accepted as a means of payment after 20 July. The use of convertible currencies was also soon banned, and since 1 August the litas has been the sole legal tender in the country. The conversion seems to have succeeded rather well, although there may have been difficulties in implementing the prohibition of the use of convertible currencies. Though the litas became the only legal tender, convertible currency deposits held in Lithuanian banks were not converted without the consent of the depositor.

Like Estonia and Latvia, Lithuania also recovered its pre-war gold reserves, a total of 6.3 tonnes, even now mostly in gold. The roubles collected in the conversion process were stored and their return was to be negotiated with the rouble zone countries. As in the cases of Estonia and Latvia as well, this issue has been made redundant by the Russian rouble note reform in August 1993.
2.4.2 Exchange rate system and foreign trade

Like coupons, litas are convertible for current account purposes. As regards capital account transactions, there are some limitations for convertibility. State companies have faced requirements to surrender their foreign currency earnings, but these requirements were abolished in 1993. Private persons are allowed to maintain foreign currency accounts in domestic banks or abroad, while enterprises need the permission of the central bank to hold accounts abroad.

Lithuania maintained a dual exchange rate system as late as autumn 1993, with an official rate set by the central bank and a market rate. Later on the dual exchange rate system was abandoned, and currently there is only one rate, which is determined by the market and quoted by the central bank. The Lithuanian central bank opened a currency exchange in autumn 1993, with daily sessions of trading in dollars and deutschmarks. The foreign exchange market is, however, very thin, and the central bank is the major participant.

In 1992, the Lithuanian fiscal policy was basically balanced but monetary policy was lax. Therefore, the authorities were unable to bring down inflation rates in the same way as in the other Baltic countries. During 1992, the yearly rate of inflation was 1163 per cent. In 1993 it had slowed down to 189 per cent, which still was considerably higher than in Estonia and Latvia. During the first half of 1994 the inflation rate however came down to a level well comparable with the other Baltic states (chapter 1).

The coupon depreciated considerably against the dollar, from 250 coupons per dollar in early October 1992 to 550 coupons in May 1993. Later, the coupon (and litas after that) appreciated, as monetary policies started to become stricter. Since the autumn of 1993, the central bank has kept the rate of the litas practically stable at 3.9 litas per dollar. (See Figure 2.2 for exchange rate developments.)

Due to the problems in strengthening the credibility of Lithuanian monetary policy, there was active discussion in the government in autumn 1993 about adopting a currency board arrangement similar to that of Estonia. In March 1994 the parliament adopted a law to that effect, and the new system became effective in April. In connection with this, the litas was pegged to the dollar at a rate of 4 litas per 1 dollar.

The decision to introduce the currency board in Lithuania was a controversial one. In particular, the central bank argued against the decision, as it was deemed that the lowering of inflation since mid-1993 showed that the monetary authorities were beginning to master the art of monetary policy under managed exchange rates. The
parliament felt, however, that the Estonian experience was a convincing argument for tying the hands of policy makers. Given recent Lithuanian political traditions, it may however be more difficult there than in Tallinn to endorse the principle of the balanced budget also in practice, not only in words. It is symptomatic that discussions of a possible devaluation of the litas flared up immediately after adopting the currency board principle. Lithuania will provide an interesting example of applying a currency board.

Already in August 1992, Lithuania and Russia reached an agreement in principle concerning payments between the countries, but practical problems were still to be resolved. In the same way as between Lithuania and Russia, payments with other CIS states are supposed to be settled through correspondent accounts held in central banks. Commercial banks may also transfer payments through their correspondent accounts.

2.5 Similar goals, different roads

The withdrawal of the Baltic states from the rouble zone and the introduction by these countries of their own currencies proceeded smoothly and the process was much easier than expected by many foreign experts. The sharp depreciation of the rouble since summer 1992 shows that the Baltic countries were right to uncouple from the rouble and issue their own currencies. In those countries where economic stability has been given priority in policy making, domestic currencies have facilitated the attainment of that goal. The convertibility of the currencies has been a key to opening up and integrating the countries. At the same time, national currencies are no panacea. A prerequisite for stability is responsible fiscal and monetary policies.

The example of the Baltic countries shows that a national currency and independent monetary policy can be introduced under very different principles and procedures. However, given the fairly sparse information often available, it is sometimes difficult to assess how the systems actually function in practice. Existing evidence however already suggests two further conclusions. First, the size of a country does not determine the credibility of a national currency. Second, far from forming an optimal currency area, the Baltic countries are dissimilar enough to make any ideas of a monetary union totally illusory.

The Baltic countries have successfully passed through the first stage of the introduction of their own currency units, that is, they have left the rouble zone. However, bigger problems lie ahead because
these countries will have to secure the long-term viability and stability of their currencies. This calls for responsible monetary and fiscal policies together with the restructuring of the economy, which, initially, will be felt in a declining standard of living. Foreign trade plays a crucial role in the small Baltic economies and the countries’ capacity to earn foreign currency through exports is a key factor in terms of the stability of their own currencies. Finally, the availability of international financial support for the changes in these economies will remain important.

2.6 The comparative efficiency of Baltic currency reforms

This chapter has argued for a pluralistic view: there are different feasible ways to reach monetary independence, each with its peculiar problems and advantages. Still, it may be interesting to probe the comparative efficiency of Baltic currency reforms.

This chapter proposes to use two criteria for such an assessment. First, the public has to accept the new currency as money. It must be generally accepted as a medium of exchange, unit of account and store of value. As new currencies are competing with roubles and other foreign monies that circulate within the country at the time of monetary reform, this will be called the Market Share Criterion. Secondly, the Interest Rate Parity Criterion will be used. Differences in interest rates for domestic currency- and dollar-denominated assets within the country involved are a suitable measure of the perceived risk of the domestic currency. As both dollar- and domestic currency-denominated accounts are offered by the same banks within a country, this criterion should neutralize both country- and bank-specific risks.

With respect to the Market Share Criterion, Estonia emerges as the clear leader. The kroon is virtually the only currency used within the country. The relative position of Latvia and Lithuania is impossible to assess due to the lack of information, but foreign currencies are widely used in both countries. However, one should note that the Latvian authorities would not accept the validity of the Market Share Criterion. In the view of the Bank of Latvia, competitive currencies are a natural market-based phenomenon. They might propose another criterion, that of Market Share Development. Most likely the lats has been able to increase its market share since its introduction.

Using the Interest Rate Parity Criterion is more complex (for an earlier discussion, see Hansson — Sachs 1994). Ideally, we would like
to compare ex ante real interest rates for assets denominated in foreign and domestic currencies within each country. Comparisons between countries of the kind made by Hansson and Sachs (1994) are also interesting, but they capture other country risk as well, not only the one risk that concerns us here, i.e. that connected with the national currency. Even in the case of the Baltics, as similar as they are in many aspects, country risk not connected with currencies might well vary substantially. The fact that Lithuania only started a strong stabilization effort in spring 1993 also complicates comparisons across countries. One would expect nominal interest rates to remain high for a relatively long time after the start of stabilization. The less the credibility of economic policies the longer the time.

Another problem arises from differential bank risk. As in other economies in transition, Baltic banks are very heterogenous and the interest rates offered and charged vary widely. It is difficult to know for each country what representative and comparable interest rates should be used.

Hansson and Sachs (1994) present various cross-country interest rate comparisons — both nominal and ex post real — for the Baltic states. They also compare indicators like bank spreads and the share of non-performing loans in bank portfolios. In all cases Estonia emerges as the winner, i.e. as the country having the lowest interest rates. They conclude that this is due to the "enhanced credibility of the exchange rate peg". This explanation is credible, but not beyond debate. As for Lithuania, a possible explanation for high nominal interest rates was suggested above. As for Latvia, one may note that as of end-January 1994 (Hansson — Sachs 1994, Table 12, reproduced as Table 2.1 here) even dollar deposits earned an average interest of 25 per cent. The figure is even higher for Lithuania, 31 per cent.

### Table 2.1

**Interest rates in local currency and US dollars (annual rates, as of end-January 1994)**

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<th></th>
<th>Deposit rates</th>
<th>Loan rates</th>
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<td></td>
<td>Local currency</td>
<td>US dollars</td>
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<td>25</td>
</tr>
<tr>
<td>Lithuania</td>
<td>56</td>
<td>31</td>
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As such, high dollar deposit interest rates may drag domestic currency rates up as well. But why are dollar interest rates so high? On the one hand, they must be regarded a sign of perceived political risk. Governments might freeze or confiscate foreign currency accounts, as has been done in various countries, including the USSR. On the other hand, banks must be able to afford to pay these interest rates. This possibility presumably reflects the profitability and character of transactions that both Latvian and Lithuanian banks are involved in between the FSU and the West.

The exact measurement of ex ante real interest rates as the difference between nominal interest rates and expected inflation is obviously impossible. Therefore, real interest rates for local currencies have to be defined as the difference between deposit rates at end-January 1994 minus — for instance — The Economist Intelligence Unit (EIU) inflation forecast for 1994. For Latvia, the real interest rate so defined is 22 per cent (37–15). This is very high and coincidentally almost the same as the dollar deposit interest rate. The Lithuanian inflation forecast was highly uncertain, but the EIU forecast puts the real interest rate at −94 per cent (56–150). Obviously, the Interest Rate Parity Criterion makes no sense for Lithuania. For Latvia, it does not point to currency uncertainty.

The Estonian case is complex. Interest rates for three-month deposits in January 1994 were around 10–15 per cent. Given the EIU inflation forecast of 20 per cent, this made real interest rates slightly negative. As sight deposits, where most savings are held, only earn 2 per cent interest annually, their real interest rates are notably negative. Because of a surge in inflation in early 1994, the Estonian inflation forecast for 1994 was later doubled. In spite of this, a well-reputed bank (Hansapank) paid at end-June just 6.95 per cent interest on a three-month deposit. Even the nominal interest rates of 16–30 per cent on loans may have made real interest rates negative.

Applying the Interest Rate Parity Criterion to Estonia is hampered by the fact that foreign currency deposits have only recently been allowed in Estonia. Such deposits are still a rare occurrence, and their interest rates are 4–5 per cent annually. This, naturally, is greatly at odds with the other Baltic countries and testifies to the perceived smaller country- and bank-specific risk in Estonia. Similarly to Latvia, the Interest Rate Parity Criterion tells of no currency risk proper.

The rarity of foreign currency accounts in Estonia indicates the success of this country on the basis of the Market Share Criterion. In comparison, it is estimated that perhaps as much as 60–70 per cent of all dollar deposits in the two other Baltic countries are of Eastern origin (The Baltic Observer, 19–25 May 1994).
2.7 Conclusions

Until spring 1994, the Baltic monetary systems could be neatly divided into two. Estonia had opted for a currency board, strict banking regulation and limited capital account convertibility. The Latvian-Lithuanian model included floating exchange rates, a liberal attitude to banking regulation and (in the Latvian case) full convertibility. Hansson and Sachs (1994) argue that the Estonian model created more credibility, which can be seen in lower interest rates as well as in other indicators.

Some of the neatness of this division into two models was always illusory. Estonia made no complete one-time jump into convertibility, but it did liberalise its foreign exchange controls gradually, and in the end sooner fast than slowly. Lithuania did the same, and by spring 1994 all the Baltic countries had either full or very high convertibility. What is more important, neither is the contrast between fixed exchange rates in Estonia and the float elsewhere all that clear-cut. The float of the lats and litas — as long as it lasted — was highly regulated, and by spring 1994 the two countries had both announced a regime change. Most of the differences between the Estonian and the Latvian/Lithuanian model had thus evaporated in less than two years.

The common features of the Baltic models should be emphasized. In particular, there was — as Hansson (1994, p. 3) puts it — an almost religious devotion to currency convertibility and trade reorientation. They were seen as essential elements of escape from the USSR and return to Europe. This is what had the highest priority in all the Baltic countries, and this separates the Baltic countries from all the other FSU states. There was the feeling of an overwhelming national mission, and this explains the relative weakness of lobbies and vested interests in Baltic politics. If industrial lobbies could have decided, trade reorientation from Russia to the West would certainly have been much slower. If the agrarian lobby had been strong, Estonia would not have completely liberalized foreign trade. In principle, the time of lobbies might come when politics turn into normally after the national mission has been fulfilled, but by then the traditional lobbies will have been much weakened by economic and social change.

There is no evidence that the practical, technically economic steps needed to make this shift had been widely understood or very competently debated in any of the countries. As Hansson (1994) describes it, the decision to adopt the currency board in Estonia was almost an accident of history. In Latvia, the powerful personality of the Bank of Latvia’s governor has certainly played a key role in the country’s choice of the liberal route. As to Lithuania, what could tell more of the role of political chance than the decision to adopt the currency board, after stabilization was succeeding without it?
3 Fiscal and Monetary Policies

3.1 Introduction

Within the basic agenda of the transition to a market economy — conventionally divided into stabilization, liberalization, privatization and restructuring — macroeconomic stabilization has an almost undisputed logical priority. In order to effectively develop markets, a fairly stable monetary environment is needed — one that enables economic agents to make rational decisions — especially those with a time horizon, like investment. In the extreme case, economies have to be protected against hyperinflation, a situation where the domestic currency starts to lose all of its functions, including the medium-of-exchange function.

In an economy in transition, the danger of high and variable inflation looms large for many reasons. Centrally managed economies were typically economies of shortage, where economic activity was primarily constrained by the availability of resources, not by demand. Given that most prices were administratively fixed, the pressure of shortages typically lead both to hidden inflation in the form of queuing, rationing and quality deterioration and to suppressed inflation in the form of a monetary overhang, i.e. purchasing power without sufficiently desirable objects to buy. Price liberalization is an absolute necessity in transition, as a market economy with controlled, socialist-type prices is impossible to imagine, but such liberalization after the existence of a shortage economy will first lead to a jump in inflation, a temporary correction of prices to equilibrium levels. In the absence of strong stabilization measures, this initial price peak all too easily turns into sustained high inflation, as expectations adapt, price rigidities remain and wage pressure soon arises.

High inflation, in addition to the dynamic efficiency losses hinted at above, is unjust, particularly in a transition economy, as people and institutions have widely differing opportunities and capabilities for adjusting to it. It also endangers liberalization, as calls for revoking controls are sure to arise. Finally, it may well destroy the political support enjoyed by a post-communist reform government.

Even in a country like Czechoslovakia, which inherited no major macroeconomic disequilibria from the socialist period, stabilization policies are an absolute necessity because of the huge corrections needed in relative prices. Due to existing rigidities, these could bring about an upward spiral of general price and wage levels.
Though Russia is trying to prove otherwise, stabilization is also a necessary prerequisite of privatization, especially if it is to take place through the sale of state assets. With high inflation, on one hand savings are wiped out and on the other hand huge properties are amassed through arbitrage and speculation. These inequities are made worse by the impossibility of rationally assessing the value of property under high inflation.

But perhaps the worst consequences of high inflation in an economy in transition concern structural effects. Paradoxically, post-socialist inflation is usually fed by the monetary expansion needed to finance budget deficits made inevitable by maintaining high subsidies, usually justified in terms of social policy and protection of production and employment. The paradox is that high inflation is the worst enemy of social justice (as seen above), production and jobs. It shortens economic decision making horizons and diverts resources from production to short-term speculation. It also makes investment almost impossible by destroying the foundations for the necessary decision-making. Therefore, high inflation leads to the deterioration of existing productive capacities and competitiveness and severely handicaps the structural modernization so badly needed in post-socialist economies.

Stabilization also has an external dimension. Most economies in transition inherited a debt problem, the servicing of which tended to make them net capital exporters at a time when they most needed investment resources. For the Baltic countries this was not a relevant consideration, as their "share" of inherited Soviet foreign debt was small and anyway the new states were unwilling to accept it. But the introduction of new currencies — so important in the first phase of independence — both necessitated and — as we have seen — partially made possible the adoption of stabilization policies to safeguard the balance of payments and hence the value of the new currencies.

Poland was the first economy in transition to engage in a stabilization programme. Drawn up by Polish economists with international assistance, the programme was based on the experiences particularly of many developing countries. The basic ingredients were simple, and they have been since repeated in several countries. An orthodox stabilization programme for a post-socialist economy was thus sketched out. There are four main parts. (1) The public sector budget has to be brought at least nearly into balance, primarily by liberalizing prices, cutting subsidies and maintaining tax revenue. If an imbalance would otherwise obtain, investment, military outlays and social expenditure may also be cut. On the other hand, foreign resources — obtained either through international financial organizations or bilaterally — are also usually available to cover any remaining
deficit. (2) The need for central bank financing is thus eliminated or strictly limited, and monetary policy is generally tightened by raising interest rates to the point where real rates are positive. (3) To prevent the emergence of a wage-price spiral, either tax-based or other income policies are applied. This is a major departure from the general goal of liberalization and shows that the origins of stabilization policies are far from those monetarist ambitions sometimes attached to them by poorly informed observers. (4) Often, though not always, economic policies anchored not only to incomes policy but also to fixed exchange rates. This further limits the possibilities of pursuing inflationary policies.

The role of a balanced budget is crucial in transition economies for two main reasons. In contrast to developed market economies, post-socialist economies do not have non-inflationary ways of financing deficits. Markets for bonds and other financial instruments either simply do not exist or the credibility of the state is not sufficient for it to raise large amounts of money on such markets. The Soviet state did raise some financing by selling financial assets to the public, but this was actually a form of involuntary taxation, as the ensuing obligations were never respected. As financial markets evolve, a post-socialist government becomes capable of raising market-based financing, but in the early phase of transition this option is not available. Deficits can only be financed through central banks — that is, by increasing the money supply — or by foreign capital inflows, primarily assistance.

Secondly, addressing the problem of budget balance is crucial because that was the main source of inflation in the final stage of the Soviet era and remains so in Russia and the other former Soviet republics.

The Polish experience at hand when the Baltic states embarked upon independence showed that stabilization is feasible even before liberalization is completed and privatization and structural change are just getting started. The priority of stabilization was thus not only well-grounded in economic thought but also possible. The challenges faced by the Baltics were somewhat different from those of the Central and Eastern European countries. In some respects, e.g. the absence of foreign debt, they were able to start without a heavy inherited burden. Also, the stabilization goal — though certainly not all of its practical implementations — may have been widely shared, as the public connected it with escape from the collapsing rouble and the achievement of a normal market economy. But on the other hand, these countries lacked most of the institutions and much of the expertise needed for conducting economic policy. Not only were central banks missing but also statistics, tax systems and foreign trade
organizations. These had to be established almost from the beginning — through a political process that was itself just beginning to evolve.

The Baltic states embarked upon stabilization immediately. Already in 1992 all the countries had agreed on their stabilization programmes with the International Monetary Fund. The importance of an IMF programme is manyfold. On the one hand, by signing a programme policy makers knowingly adopt rather specific policy measures and goals, against which their results will be judged. On the other hand, a programme and compliance with it open the door not only to IMF financing but also to a wide range of expertise and assistance from the IMF, the World Bank and other bodies. Finally, the existence of an IMF programme signals to the world at large that the country in question has embarked upon policies that are deemed rational and worthy of support by the international financial organizations. Therefore, these programmes have an important catalytic role in the channeling of both private and public financing.

Against this background, the achievements of all the Baltic states regarding stabilization are truly impressive. This chapter reviews the monetary and fiscal policies and the results of stabilization in the Baltic states since they regained independence. Although developments overall have been exemplary, it is clear that major difficulties still lie ahead. The chapter covers all the Baltic states, but in section 6 a case study of the Latvian fiscal reform is presented.

### 3.2 Monetary stabilization

The remarkable inflation record of the Baltics was already cited in chapter 1. Inflation peaked in 1992, reaching about 1000 per cent in each country. After that, the annual rate of inflation has come down considerably; in 1993 it was 35 per cent in Estonia and Latvia and about 190 % in Lithuania. Monthly rates of inflation are depicted in Figure 3.1.

The figure shows that since their impressive early achievements the countries have not been able to lower the rate of inflation further in early 1994. In Estonia inflation surged in March to a monthly rate of 8.8 per cent, which was for the first time since 1992 even higher than Russia’s rate, 8.2 per cent. Although inflation has come down during the second quarter, all the Baltic states seem certain to miss their December 1993 — December 1994 inflation targets, 34 per cent for Estonia, 22 per cent for Latvia and 36 per cent for Lithuania, set in the IMF stabilization programmes (Paljärvi — Suss — Cornelius 1994).
Figure 3.1

Monthly rates of inflation, per cent

Estonia

Latvia

Lithuania
Though stabilization has priority among transition policies, it is not a temporary policy that could be relaxed after initial success. This is well understood in the Baltics, and as will be seen below, the early 1994 upsurge of inflation in Estonia — and, as Figure 3.1 shows, to a lesser degree in Latvia as well — cannot be explained by any undue policy changes. More probably, it reflects other factors. On the one hand, transition economies in general have experienced inflation levels that have, even with strong stabilization policies, remained above those usual in Western Europe. Also, there are some unique reasons behind the 1994 inflation hike.

The average inflation in successfully stabilizing post-socialist countries often remains stubbornly around 2–3 per cent per month. This has many explanations. Given the scope of original price distortions, relative price adjustment is necessarily somewhat slow, and as there are bound to be downward price and income rigidities, this adjustment often takes place through an increase in the average price level. Slowness of adjustment is emphasised when certain prices — in particular housing rents, transport fees and others — remain administratively set or are only slowly liberalized.

Second, when sovereign currencies are introduced or existing ones made convertible, considerations of credibility and foreign trade competitiveness usually lead to the adoption of undervalued rates of exchange. The ensuing real appreciation of the currency can take place through domestic inflation without necessarily first endangering nominal exchange rates.

Third, many of the transition economies still trade widely with Russia and those other former Soviet republics that have been less than successful in stabilization. This exerts price pressure both through imported inputs — energy, in particular — and possibly through plentiful export revenues, as the Russian rouble itself has appreciated substantially in real terms since 1992, at least until mid-1994.

Fourth, the maintenance of budget balance and strict monetary policies may become very difficult over time, largely because the growth of the private sector tends to erode the tax base and social expenditure grows with unemployment. A transition recession naturally also diminishes tax revenues. There is also a problem of political feasibility, as electorates understandably over time tend to grow tired of persistent expenditure slashing.

Fifth, even in the medium-to-long term, markets may remain insufficiently competitive, and efficiency and cost gains may therefore prove to be less than expected. Sixth, price hikes will be produced by such policy measures as the introduction of VAT.
Seventh, foreign assistance, privatization and undervalued exchange rates may combine to produce a relatively large inflow of capital. The still-underdeveloped monetary policy instruments may not be adequate to neutralize the ensuing inflationary pressure via domestic liquidity, while money demand is depressed by low output levels and the slowness of the monetization of the economy. Indeed, money velocity will decline during successful stabilization.

Eighth, opening up of the economies does not imply that a large closed sector would not remain. With less competition, the prices of nontradable commodities will grow faster than those of tradables. This is possible with fixed exchange rates.

All of these factors seem relevant for the Baltic states as well. Explaining the 1994 Estonian price hike, authorities (Eesti Pank, 1994) emphasised two one-time impacts. The first came through the real appreciation of the Russian rouble, the second because of administrative and other price increases in the non-tradables sector. Indeed, by summer 1994 inflation again seemed to be under control in all the Baltic states.

### 3.3 Fiscal policy

Before 1991, Baltic budgets formed an integral part of the all-Union budgetary structure, compiled and managed by the authorities in Moscow. There was little republic-level decision making concerning expenditures and revenues.

Budgetary reform is an essential part of the overall issue of defining the new role of the public sector in transition economies. Ideally, the budget of a transition economy should promote economic recovery and serve to establish favourable conditions for the development of private entrepreneurship while at the same time providing adequate social security. The realization of these tasks is however constrained by the need to balance the budget and at the same time to lower the share of GDP redistributed through the public sector. Typically, the share of GDP redistributed in an economy in transition is as much as some 20 percentage points higher than in a market economy with a comparable level of income.

Existing budget principles need to be completely overhauled. On the one hand, the budget has to be freed from functions that in a market economy are taken care of by private business. On the other hand, certain social responsibilities which used to be shouldered by enterprises are incorporated into national or subnational budgets. Tax
reform is another essential element of the overhaul, as under central planning, taxation in the Western sense did not exist.

The implementation of these reforms has taken place under very difficult circumstances, as tax revenue has decreased with the collapse of declared production at the same time as huge needs have emerged for social benefits and the build-up of infrastructure. Still, the Baltic states have moved quite rapidly in transforming their fiscal systems. The major structural changes have already taken place. The principal task now is to improve tax administration.

The requirements of stabilization have been well heeded. Fiscal policies have been restrictive, as shown in Table 3.1. Since 1991, Baltic budgets have in most cases recorded surpluses. For 1994, the Baltic states are expecting only moderate budget deficits of one to two per cent of GDP. These deficits will be largely financed by loans from international financial organizations, such as the IMF, World Bank and the European Bank for Reconstruction and Development. In Latvia, another means of financing the planned budget deficit is with Treasury bills, the emission of which was started in late 1993. The Lithuanian government has also emitted its first Treasury bills for financing the deficit.

Table 3.1  

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<td>7.2</td>
<td>0.2</td>
<td>0.9</td>
</tr>
</tbody>
</table>

As already noted, the Estonian central bank by law cannot finance budget deficits. In Latvia this alternative is also legally restricted to highly exceptional cases. Tight institutional arrangements thus serve as one explanation for balanced budgets in these countries. But in Lithuania as well, fiscal policy has been very restrictive, although this is not enforced by law. As a matter of fact, Lithuania of the Baltic states pursued the strictest fiscal policies in 1993. This was shown by the collapse of real wages in 1991–1993 to less than half of their 1990 value (see chapter 1).

Collecting the budget revenues poses serious problems in all the Baltic states. First, tax administration and control mechanisms are only in the formation stage, and as yet there is no means of ensuring that all eligible persons and companies are taxed. Tax avoidance is quite
common, especially in the enterprise sector. It is quite obvious that a considerable part of new enterprises fail to pay taxes. One factor contributing to this development is the still-underdeveloped payments mechanisms, which has meant that a considerable portion of payments take place in (unrecorded) cash form. This concerns especially Latvia and Lithuania.

For the second, due to the economic difficulties of most of the state enterprises, their capacity to pay taxes is limited. Companies’ tax arrears are quite substantial in all the countries. For example, in Estonia and Latvia they constituted 2–3 per cent of GDP in 1993. In Estonia the stock seems to have remained stable in 1993, partly reflecting an improvement in tax administration. In Latvia and Lithuania, tax arrears are probably still growing, which is a cause for concern (Bulletin of the Ministry of Finance of the Republic of Latvia, 1994:2).

After a couple years’ declining trend, the share of budget revenue in GDP started to increase in 1993 in Estonia and Latvia. This is due to the introduction of several new taxes as well as to improvements in tax collection. In 1993, budget revenue accounted for about one-third of GDP in Estonia and Latvia. The situation continued to worsen in Lithuania, where in 1993 budget revenue accounted for only a fourth of GDP.¹ This forced a further limitation on disbursements from the budget.

The results for the first half of 1994 show that Lithuania especially is facing difficulties in balancing the budget, mainly because of the fact that revenues have fallen short of planned levels. According to government officials, it will mean further cuts in budget outlays. Latvia, on the other hand, has succeeded in keeping the budget deficit within planned limits.

The Baltic states have now introduced personal income tax and corporate tax systems, as well as several other taxes. Estonia and Latvia made the most recent modifications in their income tax systems in the beginning of 1994, introducing flat tax rates of 26 and 25 per cent respectively. Lithuania has a progressive income tax system with a maximum rate of 33 per cent. Lithuania is currently preparing a broad reform of personal and enterprise taxation. Obviously, all three countries are worried about the possible incentive effects of high income tax ratios. In societies with less than perfect obedience to the law, such worries are no doubt well justified.

¹ One must however bear in mind the limitations connected with the calculation of GDP in these countries, which make such comparisons somewhat arbitrary.
Estonia was the first of the Baltic states to establish a value added tax system in 1991. Latvia followed suit somewhat later, and Lithuania introduced VAT in the spring of 1994. In all three countries, the basic rate is currently 18 per cent. The tax structure in the Baltic states is approaching that of Western countries, and the general aim is to put more emphasis on indirect taxes.

As the income side of state and local budgets is not very well developed, it has been necessary to cut expenditures to the minimum. The real level of wages as well as various social benefits paid from the budget has fallen in all the Baltic states during the past few years. This may cause problems for the broad support of economic reform, as poorer strata of the population, especially pensioners, find it very hard to meet daily expenses. These problems are acknowledged, and for 1994 the budgets show a tendency toward increasing social welfare expenses and state sector wages in all the Baltic states, reflecting an estimated increase in budgetary revenues. Also capital expenditure has been kept very low, in spite of the need for reconstruction in several sectors of economy.

Another major change in budgetary expenses has been the almost total liquidation of various subsidies paid to enterprises during the Soviet period, which is an important factor contributing to change in the behaviour of state enterprises. Estonia has been perhaps the most radical in this respect, abolishing all price subsidies except for that of energy, and even that is being diminished gradually. (A thorough presentation of Estonian budgetary reform is found in Tang and Nilgo 1994.) Price regulation is most extensive in Lithuania, covering about 30 per cent of prices, and consequently, also budget subsidies are obviously the largest in Lithuania.

3.4 Monetary policy

As chapter 2 showed, the Baltic monetary systems have in a short time converged upon varieties of fixed or pegged exchange rates. Differences in monetary policies and institutions remain somewhat larger (Table 3.2).
<table>
<thead>
<tr>
<th>Country</th>
<th>Price liberalization</th>
<th>Fiscal policy</th>
<th>Banking regulation</th>
<th>Central bank</th>
<th>Regime</th>
</tr>
</thead>
</table>

Experience has shown that the essential factor in successful monetary stabilization is an independent central bank, free from political pressure for inflationary policies. Estonia and Latvia have chosen to have very independent central banks, and that is one factor behind their successful transition. In Estonia, the independence of the central bank is of a somewhat peculiar kind. The currency board system actually makes the Bank of Estonia independent by removing most of the tasks that an ordinary central bank might have. Latvian central bank independence is of the more traditional kind, but also enshrined in law. In Lithuania the position of the central bank has been somewhat weaker, and various political controversies and scandals have followed.

In Estonia, the currency board regime includes several specific features which are crucial for domestic financial policy. First, the central bank is not allowed to finance state or local budget deficits. As the domestic financial markets are still underdeveloped and it is virtually impossible to raise long-term financing, this implies that the consolidated budget must be generally in balance. Chances of acquiring foreign financing for budget deficits are also quite meagre, with the exception of contributions from international financial organizations.

This stringent budget constraint imposed by the currency board rule also contributes to the stabilizing of the Estonian economy in an indirect way, through expectations. It signals to economic agents that the policy conducted by the authorities will also continue in the future. Due to policy credibility, enterprises must change their behaviour if they want to survive.
Latvia and Lithuania, on the other hand, chose from the outset a traditional monetary arrangement with a central bank managing the monetary policy. In Latvia the central bank, in its monetary policy decisions, is by law independent of both the government and the parliament. Such independence has been much enhanced by the strong personality of the central bank governor, Einars Repše. This is where the source of the success of Latvian financial stabilization lies. The German Bundesbank, with its considerable autonomy, was used as a model when Latvia formed its own central bank in 1990. Right from the start, the Latvian central bank has been very successful in pursuing strict monetary policy, although the bank has done it under severe criticism and pressure from the political decision makers.

Unlike in Estonia, in Latvia the central bank can in principle finance the state budget. This obtains only when there is an exceptional shortage of liquidity. Loans are granted only for a couple of days (Dovladbekova, Muravskaya, 1993).

Also in Lithuania the central bank is in principle independent from the government. In practice, the situation has been somewhat different. The outside political pressure has been considerable. There have also been several dismissals of high-ranking central bank officials during the few years the bank has been in operation.

After an initial period of relatively loose monetary policy, the Lithuanian central bank has, since the spring of 1993, pursued quite sovereign and stringent policies, the results of which can be seen in the declining rate of inflation. In spite of this, in March 1994 the Lithuanian parliament decided to adopt a currency board system, similar to the one in Estonia. Officials of the central bank opposed to the new system. The reasons for the change of monetary regime may be found as much in political as in economic factors. It remains to be seen whether this arrangement will be conducive to monetary stabilization, that is, whether it will be carried out without compromise.

Under the rules of the currency board arrangement, the Lithuanian central bank is no longer allowed to finance budget deficits. It can finance the corporate sector only under special circumstances.

The basic problem in conducting monetary policy in all the Baltic states — as in all the former planned economy countries — lies in the underdeveloped state of the financial markets. The tools for monetary policy are not very highly developed. The whole financial system in the Western sense of the word has only just emerged. In spite of this, the Baltic countries — except for Lithuania up to summer 1993 — have not resorted to direct instruments such as interest rate limits or credit ceilings in order to conduct monetary policy. Instead, they have relied on indirect, although still underdeveloped, methods which work
through markets. This choice should be conducive to developing market institutions and instruments over the longer run.

The underdeveloped state of financial markets in the Baltics makes several traditional monetary policy tools ineffective or impossible to use. Open market operations are not feasible due to the practical nonexistence of securities markets. Reserve requirements and the central bank discount rate are also of limited use.

In all the Baltic states interest rates are market determined. Lithuania was the last to liberalize them, having had interest rate restrictions as late as autumn 1993. Due to the underdeveloped financial system and differential bank risk, interest rate variations between banks are still huge, especially in Lithuania. Spreads between lending and deposit rates are also prohibitively large, though less so in Estonia than in the two other countries.

The Baltic central banks have imposed obligatory reserve requirements for commercial banks, but these are of little operational use. As Baltic commercial banks generally have ample liquidity, reserve requirements are not effective in influencing the money supply. The problem for banks is sooner in the lack of profitable investment projects with manageable risk than in the lack of liquidity. According to the Bank of Estonia, at the end of 1993, 17–19 per cent of commercial banks’ total assets were made up of claims on foreign banks. Reserve requirements relative to deposits currently amount to 10 per cent in Estonia, 8 per cent in Latvia, and 12 per cent in Lithuania.

Due to the ample liquidity of banks, the central bank discount rate is also of little use.

Although the currency board system automatically defines the ceiling for the money supply in Estonia, there are some traditional monetary policy tools which the Estonian central bank can utilize (with the qualifications referred to above). The most important of these involves requirements for commercial banks to hold reserves at the central bank. Further, the central bank can provide commercial banks with a refinancing facility, but only in extreme situations. The facility is based on the surplus foreign currency reserves held by the central bank in excess of the backing for money in circulation.

The Estonian central bank does not set any indicative interest rate. Even the compulsory reserves of commercial banks held at the central bank do not bear interest. Average real lending rates (chapter 2) continue to be negative, while nominal rates have decreased. In the first quarter of 1994, the weighted average interest rate for commercial banks’ lending amounted to 23 per cent p.a., down from 30 per cent in September 1993. Average deposit rates have also declined,
amounting to about 12 per cent for fixed-term deposits at the beginning of 1994. (Eesti Pank, Teabeleht 26/1994, 28/1994.)

In Estonia the development of monetary policy tools is the most advanced among the Baltics. In April 1993, the Bank of Estonia started to issue certificates of deposit, which it auctions weekly. Their significance lies more in providing commercial banks with safe instruments in which to place their extra reserves than in regulating the amount of money in circulation. They also serve as collateral for interbank loans. Interest rates on these CD's closely follow those in Germany, the annual rate amounting to about 6 per cent in June 1994. (Baltic News Service, Baltic Business Weekly 6–12 June 1994.)

The interbank overnight loan market, which was launched in June 1993, seems to have become well established, although in the beginning it suffered from commercial bank risk. The central bank does not participate in these markets. As deals in the interbank markets require the mutual confidence of participating banks, not all commercial banks are active in the market. The overnight interest rate was rather volatile in 1993 but has subsequently tamed down. During the first half of 1994, the average annual loan rate has hovered at just under 6 per cent. By September 1994, the volume of overnight loans had increased to almost 1 000 million kroons (Eesti Pank, Teabeleht 56/94). A peak volume of 2 600 million kroons was reached in July 1994, but that was due to exceptional circumstances, namely the large financing needs of one of the largest banks, the Social Bank, which was later taken over by the central bank.

Financial market instruments are gradually developing in Latvia. In December 1993 the government started to issue Treasury bills of one month maturity, and in May 1994 of three months' maturity. They are auctioned to commercial banks once a week. The central bank participates in the secondary market for bills. The demand for bills has been growing since their introduction, although initially the auctions were often undersubscribed. In the beginning of July 1994 the average annual discount rate was about 24 per cent. (The Baltic Observer, 7–13 July 1994.) The rate had increased somewhat during the spring, perhaps in line with higher inflation expectations.

The Latvian central bank has initiated auctions of credit to commercial banks. The intention is to hold these auctions weekly (The Baltic Observer, 21–27 April 1994). Interbank markets also seem to be developing. All these instruments are, however, only in their starting phase and are therefore of very limited importance for monetary policy.

The Lithuanian financial system is the least developed in the Baltics. Until summer 1993, the central bank managed a system of
credit ceilings on commercial banks. The abolition of these ceilings resulted in rapid credit expansion and increases in real interest rates. Towards the end of 1993, the central bank initiated competitive tenders for time deposits for the commercial banks in order to neutralize the impact of the rapid inflow of foreign currencies into the economy. Auctions of government Treasury bills were started in 1994, but so far the volumes have been relatively small. Interbank markets are almost non-existent.

3.5 Exchange rate policy

As Table 3.2 above — based on chapter 2 — showed, all the Baltic countries have now opted for a pegged or fixed exchange rate regime.

The reasons for the preference for fixed exchange rates are clear. A fixed exchange rate regime offers a clear nominal anchor for stabilization. Combined with the liberalization of foreign trade, it is also instrumental in aligning domestic prices with those in world markets. With less uncertainty, fixed rates make it easier for companies to engage in foreign trade. These factors are important for the Baltic states whose economies are small and dependent on foreign trade. In the Latvian and Lithuanian cases, the preceding period of floating facilitated the achievement of a realistic level of exchange rates and also made it possible to build up currency reserves for an eventual defense of the fixed rates.

In Latvia, the central bank’s policy has been, until the end of 1993, to allow the exchange rate to appreciate in order to approach purchasing power parity. This has enabled the adoption of the domestic price level to world market prices with less domestic inflation. However, continuous appreciation may seriously impair exports. The limit seemed to have been reached in Latvia in the beginning of 1994, as the central bank in February announced an informal peg of the national currency, the lats, against the SDR.

The Latvian and Lithuanian commitments to peg and fix currencies are so recent that their credibility and general impact remain to be seen.

One interesting feature in the Baltic states’ transition has been the relatively massive inflow of convertible currencies into their economies (Figure 3.2). This started right after the countries left the rouble zone and established their own national currencies. In all cases, the increase of reserves was strongest during the first year of the national currency. Since then, the inflow has levelled off.
During the two years after the introduction of the Estonian kroon in June 1992, the country’s foreign exchange reserves grew almost fourfold. The amount of reserves then equalled the value of about three months’ imports. This would not be much for a country with exchange rates that need defending, but in a currency board arrangement that necessity should not arise. The growth in Estonian reserves has slowed down somewhat since mid-1993, and in the first half of 1994 the reserves (in kroons) have remained more or less stable.

Foreign currency reserves increased about sixfold in Latvia and fourfold in Lithuania during 1993. During the first half of 1994, both countries experienced a decline in reserves. In Lithuania foreign reserves in spring 1994 covered three months’ imports, and in Latvia probably somewhat more.

The large inflow of foreign currencies may have come as a surprise to Baltic officials. There are at least three reasons for the inflow. Partially, it reflects Baltic success in increasing exports. Another important source of reserves was repatriation of foreign currencies which companies had left abroad earlier, starting during the Soviet era. This has obviously been the case in Estonia and Lithuania. Both countries banned the use of foreign currencies in domestic transactions, though the ban seems not to have been in effect in Estonia since March 1994. But Latvian officials also report increasing amounts of repatriated foreign earnings.
Third, stable and appreciating exchange rates together with high interest rates, have attracted foreign investment. Especially Latvia with its extremely liberal foreign exchange regulations has attracted foreign money. It is expected that foreign investors, mainly Russian ones, will become increasingly interested in the Latvian market, as financial instruments develop there. The share of Eastern — mainly Russian — money in Latvian banks in spring 1994 may have reached 60–70 per cent of all deposits (The Baltic Observer, 19–25 May 1994).

The increase in reserves helps to maintain inflation, as it has been difficult to neutralize the inflow of foreign currencies using the traditional monetary policy instruments. However, central banks can use foreign exchange markets to influence domestic liquidity, and this has been done in Latvia and Lithuania. There are problems here as well. On the one hand, by buying foreign currencies the central bank increases domestic liquidity and thus increases the risk of inflation. On the other hand, if the central bank did not intervene in the markets, the external value of the domestic currency would appreciate to a level severely inhibiting exports.

The problem of capital inflow has eased during the first six months of 1994. There were foreign trade deficits in all three countries in 1993. Current account deficits emerged in Estonia in the last quarter of 1993 and in Latvia in the first quarter of 1994. In Lithuania, the current account showed a deficit already in 1993. Additionally, some currency uncertainty also appeared in early 1994. There seemed to be some scepticism concerning the future Latvian exchange rate. In Lithuania, the lengthy preparation and debate on the currency board arrangement obviously served to check the flow of foreign currencies into the country.

It thus seems that the excessive increase in foreign reserves has been a temporary phenomenon. It should not be a major problem for future stability. As the Baltic economies develop, it is much more likely that trade and current account deficits will continue to grow. It is here that the future problems lurk.

The Baltic states were exceptionally quick in introducing currency convertibility. They have not experienced capital flight, the threat of which has caused other countries in transition to maintain capital controls. Nor does there seem to be much reason to expect capital flight in future, as long as the Baltic states continue their tight economic policies.
3.6 Case study: fiscal reform in Latvia

The first years of Latvian fiscal policy have been turbulent. In 1991, Latvia drafted its own budget for the first time in the post-war era. A new tax system was introduced, and it has been continuously improved since then. There was a budget surplus of 6 per cent of GDP in 1991, as subsidies for food and other consumer goods were slashed and revenues increased. The increase in revenues was mainly due to a temporary improvement in the terms of trade with Russia.

In 1992 the situation changed abruptly, as the economy plunged. In the rapidly changing political and economical situation, the budget was initially drafted to cover only the first half of the year. The turnover tax was amended and new rates established. Still, revenues fell short of the projection, leading to a deficit in the first half-year. In the latter half of the year, the financial difficulties of state enterprises persisted and budget income remained below expectations. This was partly due to inadequate tax collection, a problem which arose as private enterprise expanded. There were also state enterprises with tax arrears. As of 1 January 1993, total tax debts amounted to 21 million lats. However, for the whole of 1992, the budget was in balance, according to IMF data, probably reflecting sharp cuts in expenditure.

The 1993 budget was passed with a delay. The lengthy budget debates in the parliament were motivated by the necessity of promoting economic recovery in addition to financing social measures. The ensuing delays in confirming the budget however did little to improve matters. The main problems of the 1993 budget are well-known:

- the share of tax revenue in GDP had long decreased,
- financing for social and cultural activities as well as public investment was seen to be insufficient, and pensioners and low-income residents were not satisfied with the level of pensions and other social payments,
- entrepreneurs emphasised that high taxes reduced incentives for growth,
- taxpayers complained of discrimination relative to those who avoid paying taxes, and
- tax administration and collection were extremely ineffective.

Clearly, the fiscal system needed reforming. The main objectives of such a reform are seen to include the following. First, central and local government revenues and expenditures should be matched so that the general government budget deficit does not exceed 2 per cent of GDP. Second, within the next five years 35–38 per cent of GDP should be accumulated in central and local budgets. The share of tax revenue in
GDP should thus be raised by no less than one percentage point a year. Further, financing should no longer be neglected for such social and economic activities as social support to low income residents, culture and science, protection of the state and the population, development of infrastructure via a public investment programme and others.

It is also necessary to stimulate savings to finance domestic investment for long-term development, thereby reducing dependence on foreign investment and lowering interest rates. Negative incentive effects of taxation should be avoided, and capital investment must be stimulated. Tax administration needs to be reformed and tax avoidance checked.

Obviously, tax legislation must be in conformity with other Latvian legislation. It must also be brought closer to tax legislation in European Union countries. This will promote Latvia’s integration into the economic structures of the EU. This implies a gradual change in tax structure away from income and towards consumption. The value added and excise taxes will grow in importance while the taxation of income, especially from entrepreneurial activity, will become less important. Currently, the personal income tax is less important and corporate income tax more important in Latvia than in Western countries.

Fiscal reform should be consistent with the general principles of economic effectiveness, administrative simplicity, consistency, elasticity, political responsibility and equity. Taxation should enable economic agents to engage in long-term decision making, tax allowances must be cut and central and local government revenues must be clearly separated. Local governments’ rights in the area of tax determination must be broadened so as to increase their interest in regional economic development. At the same time, however, it is necessary to ensure that local expenditures and revenues match without excessive transfers.

The year 1993 saw the increase of the turnover tax rate to 18 per cent. For foodstuffs the rate was at first 10 per cent, but starting from 1 June 1994 the rate of 18 per cent has been applied on foodstuffs as well. Excise taxes were established for gasoline, diesel fuel and for cars of several categories.

Furthermore, tax evasion was also attacked by establishing the possibility of forfeiture of property and prison sentences. The gross amount of non-paid taxes peaked in the beginning of September 1993 but then started to fall as steps were taken toward stricter tax collection. However, at the end of the year, indebtedness still remained above 30 million lats (Figure 3.3), and in 1994 tax arrears started to grow again. Tax arrears with respect to the property tax have increased constantly, which is not surprising as property does not always generate an income stream. As some tax arrears already date from 1992, collecting them will be difficult. The main task is to see that new arrears do not continue to accumulate.
In Latvia, open unemployment has been much higher than in the other Baltic states, which is also a fiscal problem. On the one hand, the official minimum wage was kept at just 15 lats until 1 January 1994 to encourage job seeking and to ease fiscal pressure. The policy of benefits has been revised so as to introduce target subsidies for indigent persons in response to their declarations. Further, liquidation of ineffective state enterprises was commenced and budget arrears pursued.

Several organizational and personnel changes have been made to improve the efficiency of the tax administration system. Still, during the first half of 1993 the budget deficit reached 18.6 million lats. This was caused both by rising social expenditure and by problems concerning budget revenues, some of them due to the organizational problems. Later in the year the adoption of the tighter measures started to bring results. Turnover tax revenue increased, slightly higher-than-expected inflation boosted nominal incomes and tax collection improved. It was finally possible to end the year with a small budget surplus.

The structure of budget revenue remained problematic in 1993. Direct taxes constituted 64 per cent of total revenue and indirect taxes just one-fourth. The profit tax and social security contributions alone constituted more than a half of the total tax income in 1993 (see Figure 3.4). A substantial part of budget revenue was also due to income tax. Hence, it follows that in 1993 mainly profits (especially from entrepreneurship) and not consumption were subjected to taxation.
Figure 3.4  Structure of tax income in 1993

1 Profit tax
2 Individual income tax
3 Social tax
4 Excise tax
5 Turnover tax
6 Customs duties
7 Other taxes

Figure 3.5  Structure of budget expenditure in 1993

1 Science
2 Defense and security
3 State management
4 Pensions and other benefits
5 Other social and cultural needs
6 Financing of the national economy
7 State institutions
8 Other
On the expenditure side, ample revenue at the end of 1993 made it possible to boost budget financing for several social programs. Pensions were increased by 18.8 million lats, benefits targeted at low-income persons were increased by 4 million lats and employees in budget-financed institutions received a 20 per cent pay increase. In 1993, 68 per cent of budget expenditure was used for financing social and cultural needs, including 41 per cent for pensions and benefits (see Figure 3.5).

The budgetary novelties for 1994 include a new classification system of budget items and new procedures for drawing up and adopting the budget. This should increase control and responsibility for state resources and budget performance. For 1994, Parliament has approved, as an acceptable maximum, a budget deficit amounting to 40 million lats or two per cent of anticipated GDP. This is in line with the agreement with the IMF.

The Ministry of Finance has finished proposals for a new package of taxation laws for implementing fiscal reform. The implementation of the new package would result in considerable changes in the composition of tax revenue. VAT revenue should increase significantly, as imported goods are now also subject to this tax and — as mentioned above — a uniform tax rate of 18 per cent has now been introduced. On the other hand, revenue from the profit tax should decrease. It is intended to transform several power-generating enterprises, which used to contribute much profit tax revenue, into non-profit enterprises. Profits will be also squeezed, as prices will rise on many inputs coming from Russia, including energy. Many enterprises may face significant difficulties with exports.

Due to these changes, new tendencies already appeared in 1994: the share of indirect taxes in total revenue increased from 21 per cent in the first half of 1993 to 33 per cent in the first half of 1994. Correspondingly, the share of the profit tax in total revenue decreased from 26 to 12 per cent.

In 1994, social security contributions — 28 per cent of the wage fund in 1993 — will remain the single most important revenue source. In the first half of 1994, there was some increase of tax revenue in real terms as compared with the first half of 1993, mainly due to higher tax rates and GDP growth.

An improving revenue flow gives leeway for planning expenditures. All items on the expenditure side of the budget will increase in 1994, in real terms the growth is expected to be some 5 per cent.

In the longer run, a lot of work is still needed in order to bring the tax system up to Western standards. Several additions and modifi-
cations are needed in the existing laws and rulings concerning turnover, income, and excise taxes as well as customs duties, among others, to improve their applicability and efficiency.

As the state of the economy improves and the revenue side of the budget develops, the budget will be gradually transformed from a survival budget to a budget providing macroeconomic stimulus. Investments in infrastructure will create the preconditions for economic development, including small and medium-sized business. More resources will be spent on financing programmes in education, and retraining will improve the professional standards of employees and will increase labour force adaptability. It is also expected that the relative number of workers employed in the social sector will decrease over time and that social consumption will drop proportionally. Transfer payments will continue to be strictly limited.
4 Banking Reform in Estonia

4.1 Introduction

The Estonian banking sector has undergone a profound restructuring and transformation process during the last few years of economic reform. Estonia leads the way in the number of banking sector bankruptcies throughout Eastern Europe and in the rapidity with which the monetary authorities have addressed the growing problems of the banking sector. An analysis of the adaptation of the Estonian banking industry also offers a window onto the banking world in the CIS, whose banking sector was a part of the Soviet banking system in the same way as that of Estonia.

The reform of the Estonian banking sector started in 1989 under Soviet rule and banking legislation. Tartu Commercial Bank in Estonia was the first commercial bank established in the Soviet Union within the framework of the 1989 banking legislation. Since the Estonian declaration of independence in August 1991, the banking sector has undergone profound structural and operational changes. Perhaps ironically, Tartu Commercial Bank was the first Estonian bank to go bankrupt at the end of 1992.

The aim of this article is to discuss developments in the Estonian banking sector against the background of transformation from the Soviet past to the turbulent economic environment of today. The article starts with an account of the main legal and institutional developments in the banking sector since 1988 and aims to identify the causes of the financial problems encountered by the banks. It will proceed to analyze the activities of the banks during the past 3 years of economic transformation. Some key issues influencing the banking sector, such as the problem of bad debts, will also be discussed. Finally, the paper will touch on foreign investment in the banking sector.

4.2 Banking legislation

The Soviet law of 27 November 1989 granted all three Baltic states a degree of economic autonomy, including the right to organize independent banking systems. Subsequently, the Estonian banking law, which was passed in December 1989, reestablished Eesti Pank (Bank of Estonia) as the central bank of the country after almost 50 years of
control by the Soviet State Bank (Gosbank). Those parts of the new law which governed banking were drafted in compliance with the banking legislation under preparation in the USSR at the time but adopted somewhat later, in 1990. Similar legislation was also passed in the Russian Republic of the USSR. The USSR law was outpaced by political developments that led to disintegration of the country and after a "war on central banks" to the merger of the former Gosbank and the Central Bank of Russia (Kivilahti et al. 1992, Hirvensalo 1993). Estonia also had two central banks for two years before the Tallinn branch of Gosbank was closed down at the beginning of 1992 and its operations merged with those of Eesti Pank (Karell 1992).

In June 1992 the introduction of the kroon, the Estonian national currency, separated Estonia from the rouble zone, tied the kroon to the deutschmark and introduced a limited currency board system. The currency reform was governed by three new laws: the Currency Law of the Republic of Estonia, the Foreign Currency Law of the Republic of Estonia and the Law of the Republic of Estonia on the Security of the Estonian Kroon. The reform was carried out successfully contrary to the many fears expressed both in Estonia and abroad. It is generally understood that the strong will of the Estonians to have their own currency played a significant role in this success (Kallas 1993).

In May 1993 the law on the Eesti Pank was renewed and the status of the bank was clarified further as an authority independent of the government (Estoniya, 19 May 1993, The Baltic Observer, 21–27 May 1993). The bank is accountable only to Parliament and cannot issue credit to the state or local governments. The limited currency board system introduced with the currency reform means in practice that the role of Eesti Pank as a lender of last resort to the banking sector is limited to very exceptional situations (Bennett 1993). Such a situation emerged in November 1992, when the central bank had to resolve the first serious banking crisis in the country.

The central bank issues licences to commercial banks and is in charge of banking supervision, which was organized in 1992. Until 1992 the minimum capital requirement for setting up a bank in Estonia was 5 million roubles (500 000 kroons). There was also a requirement that the shareholders could not be juridical or natural persons residing outside Estonia (Sörg 1991). Foreign investments in the Estonian banking sector became possible in 1992 (Quarterly Review of the Bank of Estonia 1/93).

The minimum capital requirement of the banks was raised to 6 million kroons in June 1992 and took effect in October 1992 (Eesti Pank Quarterly Review 1/93, Ernst & Young 1994). Accordingly, all banks had to increase their share capital up to 6 million kroons by the
end of 1992. A minimum of ten shareholders is required to set up a bank and all bank directors have to fulfill the educational requirements of the central bank. One shareholder is also limited to 33% of the total share capital. (Eesti Pank Quarterly Review 1993:1, p. 33).

In May 1993 Eesti Pank decided to increase the minimum capital requirements to 15 million kroons for new banks. The existing banks should reach the minimum of 15 million kroons by April 1995, 25 million kroons by April 1996 and 35 million kroons by April 1997. At the same time, Eesti Pank declared a period of stabilization in the banking sector until the beginning of 1994. No new banking licences would be issued during that period. It is further expected that the Council of the Bank of Estonia will demand that the authorized capital for a commercial bank be brought into compliance with EC standards within the next one or two years. In that case, the minimum capital requirement, ECU 5 million would amount to about 75 million Estonian kroons (Baltic News Service, 28 February 1994).

In addition to minimum capital requirements concerning share capital, Eesti Pank issued minimum requirements concerning the own funds\(^1\) of Estonian banks in September 1994. Accordingly, the own funds of the banks should exceed 50 million kroons by the beginning of 1996, 60 million kroons by the beginning of 1997 and 75 million kroons by the beginning of 1998 (Baltic News Service Week, 19–25 September 1994). This requirement was introduced after the equity capital of some banks was dissipated by losses stemming from bad debts which have had to be written off since the beginning of 1994.

It is most likely that the smallest banks will face difficulties in fulfilling these requirements, which is why new mergers in the banking sector are expected.

In April 1993 Eesti Pank decided on prudential ratios with which the banks had to comply as of 1 July 1993. These include a minimum solvency ratio of 8 per cent, a minimum liquidity ratio of 30 per cent and a maximum risk concentration ratio of 800 per cent. In addition, the maximum loan available to any one client should not exceed 50 per cent of the bank’s own funds\(^2\). In September 1994 the maximum loan available to a single client or a group of clients was further reduced to 25 per cent of a bank’s own funds (Kaubaleht, 19–26 September 1994).

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\(^1\) Including retained earnings and loan loss reserves.

\(^2\) The solvency ratio is the ratio of the bank’s own funds to the sum total of risk-adjusted and off-balance-sheet items ratio and corresponds roughly to the generally used capital adequacy ratio; the risk concentration ratio is the ratio of high-risk-concentration clients’ debts to the bank’s net assets (Eesti Pank Quarterly Review 1993:3).
Since currency reform, the ratio of compulsory reserves to be held in the Bank of Estonia was set at 10 per cent of the total deposits held by a bank. The intention was to raise the ratio gradually to as high as 15 per cent, but subsequently the ratio was dropped again to 10 per cent, where it remains. The Savings Bank was subject to 100 per cent reserve requirement for demand and savings deposits until 1/3 of its shares were acquired by Hansapank. After that, the reserve requirement was lowered to 10 per cent. However, 50 per cent of the demand deposits of the Savings Bank must still be placed with the central bank. This arrangement acts as a deposit insurance scheme even though there is no formal central bank guarantee for deposits of the Savings Bank. (Estonian Kroon, June 1993, Eesti Pank 1994).

According to Eesti Pank regulations, from 26 January 1993 the banks are required to make provisions for bad loans amounting to 25% of the net profit. Since 5 January 1994 Eesti Pank also requires that loans which have not been serviced for more than 150 days be considered bad. Until then, the definition of bad loans was not explicit.

The law on securities was passed in 1992, but the mortgage law was adopted only in June 1993 and became effective in November 1993. However, it is difficult in practice to provide security for loans. Privatization and registration of ownership rights have not proceeded very far. Thus, the most commonly used security is a pledge on machinery and equipment, often automobiles.

A new law on commercial banks has been under preparation since 1992 and has been discussed in the Estonian Parliament. In addition to banks it is expected to regulate the activities of finance companies and to limit banks’ ownership of other companies, which the present law does not do. The present law does not contain a definition of money laundering, either (The Baltic Independent, 25 March 1994). A law on a deposit insurance mechanism is also under preparation.

In developing the banking legislation and governance of the banking sector, Estonian authorities have chosen a very pragmatic road and introduced relatively simple and easily enforceable regulations. In the beginning, political unanimity helped in passing the necessary laws but lately differing views have emerged and this has somewhat slowed the passage of new legislation. The new law on Eesti Pank had to be slightly amended after review by the constitutional court, the legal procedures used in restructuring the Savings Bank were also under court supervision and the new law on commercial banks has taken longer than expected to draft due to differences of opinion among various interest groups.

It would be tempting to draw conclusions from the Estonian banking developments for the other former USSR republics, which
have detached themselves from the rouble zone. Sõrg has argued that in its early days Estonian banking reform served as a model for Russian banking legislation (Sõrg 1991). However, as far as later developments are concerned, different financial and political environments make comparisons very difficult. Estonia’s early introduction of a national currency and adoption of a currency board arrangement distinguishes it clearly from the CIS countries. On the other hand, the common heritage of Soviet institutions and learned behaviours within those inherited institutions will most likely continue to influence the banking sector throughout the former USSR republics even though the legislation already differs from country to country.

4.3 Institutional developments in the Estonian banking sector

4.3.1 Restructuring of the former state-owned banks

Until 1989, banking in Estonia was carried out by branches of the Soviet monobanking system. The banking reform started in 1988 under Soviet rule, when the two-tier banking structure was introduced in the USSR as part of the "perestroika" reform process. The two-tier banking system was instituted by separating 5 specialized banks from the former monobank (Kivilahti et al. 1993, p. 54). In Estonia the separation of the central banking and commercial banking functions did not create major changes in the banking sector, because the Moscow-based central organizations of the former specialized Soviet banks continued to control the activities of their branches in Estonia. The Soviet banking system operated in the allocation of money and credit according to state plans and official decisions rather than in the intermediation of money and credit based on supply and demand.

Locally, banking was governed and controlled by the Tallinn branch of Gosbank until 15 December 1989, when the Supreme Soviet of Estonia passed a decree establishing Eesti Pank, which was to become the central bank of the independent Estonia.

In 1990 most of the specialized Soviet banks were restructured into joint stock companies and as the political disintegration of the former USSR gathered momentum the branches of these banks became independent from the former parent bank in many republics. The shares of the banks were normally transferred from the direct ownership of the state through various ministries to state-owned companies and local authorities.
In Estonia the branches of Promstroibank, Agroprombank and Zhilsotsbank became independent by the end of 1990 and the rights of Vneshekonombank to conduct foreign exchange transactions were transferred to Eesti Pank (Sörg 1991). As part of the political battle between the former USSR and Estonia, the banks had no longer been allocated credit quotas according to the needs of the economy, especially in the agricultural sector. Also, the branches of the specialized banks had been deprived of the right to transfer payments directly to other states within the former USSR or abroad, which substantially slowed down payment transactions. (Sörg 1990, p.19)

The new law on Gosbank and the banks, which was passed in the USSR in 1990, was intended to govern Gosbank's activities as the central bank of the entire Union (Kivilahti et al. 1993, p. 54), but political developments had already outpaced the law in Estonia when the Estonian Supreme Soviet accepted the decree on the Eesti Pank. The final political division between the banking systems of the former USSR and Estonia was provided by the Estonian declaration of independence in August 1991. The formal separation between the Estonian and former Soviet banking systems came only in 1992 when the branch of Gosbank was merged with Eesti Pank and when Estonia introduced its own currency, the kroon, in June 1992.

The banks which continued the work of the branches of the old specialized state-owned banks of the USSR were reorganized into Estonian entities and privatized. However, this process has not been entirely smooth. In 1994 there are still some unresolved ownership issues involving these old banks. The banks were reestablished as separate legal entities and new shares were issued to the public in excess of the initial government holding. The banks were privatized on an ad-hoc basis without reference to the Privatization Agency, which was established to privatize the remainder of the economic sector. The procedures were not openly questioned before privatization of the Savings Bank was initiated by Eesti Pank. An open competition was declared to sell 1/3 of the shares of the Savings Bank to the bank presenting the best plan for developing the Savings Bank. The process has later been publically questioned and the matter taken to court.

The former branch of the Soviet Promstroibank was liquidated only in October 1993, but its main assets were transferred to the Estonian Bank of Industry and Construction (Eesti Tööstuse ja Ehituse Kommertsbank) already in 1990. The Estonian authorities split the bank into two legally separate institutions because the bank faced serious portfolio problems, having financed mainly Soviet state-owned industrial companies at subsidized interest rates (World Bank 1993). For almost three years there were two banks with the same name but
different balance sheets. However, the former Soviet branch did not carry out any activities during this period (Estoniya, 20 October 1993).

The former branch of the Soviet Zhilsotsbank was reorganized into the Social Bank (Eesti Sotsiaalpank), which mainly served governmental organizations and municipalities. As a result of the restructuring and privatization of the bank, there are more than 50 companies among the major owners. According to the Estonian press (Äripäev, 29 October 1993) there is also a group of Russian businessmen among the owners of the Social Bank, which has caused some political concern in the country. In August 1994 Eesti Pank declared a moratorium on the Social Bank, which faced difficulties after the state treasury withdrew deposits from the bank. As a rescue operation, the bank decided to sell the majority of its shares to the Development Bank (The Baltic Observer, 11–17 August 1994). The Development Bank, in turn, ran into difficulties and, as a result, Eesti Pank acquired more than two thirds of its voting shares in September 1994 (Baltic Observer, 22–28 September 1994; Hommikuleht, 20 September 1994). In this way Eesti Pank has also acquired the majority of the voting shares in the Social Bank.

The Social Bank has also given birth to other new banks. Two of its earlier branches became independent banks, the Revalia bank in Tallinn and Narva Bank in Narva. In 1993 both of these banks went bankrupt. A moratorium was declared on Revalia Bank in January 1993 (Äripäev 18 May 1993) and bankruptcy proceedings started. Narva Bank was also declared insolvent, with a moratorium declared in July and bankruptcy in December 1993 (Baltic Observer 56/93, Baltic News Service, 19 March 1993, Baltic Business News, 27 July Hommikuleht, 15 December 1993). Narva Bank was later sold to Development Bank. Both Revalia Bank and Narva Bank had engaged in extensive insider lending to enterprises holding shares in the bank.

The 14 branches of the former Soviet Agroprombank were also separated from the Soviet parent and formed the Estonian Landbank under the Estonian government (Sõrg 1991). Most of the branches of the Landbank subsequently became independent regional banks in May 1992. At the beginning of 1993 ten of these were merged to form the Union Bank of Estonia. The move was necessitated by the new minimum capital requirements, which the small regional banks could not fulfill (Quarterly Review of the Bank of Estonia 2/93). The remaining regional offices and branches of the Landbank were also reorganized into a joint stock company in 1992 (Estoniya, 11 October 1993).

The situation of the Savings Bank was rather peculiar in Estonia. The bank continued to be connected to the Soviet Gosbank, because
Soviet banking legislation secured the assets of the savings banks as property of the former USSR. It was possible for the Soviet republics to separate the savings banks from the Gosbank system on the condition that the republic assumed that part of the Soviet state debt which has been financed by savings collected from the republic. In Estonia this requirement would have taken all the assets of the savings banks. For this reason deposits in the savings banks had also been declining during 1990 and the amount of cash in circulation had increased (Sõrg 1991).

Eesti Pank became the owner of all the shares of the Savings Bank and guaranteed all the deposits of the bank in 1992. As described earlier, the privatization process of the bank was initiated in 1993, when the central bank declared a competition among banks to buy a third of the bank’s shares. Hansapank won the competition on the best development scheme and subsequently bought a third of the shares. The Estonian government was later accused of violating the privatization law and the matter was settled in court.

The Estonian branch of the Soviet Vneshekonombank was transformed into a department of the Eesti Pank in the beginning of 1991. In the spring of 1992 all the commercial transactions of the central bank were transferred to North Estonian Bank Ltd, which was later merged with the Union Baltic Bank and recapitalized by the central bank after the losses incurred when Vneshekonombank froze their accounts.

In the course of this process the North Estonian Bank was commercialized but all the shares remained in the ownership of the central bank. Thus the bank faces the need for privatization in the future.

The Estonian Investment Bank was founded in February 1992. The Investment Bank was needed because the Central Bank could not borrow from abroad and there was a large demand for loans in hard currencies to finance investments in the country. The central bank is the major shareholder of the bank. The European Bank for Reconstruction and Development (EBRD) became a minority shareholder in January 1993. The bank has also received considerable technical aid from the Nordic Investment Bank. The bank plans to provide financing for investments which are too large for the commercial banks and too small for the EBRD. The bank also plans to increase its share capital by acquiring new shareholders among the development funds in Finland, Sweden and Germany.
The development of the commercial banks and the banking crisis in 1992–93

The reform of the new Estonian commercial banking sector started in 1989 when the Tartu Commercial Bank (TCB) was founded. TCB was the first commercial bank established in the Soviet Union under the renewed Soviet banking legislation of perestroika. In 1990 it was given foreign exchange rights after consultation with Eesti Pank. TCB was also the first Estonian bank to undergo bankruptcy proceedings at the end of 1992. However, TCB has also given birth to another bank, Hansapank, which in 1994 has become the largest bank in the country. Hansapank started operations as the Tallinn branch of TCB and became independent at the beginning of 1992 as a result of a management buyout (Korkeamäki, p. 36).

By the end of 1990, 12 new commercial banks had been issued licences by Eesti Pank and five others were in the process of applying for a licence. By the end of 1992 the number of commercial banks had risen to 42, including the banks which had been created on the basis of the old Soviet branches of the state-owned banks. By that time, however, significant problems had already started to surface in the banking industry. In addition to TCB, which was declared bankrupt, two other banks, the Union Baltic Bank (UBB) and the North Estonian Bank (NEB), had run into financial difficulties. In November 1992 the Bank of Estonia placed all three banks under moratorium.

While the cause of problems at TCB was unprofessional management and soft budget constraints inherited from the Soviet banking culture, the main reason for the problems at the two other banks was the freeze on assets deposited at the Vneshekonombank in Moscow. The UBB and NEB were merged and recapitalized by the Estonian government and Eesti Bank. This was accomplished mainly by issuing government bonds equivalent in amount to the frozen assets. In all these cases the financial problems of the banks were connected with the old Soviet banking system. The bankruptcies of Revalia Bank and Narva Bank were examples of unhealthy insider practices, as pointed out above, and the connected lending and dividend policies of the owners of the bank.

In 1993 the restructuring of the banking sector was speeded up by the failure of eight smaller commercial banks, which could not comply with the new minimum capital requirements of the Bank of Estonia. In addition, a wave of mergers or closures among the smallest land banks brought the number of banks down to 22 by the end of 1993 (Eesti Pank Quarterly Review 1993:1, pp. 30–33)
The banks which have survived the Estonian banking crises of 1992 belong to two different groups. First, there are the former state-owned banks, which have been corporatized and privatized as a result of the privatization of the owner companies. Secondly, there are the "second wave commercial banks", which started operations after 1991. The largest "first-wave commercial banks" created between 1989 and 1991 have left the scene.

The reasons for the bank failures, in addition to those that were due to the frozen assets at Vneshekonombank, have been identified above mainly as incompetent management or bad insider practices. As these were mainly banks of the "first wave of commercial banks", one is tempted to conclude that the reason behind the failures was a deficient understanding of the risks entailed in banking. Secondly, these banks started operations in an environment which was very difficult to control. The Estonian economy was still a part of the rouble zone, and the soft lending practices prevalent in the zone were also adopted by the newly created banks. Thirdly, contrary to the state-owned banks, the first wave of privately owned banks did not have recourse to the state when they faced difficulties.

The central bank has been complimented for the swiftness with which it has tackled the major problems of the banking sector. In order to understand the magnitude of the problem it suffices to realize that the three large banks that experienced financial difficulties in autumn 1992 accounted for almost 1/3 of the combined balance sheet of the Estonian banking sector (Ross, p. 4). On the other hand, the problems were solved with relative ease, because the significance of the banking sector to the economy was still limited. Banks were generally regarded as unreliable and the move of the central bank was deemed necessary to enhance the credibility of the banking sector as a whole.

The main institutional developments in the Estonian banking sector between 1988 and 1993 are summarized in Table 4.1.
Table 4.1. **Major institutional developments in the Estonian banking sector, 1988–93**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Central Bank</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tallinn branch of Gosbank</td>
<td>Eesti Pank</td>
<td>Eesti Pank</td>
</tr>
<tr>
<td>(Tallinn branch of Gosbank)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>State-owned banks of former USSR</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Branch of Zhilsotsbank</td>
<td>Estonian Social Bank Revalia Bank Narva Bank</td>
<td>Estonian Social Bank Revalia and Narva Banks placed under moratorium</td>
</tr>
<tr>
<td>Branches of Agroprombank</td>
<td>Estonian Landbank + several independent Landbanks</td>
<td>Estonian Landbank Union Bank of Estonia</td>
</tr>
<tr>
<td>Branches of Sberbank</td>
<td>Estonian Savings Bank (under Gosbank)</td>
<td>Estonian Savings Bank</td>
</tr>
<tr>
<td>Tallinn branch of Vneshekonombank</td>
<td>Department of foreign operations of Eesti Pank</td>
<td>North Estonian Bank merged with Union Baltic Bank and taken over by Eesti Pank in 1992 Estonian Investment Bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>The new commercial banks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tartu Commercial Bank Innovationbank</td>
<td>12 commercial banks established by the end of 1990</td>
<td>Total number of banks 42 by the end of 1992 and 23 by the end of 1993</td>
</tr>
<tr>
<td>EVEA Bank Esttexitbank and a few other privately-owned banks were established</td>
<td></td>
<td>3 banks placed under moratorium in 1992 First foreign bank American Baltic Bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Hansapank became independent in 1992</td>
</tr>
</tbody>
</table>
## Assets of Estonian authorized banks, 31 December 1993

<table>
<thead>
<tr>
<th></th>
<th>Mill. EEK</th>
<th>Share of total balance volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eesti sotsiaalpank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonian Social Bank</td>
<td>1,035</td>
<td>15.5</td>
</tr>
<tr>
<td>Hansapank</td>
<td>989</td>
<td>14.8</td>
</tr>
<tr>
<td>Eesti Ühispank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Bank of Estonia</td>
<td>890</td>
<td>13.3</td>
</tr>
<tr>
<td>Pohja-Eesti Pank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>North-Estonian Bank</td>
<td>832</td>
<td>12.4</td>
</tr>
<tr>
<td>Eesti Houipank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonian Savings Bank</td>
<td>777</td>
<td>11.6</td>
</tr>
<tr>
<td>Eesti Tööstuse ja Ehituse</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kommertsfpank, Estonian Commercial Bank of Industry and Construction</td>
<td>388</td>
<td>5.8</td>
</tr>
<tr>
<td>Tallinna Pank</td>
<td>341</td>
<td>5.1</td>
</tr>
<tr>
<td>Eesti Maapank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonian Land Bank</td>
<td>231</td>
<td>3.5</td>
</tr>
<tr>
<td>Virumaa Kommertsfpank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Virumaa Commercial Bank</td>
<td>170</td>
<td>2.5</td>
</tr>
<tr>
<td>Eesti Investeerimispank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonian Investment Bank</td>
<td>127</td>
<td>1.9</td>
</tr>
<tr>
<td>ERA Pank</td>
<td>116</td>
<td>1.7</td>
</tr>
<tr>
<td>Raepank</td>
<td>115</td>
<td>1.7</td>
</tr>
<tr>
<td>EVEA Pank</td>
<td>108</td>
<td>1.6</td>
</tr>
<tr>
<td>Esttexpank (Development Bank)</td>
<td>80</td>
<td>1.2</td>
</tr>
<tr>
<td>Eesti Krediidipank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonian Credit Bank</td>
<td>80</td>
<td>1.2</td>
</tr>
<tr>
<td>Nowe Pank</td>
<td>79</td>
<td>1.2</td>
</tr>
<tr>
<td>Rahvapank</td>
<td>79</td>
<td>1.2</td>
</tr>
<tr>
<td>Eesti Forekspank</td>
<td>76</td>
<td>1.1</td>
</tr>
<tr>
<td>Keila Pank</td>
<td>69</td>
<td>1.0</td>
</tr>
<tr>
<td>Eesti Innovatsioonipank,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonian Innovation Bank</td>
<td>54</td>
<td>0.8</td>
</tr>
<tr>
<td>Ameerika Balti Pank</td>
<td>24</td>
<td>0.4</td>
</tr>
</tbody>
</table>

By the end of 1993 the number of banks in Estonia had diminished to 22. Table 4.2 lists the authorized banks and their assets at 31 December 1993. The five largest banks, Social Bank, North-Estonian Bank, Hansapank, United Bank and Savings Bank, together account for slightly more than two-thirds of the country’s total banking assets.

4.3.3 Developments up to autumn 1994

During the first months of 1994 Hansapank and Union Bank overtook the Social Bank as the largest bank in the country, mainly because the state treasury moved a part of its deposits from the Social Bank to other banks (Baltic News Service, 17 April 1994).

Subsequently, the Social Bank ran into financial difficulties and was acquired by the Development Bank, which in turn was taken over by the Bank of Estonia, as described above. In addition to the liquidity problems caused by the withdrawal of treasury deposits from the Social Bank, considerable bad debts were also revealed and were understood to be one of the reasons that caused the Treasury to act as it did.

The difficulties of the Social Bank have again focused attention on the fragility of the Estonian banking system. Confidence in the system received another hard blow after the system had barely recovered from the crisis of 1992. Due to this development and the still very low level of capitalization of the Estonian banks, it is widely expected that there will soon be another wave of bank mergers in Estonia. A further ownership restructuring is also needed for the two banks, the North Estonian Bank and the Development Bank/Social Bank, which were acquired by the Bank of Estonia as a result of its rescue operations.

4.4 Developments in banking activities

The activities of the Estonian commercial banks have also undergone significant changes during the restructuring period. Payment transfers among the Estonian banks were notoriously slow in 1991–92 and culminated in liquidity problems throughout the banking sector in autumn 1992. The situation has improved significantly since the restructuring of the banking sector in 1993. Most payments can now be effected within the 48-hours period set by the central bank as the maximum transfer time for interbank settlements. However, payments between cities can take longer. Foreign payments are transferred quickly through the Swift-network, which the major Estonian banks joined in December 1993. Payments to and from Russia and other CIS
countries are usually effected in convertible currencies through bank accounts in third countries.

From the corporate customers point of view banking services were very unreliable until the middle of 1993. One assessment is provided by a survey on the direct investments of Finnish companies in Russia and the Baltic states carried out by the Bank of Finland in June 1993. The survey included questions concerning the availability and quality of banking services in Russia and Estonia. According to the survey results banking services in both countries were generally considered poor. However, the experiences of Finnish companies in both domestic and foreign payment transfers were somewhat better in Estonia than in Russia. Obtaining credit from the banks was considered equally difficult in both countries (Laurila 1994, p. 17).

In 1991 and 1992 most Estonian banks engaged in foreign exchange operations which brought in large profits. In the highly inflationary conditions of those years nominal interest rates were very high but real interest rates were negative and companies could not provide acceptable collateral for loans, and consequently banks scarcely engaged in even short-term lending activities. In 1993 competition among the banks for foreign exchange business brought the margins down and so the profitability of that business diminished. Consequently, banks cautiously increased their short-term lending, mainly to finance trade. However, the willingness of banks to provide long-term financing to Estonian companies is still limited. In effect, most banks faced the problem of overliquidity in 1993, as low-risk investment opportunities were scarce. In 1994 the situation has changed somewhat as banks have increased their short-term lending.

The income statements of Hansapank for the years of 1992–93 provide a good illustration. The income of the bank almost tripled from 1992 to 1993. However, the share of foreign exchange income in total income decreased from about 48 per cent in 1992 to 36 per cent in 1993. At the same time the share of interest income increased from 21 per cent in 1992 to 40 per cent in 1993. The banks' balance sheets for the same years also reflect the shift in activities. The share of loans in the bank’s total assets rose from 20 per cent in 1992 to 31 per cent in 1993. Simultaneously, the share of cash and cash equivalents diminished from 76 per cent in 1992 to 58 per cent in 1993. At the same time the balance sheet total also grew by 60 per cent (Hansa-pank Annual Report, 1993).

For the Estonian banking sector in general the balance sheet development since the beginning of 1993 is summarized in Tables 4.3 and 4.4. Comparisons with earlier figures are made difficult by the new way of reporting for commercial banks, which was introduced at the beginning of 1993.
### Table 4.3. Deposit bank assets, 1993–94  
(million EEK, end of period)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves</td>
<td>977.6</td>
<td>1079.2</td>
<td>1437.4</td>
<td>1166.7</td>
</tr>
<tr>
<td>Cash</td>
<td>234.9</td>
<td>265.8</td>
<td>349.3</td>
<td>326.1</td>
</tr>
<tr>
<td>Deposits with BOE</td>
<td>742.7</td>
<td>792.8</td>
<td>1028.4</td>
<td>798.8</td>
</tr>
<tr>
<td>required reserves</td>
<td>726.4</td>
<td>568.4</td>
<td>679.4</td>
<td>629.1</td>
</tr>
<tr>
<td>Claims on BOE</td>
<td>0</td>
<td>20.5</td>
<td>59.7</td>
<td>41.8</td>
</tr>
<tr>
<td>Foreign assets</td>
<td>813.0</td>
<td>774.4</td>
<td>1055.3</td>
<td>1575.3</td>
</tr>
<tr>
<td>Kroons</td>
<td>2.7</td>
<td>2.8</td>
<td>2.5</td>
<td>88.3</td>
</tr>
<tr>
<td>Claims on general government</td>
<td>305.8</td>
<td>310.4</td>
<td>294.6</td>
<td>345.5</td>
</tr>
<tr>
<td>Claims on other fin. institutions</td>
<td>18.3</td>
<td>7.1</td>
<td>8.7</td>
<td>21.8</td>
</tr>
<tr>
<td>Claim on nonfin. public enterprises</td>
<td>405.0</td>
<td>473.0</td>
<td>416.7</td>
<td>364.5</td>
</tr>
<tr>
<td>Claims on private sector</td>
<td>925.2</td>
<td>1333.5</td>
<td>2348.5</td>
<td>3466.7</td>
</tr>
<tr>
<td>Businesses</td>
<td>879.5</td>
<td>1236.4</td>
<td>2169.5</td>
<td>3125.9</td>
</tr>
<tr>
<td>Individuals</td>
<td>45.8</td>
<td>97.1</td>
<td>179.0</td>
<td>340.8</td>
</tr>
<tr>
<td>in foreign currency</td>
<td>123.2</td>
<td>155.5</td>
<td>158.5</td>
<td>160.8</td>
</tr>
<tr>
<td>Other assets</td>
<td>561.3</td>
<td>633.5</td>
<td>534.2</td>
<td>1159.3</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>75.1</td>
<td>154.0</td>
<td>242.1</td>
<td>396.1</td>
</tr>
<tr>
<td>Credits in transit</td>
<td>53.8</td>
<td>40.1</td>
<td>52.2</td>
<td>249.0</td>
</tr>
<tr>
<td>Claims on banks</td>
<td>215.6</td>
<td>159.0</td>
<td>103.2</td>
<td>313.2</td>
</tr>
<tr>
<td>Other</td>
<td>216.7</td>
<td>280.3</td>
<td>136.8</td>
<td>201.1</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>4066.2</strong></td>
<td><strong>4611.0</strong></td>
<td><strong>6395.5</strong></td>
<td><strong>8100.0</strong></td>
</tr>
</tbody>
</table>


The total assets of Estonian banks grew by 50 per cent in 1993 and during the first half of 1994 by a further 27 per cent. The growth in assets has taken place mainly in loans to the private sector, whose share had increased from 25 per cent to 45 per cent of total assets by March 1994. However, cash reserves deposited with Eesti Pank and foreign currency deposits with foreign banks still exceeded loans to the private sector at the end of 1993. By June 1994 the volume of loans had overtaken them by a wide margin. Credits in transit diminished considerably from 1992 (which testifies to the increased efficiency of the banking system in transferring payments) but increased again in the summer of 1994 as a result of re-placing of treasury deposits.
Table 4.4.  Deposit bank liabilities, 1993–94
(million EEK, end of period)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Demand deposits</td>
<td>1502.3</td>
<td>1985.7</td>
<td>2845.6</td>
<td>2720.7</td>
</tr>
<tr>
<td>Nonfinancial public enterprises</td>
<td>573.5</td>
<td>615.4</td>
<td>654.7</td>
<td>641.3</td>
</tr>
<tr>
<td>Private sector</td>
<td>898.5</td>
<td>1353.2</td>
<td>2161.8</td>
<td>2062.2</td>
</tr>
<tr>
<td>Business</td>
<td>577.9</td>
<td>836.6</td>
<td>1402.4</td>
<td>1243.4</td>
</tr>
<tr>
<td>Individuals</td>
<td>320.6</td>
<td>516.5</td>
<td>759.4</td>
<td>818.8</td>
</tr>
<tr>
<td>Time deposits</td>
<td>110.4</td>
<td>258.6</td>
<td>516.1</td>
<td>584.8</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>33.7</td>
<td>37.5</td>
<td>55.8</td>
<td>61.6</td>
</tr>
<tr>
<td>Foreign currency</td>
<td>579.4</td>
<td>150.1</td>
<td>279.7</td>
<td>516.3</td>
</tr>
<tr>
<td>Debt certificates</td>
<td>0.3</td>
<td>0.2</td>
<td>0.7</td>
<td>13.1</td>
</tr>
<tr>
<td>Counterpart fund</td>
<td>40.4</td>
<td>70.7</td>
<td>114.3</td>
<td>105.1</td>
</tr>
<tr>
<td>Government lending funds</td>
<td>11.4</td>
<td>58.8</td>
<td>104.9</td>
<td>203.2</td>
</tr>
<tr>
<td>Foreign liabilities</td>
<td>37.7</td>
<td>96.2</td>
<td>199.0</td>
<td>364.9</td>
</tr>
<tr>
<td>General government</td>
<td>404.8</td>
<td>514.8</td>
<td>916.7</td>
<td>1527.8</td>
</tr>
<tr>
<td>Liabilities to BOE</td>
<td>273.5</td>
<td>356.0</td>
<td>329.7</td>
<td>239.3</td>
</tr>
<tr>
<td>Bank capital</td>
<td>337.3</td>
<td>548.2</td>
<td>679.5</td>
<td>723.2</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>675.0</td>
<td>534.3</td>
<td>353.5</td>
<td>1039.4</td>
</tr>
<tr>
<td>Items in transit</td>
<td>0</td>
<td>39.2</td>
<td>119.1</td>
<td>604.9</td>
</tr>
<tr>
<td>Other banks</td>
<td>122.1</td>
<td>147.6</td>
<td>91.8</td>
<td>293.1</td>
</tr>
<tr>
<td>Other</td>
<td>552.9</td>
<td>347.5</td>
<td>142.6</td>
<td>141.4</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>4006.2</td>
<td>4611.0</td>
<td>6395.5</td>
<td>8100.0</td>
</tr>
</tbody>
</table>


Among the liabilities of the banks growth has come mainly from demand deposits of the private sector, which account for 40 per cent of the total at the end of June 1994. However, their growth stopped after December 1993. The fastest growing items have been time deposits, which also grew in the first quarter of 1994. Foreign currency deposits dropped fast during the first months of 1993 but started to grow after August 1993 when Eesti Pank allowed the placement of currencies in and opening of new foreign currency accounts in the local banks. The loss of confidence in the whole banking sector after the banking crisis of 1992 was most probably also reflected in the withdrawal of foreign currency deposits from the banks. Liability items in transit have increased considerably in 1994, which probably reflects changes taking place in the placement of the government funds. Liabilities to other banks also increased in 1994,
which probably reflects growing mutual confidence among the banks. However, after the moratorium on the Social Bank, interbank liabilities have decreased to the level of 1993.

The maturity structure of the banks’ loan portfolio has also started to change. As in April 1993 short-term loans of up to 6 months accounted for 54 per cent of the total loan portfolio, which share had decreased to 37 per cent by March 1994. Most of the loans have been extended to companies. The share of individuals in the total loan portfolio of the banks reached only 8 per cent at the end of 1993 (Eesti Pank Information Service Publication, 15 May 1994).

The level of lending interest rates has decreased constantly from January 1993, when the average interest rate charged for a three-month loan was 38 per cent. In December 1993 it was about 28 per cent and in July 1994 21 per cent. Long-term interest rates were considerably lower than the short-term rates, which may reflect lower inflation expectations. The long-term interest rates also reflect the fact that long-term loans have been received from abroad at lower than market rates for development purposes. Interest rate developments during the last few of months is surprising, because contrary to lower inflation expectations, it seems that inflation will reach the level of 40–50 per cent for the whole year of 1994. This means that the real interest rate has again become negative.

Deposit interest rates have also decreased but at a slightly slower pace than the lending rates. Therefore, banks’ interest rate margin has also decreased. Tables 4.5 and 4.6 illustrate the average lending and deposit rates of Estonian banks.

Table 4.5. Weighted average annual interest rates for commercial bank loans granted to individuals and companies, by type of loan in 1994

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>26.55</td>
<td>24.58</td>
<td>23.27</td>
<td>22.86</td>
<td>23.48</td>
<td>22.84</td>
</tr>
<tr>
<td>1. Short-term loans total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>up to 1 month</td>
<td>28.02</td>
<td>26.13</td>
<td>24.83</td>
<td>24.29</td>
<td>25.31</td>
<td>24.94</td>
</tr>
<tr>
<td>1–3 months</td>
<td>36.33</td>
<td>29.00</td>
<td>27.77</td>
<td>31.94</td>
<td>31.03</td>
<td>31.80</td>
</tr>
<tr>
<td>3–6 months</td>
<td>26.43</td>
<td>26.16</td>
<td>27.9</td>
<td>29.31</td>
<td>29.19</td>
<td>26.71</td>
</tr>
<tr>
<td>6–12 months</td>
<td>27.86</td>
<td>27.48</td>
<td>23.92</td>
<td>21.40</td>
<td>25.31</td>
<td>21.17</td>
</tr>
<tr>
<td>2. Long-term loans total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1–3 years</td>
<td>24.00</td>
<td>24.04</td>
<td>22.62</td>
<td>21.38</td>
<td>22.81</td>
<td>24.80</td>
</tr>
<tr>
<td>3–5 years</td>
<td>17.17</td>
<td>16.20</td>
<td>17.50</td>
<td>18.00</td>
<td>18.56</td>
<td>17.30</td>
</tr>
<tr>
<td>over 5 years</td>
<td>21.80</td>
<td>17.20</td>
<td>18.21</td>
<td>19.35</td>
<td>20.54</td>
<td>19.89</td>
</tr>
<tr>
<td></td>
<td>13.90</td>
<td>16.20</td>
<td>16.65</td>
<td>16.89</td>
<td>17.95</td>
<td>15.10</td>
</tr>
<tr>
<td></td>
<td>7.20</td>
<td>10.16</td>
<td>10.40</td>
<td>6.78</td>
<td>10.98</td>
<td>12.04</td>
</tr>
</tbody>
</table>

Table 4.6.  Weighted average annual interest rates on commercial bank deposits in 1994

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand deposits*</td>
<td>2.58</td>
<td>2.67</td>
<td>2.74</td>
<td>2.72</td>
<td>2.69</td>
<td>2.71</td>
</tr>
<tr>
<td>Time deposits**</td>
<td>11.48</td>
<td>12.30</td>
<td>11.58</td>
<td>11.49</td>
<td>12.77</td>
<td>12.71</td>
</tr>
</tbody>
</table>

* Calculations based on net deposit balance.
** Calculations based on monthly turnover.


The problem of bad debts has not been fully resolved, and even an estimation of the magnitude of the problem is made difficult by uninformative accounting practices. Until the beginning of 1994 the definition of a bad or non-performing loan was unclear and the banks were free to report loans past due to the central bank each according to their own understanding of the term. According to Eesti Pank, loans past due, registered in this way, amounted to 6.8 per cent of the total outstanding loans at the end of 1992. How correctly this figure reflects loans that were simply rolled over and amounts of unpaid interest that were capitalized can only be guessed.

In the first half of 1993 the share of non-performing loans as reported by the central bank rose to above 10 per cent but diminished to 6.8 per cent of the total again by the end of 1993 (Eesti Pank Quarterly Review 1993:3, pp. 26 and 65). Most of the loans past due in 1993 had been unserviced for at least three months (Eesti Pank Quarterly Review 1993:4, p. 62).

After the new stipulation to write off all loans which had not been serviced for at least 150 days, the past due loans amounted to 2.9 per cent of total loans outstanding in March 1994 (Eesti Pank information service, 15 May 1994). Thus almost half of the non-performing loans of the banks had been written off since January when the regulation took effect. By this measure all the non-performing loans inherited from the old Soviet system must also have been written off.

Since the introduction of the Estonian kroon, payments to and from Russia have mostly been carried out as advance payments in convertible currencies. Although a payments agreement was reached with Russia at the time of the currency reform, direct payments with Russia functioned poorly for many months. Cash payments in roubles, although illegal, were accepted by companies that depended on their Russian trading partners. Barter transactions were also common. Eesti Pank did not quote the rouble, which increased the initial payment difficulties. Over time, several banks began to specialize in trading the rouble and
other currencies of the former USSR republics, which has improved the flow of payments (Bennett, p.5, Hansson, p.12, Sepp, p. 23).

It can be assumed that payment arrears have probably not accumulated in Estonia since the currency reform to the same extent that they have plagued the Russian companies. High Russian inflation has also wiped out any rouble receivables that the Estonian enterprises may have had from Russia. Within Estonia there is evidence of arrears, particularly in tax payments. Tax authorities, both on the central government level as well as on the local level, are coping with the problem.

There was practically no interbank money market in Estonia until the end of 1993. The budding developments in that sector received a hard blow from the bank failures in 1992. The banks had first to prove to each other that they are trustworthy partners before those markets could develop. In order to facilitate this development the central bank started to issue CDs in 1993. Developments in 1994 in the interbank money market were greatly influenced by the lending needs of the Social Bank, which became the largest borrower by the summer months. After its collapse, the market has also handled much smaller volumes.

Although the capital markets are still underdeveloped in Estonia, most Estonian banks are moving towards universal banking and plan to engage in investment banking in addition to the traditional commercial banking activities. Among the leading banks, Hansapank, has arranged a few share issues in the Tallinn stock exchange and started leasing operations via subsidiaries specialized in such operations.

Although until now the restructuring process of the banking system has gone relatively quickly, the banking sector is facing big problems in finding enough qualified personnel to carry out the increasingly complex banking services. This task has been eased by the small size of the country, which has made it relatively easy to invest in computer networks. However, there is a lack of qualified credit analysts who could serve the banks in identifying the risks involved both in increased lending to local companies and in new instruments designed to manage various kinds of banking risks.
4.5 Foreign investments in the Estonian banking sector

Foreign investment in the Estonian banking sector became possible in 1992. The first foreign-owned bank, the American Baltic Bank, started operations in 1993. Three Finnish banks have set up representative offices in Tallinn and two of them, the Union Bank of Finland and Kansallis-Osake-Pankki, plan to open a branch in Tallinn by the beginning of 1995. Foreign investment in the banking sector is favoured by the central bank, which sees it as a means to increase competition and proficiency among the Estonian banks.

In addition to western banks, some Russian and Ukranian banks have expressed an interest in establishing subsidiaries in Estonia, but so far no Russian bank has received a banking licence. The Ukranian Inko-bank received a banking licence in October 1994 and plans to acquire the bankrupt Revalia Bank (Delovoi Mir, 22 October 1994). There is politically motivated resistance in Estonia against the inflow of Russian capital. There are also growing fears among Estonian bankers that the entrance of Russian banks would significantly increase the problems of money laundering and fraud, which are plaguing the Russian banks.

The influence of Russian capital in the Estonian banking sector is, however, not limited to the possible entrance of new Russian owned banks into the country. The branches of the former Soviet banks were separated from their earlier parent banks and became independent joint stock companies under Estonian law. In practice, a significant number of the shares of these banks was held by the former Soviet state-owned companies. These, in turn, have been corporatized and privatized, often by so-called insiders, the Russian managers of these companies. As a result there is still significant Russian ownership in some banks. As there is a certain resistance towards Russian influence in the economy, the banks have also fallen victim to this attitude. The recent problems of the Social Bank, which continued the work of the former Soviet branch of Zhilsotsbank in Tallinn and was hit hard by the decision of the government to withdraw the deposits of the State Treasury, can also be seen in this light.
4.6 Concluding remarks

Estonia has been praised for the speed and efficiency with which the national currency – the kroon – was introduced, and the stability of the economy since the introduction of the currency. However, there are some critics who argue that the legally regulated tie of the "hard kroon" to the deutschmark will be very difficult to break without creating pressures against the kroon (see e.g. Baltic Business Weekly, 13 September 1993). For banks, the tie with the deutschmark has provided a natural hedge for their considerable currency positions. Breaking that tie would also introduce new risks in the banking sector. The possibilities of the banks to manage such risks would depend very much on the monetary policy of Eesti Pank and the ensuing stability of the kroon.

The increasing minimum capital requirements for the banks will likely cause another wave of mergers among Estonian banks during the next few years. Nobody can say what is the "right" number of banks for Estonia, although 22 banks does seem to be a large number to serve 1.5 million people. Competition among the banks is also likely to increase and to bring profits down.

The banks will be facing increasing challenges in developing their skills in credit analysis and management of new sophisticated instruments. Early computerization of operations will help them in this task, but it will also require continuous training of personnel. Identifying credit risks is probably the most difficult task in an environment that is changing very fast and is still characterized by non-transparent accounting practices.

To what extent could Estonian banking sector developments be repeated in Russia and other parts of the former USSR? The closest parallels are in the other Baltic countries, Latvia and Lithuania, which have both introduced national currencies of their own. Latvia in particular is facing a situation where the number of banks is most likely to decrease from the present level of about 60.

As far as Russia is concerned, the circumstances in Estonia are so different that close parallels cannot be drawn. However, the state of the Russian banks can in many ways be judged even more difficult than that of the Estonian banks. Inflation in Russia has been much higher than in Estonia. The rouble has depreciated sharply since 1992, when it became convertible. The problem of interenterprise arrears is probably much larger in Russia than in Estonia and the number of banks is much greater there than in Estonia. Consequently, one could assume that there are also serious problems in the Russian banking
sector, which could surface if the central bank continues to pursue a tight monetary policy.

In the Estonian banking industry the break with the past, when the banks were an organic part of the Soviet banking system with its soft budget constraints, has proven problematic. Politically, a clear break has taken place as Estonia regained her independence. However, economically the break is not so clear. There is a lot of trading taking place between the countries, which is economically justified but not necessarily politically acceptable. Also, Russian economic interests in the Estonian economy and banking sector are becoming more pronounced after the initial reorientation of the Estonian economy towards the West. How the banking sector will react and develop will also depend on the overall political relations between the two countries.
5  Private Sector Development

5.1  Introduction

The core component of a market economy is the private enterprise, operating in a competitive environment. This makes the ownership of companies one of the basic issues in transition towards a market economy. Private initiative must be allowed and encouraged in the former socialist countries, and state ownership must be replaced largely by private ownership.

Developing a viable private sector in a former planned economy is a huge task. Merely allowing private enterprise is not sufficient. Fundamental changes are also needed in the way the surrounding economy operates. Essential changes must be made in the financial sector, as well as in fiscal and budgetary matters. Markets must be created and private companies must become disciplined by market forces. Promoting competition requires new codes of conduct, legislation and law enforcement bodies. Markets also need organizations to supervise the activities of the private participants.

The aim of this chapter is to survey the preconditions for the development of private sector activities and the economic environment in which private business is currently operating in the Baltics, and to discuss the current stage of private sector development as well as the implications for the future.

Private sector development can be divided into two parts, both of which are dealt with in this chapter. First, there are the existing state companies. The majority of these will be privatized but some will be kept under state ownership. In either case, major changes in operating principles are required, and generally a restructuring of physical operations will be necessary. In hopeless cases, where the companies are clearly unviable, the only reasonable solution is to eliminate them.

The second part of private sector development concerns the emergence of entirely new private companies. Here, the important thing is the creation of economic conditions favourable to their development.

The Baltic countries have had considerable success in several aspects of their economic transition, and the preconditions for private initiative are improving rapidly, mainly as regards freeing the economy from the old administrative restrictions. On the other hand, accomplishing structural changes in the economy, that is, altering the way the economy functions by establishing new rules of behaviour
and economic structures, perhaps constitutes the most difficult part of the transition. Thus it should not be surprising that in this regard the pace of development has not been particularly rapid in the Baltics.

5.2 Prerequisites for private sector development

Among the prerequisites for private sector development, five are discussed in this section. They are political factors and economic stability, price liberalization, foreign trade liberalization, currency convertibility and change in the financial system.

5.2.1 Political and economic factors

What is essential for economic transition in any former socialist country is the commitment and will of its political leaders. In the Baltic countries three somewhat different situations prevail, which is reflected in the progress of transition in each of the countries.

Estonia is clearly the leader in the transition process. It seems that the Estonians support reform quite firmly and unanimously. At least so far, the people of Estonia have been ready to make sacrifices in order to help build their own national economy. After the elections of 1992, the majority of the seats in Parliament belong to right-wing parties, which together with social democrats formed the Government and are strictly committed to reform. In autumn 1994, the right-wing Government was compelled to resign after a scandal involving the sale of rouble bank notes which had been withdrawn from circulation after the monetary reform. It remains to be seen whether the elections which, according to the original schedule, will be held in March 1995 will bring about any changes in the reform policy.

In general, the transition process in Estonia, as compared with the other Baltic countries, is characterized by a high degree of consistency. One reason for the good results is that Estonian economists and scholars started to draw up plans for an independent Estonian economy as early as 1987. Concrete preparations for running a market economy were initiated while Estonia still was part of the Soviet Union.

The situation with respect to reform is less clear in Latvia and Lithuania. Latvia is troubled by a large minority — almost half — of nationalities other than Latvians, mainly Russians, residing in the country. Latvia was the last of the Baltic countries to organize free
parliamentary elections in June 1993, and the old parliament which functioned until that time was not capable of deciding major reform issues. In the new parliament, the majority of the seats went to centrist parties, two of which formed a minority Government. The ruling coalition is pushing for reform, and some major reforms have been launched since summer 1993. However, the actual progress has been quite limited due to the reorganization of ministerial and other structures after the election. After a governmental crisis in summer 1994, a new government was formed in September, with the reform minded centrist Latvian Way continuing as the leading party in the government. The fact that the ruling coalition does not have a majority in the parliament may hamper the drive for reform.

Lithuania is politically quite different from both of its Baltic neighbours. The ruling political force is the former communists, The Lithuanian Democratic Labour Party, which won a majority of seats in the parliamentary elections of autumn 1992. Despite their political past, they have declared their intent to continue the transition to a market economy. The biggest difference between Lithuania and the other Baltic states perhaps lies in the somewhat unclear commitment of the Lithuanian political leaders to reform, which is demonstrated by certain inconsistencies in the measures that have been taken.

Overall, as regards the domestic political environment, the Baltic states can be considered as generally stable and as not posing a threat to the emerging business sector. As regards state economic policy, the situation again seems to be conducive to private initiative. The economic policy pursued in these countries during the years of their new independence has not undergone any major changes that would indicate a wavering attitude towards private business. Lithuania, however, is somewhat exceptional in that its policies have shown some inconsistency. It remains to be seen whether the Lithuanian economy will take a different path from that of Estonia and Latvia.

Concerning structural reform of the economic environment to make it conducive to private sector development, one of the most important elements is legislative reform. Creating an entire body of commercial legislation from scratch is a huge task, and it must be done rapidly in order to minimize the disturbances that can take place in the absence of a legal structure.

Estonia has perhaps made the greatest advances in this area, but Latvia and Lithuania also have some important laws already in place. Among them, we might mention bankruptcy and accounting legislation; in addition, legislation concerning privatization procedures is being completed, competition and anti-monopoly legislation has been drawn up, and laws for the banking sector are in place or under preparation.
However, the biggest problems concern the enforcement of the new laws. Tight budgets in the Baltic states constrain the formation of state bodies that would monitor the observance of the laws, and there is a severe lack of trained specialists as well. This is why the new laws have not been properly implemented yet.

One clearly negative aspect of developments in the Baltic states is the weakness of state organs and their limited success in providing for the smooth functioning of the society. This can be seen particularly in the growth of crime and in the allegedly important role it plays in the economies of these countries. Naturally, no official data is available on illegal activities. They are most often mentioned in the context of trading and banking (money laundering).

5.2.2 Price liberalization

Liberalization of the economy from the old administrative methods is one prerequisite for a functioning market economy and is the foundation for private enterprise. In this area the Baltic countries have made considerable progress, and especially in Estonia the development has been surprisingly rapid.

When the administrative pricing mechanism is abolished, prices regain their role as an allocative instrument. Technically, it is quite simple to lift price restrictions, but the problem lies in the political and social acceptability of the measure, and in the tight fiscal and monetary policies that are required to prevent the possible emergence of self-sustaining inflation. As regards consumer prices, their liberalization must be coordinated with adequate social policy measures, such as aid to the poorest members of the population. In the Baltic countries, prices were liberalized relatively quickly, but without any major disapproval on the part of the population.

Estonia started to dismantle its administrative economic mechanisms at the end of 1989, when price liberalization was initiated. At first, the aim was to have higher prices so as to protect local markets against buyers from other parts of the Soviet Union who might come in and empty the relatively abundant Estonian shops. The majority of prices were liberalized by the end of 1991, and at the beginning of 1992 the rationing of most important goods was discontinued. The results were seen very soon; by the end of the same year the Estonian market was filled with goods (Kala 1993).

In Latvia and Lithuania the price liberalization process started later than in Estonia, in 1991. The initial reason for price liberalization in both these countries was the same as in Estonia, namely the need to
shield domestic markets. The wage determination system was also
decentralized, i.e. producers were allowed to raise their employees’
wages so as to partially cover the price increases. Prices were freed
gradually, with the greatest changes being concentrating in winter
1991–1992. In all these countries the liberalization process was
practically completed by the end of 1992, with only a few basic goods
and services remaining under regulation in each country.

In Estonia these regulated items include, among others, land,
natural resources, electricity, heating energy and natural gas, as well as
postal and telecommunication services. Only those goods produced or
sold by state enterprises are regulated. No price controls are applied
to private companies. The main reason for maintaining price regulation,
according to Estonian officials, is the danger of monopolistic over-
pricing in the still underdeveloped markets. In most cases, in spite of
price control, the full pass-through of cost increases to consumers is
permitted.

In Latvia and Lithuania the situation regarding existing price
controls is about the same as in Estonia. Household energy prices and
prices of municipal services are the most important items still under
regulation. Lithuania seems to have preserved the highest degree of
control; currently about 30 per cent of all prices continue to be
controlled. In all of the Baltic countries household energy prices have
been raised considerably during the past few years. The aim is to raise
these prices to world market levels and to pay compensation to the
most vulnerable members of the population as a part of the social
safety net.

Liberalization of energy prices paid by the industrial sector, which
was heavily subsidized during the Soviet era, is of the utmost
importance for the efficient allocation of productive resources. Control
over energy prices for industry seems to be continuing in the Baltics.
In Latvia energy price controls for industry have been abolished, with
the exception of electric energy; in Estonia the prices of electricity and
oil shale (the most important domestic energy source) are controlled
(Tenno, Veski, 1993). Control over energy prices is clearly most
comprehensive in Lithuania.

5.2.3 Foreign trade liberalization

Liberalizing foreign trade increases competition in the home market
and reduces the strength of domestic monopolies. Foreign trade
liberalization is also connected with price liberalization, as imports
help to align domestic prices with world market prices, in both absolute and relative terms.

Because the Baltic countries are small and highly dependent on foreign trade, the opening up of their economies in the past couple of years has had a marked effect on their development. In Estonia, which is probably the leader among the Baltics in this respect, exports accounted for about 40 per cent of GDP in 1993, according to official statistics. (Of course, one should bear in mind the questionable reliability of the statistics!)

During the Soviet era foreign trade in the Baltic countries was conducted by specialized state organizations, and trade was strictly regulated by quotas and licences. Customs duties were not used. As a result, the entire foreign trade system has to be built from scratch now.

Estonia is the leader among the Baltic countries in foreign trade liberalization. It presently has one of the most liberal foreign trade systems in the world, and certainly the most liberal one in Europe. In Estonia there is at present no import licensing, and import tariffs are levied only on a few items considered to be luxuries, such as furs and cars. The view of the Estonian government is that it is in the Estonian consumers’ interest that the state not protect domestic producers from the competition of cheaper imports.

Estonia is one of the few countries that does not have any import restrictions on agricultural products. This liberal policy has caused problems and has been severely criticized by Estonian producers. For instance, grain received as humanitarian aid has been exported from Russia to Estonia at very low prices. To cut off this exceedingly cheap source of imports, the Estonian government imposed a 70 per cent duty on it in August 1993. As this only caused the importing to take place through third countries, the government lifted the duty in December.

The improved situation in the consumer market following price liberalization allowed Estonia to abolish most of its export restrictions in 1992. Currently, there are export quotas and licensing requirements covering only the most important natural resources such as shale oil and some clay and sand used for construction materials. Export tariffs are currently levied on a few items, such as metals and works of art.

The trade regimes adopted in Latvia and Lithuania resemble more closely those of the Western countries than that of Estonia. Both of these countries protect imports by means of tariffs in varying degrees. Unlike Estonia, Latvia and Lithuania have imposed effective tariff protection for agricultural production.

Nonetheless, Latvia has made considerable progress in liberalizing and introducing market elements into its foreign trade. Quotas have
been abolished almost completely, except for a few export items. During the past few years Latvia has introduced a system of import tariffs, which applies to most industrial products but not to raw materials. Latvia has levied tariffs on agricultural imports as well. The amount of the tariffs varies between 15 and 20 per cent. Latvia is currently rebuilding its tariff system with the aim of streamlining it, as several ad hoc decisions to introduce new protective tariffs in the past year have made the system rather complicated.

Lithuania ranks last of the Baltic countries in building a foreign trade system suitable for a market economy. The last administrative quotas and licensing requirements were abolished only in summer 1993 and were replaced by tariffs. The rate of import tariff varies from 5 to 15 per cent, but a higher rate is applied to some foodstuffs and to a few industrial goods. Lithuania also taxes exports, mainly raw materials, to protect domestic consumption, but the aim is to remove these taxes.

One problem in liberalizing foreign trade concerns the formation of supervisory organizations, which is a time-consuming process. Latvia and Lithuania are now just in the process of creating their customs service, and the effectiveness of their border control — especially towards Russia and Belorus — is still questionable. The Estonians repeatedly referred to this problem, primarily concerning Lithuania, during negotiations on the Baltic Free Trade Zone.

The Baltic countries are interested in developing their trade ties to Western European countries, and according to statistics they have been quite successful in their endeavour. The leader is again Estonia, whose trade with Russia, its former main partner, in 1993 accounted for 20 per cent of its trade. For Latvia and Lithuania, Russia still was the most important single trading partner, accounting for about 30 and 60 per cent of their foreign trade, respectively.

But this is only according to the official statistics. It is obvious that a considerable part of the Baltic countries' foreign trade takes place outside customs control or statistical monitoring, and taking into account the missing part could alter the shares of different countries — by increasing the share of Russia. It is understood, for example, that Estonian official statistics include a 10 per cent mark-up in the value of imports from Russia, as compared to customs figures.

As regards trade policy measures, the Baltic countries have been quite active in building their relations with Western countries. The Baltics have concluded free trade agreements with several member countries of EFTA; namely Finland, Sweden, Norway, and Switzerland. In 1994 the Baltic states concluded free trade agreements with the European Union.
As a sign of joint cooperation, the Baltic countries formed a Baltic Free Trade Zone in autumn 1993. The pressure for this action actually came from outside rather than inside the region. The Baltic countries themselves have not been especially interested in mutual cooperation, as they regard themselves more as competitors than partners in world markets. It is the EU which has stressed the need for cooperation among the Baltics as a prerequisite for wider cooperation with the Union. Mutual trade among the Baltic countries currently accounts for about 10 per cent of each of the countries’ total foreign trade.

Since the markets of each of the Baltic states are quite small, the formation of the Free Trade Zone, by creating a single market of more than 8 million people, should provide an important spur to economic activity. This should enhance economic cooperation between the Baltic states and create new opportunities for private business.

Estonia’s forthright progress in liberalizing foreign trade has a bearing on private sector development as well. This concerns the increase of competition in the home markets, especially in consumer goods production, as Estonian companies sometimes find it difficult to compete with attractive imported goods. The situation is most difficult in agriculture and food processing, where local producers suffer from cheap imports of subsidized Western products.

The aim of Estonian decisionmakers is to bring about rapid changes in the country’s structure of production and to identify those sectors in which Estonian producers are most competitive. The agricultural sector will clearly diminish in size as a consequence of these policies, but this is only natural, as during the Soviet era the share of agriculture in the Baltic states’ economies was greater than what it usually is in the Western countries. In 1991, for example, agriculture employed about a fifth of the total Estonian labour force.

On the other hand, the trade policy pursued by Western countries is not always conducive to economic development and the exploitation of current comparative advantages in the Baltics. Western countries have a reserved attitude towards the Baltic states’ exports of agricultural products as well as textiles, which could both be major currency earners for the Baltics. Both these sectors have been excluded from the free trade agreements between the Baltic and Western countries, and they are governed by special, more restrictive protocols.

In the foreign sector, in addition to lifting administrative foreign trade barriers, the Baltic countries have made considerable progress towards making their currencies convertible since they left the rouble zone in the summer and autumn of 1992. This can be characterized as one of the greatest successes to date in their reform programme, and it
is an admirable achievement also when compared with any other former socialist country.

The fact that the Baltic states have achieved and maintained full convertibility of their currencies, has contributed to the development of new businesses, especially in banking and trading, which are among the most important areas of private activity. Although the still relatively high rate of inflation in all the Baltic countries makes the economic environment somewhat unstable, the stable or appreciating exchange rates of the currencies have served to increase the credibility of the Baltic economies.

5.2.4 Financial system reform

One of the basic tasks in making markets function in the former socialist countries is to scrap the old financial system, which distributed state financing to companies irrespective of their operating results, and to build a financial environment conducive to private enterprise.

As regards private sector development, the task is twofold. First, it entails a change in the functioning of the old state-owned enterprises, including such measures as abolishing the system of automatic budgetary financing, and the introduction of financial discipline, which requires bankruptcy procedures. Second, in order to enable private companies to go about their normal tasks, a commercial banking system must be established, with all the necessary financial legislation.

In general, budget subsidies to state-owned companies have been largely abolished in all the Baltic states, with the possible exception of Lithuania. The elimination of subsidies is important for the development of new private companies, as subsidies serve to preserve old and often outdated production structures and hamper structural change in the economy.

The introduction and utilization of bankruptcy procedures is the main tool in changing the behaviour of enterprises. In Estonia — unlike the other Baltic countries — bankruptcy procedures have been initiated and several companies have been declared bankrupt since September 1992, when the bankruptcy law became effective. These firms include, among others, large state-owned companies in wood processing and chemical industries, as well as some private banks. With these measures Estonia has clearly been able to impose a certain amount of financial discipline on the enterprise and banking sectors.

The same has not happened in Latvia or Lithuania, in spite of the fact that bankruptcy legislation is also in place in these countries. This
is a common problem in almost all the former socialist countries, with the possible exception of Hungary. In the other countries, bankruptcy laws have not been applied very effectively. Firms continue to accumulate debts from each other and tax arrears continue to grow.

There may be several reasons for these developments. Clearly, one reason is that it takes time to draw up specific regulations concerning the implementation of bankruptcy legislation and to organize courts and train personnel to handle bankruptcy cases, even if the legislation is in force. Further, certain necessary elements, such as accounting, are still incompletely applied. Another reason might be that in Latvia and Lithuania state enterprise managers still comprise a strong pressure group in the economy, and they can affect the financial decisions of the state or state banks.

Inter-enterprise arrears are a typical feature of the former planned economies, also in the Baltic countries. By not paying their mutual debts, enterprises try to avoid the need for restructuring, which the state attempts to force upon them by applying its financial discipline. Especially in Latvia and Lithuania these arrears may be considerable.

Creation of an effective banking sector is a precondition for the development of private enterprises. In all the Baltic countries there are problems with the creation of a banking sector, although these problems are not unique and are shared by all the other countries in transition.

The Baltic countries have inherited the branches of the five specialized banks of the Soviet Union, and most of them are still operating. These banks formerly distributed state credits to the industries which they served. The current role of these banks and their successors in Latvia and Lithuania is somewhat unclear. It is likely that they are still carrying out their old functions, i.e. crediting state companies with money allocated from the budget, at least in Lithuania, where the state still supports enterprises. In principle, this should not be happening in Latvia due to the strict monetary and fiscal policies followed there. For a discussion on Estonian banks see chapter 4 in this volume. In Estonia the state does not, as a rule, subsidize enterprises through the budget or by granting preferential credits.

Another and more dynamic part of the banking sector is formed by new private banks. They have emerged in the Baltic countries in large numbers during the past few years. In Estonia there are currently more than 20 such banks, in Latvia more than 60 and in Lithuania about 30. These banks are small, and they have in many cases been established by large enterprises as service units. Due to credibility problems pertaining to both banks and their customers, the banks’ clientele is limited, and in this regard they cannot be considered as normal banks in the Western sense.
The underdevelopment of the banking sector concerns both financing and other banking services. It is practically impossible to obtain long-term financing, as private banks concentrate on short-term trade-related financing and currency exchange operations, which secure them the biggest profits. Only in Estonia do commercial banks seem to have recently started to grant longer-term loans to their best customers.

The absence of longer-term financing is also due to the fact that the banks’ risks with respect to their lending operations are prohibitive, and banks cannot find enough investment opportunities for their free reserves. Putting into effect mortgage and other collateral procedures is complicated even when the necessary legislation is in place. Another factor contributing to the lack of long-term financing is, of course, the still relatively high rates of inflation prevailing in the Baltic countries.

Real interest rates on loans turned positive in Lithuania 1993, while in Estonia they are still negative (Bulletin of the Bank of Lithuania 1994:2; Hansapank & Hoiupank, Estonian Economy 1994:1). In Latvia real interest rates are positive by a wide margin, which makes it virtually impossible for ordinary borrowers to obtain loans.

There are some problems caused by the low quality of other banking services as well, mostly concerning Latvia and Lithuania. Payment transfers are effected slowly and banks are not always reliable intermediaries. It is partly for this reason that in Latvia and Lithuania — and perhaps to a lesser extent in Estonia — a considerable share of payments between enterprises are effected in cash, in Latvia and Lithuania most often in dollars. One unofficial estimate put the share of cash payments in Latvia at the beginning of 1993 as high as 90 per cent of all inter-enterprise payments. (But there is another, and nowadays even more important, reason for the wide use of cash in Latvia, namely tax evasion, which is alleged to be quite extensive in the enterprise sector.)

One way of improving banking services is to establish an efficient banking supervision mechanism, which is an essential element of the state control function in all market economies. In Latvia and Lithuania banking supervision is still in a rather underdeveloped state. It is in the hands of the central banks, which started their central banking operations from scratch only some three years ago. During this time, these central banks have established basic rules for commercial banks, such as minimum capital requirements, capital ratios, lending risk criteria etc.

The degree of adherence to these rules by the commercial banks is unknown. There may be reason to believe that the banking supervision is not very effective because of a lack of expertise, personnel, and other resources. On the other hand, it is not always even an aim of the
officials to establish control systems. In Latvia, for example, there is no supervision concerning the foreign currency operations of banks.

Estonia, on the other hand, has succeeded relatively well in imposing discipline in its banking sector through a real threat of bankruptcy. At the end of 1992 the operations of three Estonian commercial banks were suspended. One of them was declared bankrupt and the other two were merged together. The first of these banks had got into difficulty because of unprofessional and overly easy credit extension, while the other two banks suffered from having their currency reserves frozen in the Moscow-based Bank for Foreign Economic Relations as a result of that bank’s financial difficulties. These measures served as a clear sign to all the other Estonian banks that the central bank is serious about getting them under control. Consequently, problems with banking services such as payments transfers are much less frequent now than they were a year ago.

5.3 Creation of a private sector

5.3.1 Emergence of new companies

The growth of private activity in the Baltic states has been very pronounced during the past couple of years. It can be seen in the creation of new small-scale enterprises, which abound in the capitals and bigger cities. In addition to everyday services, trading and financial and other services rendered to the enterprise sector are areas in which new companies are active.

It is difficult to get a clear picture of the current stage of development of the private sector in the Baltics, as the statistical systems in these countries are still in the formative stage. The best data is available on Estonia; the data on Latvia and Lithuania are more or less fragmented.

In November 1993, of all the 48 thousand enterprises registered in Estonia, apparently more than 60 per cent were privately owned. (These figures include 5 thousand private farms.) This share reflects more the rapid emergence of new private companies than the privatization of medium- and large-scale enterprises. This is evident if one compares the aforementioned number of registered enterprises with the corresponding number at the end of the previous year, that is, about 34 thousand. By September 1994, the number of registered enterprises had already grown to 78 thousand.
The growth of new private initiative is also clear from the fact that Estonian business life is dominated by small-scale enterprise; about 95 per cent of all companies employ 50 or less persons, and of these small companies the share of those employing 4 persons or less is as high as 82 per cent. However, a large proportion of companies have not commenced their operations. According to some estimates, one-third of all newly established enterprises, have not yet started up; these are for the most part small companies. Inactive enterprises are usually formed in order to be sold. (Venessaar, Vitsur, 1993.)

In Estonia small-scale firms employed more than a fourth of the total workforce at the end of 1993.

New private initiative is not restricted to the service sector. For example, in Estonia, of all private companies established in 1992, 25 per cent were in trading, 20 per cent in other services and 17 per cent in production.

In Latvia, more than 20,000 private companies were established between 1991 and 1994. The major part of these firms operate in the trading sector. Private initiative is also very pronounced in the financial sector. In Lithuania, during the past four years about 106 thousand companies were registered, often with only one person involved (Finansovye Izvestya, 12–18 May 1994).

5.3.2 Privatization

All the Baltic states have ambitious plans for privatizing state-owned enterprises. Estonia seems to be moving towards an economy with fairly limited state participation in the business sector. According to some information sources, approximately 80 per cent of all state-owned companies are slated to be privatized. Those enterprises which will not be privatized are mainly in the energy and transportation sectors. In Latvia and Lithuania also, privatization is in principle intended to cover most sectors of the economy, except for energy. However, in Lithuania the state obviously intends to hold ownership shares in practically all the larger enterprises.

Privatization of state and municipal property can be divided into two separate parts, privatization of small-scale enterprises and privatization of medium- and large-scale enterprises. Privatization of small enterprises has proceeded quite rapidly in the Baltics. This concerns mainly the services, such as catering and retail trade. In Estonia and Lithuania, by the end of 1993, about 80 to 90 per cent of formerly state owned small-scale firms had been privatized, in most cases by auctioning. Quite often the management and employees have
bought the company. Latvia, on the other hand, is clearly lagging behind its neighbours, as only about 50 per cent of the small-scale firms had been sold or leased by the beginning of 1994.

On the other hand, the privatization of large state-owned companies has proceeded rather slowly in the Baltic countries — as is the case in all the other countries in transition. Preparations for selling these firms as well as the sales procedures are far more complicated than in the case of small companies. Further, it is quite difficult to find buyers for these companies; there is not enough domestic money and foreign investors are not very interested in acquiring them, except perhaps for a few of the best companies.

One solution to this problem is to distribute the ownership of the companies among the population gratis with the help of various voucher schemes. Lithuania has used this method for several years already, and now Estonia and Latvia are introducing their own variants of voucher privatization. The Baltic countries are employing other methods also in addition to this type of so-called mass privatization.

The Baltic countries have strongly emphasized privatization in their economic development programmes, and they have all recently launched new privatization schemes and restructured their privatization policies. This may indicate that a significant portion of state enterprises are considered viable and worth privatizing. The other option would be to let those companies die a natural death and sell that part of the machinery and buildings that are worth something. This will probably be done eventually with the companies that do not find buyers.

Estonia initiated its medium- and large-scale privatization in 1992 (after an experimental privatization of some companies in 1991), and has since then embarked most actively on offering its companies in international tenders. During 1992–1993 it organized three rounds of tenders with 130 companies being offered to both domestic and foreign buyers. By the end of 1993, 54 deals had been concluded. Foreign investors showed only modest interest, being involved in only 10 concluded deals. The share of foreign capital accounted for less than 20 per cent of the total. Of the ten foreign buyers, there were four from Finland, three from Sweden and one from each of Germany, Russia and the USA.

Companies that have been offered for privatization represent most areas of economic activity. They include major hotels, textile and food processing factories, wood processing mills, metal and engineering plants, etc.

In Estonian privatization rounds, the highest bid does not necessarily win, as commitments to make new investments and
preserve employment are also taken into consideration. This is the
same method as that employed in the privatization of East-German
companies.

In 1994 the Estonian authorities have continued their international
offerings, but with some changes. Now, a certain part of the shares of
each company is left with the state to be sold publicly later on. This
should help in the start-up of the Estonian securities’ markets. Estonia
is also issuing two types of privatization vouchers. The first type are
distributed among the population according to number of years
employed in Estonia, and they are intended to be used mainly for
acquiring housing. The second type, the so-called compensation
vouchers, will be allotted as compensation for property confiscated
during the Soviet era.

The privatization of medium- and large-scale enterprises has
proceeded quite rapidly in Estonia. The principles followed by the
authorities are clear and the procedures seem to be well organized.
Estonian officials estimate that the most attractive companies,
especially from the point of view of foreign investors, have already
been offered for privatization.

Privatization of medium- and large-scale enterprises has proceeded
the fastest in Lithuania, where the process was started as early as
1991. Lithuania has from the very beginning relied primarily on a
system in which vouchers are distributed to all citizens for use in
buying housing, land, or companies or their shares. Employees of the
companies to be privatized are in an exceptionally good position; they
now have the right to acquire at a discount up to 50 per cent of the
company’s shares (of these three-fifths are regular shares and two-
fifths are without voting rights). At least for larger enterprises, a
certain part of the shares remain with the state.

Lithuania has also offered a few enterprises for privatization to
foreign investors, but there has been very little interest shown. On the
other hand, there seems to be some reluctance also on the Lithuanian
side. It was decided in October 1993 to compile a new list of
companies which would be offered for privatization in exchange for
hard currency, according to the same principles that are applied in
Estonia. However, by summer 1994 it had become clear that, for some
reason, no suitable companies had been found for hard currency

By the spring of 1994, about 70 per cent of all state companies
eligible for privatization had been privatized; they represent 35 per
cent of the eligible capital. It is clear that the rapid pace of
privatization has affected the outcome of the process. It is widely
rumoured that authorities have not been able to control the process of
privatization and that illegal money is used extensively in buying companies.

It is also clear that the privatization policy followed in Lithuania, wherein employees and management become important shareholders, does not result in ownership that is able to decide on major questions regarding enterprise restructuring and staff reduction, which inevitably come up. Industrial management may well have the bargaining strength to continuously gain special treatment from the state. Large employee ownership may also constitute a hindrance to outside investors interested in acquiring ownership in enterprises.

In Lithuania privatization of medium- and large-scale enterprises has slowed somewhat after a rapid start in 1991. The process was halted altogether after the victory of the Democratic Labour Party in the autumn 1992 parliamentary elections but was revived later on. Currently, preparations are underway to alter privatization methods, for example, by abolishing preferential treatment of employees in acquiring shares.

In one respect Lithuania has been in a far better position than its Baltic neighbours: the ethnic Lithuanians form a clear majority of the population, about 80 per cent. As a result, privatization in Lithuania has proceeded without much fear of other nationalities acquiring the country’s wealth.

Privatization has moved ahead most slowly in Latvia, where some 30 to 60 medium- and large-scale companies have been privatized so far (figures differ according to source). One reason for the sluggish progress has been the problematic nationality structure of the country’s population, with the large minority of non-Latvian ethnic groups.

Another reason for the slow pace was the initial decentralized method of privatization, which made sectoral ministries responsible for privatizing enterprises belonging to their jurisdiction. As the ministries were clearly unwilling to do the job, a new centralized system was established in 1994. Latvian officials are planning to start privatizing medium- and large-scale companies according to new principles in 1994. Only a small number of privatizations will be attempted, for the purpose of testing different privatization methods.

The implementation of voucher privatization has not yet started in Latvia, and rules governing the procedures are currently being prepared. The number of vouchers allotted to each citizen depends on the number of years lived in Latvia; non-citizens receive a smaller number.

Markets in the Baltic states are small, and hence there is a danger of privatized companies exercising monopoly power. This is due to the fact that during the Soviet era companies were generally very large,
and in most cases they are not being restructured prior to privatization. Further, markets are not functioning properly and state control over monopolies is not yet very effective.

One special factor retarding privatization in all the Baltic countries is the attitude towards restitution of property that was confiscated after the annexation of the Baltic countries to the Soviet Union. The Baltic countries have chosen to honour the requests of former owners to get their property back. In this respect, the policies of the Baltic states differ from those of Central and Eastern European countries, where restitution has not taken place on a large scale because it would retard privatization.

Restitution hampers the process as new investors cannot be certain of the real ownership of the property when they buy it. In Latvia, for example, the period for filing restitution claims for land in towns and cities is ten years. Recently, however, there have been proposals to shorten the period.

In Estonia the deadline for restitution claims elapsed in spring 1993, and the claims are currently being reviewed by local authorities. The process is, however, a lengthy one. The government intends to issue state guarantees to new owners to protect them from restitution claims from previous owners. The previous owners would then receive compensation for their property in the form of compensation vouchers.

One important factor in privatization is the question of land ownership. In Estonia legislation concerning the ownership and sale of land and real estate was passed by the parliament in the spring and summer of 1993. These laws institute private ownership of land and real estate for Estonian citizens and enterprises. A foreign enterprise is allowed to acquire land or premises provided it is necessary for the operations of the company. Special permission from municipal authorities is required. As the legislation concerning the procedures for the sale of land is just now being prepared, these sales are only in the beginning phase.

Latvia passed laws concerning the privatization of land in 1991 and 1992. As in the other Baltic countries, privatization started with the restitution of ownership rights to former landowners, which has slowed the process considerably. Landownership is currently not allowed in Latvia for domestic or foreign legal persons or foreign citizens, but a lease of 99 years is permitted. There are plans to permit the ownership of land for legal persons, including foreign ones.

Lithuania allows private ownership of land only to Lithuanian citizens. There have been discussions about extending ownership to domestic legal persons as well, but it is unclear whether this has been done yet. In October 1993 the parliament rejected a bill that would
allow the sale of land to foreign enterprises. The long-term lease remains the only course open to them.

5.3.3 Foreign investment

Investment needs in the Baltic economies are huge, as investments in the productive sector have collapsed since 1990 and production facilities are generally outdated. State companies have not received budget funding for investments, and in expectation of being privatized they have not been willing to make investments out of their own resources in the few instances where that would have been possible. Investments in the private sector have been quite limited, too, due to difficulties with their financing, referred to above.

Therefore, foreign investment is vital for the development of the private productive sector in the Baltics. During the past few years, the largest single investments have clearly come from foreign investors.

Estonia seems to have attracted by far the largest share of foreign investment, due to the fact that the Estonian economy is the most developed in the Baltics. According to the statistics of the Estonian central bank, in 1993 direct foreign investments in the Estonian economy amounted to 2.2 billion kroons (about 160 million dollars). This is a huge amount of resources compared to Estonia’s GDP, roughly 10 per cent. The largest investors were Finland and Sweden, together accounting for more than 60 per cent of the total (Eesti Pank Teabeleht 12/1994). The active presence of the Nordic countries certainly helps Estonia in developing its economy.

In 1993 about 60 per cent of foreign investments in the Estonian economy in the form of share capital went to industry. The trade sector accounted for 35 per cent and finance for about 10 per cent (Baltic News Service, 21 April 1994). The share of industry is surprisingly large. Of the industrial sectors, especially the textile industry and food processing as well as construction materials production were of interest to foreign investors.

The share of Nordic investment decreases sharply as one moves southward in the Baltics. In Latvia, according to some information, it accounts for some 30 per cent and in Lithuania only about five per cent of the stock of foreign investment in form of share capital (Baltic Business Weekly, 24–30 January 1994). Here, the most active foreign investors are from Russia, Germany, the USA and the United Kingdom, among others.

The total amount of foreign investment is apparently smaller in Latvia and Lithuania than in Estonia. In Latvia and Lithuania foreign
investment in 1993 amounted to about 80 and 100 million dollars, respectively. These figures probably cover only investment in share capital and are therefore not strictly comparable with those of Estonia. In addition, one has to remember that the statistical systems of the Baltic countries (especially in Latvia and Lithuania) are not highly developed yet, and it is probably best to treat the data as a rough estimate only.

Estonia appears to be the most willing of the Baltic countries to allow foreign investors to set up operations in the country and to take part in privatization. In Lithuania the attitude towards foreigners tends to be somewhat more reserved. This is demonstrated, for example, by the difficulties encountered in the latest attempt at hard currency privatization. It is more difficult to judge the attitude in Latvia, as privatization is only in its beginning phase.

At the same time as the Baltic countries are waiting for Western investors to establish operations and take part in privatization, there is a general fear that Russian money is entering in large quantities — most often through third-country mediators — and getting a grip on the Baltic economies. Of course, no exact figures exist on how much invested money is of Russian origin, but there is speculation that a considerable share of Western investment is actually Russian in origin.

### 5.4 Significance of private activity

The current economic environment in the Baltics seems relatively favourable for the development of small-scale enterprise, where both the need for initial investment and the risks involved are modest. As regards private activity in the medium- and large-scale sector, the still considerable instability of the economy, related to underdeveloped economic structures and the still quite high inflation, constitute a hindrance to development. The lack of domestic financial resources is another factor impeding development.

Figures showing the share of the private sector in the economy are available only for Estonia. In 1993 the private sector accounted for 35 per cent of the country’s GDP. In 1993 about 10 per cent of industrial workforce was employed by the private sector, while private companies produced more than a quarter of industrial production (BBC Summary of World Broadcasts, SUW/0329, 22 April 1994). This is an indication of the greater effectiveness of private companies, but it also alludes to the fact that state companies have not cut their workforce to the extent that their production has fallen.

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It seems that the significance of the private sector in the economy is greatest in Estonia, largely due to new small-scale firms. In Latvia also, the private sector consists largely of new small-scale enterprises. Although Lithuania leads the list in medium- and large-scale privatization, it is doubtful whether all the privatized companies actually behave like genuinely private enterprises.

Although production in all the Baltic countries has decreased considerably since the demise of the Soviet Union, official unemployment rates have not grown correspondingly. On the one hand, this is certainly due to deficiencies in the official statistics, but especially in Estonia the expanding private service sector may have been able to accommodate a large number of new workers. As part of their stabilization policies, the Baltic states have imposed limitations on the increase of wages in the state sector, which has contributed to the shift of labour from the state sector to the private sector, where there are no restrictions on wage increases.

As services were certainly underdeveloped during the Soviet era, it is clear that they now comprise one of the most dynamic areas of private enterprise and are able to employ large numbers of people who became redundant in the state industrial sector. Banking is one sector in which private initiative has been most influential in the Baltics. In Estonia and Latvia, several of the most important commercial banks are genuinely private. In Lithuania, on the other hand, almost all the commercial banks, at least in the beginning, were state owned, either directly or indirectly through state-owned companies.

In general, the small commercial banks in the Baltics are quite successful, as they deal mostly with foreign currency operations and the financing of trade between Russia and Western countries, which is highly profitable. As noted above, the banks do not function primarily as financial intermediaries that channel money for investment needs.

Acting as a trade intermediary between Russia and the other CIS states and the West is the most profitable business in the Baltic countries. According to estimates made by a Latvian private financial company in spring 1994, the largest profit was secured by trading cotton and colour metals (25 and 20 per cent respectively). Considerable profits could also be made by trading ferrous metals, foodstuffs, timber, coal and oil (Baltic Business Weekly, 2–8 May 1994).

Subcontracting for foreign companies in the textile and wood processing industries is a very important field of activity also for privatized companies, especially in Estonia. In Estonia the contractors are most often Finnish, but other Nordic, as well as German and British, companies have also discovered the relatively cheap Baltic production possibilities.
5.5 Concluding remarks

Taking into account the short period of time that the Baltic states have been independent and able to build their own national economies, their achievements in preparing for the functioning of a market economy and the development of private enterprise are considerable. Liberalizing the economy from the former administrative practices has proved to be fairly easy. These successes in freeing prices and foreign trade as well as in introducing own currencies and maintaining their stability have to a significant extent accelerated the emergence of markets and competition.

On the other hand, it has been much more difficult and time consuming to accomplish structural changes in the economy. In all these countries the building of a functioning financial sector to support enterprises has proceeded quite slowly. This is perhaps one of the biggest problems in the development of private initiative in the Baltic countries. Further, creating supervisory mechanisms for the rapidly emerging markets has been cumbersome, and this has in many instances brought about rather serious misconduct and even outright criminality.

The faltering progress of structural reforms has contributed to the decline of economic activity in the Baltic countries. Their economies do not respond fully to market signals, and they have not been able to completely absorb the available international financial assistance. Another problem is that weak state organizations increase the risks of private enterprises and compel them to adopt inefficient and expensive methods to protect themselves. As an example of this, one could cite the above-mentioned large share of cash payments between enterprises.

The Baltic countries have proceeded with varying speeds in different areas of reform. If one compares the Baltic countries with each other, the importance of political commitment to reform is clearly noticeable. In this respect Estonia is the clear leader. In Estonia a large part of the legislation necessary for the proper functioning of a market economy has been passed, and the great challenge now is to make these laws operative by preparing the necessary rules for their implementation as well as ensuring that the required organizations are functioning.

Although the Baltic officials plan to accomplish medium- and large-scale privatization in a few years time, it is more likely that it will take several years to complete the process. Until then, state-owned companies must be made to work on a self-supporting basis. This presupposes a functioning financial sector, abolition of state subsidies and the imposition of a real threat of bankruptcy. Otherwise, the
special treatment that the old enterprises receive will hamper the
development of the private sector. This concerns Lithuania above all.

What the Baltic states are currently experiencing is a period of
highly active capital accumulation as a result of flourishing small-scale
business and banking. This will in the future very likely serve as the
basis for long-term economic development as the economic
environment becomes more stable.

The longer-term problem for the Baltics is to identify those areas
of production where they have a competitive advantage and which will
secure them sufficient export income in the future. The most
promising areas in the shorter perspective are those exploiting the
relatively low wage levels in these countries, as, for example, the
textile industry. For the longer term, local raw materials, such as
wood, offer possibilities for production, although they may involve
considerable new investment. The geographical location of the Baltics
and their good ports make them important transport links for Russia
with the West. This may become a significant area of activity for
these countries, provided that political relations between the countries
are favourable.
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