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ABSTRACT

Estonia's Emerging Financial System: Progress and Prospects

by

Gail Buyske and Elisabeth Rhyne

August 1993

This is one of four country studies of financial sector reform in Bulgaria, Hungary, Poland, and Estonia. It was commissioned by USAID to assist the USG in planning programming in this sector. Each report examines the macrofinancial environment; the functions of central banks, including bank regulation and supervision; the future role of state banks, the development of banking services, capacity development in the banking system, and the role of donors. A synthesis report was also prepared to draw common findings and lessons from the four country studies.

This study highlights two important policy decision that the Estonian central bank has taken to set a firm context for future development: (1) the decision to establish the currency board which helped to establish confidence in the currency and dealt swiftly with inflation; and (2) the government's strong response to the banking crisis which injected prudence into the banking system far more effectively than many alternative policies would have done.

At the same time, weaknesses remain which need to be addressed, including continued containment of the banking crisis to build public confidence, improving the quality and quantity of retail banking services for individuals, developing the money market and other forms of interbank cooperation, improving the legal foundation for secured lending, and improving the skills of bank staff and management.

The report concludes with observations and recommendations for U.S. Government assistance.

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Estonia's Emerging Financial System:

Progress and Prospects

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The views and interpretations in these papers are those of the authors and should not be attributed to the Agency for International Development, the Harvard Institute for International Development, or CAER subcontractors.

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SECTION ONE

ESTONIA'S UNIQUE PATH

Since gaining independence in 1991, Estonian experience in building a modern financial system has differed in five important respects from the experience of most Central and Eastern European (CEE) countries:

- **The Currency Board**. In June 1992, Estonia launched its own currency, the kroon, under a system known as a currency board — which requires that all central bank liabilities be backed by foreign exchange reserves of the Bank of Estonia (BoE, the central bank), pegs the exchange rate to the German mark, and prevents BoE from lending to the government. The currency board was instrumental in reducing inflation quickly to a manageable level, and shapes numerous other aspects of the financial system.

- **Frozen Accounts in Russia**. Because some Estonian banks were formerly part of the Soviet banking system, and because of continuing trade with Russia, several important banks had large portfolios of claims against Russia. These accounts were frozen by Russia in January 1992, causing considerable difficulty for exposed banks, and ultimately helping to provoke a major banking crisis.

- **Private Banks**. The Estonian financial market is characterized by the development of private banks to a greater degree than are the markets of several other CEE countries. At present, the largest bank (based on capital) is mostly privately owned, the second largest is fully state-owned, and the third largest is fully privately owned. Thus, the future development of the financial system is not synonymous with the restructuring of state banks.

- **Caveat Owner/Depositor**. BoE has taken a more free-market approach to banks than have central banks in other CEE countries, as demonstrated during the banking crisis of late 1992. BoE closed failing banks — generally without protecting depositors — and carried out a relicensing process that reduced the number of banks from 43 to 23.

- **Distance from the Privatization Process**. Unlike most CEE countries, Estonia's financial system problems have not centered on the resolution of bad debts to state enterprises. An unmanageable bad loan problem had not surfaced as of spring 1993 and is unlikely to do so, given that only a small portion (13 percent) of bank assets takes the form of loans to state-owned enterprises (SOEs).

These five characteristics set Estonia apart from other CEE countries. Accordingly, Estonia represents a very different model with which to contrast other experiences. Two of these five characteristics are important policy decisions that the Estonian central bank has taken — decisions that have already served Estonia well and that set a firm context for future development. The decision to establish the currency board helped to establish confidence in the currency and dealt swiftly with inflation. Second, the government's strong response to the banking crisis has injected prudence into the banking system far more effectively than many alternative policies would have done. Both of these decisions may help speed the transition to a modern financial system.

Nevertheless, remaining weaknesses pose significant risks for the Estonian financial system, and policy makers will need to take action to reduce the vulnerability of the system. The banking crisis may not be entirely over, as weak banks remain. To build public confidence in the system (thereby increasing deposits and thus the basis for lending), it is important that the authorities demonstrate their containment of the crisis. They must be able to ensure that institutions are operating under sound banking principles. The system will remain vulnerable to additional bank failures until legislation is passed and regulations are implemented that tighten behavioral rules for banks; BoE increases its capacity to supervise banks; and banks begin submitting more reliable, relevant, and timely information about their financial condition.

In addition to reducing these risks, Estonia has several important tasks to undertake to build the conditions for a full-service competitive banking sector that actively serves a financial intermediation function. These include improving the quality and quantity of retail banking services for individuals (including revamping the Savings Bank), developing the money market and other forms of interbank cooperation, improving the legal foundation for secured lending, and improving skills of bank staff and management. These changes will make increased financial intermediation possible.

The findings sketched above constitute the major themes of this paper — themes that will be amplified throughout. Section Two examines the financial system environment, with a focus on activities carried out by BoE, including the currency board and bank supervision. Section Three looks more closely at the banks themselves, their structural evolution, and their service development. This section will cover the 1992 banking crisis and its resolution. Section Four reviews capacity development by both BoE and commercial banks, and details donor assistance activities in this sector. Section Five makes brief concluding recommendations to donors.

SECTION TWO

THE FINANCIAL SYSTEM ENVIRONMENT

MONETARY POLICY

Estonia's monetary policy, as well as its fiscal and foreign exchange policy, is driven by its adoption of a currency board, according to which all central bank liabilities must be 100 percent backed by foreign currency reserves held by BoE and pegged at a fixed exchange rate of 8:1 to the German deutsche mark (US$ 1=EEK 12.3). Under currency boards, there is no scope for the central bank to manipulate interest rates or credit levels in the banking system, to act as lender of last resort, or to lend to government. As a result, it is often claimed that currency boards completely replace monetary policy. In fact, in a pure currency board system, such as that in Hong Kong, there is no central bank and only bank notes are backed by hard currency.

Estonia employs a hybrid system, which differs from the pure model in two respects. First, in addition to bank notes, the reserves of the commercial banks that are held with the central bank are also backed by hard currency. Second, BoE maintains a small surplus of reserves (the so-called Banking Department), which allows it some very limited scope for policy actions.

A key advantage of a currency board for newly independent countries such as Estonia is that it "ties the government's hands" by committing the government to a well-defined course of monetary policy in which the central bank's liabilities are backed by foreign assets. This is important for a government that needs to establish its credibility quickly, including creating confidence in long-term price stability. A currency board also dictates important features of fiscal and foreign exchange policies.

Since the introduction of the Estonian kroon and the currency board system on June 20, 1992, inflation in Estonia has steadily declined. Until that date, Estonia had been in the ruble zone and its inflation resembled the high levels characteristic of Russia. Inflation for the full year 1992 was more than 800 percent; the annual rate for 1993 is estimated at 40 percent.

There are two points to note in the relationship between the currency board and relative inflation rates in Estonia and Germany, where inflation is approximately eight times lower than in Estonia. The first point is that the introduction of the kroon and the currency board was accompanied by price liberalization and the removal of government subsidies for a wide range of goods and services. The consequent price increases resulted in inflationary pressures that initially counteracted the deflationary impact of the currency board. This initial price adjustment influence appeared to abate by early 1993.

Second, because currency boards maintain a fixed nominal exchange rate between two currencies, adjustments that reflect real differences between the two economies are reflected in interest rates and prices and, therefore, in inflation. Several specialists anticipate that Estonian inflation will remain higher than inflation in Germany for two major reasons. One is the likelihood of more rapid economic growth in Estonia related to the reconstruction of the economy. The other is that prices in a service economy, such as Estonia seems to be becoming, are more flexible than prices in economies with a large manufacturing base. However, provided that the higher inflation rate is based on higher productivity and not on supply shortages, this does not endanger the viability of the pegged rate in the near term.

Interest rates in a currency board system are market determined. They move to equilibrate the supply and demand for foreign and domestic currency when the nominal exchange rate is fixed. The central bank has limited resources with which to influence interest rates. Furthermore, since the central bank is not a lender of last resort and therefore does not operate a discount window, it cannot indicate which interest rates it considers appropriate. The current Estonian banking law states that all interest rates are established freely by the commercial banks.

Interest rates in Estonia are higher than in Germany, although the explanation involves more than differences in the relative rates of inflation. The evolution of interest rates since the introduction of the kroon reflects extremely high lending risks, reflecting economic and political uncertainty; reliance on the funding spread as an important source of bank profitability; and a decline in inflation. Posted lending rates are between 30 and 40 percent, although observers state that actual lending rates are higher. The average cost of funding is likely to be less than 15 percent.

Although a defining feature of a currency board is the extent to which it reduces discretion in monetary policy (and, in the case of pure currency boards, eliminates all such discretion), there are ways BoE can exercise monetary policy "on the margin." The first concerns the level of excess reserves BoE maintains for unforeseen uses, including the provision of temporary commercial bank liquidity. These excess reserves consist of pre-World War II funds returned to Estonia after the currency reform (and therefore not needed to back existing central bank liabilities) and interest earned on the currency board's reserves. BoE has an informal agreement with the International Monetary Fund (IMF) that this level of excess reserves will not fall below $20 million. To the extent that the Estonian authorities use their discretion to utilize this reserve, they are exercising their own monetary policy. Second, reserve requirements levied on banks are another tool of monetary policy available to the Estonian authorities; the reserve requirement is currently 10 percent.

In conclusion, the currency board and the increasing confidence in exchange rate stability appear to have contributed to declines in inflation and interest rates. The still-relatively-high interest rates reflect several other factors common to an economy undergoing economic reform. Development of an Estonian money market could make an important contribution to establishing a base interbank lending rate comparable to the federal funds rate in the United States and therefore could result in more interest rate convergence.

FISCAL POLICY

The most important feature of fiscal policy in Estonia is BoE's lack of ability to fund any government fiscal deficits. This feature is a direct outcome of the currency board, because BoE cannot create liabilities that are not backed 100 percent by foreign reserves. The Estonian banking law also prohibits BoE from providing such deficit funding. As a result of this structural deterrent, as well as considerable resolve on the part of the Estonian government, Estonia achieved a fiscal surplus in 1992 and is budgeted for the same in 1993. (Estonia is also said to have had a fiscal surplus in 1991, when it was still in the ruble zone, but these accounts are difficult to decipher.) It should be noted that the currency board does not prohibit the government from having fiscal deficits; it just prohibits the central bank from financing deficits.

Estonia was able to increase its tax revenue base in 1992 by increasing the value-added tax (VAT) from 10 to 18 percent and by introducing graduated personal income taxes. Its main sources of tax revenue are VAT, excise taxes, and personal income taxes collected through wage withholding.

Enterprise taxes contributed 17.4 percent of tax revenue in 1992 and are projected to contribute 11.9 percent in 1993. They are the weakest source of potential tax revenue for the next several years because of the impact of economic reform on enterprise performance.

The main apparent threat to fiscal stability is the social safety net. Social security taxes are currently not adequate to finance the safety net requirements, which are anticipated to grow as economic reform proceeds. Registered unemployment, for example, was 3.2 percent in April, and the estimate for effective unemployment is 7 percent. It is reasonable to assume that Estonia will eventually experience the double-digit unemployment characteristic of its neighbors. This and other economic hardships related to economic reform will put tremendous pressure on the government to provide additional social assistance. This looming problem is well understood by the government and is a partial explanation for the government's deliberate approach to privatization.

Some relief to a potential deficit problem could be provided by issuing government securities domestically. The Estonian government has not yet taken this step for a number of reasons, including the simple technical reason that such a market does not yet exist. It appears that the government is also concerned about the slippery slope that this method of deficit financing potentially represents. (With regard to the banking crisis, the government did issue a 300-million-kroon 10-year bond to recapitalize the Northern Estonian Bank, which resulted from the merger of two of the closed banks.)

In conclusion, it appears that there is a successful synergistic relationship between Estonia's currency board and its fiscal policy. The currency board enforces fiscal discipline, and the government's willingness to submit to that discipline in turn increases the likelihood that the currency board can be maintained.

FOREIGN EXCHANGE POLICY

A currency board also has a dominant influence on foreign exchange policy, because the central bank must stand ready to convert deutsche marks into kroons and kroons into deutsche marks at the currency board's pegged rate. Therefore currency boards imply complete convertibility at a fixed rate, although the degree of control over actual convertibility (who can do so and under what circumstances) can vary according to the government's policy. Estonia has effective current account convertibility and capital account controls. The government considers these controls necessary to prevent large capital outflows during a period when confidence in the future of the Estonian economy has not been fully achieved. It should be noted, however, that capital controls are often not effective, because of the number of ways they can be circumvented.

Enterprises in Estonia are required to surrender foreign currency receipts at the pegged rate unless they can demonstrate that they will need the foreign currency for future imports. Enterprises that demonstrate a valid need for foreign currency for current account transactions can purchase that currency. Following the monetary reform there was a moratorium on opening new enterprise foreign currency accounts in or outside Estonia. Previously owned accounts could be maintained, but new funds could not be added. This moratorium on enterprise accounts was lifted in April 1993, although enterprises opening such accounts must get approval from BoE and demonstrate a business rationale for the accounts.

Individuals can also purchase foreign currency as needed. Individuals were able to retain any foreign currency accounts that they held prior to the monetary reform, but they have not been able to add to those accounts or to open new foreign currency accounts. With regard to the capital account, foreign investors are free to convert and repatriate their kroon earnings. Other capital account transactions must be approved by BoE.

Estonia does not have an interbank foreign exchange market, largely because the banks do not have adequate confidence in one another's creditworthiness to take on the counterparty risk. As a result, BoE also exchanges currencies other than deutsche marks with the banks. Estonia also has a foreign exchange auction market intended for commercial (in contrast to individual or tourist) transactions, but it does not operate daily.

It is estimated that Estonia achieved a small current account surplus in 1992, when income on services (notably shipping and port fees) compensated for a trade deficit. In 1992, Finland edged out Russia as Estonia's largest trading partner. Capital account data are incomplete, particularly for Estonia's private sector. The most significant change in the capital account is because of the return to Estonia of assets that had been placed overseas by the Government of Estonia before World War II.

THE MONEY MARKETS AND THE STOCK MARKET

Estonia does not yet have a money market. As a result of the currency board, BoE does not operate a discount window. In addition, interbank lending is not common because banks do not have enough reliable financial information about one another to accurately assess the risks of such lending. Earlier this year, BoE attempted to assist in the development of this market by providing an interbank reserve clearing system. However, the banks did not make use of this capacity. A further contributing factor, at least in the short term, is that many Estonian banks are extremely liquid and have little need to borrow in a money market. During 1993, reserves held at BoE have at times exceeded 20 percent, compared with the required reserve level of 10 percent. As of May 1993, reserves were approximately 18.5 percent. One apparent reason for this high reserve level is the increased caution inspired by the banking crisis. Interest is not paid on these reserves.

BoE is continuing its efforts to develop a money market, which will also provide the banks with a way to earn income on their surplus reserves. In May 1993, BoE established the first auction of its negotiable short-term certificates of deposit (CDs). (The basis for the CD issuance is excess international reserves held by BoE, to comply with the currency board requirements.) Auctions will be held every two weeks, and the CDs will have maturities in the range of four weeks. BoE will maintain a secondary market in the CDs. It is anticipated, that initially, the CDs will be held to maturity, but, as the banks become more sophisticated, the CDs could be traded among the banks and also could be used for repurchase agreements. Because the CDs represent essentially riskless collateral that can always be redeemed by BoE, the problem of a banking partner's creditworthiness is reduced.

The initial CD issue was 5 million kroons, of which 2.5 million kroons of the issue was purchased. The average annual interest rate on the certificates was 8.92 percent. BoE is introducing this new product gradually because of uncertainty about its market acceptance. An additional reason for the gradual introduction is that these CDs will have an impact on the money supply in the short run. If these CDs become a widely used tool for liquidity management by the commercial banks, and — in particular — if some portion of these CDs can be counted against the reserve requirement, these CDs could play a role as one of the key rates against which other interest rates are set. This role would be reinforced to the degree that there is not a significant domestic market in government securities.

The only government security of note issued to date is the 300-million-kroon 10-year bond to recapitalize the Northern Estonian Bank, which was created from the merger of two of the banks closed in 1992. It appears that these bonds may have been underpriced at 10 percent. Consideration is being given to increasing the marketability and tradability of these bonds by stripping the coupons and selling the different maturities separately.

The Estonian stock market is at least as undeveloped as the money market and appears to be further away from active functioning. Estonia does not yet have a securities trading law nor the technical infrastructure for a secondary securities market. Currently, there are five or six companies issuing shares on the primary market. These shares can be resold only to the original broker or to the issuing company itself. A major impetus to the development of the stock market could come with privatization of the large-scale enterprises, depending upon whether the government decides to offer shares to the public as part of this process. (Current legislation calls for shares to be available to the public, but there is an ongoing debate about this approach, in particular because it reduces potential income to the government when compared with selling the assets to foreign investors. However, any changes to the program would require changes to the highly sensitive privatization legislation.) Because the Estonian stock market is undeveloped, the role of banks in providing enterprise funding has added importance.

THE BANK PAYMENTS SYSTEM

Considerable progress has been made in the interbank payments system in Estonia. A clearing system has been established at BoE and most, if not all, banks are connected to it by computer. All domestic payments among banks are made through this system. The completion of this system, as well as enforcement of a BoE requirement that all payments settle in two days (with a 0.5 percent penalty per day of delay), has helped clear up the payment delays of up to several weeks, common in 1992. At least as important a factor in reducing payment delays was the moratorium on the three banks that were the major perpetrators of the delays. The rapid disappearance of major payment delays demonstrates the extent to which slow payments tend to result from incentives, rather than from technology alone (as is often thought). When BoE set clear incentives in favor of rapid settlement, banks were able to comply.

Although these are substantial improvements, the interbank payment system could be improved further by developing a system for direct bilateral settlements between domestic banks. This would reduce one step in the payment process as well as increase the confidentiality of payments. Several Estonian banks plan to join the international automated clearinghouse system SWIFT this year, and they may be able to take advantage of that system to develop a domestic payments system, at least among SWIFT members. In any case, development of a more widely based domestic direct payment system will require greater cooperation among the banks and may be an appropriate task for the banking association. (However, the banking association does not yet appear to be very active.) A bilateral payment system will also require greater confidence among the banks in one another's creditworthiness, because the bilateral nostro accounts needed to make payments represent a form of credit exposure.

Pending introduction of SWIFT, international payments to western countries are made bilaterally (that is, not through BoE) on the basis of telex instructions. Payments to other Soviet successor states are made through BoE, which maintains accounts with the central banks of these countries.

The other noticeable shortcoming in the domestic payments system is the lack of a check payment system. Almost all transactions are carried out in cash, which puts a heavy burden on bank personnel and clients and is a drag on overall system efficiency.

THE TAXATION AND LEGAL ENVIRONMENT

Estonia has made substantial progress in establishing the legal framework for banking activities, although this remains an ongoing process. The most significant bank-related legislation passed in the past nine months is the law on bankruptcy, which establishes the rights of banks when loans are not paid and which contributes to increasing borrower discipline. Since the bankruptcy law became effective last September, some companies have been forced into liquidation by the tax authorities and some by larger creditors such as the energy supply companies. The liquidation of Tartu Commercial Bank has also forced some of its borrowers into bankruptcy. It is not clear whether many banks have directly used the law to force their borrowers into bankruptcy. This is most likely to occur only when there are strict requirements for reporting past due loans; otherwise, there are limited incentives for bankers to initiate bankruptcy proceedings (with the one possible exception noted below). Several bankers commented that they had not yet had enough experience with the bankruptcy law and its implementation by the courts (which themselves are inexperienced) to form a judgment on the law's impact on their business.

There is one twist to bankruptcy proceedings in Estonia that deserves note. In contrast to Chapter 11 in the United States, which is designed to give borrowers protection from their creditors and some time to reorganize their business as a going concern, the focus of Estonian bankruptcy law is on providing value to creditors. Partly as a result, bankruptcy has the potential to be "in competition" with the privatization process. When a creditor forces a borrower into liquidation, the creditor receives the proceeds. However, when the government privatizes an enterprise, it is the government that drives the process and receives the proceeds. Although creditors will have rights in the privatization process, they may see it in their interest to take the initiative and pursue liquidation of their borrowers with overdue loans, rather than waiting for such borrowers to be privatized. As a result of this potential risk, there may be some changes to the bankruptcy law or to its implementation, to prevent its serving as a legal route to asset stripping.

Progress has been slower in completing a law on secured lending. Estonia had a draft law on secured lending prepared last fall (with the assistance of EC PHARE), but this draft law was subsequently superseded by a new draft based on Estonia's pre-1940 legislation. This draft law is currently in Parliament. The law also provides for a central registry of security interests.

The lack of a law on secured lending is considered by many Estonian bankers, as well as foreign advisers, a major impediment to lending — in particular, to long-term lending. There is little doubt that this is a contributing factor, as well as one of the factors that can be resolved at least partly by law. Such a law will assist in collateral-based lending against assets for which there is clear title, such as products made by privately owned enterprises. However, there remains considerable property in Estonia, including land and state-owned enterprises, where the assets are subject to restitution claims or where they will be privatized. Until these ownership issues are resolved — a resolution that already has been a lengthy process — the law on secured lending will have only a partial impact. Other impediments to longer term as well as to project- based lending are discussed below. The law on secured lending, although extremely important, is not a panacea.

Banks in Estonia are taxed in the same way as enterprises, at a rate of 35 percent of profit. In addition, banks are entitled to make deductions for loan loss provisions. The precise tax treatment of the provisions, however, is somewhat controversial, because of lack of clarity in the regulation. Estonian banks are permitted to set aside in reserves, including loan loss reserves, up to 25 percent of income, and this amount is deductible for tax purposes. However, the income on which the 25 percent is calculated is not well defined, and it appears that different banks use different income figures, such as net income before versus after interest expense, and so forth. A related issue is that currently the banks are lending quite a low portion of their total assets, yet are able to avoid taxes by building up 25 percent reserves that bear no relationship to the size of their loan portfolios. The U.S. Treasury advisor on taxation favors reserves based on actual loan and interest income.

In conclusion, the taxation and legal environment for the Estonian banks is well into the development process. However, although enactment of laws is extremely important, it is only one of several factors affecting the banks' operating environment. Some of these issues, such as privatization and establishment of ownership rights, can be legislated, but others, such as developing confidence in long-term interest rate stability, take time.

PRUDENTIAL REGULATION AND SUPERVISION

The introduction to this review highlighted the bank regulatory and supervisory environment as one of the critical weaknesses in the Estonian banking system. This topic can be broken down into the following categories: the nature of the information provided to the supervisory authorities, the ability of the authorities to analyze that information, and the ability of the supervisory authorities to take prompt and appropriate steps based on their analysis.

The challenge to adequate bank supervision in Estonia begins with the nature of the information provided to the Supervision Department of BoE. Estonia does not yet have standardized accounting principles; an accounting standards board has just been formed and has just begun work on this project. Furthermore, although banks are required to have their annual financial statements audited by an outside firm, this requirement has not yet been enforced. Therefore, in several cases the only check on the accuracy of the information provided to BoE is through on-site audits conducted by the Supervision Department.

The lack of standardized accounting principles has several implications; only those implications related to the banks' loan portfolios will be noted here. First, there are no prohibitions against capitalizing interest payments on past due loans or against continuing to lend to borrowers with past due loans. Second, although BoE has issued a regulation that requires provision against past due loans, this applies only to loans past due for one year or more (unless the company has gone bankrupt in the interim). As discussed earlier, it appears that provisions for and reporting of past due loans is dominated by tax considerations, rather than by the principle that financial statements must represent a bank's financial position fairly.

Estonian banks provide balance sheet and other information to BoE on a monthly basis, with some reports provided more frequently. Although a standardized chart of accounts is not yet used, a new interim format has been in use since January. This format is considered an improvement over the previous format, but it still suffers from inconsistencies in the way the underlying information is calculated. This will be partly mitigated by a project just completed to revise the financial requirements made of the banks, including balance sheet ratios based on the Basle Accord. The banks are also being provided with instructions about how to calculate these ratios. The deadline for complying with these regulations is January 1, 1994.

An additional shortcoming in the information available to the Supervision Department concerns bank ownership. Although it is known who owns the banks directly, the question of who in turn owns those owners remains largely in secrecy. As a result, concentrations in bank lending to shareholders and potential concentrations in bank ownership are not always apparent.

At least as important as the information provided is the ability of the Supervision Department staff to analyze the information promptly and accurately. Although earlier reports by foreign advisors have noted that information provided from the banks to BoE is dispersed among several departments, this process appears to have become streamlined. The Department of Statistics is the primary initial recipient of information as well as the locus of responsibility for working out what information is required. Nevertheless, it remains unclear why the Supervision Department has not played a larger role in determining what information is required from the banks.

A member of the Supervision Department commented that the volume of current demands forces the department to act as "janitors" rather than as "doctors" — it cleans up problems as they occur, but is not yet able to take steps to prevent problems from occurring. It is not completely clear why this is the case; a lack of staff seems to be too simple an answer for a central bank that has been so effective in fulfilling so many of its other functions. However, at least part of the answer does lie here; the department head, for example, was responsible for managing the recent moratorium of Revalia Bank, which clearly took time away from longer term developmental issues. In contrast to countries in which the majority of banks are still state-owned and may face political or fiscal incentives to circumscribe bank supervision, there do not appear to be similar reasons why BoE or other players would not want the Supervision Department to function effectively.

The supervisory staff currently consists of 10 individuals, who were deemed by an IMF mission to be well qualified. Staff are undergoing various training programs in different countries. In addition, their work is supplemented by an EC PHARE advisor. However, it must be stressed that progress in developing the department's capabilities moves together with improvement in the information provided to the department by the banks.

The final supervisory issue is the ability of the Supervision Department to impose credible sanctions on banks that do not report information as required or provide information that indicates corrective steps are needed. Since summer 1992, BoE has been increasing its ability to enforce its authority over the banks. Amendments to the bank law were made in July 1992 that gave BoE the right to impose moratoria on banks that were deemed in weak condition, and this authority was exercised in November. The amendments also gave BoE the right to apply economic sanctions — that is, fines — against banks that did not comply with required balance sheet ratios or clearing procedures. The existing law already gave BoE the right to cancel bank licenses under defined circumstances.

It appears at least one bank recently under moratorium was providing misleading if not false data to BoE. One would assume that the impressive exercise of authority by BoE in imposing moratoria has been a significant incentive to other banks to provide accurate data. However, one BoE staff member noted that during on-site inspections, data collection can be thwarted by banks that have something to hide. Therefore, it appears that the sanctioning power of BoE requires further strengthening. Since this power already exists in the law, one can only conclude that it must be enforced in practice. Presumably, providing more transparent financial information to better trained supervisory staff will be a step forward in this direction.

Banking legislation in Estonia is being revised. Estonia has been operating under a banking law passed in December 1989 that covered the activities of both the commercial banks and the central bank, supplemented by the charter of BoE. The banking law has had several amendments. Under the urging of the IMF, Estonia has drafted two banking laws, one on the central bank and one on financial institutions. A draft of the central bank law is currently in Parliament and a draft of the credit institutions law is before the BoE board. It is expected that both laws will be passed before the end of summer 1993. The laws are not expected to provide any major departures from the current law and statute. One of the important features of the law on credit institutions is a framework for controlling risks in lending to shareholders as well as in bank purchases of corporate equities. (To date there have been few equity investments by banks, because other operations are more profitable.) Several foreign advisers provided input into these laws based on the current banking law and central banking statute.

The current banking law attempts to maximize the independence of BoE, and consultants from the Bundesbank have made suggestions for further enforcing that independence. Clearly, the existence of the currency board bolsters BoE's independence, because it removes monetary policy from political influence. Competition between BoE and the Ministry of Finance over potentially overlapping areas of influence, such as the management of state banks, appears to be limited.

In conclusion, of the three elements of bank supervision noted at the beginning of this section, the most critical are the nature of the information provided to the Supervision Department and the Department's prompt and incisive analytical capabilities. The third issue, credible sanctions, is dependent on these other two elements and was presumably given a big boost by the moratoria. Progress is being made in both of these areas; technical assistance should focus on speeding this process up.

SECTION THREE

THE DEVELOPMENT OF THE BANKS

THE RECENT EVOLUTION AND THE CURRENT STATUS OF ESTONIAN BANKS

Prior to the perestroika era, the Estonian banking system consisted of branches of the six Soviet state-owned banks headquartered in Moscow (five specialized banks and the central bank). These branches took their orders from Moscow, and they served mainly as transfer agents for the central government. The Estonian branches had neither autonomy of action nor access to the deposits they generated, which were held in Moscow.

The perestroika era brought the beginnings of bank reform to Estonia. The first commercial bank to be formed in the Soviet Union was the Tartu Commercial Bank of Estonia, founded in December 1988. Tartu Commercial Bank was originally owned by state enterprises because there was minimal private enterprise at the time; its principal significance was its ability to act independently of the Soviet and Estonian governments.

From this period until Estonia's independence, there was considerable conflict between the Soviet and Estonian authorities regarding the Estonian banking system. In November 1989, a Soviet law was passed that allowed the Baltic republics a greater degree of economic independence, including the right to establish and organize their own banking systems. This law did not include the right to establish their own central banks, but Estonia argued that it could not have its own banking system without having its own central bank. Estonia passed its own banking law in December 1989, which included establishing BoE. BoE coexisted for two years with the Estonian branch of Gosbank (the Soviet central bank).

During this period, different relationships developed between the branches of the five specialized Soviet banks and their headquarters. The general trend, enforced by Moscow's deteriorating control in all realms, was for increased independence of the Estonian branches. Some of them were restructured as joint stock banks, with injections of capital from state-owned enterprises and the private sector. Some branches of the Agricultural Bank were spun off into individual banks. In addition, a number of indigenous private banks were formed. These different processes resulted in a total of 43 banks in Estonia by autumn 1992.

It is important to note that, because the transfer of the banking system from Soviet to Estonian hands also meant a large-scale transfer from Russians to Estonians, the banking system (particularly BoE) is largely staffed by people who, although lacking experience, are market-oriented (having no pre-established habits under the old system). This phenomenon helps explain why Estonia has taken such a strong market approach, and also helps explain the relative importance of private banks in Estonia.

In late 1992, several banks began to experience severe difficulties in making payments, brought on by an inability to recover claims against Russia — an inability that rose from Russia's freezing of assets in January 1992 — as well as by non-performing domestic loans. In November 1992, BoE declared moratoria on the activities of three banks, Tartu Commercial Bank (majority privately owned), the North Estonian Shareholders Bank (state-owned), and the Union Baltic Bank (majority privately owned). The purpose of the moratoria was to halt all the activities of these banks while BoE studied the extent of their problems and possible solutions. This process took several months, at the end of which the Tartu Commercial Bank was closed and the other two banks were merged and recapitalized. BoE then carried out its already planned relicensing process for the entire banking sector, a process whose main feature was an increase in the minimum capital requirement from EEK 3 million to EEK 6 million. As a result of the crisis and its resolution, the number of banks in Estonia dropped from 43 to 23. Ten of the smaller land banks merged into a single bank, six banks have gone into liquidation, and four closed voluntarily (presumably because of inability to raise capital).

The following observations help identify the array of existing banks:

- The leading private commercial banks are Hansa Bank and the Bank of Tallinn; smaller banks include Keila Bank, Evea Bank, and Tallinn Business Bank. Some of these banks have partial ownership by government entities and state-owned enterprises.

- BoE owns Hoiupank (the Savings Bank) and the Estonian Investment Bank (an investor and on-lender of donor credit lines).

- The Ministry of Finance owns controlling shares in the North Estonian Bank (the government commercial bank created from the merger of two banks under moratorium). It owns minority shares in the three agricultural banks (the Estonian Land Bank, the Estonian Union Bank, and Rahvabank), the Estonian Social Bank, and Innovation Bank.

- The banks based on the previous Soviet specialized banks are the Social Bank, the Bank for Construction and Industry, the agricultural banks, the Savings Bank, and the North Estonian Shareholders Bank.

- Only one foreign bank is operating, the Baltic American Bank. Foreign participation in other banks is negligible.

As Table 1 shows, even the larger Estonian Banks are quite small. Only the larger banks are highly leveraged, probably because the smaller banks have not yet been able to attract deposits. Estonian bankers worry that a single strong foreign competitor could enter and dominate the market, given the low minimum capital requirement. Further increases in the minimum capital requirement are expected.

The consolidated balance sheets for the banking sector (Tables 2 through 5) show a young system suffering from the withdrawal of foreign deposits following the introduction of the kroon and from the shock of the banking crisis. The assets of the banking sector in Estonia have been shrinking throughout the past year, from EEK 6.2 billion to EEK 4.7 billion. Only in 1993 has the decrease begun to slow. The data show a slight nominal increase in March 1993, but this is nevertheless a decrease in real terms. The decrease is concentrated in foreign-denominated (generally hard currency) deposits, which Estonian companies and individuals had been holding in local banks. At the time of the currency reform, it became illegal for Estonians to hold deposits in foreign currencies or to add to their accounts (although they could keep existing accounts). Some Estonians converted their foreign accounts to kroons, as the increase in demand deposits during September shows. However, it is clear that many of these foreign deposits left the financial system, either to be held in cash or to be invested (not quite legally) in foreign banks. Unfavorable rates paid on deposits and low confidence in the banks (in the clear absence of an implicit deposit guarantee) are further disincentives to placing deposits in the domestic banking system.

TABLE 1

BANKS OPERATING IN ESTONIA, BY SIZE OF ASSETS
March 1993
(millions of kroons)

Name of Bank	Type/Comments	Capital	Assets	Capital/Assets
Social Bank	minority state-owned, was Soviet bank	44.8	818.4	0.05
North Estonian Bank	state-owned, merger of two banks under moratorium	44.3	656.6	0.07
Hansa Bank	private	29.9	575.4	0.05
Estonian Union Bank	agricultural bank, from merger of nine land banks	57.1	495.4	0.12
Savings Bank	only retail bank, no loans, owned by central bank	1	434.1	0.002
Bank of Construction and Industry	was Soviet bank, state-owned, aimed at industry	15.1	256.7	0.06
Estonian Land Bank	agricultural bank	9.1	136.5	0.07
Tallinn Bank	private and SOE ownership	11	134.5	0.08
ERA Bank	private	7.9	82.1	0.10
Nowe Bank	private	7	71.6	0.10
Estonian Investment Bank	owned by central bank, an on-lender	70.9	70.9	1.0
Narva Commercial Bank	private	9.8	67.2	0.15
Estonian Credit Bank	private	14.1	57.4	0.25
Virumaa Commercial Bank	private	9.6	54.6	0.18
Revalia Bank	in liquidation	11.3	53.1	0.21
Esttex Bank	private	8.4	48.1	0.17
Rahvabank	land bank	7.1	46.7	0.15
Evea Bank	private, small business bank	12.2	45.5	0.27
Estonian Foreign Exchange Bank	specializes in foreign exchange	6.6	32.2	0.20
Innovation Bank	partially state-owned	5.2	25	0.20
Keila Bank	private	5.5	23.6	0.23
Tallinn Business Bank	aimed at Russian community	7.7	11.8	0.65
Baltic American Bank	foreign-owned	4	10.6	0.38

TABLE 2

CONSOLIDATED BALANCE SHEET OF THE BANKING SECTOR: ASSETS

(in millions of kroons, end of period, June 1992 to March 1993)

	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC	JAN	FEB	MAR
RESERVES	498.8	547.7	688.1	675.3	737.4	633.0	835.0	990.7	1,079.5	1,040.7
CASH	130.0	137.6	171.7	150.8	143.8	180.3	187.6	237.9	264.8	276.7
DEPOSITS WITH CENTRAL BANK	368.8	410.1	516.4	524.5	593.6	452.7	647.4	752.9	814.7	764.1
IN KROONS	210.3	315.2	425.8	437.5	510.5	365.8	571.4	736.5	810.6	759.4
OF WHICH:REQUIRED RESERVES		77.5	89.0	114.4	125.8	138.5	379.7	363.9	387.3	378.8
IN FOREIGN CURRENCY	3.4	3.4	3.4	0.0	0.0	0.0	0.1	16.3	4.1	4.7
IN RUBLES	155.1	91.5	87.2	87.0	83.1	87.0	75.9	0.1	0.1	0.0
FOREIGN ASSETS	1,968.8	2,115.1	1,748.6	1,661.3	1,749.7	1,737.3	1,585.7	885.2	706.3	702.5
FOREIGN CURRENCY	1,632.8	1,782.6	1,410.6	1,323.0	1,406.6	1,398.3	1,538.0	864.1	673.8	685.3
CASH	108.5	93.6	102.2	104.0	106.9	99.1	116.0	88.4	83.3	107.7
CLAIMS ON FOREIGN INSTS.	1,524.3	1,689.0	1,308.4	1,219.1	1,299.6	1,299.1	1,422.1	775.8	590.6	577.7
RUBLES	336.0	332.4	337.9	338.2	343.1	339.0	47.7	18.3	31.6	15.3
CLAIMS ON GOVERNMENT	57.9	68.3	85.4	94.9	110.5	125.6	14.5	308.9	331.3	331.0
CLAIMS ON CENTRAL GOVERNMENT	17.3	21.3	30.6	32.4	39.0	46.6	1.8	300.2	326.3	327.9
CLAIMS ON LOCAL GOVERNMENT	40.6	47.0	54.8	62.5	71.5	78.9	12.7	8.7	5.0	3.1
CLAIMS ON OTHER FIN.INSTITUTIONS								18.3	7.6	7.3
CLAIMS ON SOES	473.6	482.0	496.6	589.4	545.6	597.1	644.4	580.2	599.3	597.2
CLAIMS ON PRIVATE SECTOR	1,145.0	1,170.3	1,090.0	1,076.6	1,112.4	1,032.6	986.1	1,120.6	1,152.1	1,239.6
BUSINESSES, COOP & PVT. ENT.	1,108.1	1,109.6	1,036.9	1,019.8	1,031.9	951.2	900.0	1,053.4	1,077.6	1,149.0
INDIVIDUALS	36.9	60.6	53.1	56.8	80.4	81.5	86.1	67.2	74.4	90.6
OF WHICH IN FOREIGN CURRENCY	552.9	478.2	277.2	12.1	9.3	8.2	106.3	125.5	109.9	115.8
OTHER ASSETS	2,111.5	2,353.1	2,133.3	1,331.3	1,466.4	1,731.9	722.4	783.8	763.0	820.9
FIXED ASSETS	32.6	40.8	39.5	51.0	57.7	66.6	92.1	95.0	90.8	100.6
CREDITS IN TRANSIT	130.1	118.5	164.3	136.6	197.1	229.7	222.2	116.8	29.3	34.9
CLAIMS ON BANKS	36.5	23.6	50.7	163.1	106.0	273.0	152.0	310.6	237.2	301.4
UNSECTORIZED BANKS	131.8	137.8	119.3	81.7	81.7	81.7	0.9	0.2	0.2	0.2
OTHER	1,780.5	2,032.3	1,759.5	898.9	1,023.9	1,080.9	255.1	261.1	405.5	383.8
TOTAL ASSETS	6,255.6	6,736.4	6,242.0	5,428.7	5,721.9	5,357.4	4,788.1	4,687.7	4,639.1	4,739.3

Source: Bank of Estonia

TABLE 3

CONSOLIDATED BALANCE SHEET OF THE BANKING SECTOR: LIABILITIES
(In millions of kroons, end of period, June 1992 to March 1993)

	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC	JAN	FEB	MAR
DEMAND DEPOSITS	766.5	1,166.0	1,364.5	1,646.4	1,759.5	1,884.5	1,679.8	1,724.0	1,699.1	1,838.2
TIME DEPOSITS	33.3	35.9	61.7	87.6	143.9	145.1	170.2	160.1	190.4	178.0
SAVINGS DEPOSITS	244.4	21.7	32.7	57.2	65.0	75.7	78.1	60.6	47.0	48.7
FOR. NON-CONVERT. CURR.	0.0	0.0	0.0	3.5	7.7	10.1	10.3	25.1	38.0	17.7
FOREIGN CURRENCY	1,911.2	1,773.1	1,488.7	865.2	879.1	877.5	873.7	611.7	353.2	356.7
SOEs	0.1	55.1	0.1	0.2	0.0	0.1	70.7	29.8	85.4	178.0
OTHER	1,911.1	1,718.1	1,488.6	865.0	879.1	877.4	803.0	581.9	267.8	178.6
DEBTS EVIDENCED BY CERTIFICATES			0.0	0.0	0.0	0.0	0.0	0.3	0.3	0.1
COUNTERPART FUNDS	0.0	14.5	17.0	33.5	40.9	43.9	51.5	51.7	65.2	68.2
FOREIGN LIABILITIES	869.9	968.6	259.8	359.2	338.0	389.4	102.6	43.1	53.2	59.7
IN FOREIGN CURRENCY	791.6	876.9	159.6	237.1	202.1	236.3	62.0	19.3	33.8	25.5
IN KROONS	0.0	0.0	0.0	0.0	0.0	0.0	11.0	18.6	19.2	29.3
IN RUBLES	78.3	91.6	100.2	122.1	135.9	153.1	29.7	5.3	0.2	4.9
GENERAL GOVERNMENT	217.8	237.4	203.4	269.6	178.9	185.0	289.5	406.4	494.1	536.3
CENTRAL GOVERNMENT	109.1	98.7	74.3	157.0	79.3	55.4	128.9	205.3	291.0	341.2
LOCAL GOVERNMENT	108.7	138.7	129.1	112.6	99.5	129.6	160.6	201.1	203.1	195.1
LIABILITIES TO CENTRAL BANK	349.7	278.5	348.7	486.9	449.9	359.3	271.0	312.7	458.2	455.0
OF WHICH: FOREIGN CURRENCY	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BANK CAPITAL	344.3	404.8	429.3	471.3	574.6	634.9	493.9	428.0	442.3	502.1
OTHER LIABILITIES	1,518.6	1,836.0	2,036.1	1,148.5	1,284.4	1,252.2	767.4	863.9	797.9	678.6
TOTAL LIABILITIES	6,255.5	6,736.4	6,242.0	5,428.9	5,721.9	5,857.4	4,788.1	4,687.7	4,639.1	4,739.3
NOTE: Sources of Demand and Time Deposits										
OTHER FIN.INSTITUTIONS								42.3	47.8	24.7
SOEs	471.7	532.4	672.5	612.2	696.1	773.4	520.4	667.1	662.5	626.5
PRIVATE SECTOR	323.4	664.5	750.7	1,119.8	1,206.1	1,254.9	1,328.9	1,174.1	1,178.5	1,364.5
BUSINESSES, COOP.& PVT.	299.4	408.8	479.8	865.4	906.4	949.5	994.9	804.2	775.3	857.3
INDIVIDUALS	24.1	255.7	270.9	286.5	299.6	305.4	334.0	369.9	403.2	507.1
BANKERS' DRAFTS	4.6	4.8	3.1	1.9	1.2	1.2	0.7	0.7	0.6	0.6

Source: Bank of Estonia

TABLE 4

DISTRIBUTION OF ASSETS IN ESTONIAN BANKING SYSTEM
(percent of total banking system assets, from June 1992 to March 1993)

	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC	JAN	FEB	MAR
RESERVES	8.0	8.1	11.0	12.4	12.9	10.8	17.4	21.1	23.3	22.0
FOREIGN ASSETS	31.5	31.4	28.0	30.6	30.6	29.7	33.1	18.9	15.2	14.8
CLAIMS ON GOVERNMENT	0.9	1.0	1.4	1.7	1.9	2.1	0.3	6.6	7.1	7.0
CLAIMS ON SOEs	7.6	7.2	8.0	10.9	9.5	10.2	13.5	12.4	12.9	12.6
CLAIMS ON PRIVATE SECTOR	18.3	17.4	17.5	19.8	19.4	17.6	20.6	23.9	24.8	26.2
OTHER ASSETS	33.8	34.9	34.2	24.5	25.6	29.6	15.1	16.7	16.4	17.3
TOTAL ASSETS	100	100	100	100	100	100	100	100	100	100

TABLE 5

INFLATION-ADJUSTED ASSETS AND LIABILITIES
OF THE ESTONIAN BANKING SECTOR
(in millions of kroons, June 1992 to March 1993)

	JUNE	SEPT	DEC	MAR
CPI	100	157	192	209
Total Assets	6,256	3,458	2,494	2,268
Reserves (including cash)	499	430	435	498
SOE Loans	474	375	336	286
Private Sector Loans	1,145	686	514	593
Foreign Assets	1,969	1,058	826	336
Claims on Government	58	60	8	158
Deposits of Individuals	268	219	215	266
Deposits of SOEs	472	390	271	300
Deposits of Private Bus.	299	551	518	410
Deposits of Government	218	172	151	257
Liabs. of Central Bank	350	310	141	218
Foreign Currency	1,911	551	455	171
Foreign Liabilities	870	229	53	29
Bank Capital	344	300	257	240

Despite the fall in assets, banks in Estonia are excessively liquid at present. Their deposits with BoE are twice as high as required and have been increasing as a share of total assets. All reserves, including cash, rose from 8 percent of assets in June 1992 to 22 percent of assets in March 1993 (Table 4). This ratio of total reserves to required reserves declined in April and May. Deposits in foreign banks have dropped dramatically (this is where the Russian deposit write-offs appear, between December 1992 and January 1993). Loans to state-owned enterprises have gone up slightly in nominal terms, although they have decreased in real terms (Tables 4 and 5). Loans to the private sector have grown only slightly faster, becoming a more important portion of total assets, though also decreasing in real terms. The pace of loans to the private sector provides some hope that a corner has been turned. Loans to the private sector have been on the increase since January 1993.

The picture that emerges of the current banking system is one of conservatism on the part of banks, due in part to the banking crisis; caution on the part of depositors, including much avoidance of the banking system; and fragile recovery in recent months.

A popularly held notion is that banks may be making money inappropriately from foreign exchange transactions, rather than from lending. A few comments about this activity are in order. First, this type of activity is not as pervasive as might be thought, but is concentrated among a few of the more active private banks. Second, it is generally occurring on a spot basis, rather than through forward contracts, and, hence, exchange rate risk is low. Third, to the extent that it is denominated in deutsche marks, as much of it is, there is no risk, because of the peg to the kroon. The central bank is monitoring the open position of the banks (the difference between the value of assets in foreign currency and the value of liabilities in that currency) and is in the process of introducing regulations that would require banks to keep that position within limits BoE considers prudent.

THE BANKING CRISIS[1]

Causes of the Crisis

The bank failures in Estonia resulted from several causes, which affected each of the failing banks differently. Two banks, the North Estonian Shareholders Bank (NESB) and the Union Baltic Bank (UBB), had maintained reciprocal accounts with the Vneshekonombank in Russia, which had been used to facilitate trade. When Russia froze the accounts in Moscow in January 1992, assets in the Russian accounts in Estonia did not cover the losses. Prospects for eventual recovery of those assets, totaling $76 million, are unknowable. The Savings Bank also suffers from frozen accounts in Russia, as discussed below.

The remaining bank failures, particularly those of Tartu Commercial Bank (TCB) and, more recently, Revalia Bank, resulted from poor lending decisions that grew into bad loans. A large portion of the bad loans of TCB had gone to a state-owned energy company, Eesti Kutus, which had in turn been hurt by sudden changes in government pricing policy. (There is some controversy about the government's responsibilities in this issue.) Revalia's bad loans had been made largely to shareholders.

[1] This section relies in part on the International Monetary Fund, March 12, 1993, and March 22, 1993, for factual details about the crisis and its resolution. Opinions and judgments expressed are the responsibility of the authors.

Some observers have argued that the institution of the currency board in June 1992 contributed to the banking crisis, particularly because under the currency board system there is no automatic lender of last resort to help solve liquidity problems. The most compelling aspect of this point of view is the information that has been emerging over time on the amount of recoveries expected from TCB. It is agreed that depositors of the liquidated bank will lose less than originally anticipated — perhaps little or nothing. The speculation is that if TCB had received liquidity-related loans, it could have remained open.

The counterargument to this point of view is that even at TCB the problems were too serious to be dealt with simply by restoring liquidity. In fact, BoE did use its excess reserves to cope with the crisis. In October 1992, before finally concluding that a moratorium was necessary, BoE made a liquidity loan to NESB. BoE also made a loan to allow the successor North Estonian Bank to open before the formal merger process had been completed. A pure currency board system does not allow for a lender of last resort, but in a hybrid system such as Estonia's, where BoE holds excess international reserves, there is room for some discretionary support to troubled banks.

Steps Taken to Resolve the Crisis

Because the failures of NESB and UBB were seen as beyond the control of either institution, and as one more cost in the process of breaking away from the former Soviet Union, BoE treated it far differently than it treated TCB, where problems were seen to be the responsibility of bank management and ownership. BoE assisted in merging NESB and UBB into the North Estonian Bank, which was recapitalized with EEK 300 million in long-term low-interest government bonds issued by the Ministry of Finance. At the same time, the frozen assets and corresponding deposits were moved to BoE and placed in a fund known as the VEB Foundation. BoE will continue to manage the Russian accounts, repaying depositors as possible. Thus, these depositors remain at risk. The merged bank is the second largest commercial bank in Estonia, based on its capital.

TCB, in contrast, was placed in liquidation. Sales of its assets began in January 1993, and efforts to recover the major bad loans are continuing. Recoveries are passed to depositors as they are received. Branches have been sold to other commercial banks and are already operating in their new identities. Since the initial moratorium, prospects for full recovery of assets have increased, and persons interviewed gave estimates ranging from 60 to 100 percent of assets that may ultimately be recovered.

Resolution of the crisis included not only the reorganization and liquidation of the three large banks involved in the November moratoria, but also the wholesale relicensing of the banking sector. BoE had already scheduled an increase in the minimum capital requirement to EEK 6 million, effective in January 1992. Through this process, the weakest banks have closed or merged.

The banking crisis may not be completely over, as banks continue to go into liquidation. Most recently, Revalia Bank has entered a court-managed liquidation proceeding, following its acute liquidity crisis in March 1993, brought on by non-performing loans to shareholders. BoE has stated that 1993 is a year of consolidation for the banking system and that no new bank licenses will be issued.

Implications and Results of the Banking Crisis

Despite the size of the banks involved in the banking crisis, whose deposits made up 40 percent of the broad money supply,[2] the Estonian financial system weathered the crisis without undue spread effects. There was not a massive withdrawal of deposits from the system following the crisis (most of the withdrawals observed in 1992 followed the introduction of the kroon and were apparently decisions to keep foreign currency abroad). There are signs of a drop in confidence by foreign banks, but it is important to distinguish the reasons for that drop; it appears to result more from the bank failures themselves, rather than from BoE's handling of the crisis. It could be argued that, over the long term, foreign banks are likely to have more confidence in the strength of Estonia's surviving banks, because BoE has indicated that it is serious about developing a healthy banking sector.

The overall result of the crisis has been positive for the financial system in its overriding message that bad banks and their depositors will not be bailed out. This message will be more effective and faster than improvements in bank supervision in inducing banks and depositors to operate prudently. Given the current weakness in bank supervision, such a signal may be the most important single step the government can take to promote the development of a sound financial system.

The picture is not completely positive, however, and a number of caveats are called for. In order to build the kind of long-term confidence needed to bring depositors into the banking system, the crisis must be shown to be over. The problems of Revalia Bank undermine that message, seeming to indicate that Estonia could be in for a continuing trickle of bank failures. In this respect, one must ask whether BoE can now be certain the banks it relicensed were actually sound when relicensed (or whether BoE merely checked that the minimum level of capital was met), and whether banking regulations and supervision will be adequate to prevent banks from engaging in overly risky business.

Moreover, the message the government sent on government-owned banks was not as strong as the message it sent on private banks. TCB, a privately owned bank, was not bailed out; NESB, a state-owned bank, was. UBB, a private bank, was also bailed out, although it converted to government ownership. Although the arguments for different treatment of the banks because of their different problems are convincing, they nevertheless signal that the government may take a softer position toward state-owned banks.

Finally, the banking crisis revealed the inadequacy of the information available to BoE on the financial condition of banks, as well as the lack of capability at BoE to anticipate problems before they become full blown. Some bank failures may be averted by early detection, if information is more accurate and is better used.

BANK INVOLVEMENT WITH STATE-OWNED ENTERPRISES

In contrast to the attention given to the banking crisis, there has been little focus on the relationship between banks and state-owned enterprises — a relationship that has occupied the center of attention in several other CEE countries. This is in large part because bank exposure to such enterprises is not great, accounting for only one-third of all loans to enterprises and only 13 percent of total assets

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[2] International Monetary Fund, March 22, 1993, p. 38.

(see Table 2). Even if a major share of those loans go bad, as is entirely possible, the banking system will not collapse.

Loans to SOEs are not distributed evenly across banks, however, but are concentrated among a few banks, particularly those that are partly or fully owned by government, most clearly including the Bank for Construction and Industry. Privatization of large SOEs has not begun on a major scale yet, pending government and legislative agreement on the process that will be followed. However, a new bankruptcy law went into effect in September 1992, and this has resulted in creditors of all types — not primarily banks — initiating bankruptcy proceedings against several SOEs. As these bankruptcies continue, and as the formal privatization process unfolds, many SOEs run the risk of failing to repay loans. Indications of future problems include high tax and interfirm arrears in several SOEs. Before more SOE loans go bad, action should be taken to address the problems of those banks with high concentrations of such loans.

On the other side of the balance sheet, it is important to reduce or eliminate ownership of banks by SOEs. SOE ownership can be problematic because of a relative lack of banking expertise and a relative lack of attention to the bottom line among SOE owners and because of the still-prevalent view that SOE-owned banks exist to serve the credit needs of their constituency. Many banks, including many widely perceived as private, are owned in part by SOEs. For example, Tallinn Bank, a highly regarded bank, is one-third owned by state entities, although this ownership is dispersed among a variety of enterprises and municipalities. The Estonian Social Bank is also approximately one-third owned by SOEs. At least four other banks that are seen as private banks have significant SOE ownership. Existing controls on concentration of ownership (no one owner may hold more than a one-third share) and on lending to any one borrower (no more than 50 percent of capital) reduce but do not eliminate the likelihood that problems will arise from SOE ownership. SOE ownership should be watched and reduced, because of the governance factors that have been noted.

BANK SERVICES TO PRIVATE ENTERPRISE

With the exception of several specialized banks (for example, savings and agricultural banks) all the banks in Estonia aim to serve corporate clients. In less than three years, the Estonian banking system has oriented itself clearly toward private enterprises. There are now twice as many loans to private enterprises as to SOEs, and depositors are also overwhelmingly from private businesses. Banks provide two broad categories of services for their private customers — loans and payment services. These are examined in turn.

Loans

Estonian banks make few loans. Only 30 percent of total banking system assets are held in loans, and, on average, banks reported that no more than one-third of total income came from loans. Moreover, loan terms are relatively unfavorable. Nearly all loans are extended for less than one year, with most extended as overdrafts or as three- or six-month loans. Officially, banks quote their average interest rates as 30 to 40 percent, but many observers believe that most transactions occur at much higher rates. Even a rate in the 30 to 40 percent range, while not high in real terms, represents a very high spread for banks whose average cost of funds is likely to be less than 15 percent. Most loans are relatively small. Three banks quoted EEK 1 million (US$ 82,000), EEK 500,000, and EEK 250,000 as their average loan sizes. The principal reasons that loans are relatively small are because of lending for specific transactions, rather than for major investment; the size of the majority of clients, which are mostly commerce and service businesses; and limits imposed by the small size of bank capital. Loans are highly collateralized by land, buildings, equipment, and third-party guarantees, leading one observer to conclude facetiously that banks need no loan loss reserves. Some banks have begun to explore leasing, though not yet on a large scale.

Given the current excess liquidity of the banking system and the demand for credit among Estonian entrepreneurs, it becomes crucial to understand why banks are making so few loans, and what might cause them to lend more readily. There appears to be a constellation of factors, many of them interconnected and difficult to change quickly. They include:

- **Lack of clear property rights and collateral law.** As described above, some legal reforms — such as the enactment and implementation of laws on secured lending, the resolution of real property claims throughout the country, and the development of court systems capable of resolving disputes — are necessary before land and business assets can become more practical forms of loan collateral. Progress is being made on these fronts, but the issues are complex.

- **An economic environment in which high business risk is endemic**, such that prospective borrowers are correctly perceived as risky. A high proportion of prospective borrowers are new businesses lacking a track record and often undercapitalized. In the market, companies face attractive, although unfamiliar (which banks read as risky) opportunities in the West, while the better understood markets flounder: the Eastern market is moribund and the domestic market is in recession. Relatively high levels of risk are already apparent in bank loan portfolios. Banks report that problem loans among private clients far outnumber those of SOEs, although most of the private sector loans are small.

- **Lack of skills and procedures among banks and bankers for credit analysis.** As discussed more fully below, Estonian bankers are operating without a tradition of risk-based lending and are not yet systematically learning Western techniques, inside or outside their institutions.

- **Lack of reliable information from borrowers, because of the lack of accounting standards.** Without the adoption of accounting standards and their widespread use by businesses, bankers will be unable to rely on and interpret the information borrowers present to them.

- **Lack of means for banks to reduce risk through arrangements with other banks.** Until a money market develops, which will be slow given the lack of confidence among banks about one another's creditworthiness, banks will attempt to cover liquidity risk by holding excess liquidity and requiring higher interest rates on loans to compensate for the low-yielding assets. Similarly, development of credit reference practices and formal credit reference services would help banks reduce their exposure to credit risk. The Estonian Social Bank and Hansa Bank are in the process of forming a company called CreditInfo, which will provide credit references for a fee.

- **Low confidence in the stability of the financial system, causing banks to wish to maintain high liquidity.** There is at present probably overcaution induced by BoE's willingness to liquidate troubled banks. A more appropriate balance between prudence and willingness to lend will doubtless emerge over time, and temporary overcaution is not too high a price to pay for sound banks.

- **Interest rates that appear prohibitively high to borrowers,** together with the hope that inflation and interest rates will decline in the future.

- **Instability in funding sources and absence of long-term funding sources,** such that banks are willing to lend only for very short terms.

From the length of this list, it is apparent that progress on many fronts is necessary to bring about increases in lending. In fact, the arrival of active lending (including improved loan terms and products) may be considered synonymous with achievement of the goal of building a modern financial system. It should also be apparent that no single problem dominates all others in creating the conditions that will lead to increased lending. However, one might wish to separate out the problems that are amenable to specific action within the context of financial sector development, as opposed to other arenas of economic policy. They include collateral reform, improvement in bank skills, money market and credit reference development, and maintenance of confidence in the financial system.

Transactions and Payments

When bankers in Estonia speak of their customers, they are generally referring to depositors for whom they provide transaction services. Banks report making up to one-third of their income from such fee-based services. Available services are domestic money transfers and international transactions (currency exchange and international payments through documentary collections and letters of credit). There are no standard checks or credit cards. For the most part, these payments are effected quickly, as banks comply with the two-day limit for clearing transactions imposed by BoE.

However, the services are expensive and inconvenient. Time spent at banks is high, as businesses bring in bundles of cash to make multiple payments, one by one, at teller windows. Charges for some types of transfers run as much as 4 percent — sometimes more for international transactions. Many banks charge a fee for withdrawals from non-interest-bearing deposit accounts. The current state of bank services constitutes a significant drag on the efficiency of Estonian businesses that must use them, and certainly causes businesses to carry out transactions in cash to the maximum degree possible.

There are glimmers of future improvement in services. A few banks are considering introducing checking or credit card services. In addition, banks report that competition is driving down the margins on fee-based business. They report lowered prices and higher volumes of transactions.

RETAIL BANKING AND THE SAVINGS BANK

The low level of development of the retail banking business is reflected in the fact that deposits by individuals make up only 10 percent of total bank liabilities and capital, and loans to individuals constitute only 2 percent of total bank assets. Poor or costly service drives most Estonians to avoid using banks as much as they can. Salaries (even at BoE) are paid in cash, and cash is kept at home. Urban professionals with more discretionary income report buying CDs in commercial banks, although three-fourths of all individual deposits are demand deposits. Wealthier people also keep money abroad. Despite the fact that Estonians have suffered recent decreases in their real income, there should be potential for much more financial intermediation.

In the minds of most Estonians, only one bank matters — Hoiupank, or the Savings Bank. Other banks do not serve individuals or serve only a few wealthy depositors. The Savings Bank offers demand, savings, and time deposits; currency exchange; and payments services. People carry out several government-related transactions, such as payment of rent and some taxes, at the Savings Bank's more than 400 outlets. Although interest rates on deposits at the Savings Bank are very low (2 percent on savings accounts; up to 9 percent on three-year CDs), only the Savings Bank can offer a government guarantee. The guarantee, the branch network, the special role of the bank in accepting payments to the state, and low or no service charges help explain why people use the bank despite its low interest rate. In fact, there has been a shift away from sole reliance on the Savings Bank, as it appears that the bank now has between 50 and 60 percent of all individual deposits. The number of accounts at the Savings Bank (1.1 million) approaches the number of Estonians old enough to have accounts. However, the average account size is small, in the range of EEK 200-400, reflecting the current lack of savings of most Estonians and the unattractiveness of keeping money in the bank.

In the Soviet period, what is now the Savings Bank was simply the Estonian portion of the Soviet savings bank. The Soviet system required that all deposits be moved to Moscow. This policy has important repercussions today. First, the Savings Bank never developed its own ability to make loans or its relationships with other banks for which it could be a source of funding. Second, the Savings Bank lost most of its pre-1992 deposits when Russia froze its deposits. BoE (assisted by inflation) had to back these losses to individuals. At present, the Savings Bank is fully owned by BoE and breaks even on its operations. All of its deposits are required to be placed with BoE. Although this practice is prudent, it means that a major effort will eventually be needed to develop a capacity at the Savings Bank to place funds on its own.

The future of retail banking in Estonia is far from clear. Many bankers express the view that doing business with individuals is not profitable now and will not be profitable for some time to come. At the same time, it will clearly be beneficial to bring household deposits into the financial system and involve more of the banks in financial intermediation. For that reason, BoE has begun to work with the World Bank to investigate deposit insurance. At present, only Savings Bank deposits are guaranteed by the state, and it is clear from the resolution of the banking process that there is no implicit state guarantee of deposits. Preliminary concepts under discussion for deposit insurance include independence of the deposit insurance fund from BoE, limited amount of coverage, and availability only for individuals. The issue of deposit insurance and its potential effects on bank behavior (moral hazard) will need further investigation in Estonia.

BoE is considering selling one-third of its shares in the Savings Bank to Hansa Bank. Such a sale may allow the introduction of market principles into Savings Bank operations, which could be very useful, particularly if a way can be found to use Savings Bank deposits more actively. However, the appropriate relationship between a single, dominant commercial bank and a bank with a near monopoly on retail banking may need further scrutiny. The European Bank for Reconstruction and Development (EBRD) is also investigating the possibilities of developing tradable Savings Bank bonds and purchasing shares in the Savings Bank. A new statute for the Savings Bank is now in development to reorganize it as a joint stock company so that these sales can take place. Finally, it is rumored that the Finnish Postibank, a post office and savings bank, may be preparing to enter the Estonian market, which would provide direct competition to the Savings Bank.

SECTOR-SPECIFIC BANKS AND LINES OF CREDIT

A variety of institutions and mechanisms exists in Estonia for channeling credit to preferred sectors. These efforts fall into two overlapping categories — specialized state-owned banks and lines of credit (mainly from donors). State-owned specialized banks include the three agricultural banks (the Estonian Land Bank, the Estonian Union Bank, and the much smaller Rahvabank), the Social Bank, and the bank for Construction and Industry. Somewhat differently, the Estonian Investment Bank (EIB) acts as an apex institution for lines of credit. There is no housing bank at present, but one may be set up as the result of the housing privatization program now in process.

There are at least four lines of credit in effect or under discussion. A hard currency export credit line from Finland and a generalized line of credit from the European Community (EC) will pass through EIB to the commercial banks. Two agricultural lines of credit are already available in kroons — one from the government budget, and one from an American PL 480 loan. Both of these go through the agricultural banks. There is also some indication that the government may provide a line of credit for small business development.

Two of the specialized banks — the Social Bank and the Bank for Construction and Industry — are reorienting themselves as mainstream commercial banks. Public sector ownership in both has been reduced to one-third, and the banks are lending from their own deposit resources. However, both banks retain some of their original character, including exposure to SOEs. For the Social Bank, this exposure is primarily in its SOE deposit base.

The agricultural banks are two-thirds owned by farmers unions, who are in turn financed by the government budget, and one-third by the Ministry of Finance. Although the banks offer deposit and transaction services, they are essentially traditional agricultural banks, providing lines of credit at highly subsidized interest rates.

The use of specialized banks and lines of credit is an understandable response to the perceived urgency of speeding the development of certain sectors. Although one may sympathize with the aim, the means leave much to be desired. Directed credit generally undermines the development of the financial system and, in so doing, perpetuates the situation that engendered it — that is, a lack of market-based lending to the preferred sectors — thus creating dependency.

Experience with subsidized lending has been uniformly negative, because it discourages the development of profitable financial intermediation for banks that use it, and results in misallocation of real sector resources. Estonia is relatively progressive; only its agricultural sector is now dominated by this type of lending, and it has reoriented most of its other specialized institutions — the exception perhaps being the Bank of Construction and Industry, which, at the least, raises its own funds from depositors. There is a great deal of room for introduction of market forces into the agricultural banks, beginning with charging a market-related cost of funds to the banks and bringing borrower rates to market levels. The U.S. government (USG), with whose funds subsidized loans were made in 1992, should take action to help restructure the line of credit and the agricultural banks.

The foreign currency lines of credit flowing through EIB to the commercial banks should also be limited. At a minimum, they need careful redesigning if they are to contribute to, rather than retard, financial sector development. Estonian banks are already overly liquid. They do not need additional funding, but rather encouragement to lend the money they have. (However, long-term funding could be helpful for banks concerned about a tenor mismatch.) In this setting, partial guarantees could lead to an increase in lending, without removing from banks the pressure to raise their own deposits and use them to lend (although it is difficult to implement an effective guarantee system). In addition, foreign currency loans, unless made to exporters who will receive income denominated in deutsche marks or other hard currency, will expose borrowers to unnecessary exchange rate risk.

SECTION FOUR

CAPACITY BUILDING AND DONOR ACTIVITIES

This section is organized according to the following three topics: increasing of capacity at the central bank, increasing of capacity among the commercial banks, and bank training activities.

BANK OF ESTONIA

As mentioned above, the staff of BoE is young, free of habits related to the old system, and eager to learn Western central banking. While staff members are seeking opportunities to gain skills, most of their learning is done on the job or in short specialized courses offered by organizations such as the Bank for International Settlements or the New York Federal Reserve, which staff can attend only occasionally. In this context, external assistance to BoE is particularly important.

As in other countries, IMF carried out the initial work in this area through a series of diagnostic missions comprising experts from the central banks of member countries. This diagnostic work has been followed by assistance, usually on the basis of approximately two-week projects, in foreign exchange operations, monetary operations and money markets, monetary analysis, payments, accounting, supervision, and balance of payments. Further projects planned for 1993 are in foreign exchange operations and accounting.

The banking crisis provided the impetus for a joint effort by major donors, including the World Bank, EC PHARE, and EBRD, to coordinate assistance. The World Bank report resulting from that effort remains in draft. (The World Bank does not expect to make a financial sector loan to Estonia, but instead expects to cover the financial sector in a broad structural adjustment program in 1994). Last fall, BoE established an office to coordinate assistance from these and other bilateral organizations in an effort to maximize the usefulness of this assistance. This office is in the process of recording assistance that has already been provided and establishing a strategy on the basis of assistance provided to determine future assistance required.

EC PHARE's two major contributions are advisors specializing in bank restructuring and advisors specializing in training. With regard to bank restructuring, EC PHARE is currently funding one individual who will be in Estonia for six months; EC PHARE also plans to assign an advisor to the Supervision Department soon. The World Bank is providing technical advice to BoE in evaluating a possible deposit insurance program.

EBRD's assistance to BoE as part of the coordinated donor plan has focused on the Savings Bank, which is fully owned by BoE. EBRD is evaluating the possibility of assisting the Savings Bank to capitalize itself through issuing securities. This issue would also help develop the local financial market. EBRD is also considering purchasing a one-third share of the Savings Bank.

The above programs of EC PHARE, the World Bank, and EBRD were developed and coordinated among these three organizations after the banking crisis of November 1992. There has been no technical assistance provided to BoE by the U.S. government, other than a short project in 1992 to comment on the banking law prior to its revision.

Based on our discussions and observations, it appears that this assistance to BoE is well focused and is achieving good results. As will be discussed in Section Five, the one area of BoE where more technical assistance might be warranted is in the Supervision Department. The Supervision Department should be the fulcrum of efforts to strengthen Estonia's banking system. However, training in bank supervision takes a long time — five years to train a bank examiner in the United States — and, meanwhile, there are many pressing daily demands on staff.

COMMERCIAL BANKS

Many of the new commercial banks are staffed by young, bright, energetic, and westward-looking people, who have little experience with either the old system or Western banking. The banks that emerged from the old Soviet system have larger numbers of staff remaining from that period (although, in many cases, leadership has changed). Just as in the case of BoE, exposure to Western banking systems and practices is extremely important but is currently taking place haphazardly, by banks sending staff outside Estonia when demands allow.

In general, the amount of exposure to Western banking is far lower than optimal. Little technical assistance has been provided to Estonia's commercial banks. Some assistance, mostly in the form of training, is provided by correspondent banks, but this appears to be extremely limited. Furthermore, the lack of foreign bank investment in Estonia limits the possibilities of learning through technical partnerships or by trying to keep up with foreign competition. Therefore, although ideally the market would take care of the developmental needs of the banks, this is happening very slowly.

It is our conclusion that direct technical assistance to the commercial banks to speed up the development process would be highly beneficial. The economic rationale for such assistance is essentially the same as the rationale for developing training for banks. Estonia's banking system remains quite vulnerable, it is not contributing to economic growth as much as is desirable, and it may take some time before it begins to do so. An expansion of technical capacity throughout the banking system is one of the aspects of that vulnerability and is a prerequisite to preparing banks to engage in more active financial intermediation. Given the small size of the banks and the difficulty of attracting foreign expertise, direct technical assistance may be as or more effective than development of bank training institutions in helping to develop that capacity, because direct technical assistance can combine increase in staff skills with organizational change. Strong bankers without strong banks are of no use, and the best way to help banks become technically strong is to assist them internally, during a limited time.

This conclusion is based on the comments of many Estonian bankers as well as by the experience of the U.S. Treasury advisor, who has been assigned as a bank training specialist for the three Baltic states. This advisor has found that the banks in Estonia are more interested in his capabilities as an advisor than in the more formal training programs he had intended to provide. Our recommendation is that more technical assistance, in particular in the form of banking advisors, be provided to the commercial banks. Advisors in banks can work together with senior managers on strategic and operational issues, as well as on the specific needs of each bank, in ways that training programs cannot.

Although this review has emphasized that the Estonian banks appear to have a comparatively low bad loan portfolio problem, this is as much a result of the low level of lending as of sound lending practices. Technical capacity in almost all areas of banking is underdeveloped, which in turn stands in the way, along with other factors discussed in this review, of greater financial intermediation.

BANK TRAINING

Although individual advisors have a unique role to play, training on a broader scale is also important. EC PHARE has launched an ambitious effort to work with BoE to form a banking academy, and, meanwhile, it provides ongoing banking lectures. These lectures are available to the central bank and to the commercial banks, depending on the topic. There are also training programs on central and commercial banking offered outside Estonia on a bilateral basis.

The EC PHARE program appears to be only a qualified success and is currently being revamped. EC PHARE is considering moving its training focus away from the central bank and toward the commercial banks and is considering raising the complexity of the topics taught — to issues such as portfolio management, information management, and treasury management. Training and advisor services provided to individual banks are also being considered. It is not yet clear whether the revised EC PHARE program will continue to center upon the creation of a bank training academy.

The U.S. Treasury advisor was placed at the nascent Estonian Bankers Association, with the expectation that the association would develop an extensive bank training program. However, the association itself has not yet become an active organization, and plans for a bank training program are far from being realized.

SECTION FIVE

PRIORITY AREAS FOR DONOR ASSISTANCE

Based on this review of the Estonian banking system, our conclusion is that further technical assistance is needed in the following areas, and we recommend that the U.S. Government consider these areas as focal points for possible assistance:

- **Development of accounting standards and a standardized chart of accounts.** Adequate supervision of the banks hinges on the quality of information provided by the banks. Although progress is being made in developing accounting standards and standardized charts of accounts, assistance could be targeted to speed this process up.

- **Foreign audits of Estonian banks.** There is considerable vagueness in the Estonian banking system about issues such as the actual condition of loan portfolios, interlocking shareholder-borrower relationships, and the like. The banks themselves have followed various policies on auditing their financial statements. Countries such as Poland and Hungary have benefited from one-time foreign audits of commercial banks, because these have helped the banking authorities understand and quantify the potential risks in the banking system. A similar program of one-time foreign audits in Estonia could be very helpful in this regard. Perhaps these audits could be combined with implementing a new accounting system. They could also serve as a training opportunity for BoE's Supervision Department staff.

- **Advisors for commercial banks.** To date, most banking assistance in Estonia has been provided to BoE. Given factors such as the success of this assistance in strengthening BoE, the developmental needs of the commercial banks, the relative slowness of the market in addressing those needs, and the importance of the banking system to Estonia's economy, increased focus on the commercial banks appears warranted. In particular, a program of individual advisors was mentioned by several bankers as one of the most effective means of technical assistance.

- **Customized bank training.** There is no question that there is a need for more formal bank training in Estonia, but the exact format and mix are not easy to prescribe. A training package off the shelf or a trainer off the plane can easily be provided. Bankers in Estonia have an unusual mix of knowledge and skills. Many are proficient at various aspects of banking operations but have gaps of information about how market economies function. We consistently heard complaints about bank training courses that began with the ABCs of banking or provided broad overviews without practical information. Effective bank training requires understanding the needs of the banks, jointly and individually, better than is possible on short trips made by training specialists. Any training that is developed should be developed jointly with Estonian bankers and advisors working in the banks. Economies of scale might then be achieved by reproducing these training materials for any interested banks.

- **Consideration should also be given to providing further assistance to BoE's Supervision Department**, in coordination with the current efforts of EC PHARE.

This review will conclude with comments on three aspects of USG assistance: the agricultural credit program, the regional advisor program, and the overall influence of USG assistance to the banking sector. First, the team is concerned with the design of the U.S.-funded agricultural credit program, particularly as a new round of funding is negotiated. While there may be a good economic rationale for providing financial support to Estonian farmers, the chosen design is detrimental to financial sector development. Some of the problems in the design could be decreased if interest rates were increased, but the fundamental problem is the use of the agricultural banks as funnels for subsidized credit. If there is to be another round, the principles of financial sector development should be incorporated.

Second, regional advisors attempting to cover the three Baltic states strongly express the opinion that regional assignments do not work well in the Baltics. The great differences among countries (including those of language) reduce efficiency. Perhaps more important, the discontinuity of contact involved in serving three countries means that it is very difficult to develop the kinds of working relationships with counterparts that make for successful advisory services.

Finally, USG is not perceived as a prominent player in the Estonian banking sector. This is principally because of three factors. First, there is only one resident banking specialist, who is also responsible for the other Baltic states. Second, this advisor is working with the Estonian Bankers Association, which has not yet become very active. Third, the advisor has chosen to take a discrete approach and, in particular, to distance himself from the activities of BoE. This is on the assumption that the private banks with which he is attempting to build his credibility are suspicious of any programs that appear to be connected with BoE.

This review has stressed the importance of providing technical assistance to Estonia's commercial banks. Nevertheless, consideration should be given to supporting this assistance with technical assistance or at least a policy dialogue with BoE, for several reasons. First, BoE is the fulcrum of banking policy in Estonia. Therefore, if USG wants to have a more visible and policy-oriented role in providing technical assistance to banking in Estonia, BoE is the prime contact. Second, the type of hands-on technical assistance provided by bank advisors working in the banks can be delivered most effectively when it is part of deliberate overall technical assistance program worked out between USG and BoE. For example, if USG were to provide technical assistance to BoE's Supervision Department, that advisor would be able to provide important input on which banks were in the most need of various types of individualized assistance. Third, advisors working with the commercial banks would be able to give feedback to a BoE advisor or primary USG contact at BoE regarding BoE activities that affect the banks, such as the development of a training academy.

One final note places these recommendations in the larger context of CEE financial sector development. An argument could be made that Estonia has made sufficient progress toward developing a market-based banking system that USG could deploy its resources more effectively by focusing them on countries where the banking systems have not made as much progress. If this argument is accepted, then it would make sense to deploy future activities mainly in Lithuania and Latvia. The counterargument to this is that Estonia could provide an important demonstration effect and that therefore every effort should be made to ensure that its banking system survives this still-vulnerable phase. In that case the USG program would have a greater impact if the current (and potentially expanded) technical assistance for the commercial banks were supplemented by improved contacts with BoE, through direct technical assistance or an ongoing policy dialogue. Our overall recommendation is that a few tightly focused technical assistance programs are more effective than a large number of programs with regional scope.

ANNEX A

PERSONS INTERVIEWED

PERSONS INTERVIEWED

Mr. Brewster Campbell
U.S. Treasury Advisor

Mr. Adrian de Graffenreid
A.I.D. Representative

Mr. Riho Hagel
Vice President
Estonian Land Bank

Ms. Liia Hanni
Minister for Reforms
Government of Estonia

Mr. Thomas Hart
Advisor to the Baltic Republics
U.S Treasury Department

Mr. Allan Karell
Chief Dealer
Bank of Estonia

Ms. Katrin Kvell
Foreign Aid Coordinator
Bank of Estonia

Ms. Lidia Levchenko
Vice Chairman of the Board
Bank of Industry and Construction

Mr. Andrus Maran
Executive Director
Finest Vendors

Mr. Heldur Meerits
Vice Chairman
Hansabank

Mr. Erik Nigola
Vice Chairman of the Board
Estonian Social Bank

Mr. Mikhel Nommela
Acting Head, Banking Statistics and Analysis Department
Bank of Estonia

Mr. Heiti Pakk
Personnel Director
Savings Bank

Mr. Jukka Paljarvi
IMF Representative to Estonia

Ms. Mai Parras
Director
Linette Co.

Mr. Raivo Pavlov
Head of Banking Department
Ministry of Finance

Dr. Aivo Rainer
General Secretary
The Exchange Association of Estonia

Mr. Jan Rapacki
Coordinator for Foreign Assistance
EC PHARE Program

Mr. Andres Root
Partner
KPMG Estonia

Mr. Martti Siimann
Manager, International Department
Bank of Tallinn

Mr. Andres Sutt
Officer, Department of Monetary Policy
Bank of Estonia

Mr. Margus Tilga
Head, Bank Supervision Department
Bank of Estonia

Mr. Sven Tolp
Deputy Head
Central Banking Policy Department

Mr. Harry-Elmar Volmer
President
Estonian Land Bank