Banking in the Baltics – The Development of the Banking Systems of Estonia, Latvia and Lithuania since Independence

The Emergence of Market-Oriented Banking Systems in Estonia, Latvia and Lithuania (1988–1997)[1])

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1 Introduction

Banking reform has proved to be one of the most difficult elements of structural reform in economies in transition. So far, nowhere in the transition world does a banking system appear to have emerged yet that would deal with the basic function of efficient financial transmission in a satisfactory manner. This goes particularly for most countries of the former USSR. But the Baltic states have obviously developed in a substantially different manner than their ex-Soviet neighbors, with whom they arguably share a common point of departure. This study will attempt to outline the major reasons why the Baltic countries and their banking sectors have been so successful in "taking off" and outstripping their Eastern neighbors and in their establishment of market-oriented systems. The subject of this study is the development of banking in the Baltics from the collapse of the USSR up to the point in the second half of the 1990s when, after having weathered their first profound crises, relatively stable market-oriented Baltic banking sectors emerged. Moreover, at this point a first break-through toward successful financial intermediation between savers and the real sector occurred. Reference is made to the relatively calm period immediately preceding the Asian and Russian economic crises of 1997 to 1999.

The comparative analysis of the development of the Estonian, Latvian and Lithuanian banking sectors from 1988 to 1997 is carried out in four main chapters. Although respective evolutions have been at variance, it is possible to discern a number of common successive stages of development in all three countries. Chapter 2 deals with the late Soviet period (from the end of the 1980s to late 1991). Chapter 3 examines independence, currency reforms and the initial expansion of banking sectors (which took place at different periods during the first half of the 1990s). Chapter 4 covers the establishment of fixed exchange rate regimes and the tightening of banking regulations and analyzes ensuing banking crises (around the mid-1990s). Chapter 5 reports on recovery from the crises and temporary stability (up to late 1997), which was followed by the impact of the Asian and Russian crises.[3]) Chapter 6 summarizes the study and draws some conclusions.

Generally, the study attempts to give a concise overview over historic evolutions and interrelationships. Topics covered comprise legal foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring and the role of foreign banks and foreign direct investment (FDI). Where necessary, the major traits of real sector development will be briefly outlined, given their importance for the state of health of banks.

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3 *The Asian and Russian crises and the dynamic period of changes following them (up to the present) is dealt with in the study by Martin Ådahl on "The Internationalization of Baltic Banking (1998–2002)" immediately following this analysis.*

2 Soviet Period (until August 1991)

The paths of transformation of the Baltic banking systems started from a quite common point of departure: In 1988 the Soviet monobank system was formally changed into a two-tier banking system, consisting of Gosbank (the State Bank of the USSR) and a number of specialized state-owned institutions: Promstroibank (Industry and Construction Bank), Agroprombank (Agricultural Bank), Zhilsotsbank (Residential Construction and Light Industry Bank), Vneshekonombank (Foreign Economic Relations Bank) and Sberbank (Savings Bank). Gosbank as well as the specialized banks had branches in all Union republics, including the Baltic republics. In 1989 Soviet enterprise and banking legislation allowed the creation of (private) cooperatives, including banking cooperatives. This was the initial step for establishing commercial banks. Tartu Commercial Bank in the Estonian Republic was the first commercial bank established in the Soviet Union (1989).[1])

As the political decentralization of the USSR accelerated, the Baltic republics seized the opportunity to achieve greater economic and political independence. In December 1989 the Estonian authorities passed their own banking law, which reestablished Eesti Pank as the central bank of the republic, after almost half a century of control by Gosbank, whose branch, however, continued to exist and function in Tallinn. Given that the Soviet ruble remained Estonia's currency for the time being, Eesti Pank's authority was confined to monitoring commercial banks. In February 1990, Lietuvos Bankas, the Lithuanian central bank, was founded. In July 1990 Latvijas Banka, the Latvian central bank, followed. They too initially focused their attention on the banking sector. Eventually, the three central banks started preparations for the introduction of national currencies.

Given the further weakening of Soviet power, increasing macroeconomic instability and lax or nonexistent banking regulations and supervision, the number of credit institutions established in the Baltic republics (and in other parts of the former USSR) started to expand strongly. Barriers to entry were very low: Minimum capital requirements initially amounted to RUB 5 million (equivalent to about USD 100,000 at end-1991) and were quickly eroded by mounting inflation. The total number of commercial banks in the Baltics grew from about 20 in 1989 to over 50 in the fall of 1991. The main sources for quick earnings in this situation were foreign currency speculation and short-term foreign trade arbitrage transactions between the former USSR and the West.[2]) Many banks were set up specifically to finance such deals. In some cases credit institutions were also established to provide cheap financing for their owners/owner enterprises.[3])

In 1990 most of the Soviet specialized state-owned banks in Estonia were restructured into joint stock companies and toward the end of the year became independent of their headquarters in Moscow. Most of them in fact came under

1 *Korhonen (1996, p. 33).*

2 *As long as the prices of many commodities in the former Soviet Union and the world markets differed substantially, there were considerable profit-taking opportunities to be had from e.g. purchasing raw materials in Russia and reexporting them to the West.*

3 *Such banks often functioned like extended financial departments of respective firms and were called "pocket banks."*

control of the Estonian authorities. In the course of 1991 the Latvian and Lithuanian central banks took over the majority of the specialized banks in their republics and thus, at least temporarily, took up commercial banking themselves. A notable exception were the republican branches of Sberbank, which for the time being remained connected to the all-Union Sberbank, since most of their assets were held and effectively frozen by the Soviet headquarters. Whatever the reorganizational measures, the specialized banks largely continued to allocate credits to their traditional clients – big industrial enterprises, collective farms and other institutions, with scant regard for profitability.

3 Independence, Currency Reforms, Initial Expansion of Banking Sectors

Independence achieved by the Baltic states in August 1991 enabled them to decisively push forward and accelerate market-oriented reforms, establish their own currencies and reintegrate into the world economy after half a century of isolation. This isolation had been very profound and was characterized by a strong dependence of the Baltics on raw material and energy deliveries from the rest of the USSR in exchange for (heavy) industrial products sold almost entirely on the Soviet market.[1])

The collapse of the centrally planned economy and the foundering of ties with the former Soviet Union were accompanied by the collapse of exports to the Baltics' eastern neighbors in 1990 to 1991 and the energy price shock of 1992, when Russia substantially increased its export prices for oil and other raw materials. The combination of the above-mentioned factors triggered precipitous declines of economic activity. In the four years from 1990 to 1993, according to official estimates, real GDP plummeted by a cumulative 35% in Estonia, by 45% in Lithuania and 48% in Latvia. This was only partly compensated for by an expanding unregistered, informal sector.

Toward the end of 1991 and early in 1992 the Baltic branches of Gosbank were taken over by the respective national central banks. However, the Baltic countries at this point were still part of the ruble area. This coincided with a situation where the supply of rubles from Russia was disrupted more and more. Urgent measures became necessary to maintain monetary equilibrium.

3.1 Estonia (until the Autumn of 1992)

Estonia opted for the boldest and swiftest strategy to solve its monetary problems. In June 1992 the Soviet (Russian) ruble was fully replaced by the final new currency, the Estonian kroon. At the same time, a currency board regime, Eesti Pank was established and linked the kroon to the Deutsche mark (DEM 1 = EEK 8). This new monetary framework meant that the role of Eesti Pank as a lender of last resort was strongly restrained and confined to exceptional situations. With the currency board regime, central bank lending to commercial banks is only possible if there are sufficient excess reserves surpassing the amount of foreign exchange reserves necessary to match the currency in circulation. This has been the case in Estonia, where reserves expanded strongly in the years following the inception of the currency board.

1 *Most of the factories participating in this division of labor had been erected by the Soviet authorities.*

The currency board regime proved successful in combating inflation. End-year CPI inflation, boosted by price liberalization in 1991 and 1992, had grown to about 950% in 1992, but was brought down to 36% in 1993 (table 1). Strict fiscal policies constituted another element of successful macroeconomic stabilization. True enterprise privatization started in 1992, with small-scale privatization soon accompanied by tenders and direct sales of a number of larger firms. A bankruptcy law also applicable to banks was passed in September 1992.

After being corporatized, most of the former specialized state-owned banks were (indirectly) privatized as a result of the privatization of their owner companies. In 1992 Eesti Pank took over the Savings Bank and guaranteed the deposits of the bank. The successful monetary reform decreased the opportunities for quick profits from currency speculation. Moreover, the large number of participants in the foreign exchange market must have contributed to pushing down returns on these transactions. Lack of professional banking know-how, continued weak supervision and frequent insider lending practices giving rise to bad loans added to the destabilization of the young Estonian commercial banking sector. In the fall of 1992, the first Baltic transition-era banking crisis – and one of the first such crises in any transition country – loomed in Estonia.

Table 1

Banking Sector-Related Indicators for Estonia (1991 to 1997)

Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Consumer price inflation (year-end)	Deposit rate (over 12 months, year-end)	Lending rate (over 12 months, year-end)	Domestic credit (year-end)	Domestic credit to the private sector	Nonperforming loans	EBRD index of banking sector reform (1 to 4+)[1]
	number	%		*% p.a.*		*% change*	*% of GDP*	*% of total loans*	
1991	..	..	304	..	..	..	18.8	..	1.0
1992	..	..	936	..	..	30	7.6	..	2.0
1993	21 (1)	25.7	35.6	..	..	53	11.1	..	3.0
1994	22 (1)	28.1	41.7	8.8	17.5	42	13.4	3.5	3.0
1995	18 (4)	9.7	28.9	8.7	15.8	59	14.7	2.4	3.0
1996	15 (3)	6.6	14.8	10.5	13.9	92.5	19.2	2.0	3.0
1997	12 (3)	0.0	12.5	10.8	11.2	78.3	26.4	2.1	3.3

Source: EBRD.

[1]) 1 means little progress beyond establishment of a two-tier system; 4+ corresponds to standards and performance norms of advanced industrial economies, provision of full set of competitive banking services.

3.2 Latvia (until the End of 1993)

Latvia implemented a step-wise currency reform. First, an interim currency, the Latvian ruble, was issued alongside the Russian ruble at an exchange rate of 1:1 in May 1992. Latvijas Banka maintained this exchange rate until mid-July 1992, when the Latvian ruble became the sole legal tender in the country. The exchange rate was also delinked from the Russian currency; inflation in Russia increasingly outstripped that in Latvia. The Latvian ruble was floated against all currencies. After some delays, the permanent currency, the Latvian lats, was introduced in March 1993 (rate of exchange: LVB 200 = LVL 1). Again, the interim currency was only gradually phased out, and Latvian ruble notes were finally withdrawn from circulation in October 1993.

Latvia, too, proved to be quite successful with disinflation and macrostabilization. Given the central bank's restrictive monetary policy, largely carried out by foreign exchange and open market transactions, end-year CPI inflation fell from a triple-digit level to 35% in 1993. The fiscal stance was substantially

tightened in 1992 and remained tight in the following years. As opposed to small-scale privatization, the privatization of large companies initially lagged behind other areas of reform. Although a bankruptcy law had been passed in 1991, it proved ineffective in the first years of transition.

In 1992 the Latvian government took over Sberbank in Riga. The central bank law passed in May 1992 stressed the independence of Latvijas Banka, and the commercial banking law passed the same month provided the legal foundations for market-oriented banking in Latvia. In mid-1993 the central bank separated itself from the commercial branches it had acquired two years earlier. Some branches were auctioned off to private commercial banks, some were made independent credit institutions, some were liquidated, and the remaining branches were consolidated into a new government-owned commercial bank, Universal Bank. Thus it can be said that this change finally brought about a two-tier banking system in Latvia.

With the number of credit institutions continuing to rise, the central bank tightened or, in some instances, started to seriously apply, banking supervision rules. Among other things, capital requirements were raised, credits granted to single borrowers were capped at 50% of a bank's own capital, banks were required to start evaluating the quality of their credit portfolios. To ensure compliance, on-site inspections were launched. This curbed the growth of the number of new banks in Latvia, which nevertheless reached a maximum of 62 at end-1993 (table 2).

The stricter regulations and supervision added to other forces that were changing the environment for banking business in Latvia. Apart from the fading of earnings from currency speculation, the profits from financing trade deals between Russia and the West started to gradually disappear. Latvian banks were more involved than others in such trade deals, and were thus hardest hit by the shift.[1]) These factors contributed to reducing the profitability of most banks and forced them to focus increased attention on their loan portfolios, which were often in a weak condition.[2])

Table 2

Banking Sector-Related Indicators for Latvia (1991 to 1997)

Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Consumer price inflation (year-end)	Deposit rate (short-term, under 1 year, year-end)	Lending rate (short-term, under 1 year, year-end)	Domestic credit (year-end)	Domestic credit to the private sector	Nonperforming loans	EBRD index of banking sector reform (1 to 4+)[1])
	number	*%*		*% p.a.*		*% change*	*% of GDP*	*% of total loans*	
1991	14 (. .)	. .	262	. .	. .	91	. .	. .	1.0
1992	50 (. .)	. .	959	. .	. .	304	. .	. .	2.0
1993	62 (. .)	. .	35.0	28.4	70.8	146	. .	. .	2.0
1994	56 (. .)	7.2	26.3	18.8	36.7	72.3	15.9	11.0	3.0
1995	42 (11)	9.9	23.1	15.0	31.1	– 28.2	7.4	19.0	3.0
1996	35 (14)	6.9	13.1	10.0	20.3	6.0	6.8	20.0	3.0
1997	32 (15)	6.8	7.0	5.3	12.1	39.3	10.5	10.0	3.0

Source: EBRD.

[1]) 1 means little progress beyond establishment of a two-tier system; 4+ corresponds to standards and performance norms of advanced industrial economies, provision of full set of competitive banking services.

1 *According to some estimates, during the early years of transition, Russian transit trade and financing made up as much as a fifth of the country's GDP. See Jones (1998, p. 51).*

2 *Korhonen (1996, p. 36).*

3.3 Lithuania (until the Beginning of 1994)

Lithuania's monetary reform was generally conducted in a similar way to Latvia's: A temporary currency was launched, followed by a permanent one. In May 1992 the talonas (coupon) was introduced alongside and at par with the ruble. Rubles were withdrawn from circulation at end-September 1992; after that, they were regarded as foreign currency and could be exchanged for talonai at the market exchange rate. The Lithuanian permanent currency, the litas, was finally put into circulation in June 1993. In August 1993 the litas became the sole legal tender.

Disinflation was not achieved in Lithuania as quickly as it was in its two Baltic neighbors. Inflation surpassed 1,100% in 1992 and still reached about 190% in 1993, before it descended to 45% in 1994. Unlike in Estonia and Latvia, monetary policy remained more accommodating in 1992 and was strongly tightened only in 1993. Fiscal policy was also somewhat looser than in the other two Baltic countries and featured general government deficits of 3.3% of GDP in 1993 and 5.5% in 1994. While privatization of small businesses progressed swiftly, large-scale privatization in the first years of independence was preferably carried out through MEBOs (management and employee buy-outs). The new owners, many of them worker collectives, often lacked necessary capital and know-how for restructuring and favored job security over labor shedding. A bankruptcy law was enacted in September 1992, but supporting regulations were not passed until several years later.

Like its Latvian counterpart, Lietuvos Bankas soon divested its commercial banking operations. After some sales, in September 1992 the remaining commercial branches of the central bank were separated from the latter and organized into the State Commercial Bank of Lithuania. This can be seen as the definite establishment of a two-tier banking system in the country. Like its predecessors, former specialized state-owned banks, the State Commercial Bank's major activity was granting credits to (former) state-owned enterprises. Its loan portfolio was therefore poor in quality. The same goes for the state-owned Agricultural Bank, which extended subsidized credit to the farm sector. The majority interest in the Savings Bank was taken over by the state.

Newly founded private banks specialized on foreign currency deals, which remained lucrative throughout 1993, as well as on financing trade. On the other hand, due to a number of obstacles (including a lack of information and the above-mentioned bankruptcy regime), medium- to long-term credits to the new private sector remained largely unavailable. This hampered private sector growth. While the commercial banking law of July 1992 introduced prudential regulations, these only started to be seriously enforced in the following year. Capital adequacy standards were established and minimum capital requirements raised. The total number of banks climaxed in 1993 and then started to fall.

Table 3

The Baltic Banking Sectors – Chronology of Some Important Events (1988 to 1997)

	Former USSR-Related Events
1988	– Soviet monobank system changed into two-tier banking system, consisting of Gosbank (State Bank of the USSR) and a number of specialized state-owned banking institutions
1989	– Soviet enterprise and banking legislation allows creation of (private) cooperatives, including banks – Establishment of Tartu Commercial Bank in the Estonian Republic, the first commercial bank established in the Soviet Union

	Estonia	Latvia	Lithuania
1989	– December: Estonian banking law adopted, reestablishment of Eesti Pank	–	–
1990	– Estonian authorities assume control of most Soviet specialized state-owned banks in the republic	– July: Latvijas Banka founded	– February: Lietuvos Bankas established
1991	–	– Fall: Latvijas Banka takes over most Soviet specialized state-owned banks – December: Latvijas Banka acquires Riga branch of Gosbank	– First half year: Lietuvos Bankas takes over most Soviet specialized state-owned credit institutions – December: Lietuvos Bankas acquires Vilnius branch of Gosbank
1992	– January: Eesti Pank takes over Tallinn branch of Gosbank – April: Eesti Pank takes over (former state-owned) Savings Bank – June: currency reform: Soviet (Russian) ruble fully replaced by the final new currency, the Estonian kroon; establishment of currency board linking the kroon to the Deutsche mark (DEM 1 = EEK 8), therefore restricted lender of last resort function – Privatization of most former specialized state-owned banks – September: bankruptcy law (also valid for banks) adopted – October: prudential requirements strengthened – Fall: first Baltic transition-era banking crisis breaks out in Estonia – November: Eesti Pank suspends operations of the country's three largest banks; Tartu Commercial Bank is closed and liquidated, the other two institutions are merged and recapitalized (North Estonia Bank)	– May: interim currency, the Latvian ruble, introduced alongside Soviet (Russian) ruble – May: central bank and commercial banking laws adopted, providing legal foundation for market-oriented banking – July: Latvian ruble sole legal tender, government takes over Savings Bank	– May: temporary currency, the Lithuanian talonas (coupon), introduced alongside the Soviet (Russian) ruble – July: commercial banking law adopted – September: ruble withdrawn from circulation – September: bankruptcy law enacted – Lietuvos Bankas divests most of its commercial banking operations, remaining commercial activities are separated from central bank and organized into State Commercial Bank
1993	– May: new central bank law confirms independence of Eesti Pank – June: privatization/sale of a third of Savings Bank to Hansapank; later, EBRD acquires another 30%	– March: permanent currency, the Latvian lats, introduced – Mid-year: Latvijas Banka separates itself from the commercial branches it had acquired two years earlier; some are privatized, some liquidated, some consolidated into state-owned Universal Bank – October: Latvian lats sole legal tender	– June: permanent currency, Lithuanian litas, introduced – August: litas sole legal tender
1994	– Spring: state treasury withdraws deposits from Social Bank (former Zhilsotsbank, largest credit institution at the time), bank suffers serious liquidity and solvency problems – Fall: after strong liquidity support Eesti Pank acquires majority stake in Social Bank	– February: launch of de facto fixed peg of lats to SDR (SDR 1 = LVL 0.8), Latvijas Banka applies currency board-like monetary regime	– April: adoption of currency board regime, peg of litas to U.S. dollar at rate of USD 1 = LTL 4; lender of last resort function restrained – December: new laws on Lietuvos Bankas and on commercial banking enacted – December: Lithuanian Development Bank founded; purpose: support economic development by financing private investment; shareholders: government, EBRD

Table 3

The Baltic Banking Sectors – Chronology of Some Important Events (1988 to 1997) – cont.

	Estonia	Latvia	Lithuania
1995	– January: new credit institutions law becomes effective, International Accounting Standards (IAS) obligatory for banks – May: Social Bank's license withdrawn, transfer of its deposits and part of its assets to North Estonia Bank (fourth-largest bank), remainder of institution turned into asset recovery agency	– First half year: banking crisis unfolds, involving Banka Baltija (largest commercial bank of the country); authorities engage in restructuring negotiations, while managers reportedly strip bank of USD 260 million of assets – May: Banka Baltija declared insolvent, chairman and president arrested – Mid-year: after strengthening of supervision and release of IAS-based financial statements, the activities of about a dozen banks (35% to 40% of banking sector assets) are suspended; bankruptcy procedures ensue – December: Banka Baltija declared bankrupt	– December: central bank suspends activities of Lithuanian Innovation Bank (largest private credit institution) and of Litimpeks Bank, directors arrested; this triggers banking crisis
1996	–	– January: new banking law effective – Capital adequacy requirements adjusted to 10% – A number of credit institutions create extensive information and business networks in Russia, exploit interest rate differentials with Russian markets (GKOs) – Latvijas Banka establishes rigorous bank inspection regime (six on-site inspections per year) – Unibanka (largest remaining state-owned bank) privatized through sales of majority stakes to foreign investors, including the EBRD – June: Hansapank (Estonia) acquires Deutsch-Lettische Bank (third-largest bank), now Hansabanka (Latvia) – December: comprehensive bankruptcy law comes into force	– January: emergency partial deposit insurance law enacted – Restoration of operations of Lithuanian Innovation Bank and of Litimpeks Bank – August: recapitalization of three large majority state-owned banks launched (Agricultural Bank, Savings Bank, State Commercial Bank) – August: establishment of Turto Bankas (Property Bank), an asset recovery agency – Second half year: revocation of licenses of a number of (smaller private) banks that did not fulfill strengthened prudential requirements
1997	– January: Eesti Ühispank (Union Bank of Estonia) takes over North Estonia Bank – Commercial banks substantially increase stakes in leasing firms, investment funds and insurance companies, many of them listed on Tallinn Stock Exchange – October: Eesti Pank moves minimum capital adequacy ratio from 8% to 10% (of risk-weighted assets) – Fall 1997: following Asian crisis, partial contagion, collapse of Tallinn stock market, some banks' balance sheets weaken	– Privatization of Latvijas Krajbanka (Savings Bank) launched – Eesti Hoiupank (Savings Bank, Estonia) purchases controlling stake in Latvijas Zemes Banka (Latvian Land Bank)	– January: IAS introduced for banks – Spring: liquidation of Lithuanian Innovation Bank – June: amendments to deposit insurance law passed, providing for equal partial protection of depositors at state-owned and at private banks – Parliament exempts all three large state-owned credit institutions (Agricultural Bank, Savings Bank, State Commercial Bank) from meeting capital adequacy requirements, pending their planned privatization – Consolidated supervision introduced – Minimum capital adequacy ratio raised to 10%

4 New Exchange Rate Regimes, Tightening of Banking Supervision, Banking Crises

4.1 Estonia (until the End of 1994)

As mentioned above, the establishment of the currency board strongly changed the environment for banking business in Estonia. In the fall of 1992, a number of banks became illiquid. After granting some initial liquidity assistance without visible impact, Eesti Pank in November 1992 took a decision to suspend the operations of the country's three largest commercial banks.[1]) The actual factors which led to the failures varied from bank to bank. Tartu Commercial Bank was saddled with unprofessional management and had engaged in insider and connected lending practices (inherited from Soviet banking culture) which ended in insolvency. Northern Estonian Bank and Union Baltic Bank suffered from the freeze of their assets deposited at the Vneshekonombank in Moscow. Tartu Commercial Bank was closed and liquidated under the newly adopted bankruptcy law. Depositors received only modest reimbursement. The other two credit institutions were merged and recapitalized by government. The new entity was called North Estonia Bank.

After these first major restructuring measures, the banking sector remained unstable in 1993, but serious problems only showed up in smaller banks that year. In October 1992 minimum capital requirements had been raised (from EEK 500,000 or formerly RUB 5 million) to EEK 6 million and were later raised further. Eight small credit institutions could not meet the requirement and were liquidated in early 1993. In March 1993 ten other small rural banks were merged into a new bank, Union Bank of Estonia (Eesti Ühispank). Two further credit institutions that had engaged in extensive insider lending to companies holding shares in them went bankrupt and were shut down without any compensation payments in 1993. Thus the total number of Estonian credit institutions was almost halved in the course of one year and fell from a maximum of 42 at end-1992 to 21 at the end of 1993 (see table 1). Another element of bank restructuring in 1993 was the privatization/sale of a third of the Savings Bank to Hansapank by competitive tender. Later on, another 30% of the Savings Bank was sold to the EBRD. Hansapank had been created from the Tallinn branch of the former Tartu Commercial Bank after a management buyout in early 1992.

The new central bank law of May 1993 confirmed the status of Eesti Pank as an authority independent of government. Although prudential regulations were tightened in 1993, these steps were not enough to prevent a new crisis. Toward the end of 1993, an Estonian interbank market started to develop. In spring 1994 the state treasury decided to withdraw deposits from the Social Bank, the descendant of the former Estonian branch of Zhilsotsbank. The authorities cited the need to diversify risks and moved some funds to other banks. The Social Bank had acted as the government's main fiscal agent and was also engaged in trade financing and connected lending.[2]) The withdrawal of resources triggered serious liquidity and solvency problems. The Social Bank quickly

1 *These institutions are reported to have accounted for almost a third of the combined balance sheet of the Estonian banking sector. See table 5.*

2 *At end-1993 the Social Bank represented about 20% of the country's total commercial bank assets.*

became the largest borrower on the interbank market, which, in turn, became overburdened.

But in this crisis situation Eesti Pank reacted differently from the way it had reacted in the past. In August and September 1994 strong liquidity support was granted (6% of the base money of that period).[1]) But financial problems continued to plague the Social Bank, and in the fall of 1994 Eesti Pank decided to acquire a majority share in the institution. In May 1995, the Social Bank's license was withdrawn and creditors – but not shareholders – were fully compensated by the government. The bulk of the Social Bank's deposits and an equivalent amount of its assets were transferred to North Estonia Bank. The remainder of the institution was turned into an asset recovery agency, which finally wound up its activities in August 1996.

In mid-1994 Hansapank and Eesti Ühispank became the largest credit institutions of the country. As regards commercial banks' favored sources of earnings, after the decline of currency speculation and foreign trade financing, banks increasingly turned to short-term lending to the real economy. After some time, loans shifted to slightly longer terms. Notwithstanding the banking crises, the overall macroeconomic situation stabilized from 1992 to 1994, although GDP still contracted considerably in 1993. Inflation amounted to 42% in 1994. In the same year current account deficits started to emerge, but they were more than fully covered by FDI. Privatization of large enterprises has favored strategic investors.

4.2 Latvia (until the End of 1995)

Since February 1994, the Latvian monetary authorities have applied a fixed exchange rate regime, although this has been done informally. The lats was pegged to the Special Drawing Right (SDR) in a ratio of SDR 1 = LVL 0.8 (which has remained unchanged to date). Latvijas Banka has followed a currency board-like monetary stance of holding enough foreign exchange reserves to "cover" the domestic currency in circulation. Over the years, it has strictly adhered to its anti-inflationary stance, as witnessed by the fact that Latvia has boasted the lowest inflation rate in the Baltics during most of the 1990s.

Until end-1994 overt problems in the Latvian banking sector were confined to insolvencies of some smaller banks. The major crisis evolved in the first half of 1995 and concerned Banka Baltija, the biggest credit institution of the country at the time. Banka Baltija held over a quarter of all assets and about 30% of all bank deposits in Latvia, including around 200,000 deposits belonging to households. In March 1995 Banka Baltija, which had followed an aggressive and risky expansion strategy, took over two medium-sized banks, Latvijas Depozitu Banka and Centra Banka. Both institutions were in financial trouble and already had ownership and interbank links with Banka Baltija. Despite attempts of the new owner to rescue the two banks, both went bankrupt two months later.

This weakened the situation of Banka Baltija, which started to exhibit growing liquidity problems. The central bank initially responded with liquidity injec-

1 *This high liquidity support was possible because the Estonian monetary authority had already built up a sizeable amount of excess reserves by 1994.*

tions, but when the insolvency of Banka Baltija became evident, the support was terminated. Yet, rather than moving to close Banka Baltija, the authorities began negotiating with the institution's management and owners to work out a restructuring plan. While these negotiations proceeded, managers were reportedly able to strip the bank of some USD 260 million of assets and transfer part of them to a Russian financial institution.[1]) Banka Baltija was finally declared insolvent in May 1995; its chairman and president were arrested on charges of fraud and other criminal activities and Latvijas Banka took over the management of the bank, which was renationalized.

Another blow came from the release of, or failure to release, International Accounting Standards-based financial statements for 1994 by April 1, 1995. The monetary authorities, pursuing a far-reaching initiative to strengthen prudential norms and adjust accounting rules, had required that all commercial banks' financial statements be brought into line with international accounting standards and be audited by international accounting firms. Two thirds of reporting banks signaled losses for 1994, and Banka Baltija and some others failed to observe the deadline. In the end, the activities of about a dozen banks were suspended. They accounted for about 35% to 40% of the assets of the sector and for more than half of all household deposits (table 5).

With national elections approaching, the authorities initially opted for a plan to resolve the crisis which combined closure of the failed banks with partial compensation payments for all depositors. But the chosen strategy eventually turned out to be too costly for the central bank as well as the state budget. Banka Baltija was declared bankrupt in December 1995, and the new government decided to discontinue the program. The majority of depositors were left to collect their share of recoverable assets via bankruptcy procedures.[2]) Thus, this severe banking crisis was finally resolved in a quite harsh way. As shown in table 2, the total number of Latvian commercial banks fell from 56 at end-1994 to 42 at end-1995.

After slightly expanding in 1994 (for the first time since independence), GDP contracted again in 1995, no doubt influenced by the banking crisis. But GDP contracted by less than 1%, despite the severity of the crisis. This can be taken as a sign of the still limited importance of the banking sector for the real economy in Latvia in the mid-1990s. Enterprise privatization, hitherto dominated by MEBOs and voucher schemes, started to feature international tenders in 1995.

4.3 Lithuania (until the End of 1996)

In April 1994 Lithuania introduced a currency board regime. The litas was pegged to the U.S. dollar at a rate of USD 1 = LTL 4. Inflation subsequently fell from 45% in 1994 (year-end) to about 13% in 1996. Given the nature of the new regime, like in Estonia, the resources of the central bank to assist commercial banks in difficulty were considerably restrained. A new law on Lietuvos Bankas and a new commercial banking law enacted in December 1994 gave

1 *Fleming and Talley (1996).*

2 *Hansson and Tombak (1996, p. 4–5). As regards Banka Baltija, in the end nearly 12,000 depositors received some very modest compensation, equivalent to 1% of household claims on the bank (IMF, 1996, p. 24).*

Table 4

Banking Sector-Related Indicators for Lithuania (1992 to 1997)

Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Consumer price inflation (year-end)	Deposit rate (average rate on demand deposits, year-end)	Lending rate (average rate on loans, year-end)	Domestic credit (year-end)	Domestic credit to the private sector	Nonperforming loans	EBRD index of banking sector reform (1 to 4+)[1]
	number	*%*		*% p.a.*		*% change*	*% of GDP*	*% of total loans*	
1991	..	..	345	..	..	..	..	..	1.0
1992	..	..	1,161	..	..	..	..	..	1.0
1993	26 (0)	53.6	189	19.7	88.2	109.4	13.8	..	2.0
1994	22 (0)	48.0	45.0	7.6	29.8	78.1	17.6	27.0	2.0
1995	15 (0)	61.8	35.7	7.4	23.9	10.7	12.6	17.3	3.0
1996	12 (3)	54.0	13.1	4.3	16.0	1.8	9.4	32.2	3.0
1997	12 (4)	48.8	8.4	1.9	11.9	37.6	9.3	28.3	3.0

Source: EBRD.

[1]) 1 means little progress beyond establishment of a two-tier system; 4+ corresponds to standards and performance norms of advanced industrial economies, provision of full set of competitive banking services.

the central bank the power to better enforce prudential regulations. In accordance with the new legislation, prudential requirements were tightened and banking supervision was more strictly applied. Minimum capital requirements were raised to LTL 10 million (about USD 2.5 million) in mid-1995.

Monetary tightening and the fading of speculative sources of earnings contributed to increasingly frequent liquidity problems in the course of 1994 and 1995. Whereas previously mostly smaller credit institutions had been affected, in the summer of 1995 two medium-sized private banks experienced serious liquidity bottlenecks. After receiving some liquidity assistance, one was closed and the other nationalized at end-1995. In this fragile atmosphere, a banking crisis finally broke out in December 1995, when it was reported that Lietuvos Bankas had suspended its activities and the authorities had arrested the directors of the largest private bank, the Lithuanian Innovation Bank, and of another large private bank, Litimpeks Bank. The portfolios of these two credit institutions, which had attempted to merge, featured substantial loans for fuel purchases by financially weak energy companies frequently lacking collateral. Activities allegedly also involved fraud. Both banks together accounted for about a fifth of total Lithuanian commercial banking assets.

Mounting insecurity triggered runs on these as well as on some other banks in the first two months of 1996. These runs apparently induced the government and the president of Lithuania to take some hasty moves to protect depositors. Immediately after the crisis broke, the president promised that all deposits in the troubled banks would be guaranteed. At the beginning of 1996, parliament enacted an emergency partial deposit insurance law covering all credit institutions (table 6). Other legislative acts established state guarantees for all creditors of the Lithuanian Innovation Bank and of Litimpeks Bank and mandated the restoration of their operations.[1]) But after some hesitation and considerable delays, the authorities eventually decided to liquidate the Lithuanian Innovation Bank in early 1997; Litimpeks Bank continued to operate.

In a separate, but related move, the government in August 1996 decided to recapitalize the country's three large majority state-owned banks – the Savings Bank, the State Commercial Bank and the Agricultural Bank. Given that these

1 *Hansson and Tombak (1996, p. 7).*

three credit institutions accounted for nearly half of all assets and deposits, this new rescue operation underlines the dimension of the Lithuanian banking crisis of 1995–96.[1]) In August 1996 parliament also passed a law that provided for the establishment of the Property Bank (Turto Bankas), to which bad loans from state-owned banks' as well as other problem banks' portfolios would be transferred. In September 1997, finally, the government issued recapitalization bonds for the three state-owned banks.

On the other hand, in line with the strengthening of prudential regulations, the remaining credit institutions that did not fulfill the minimum capital and similar requirements had their licenses revoked. Thus, as table 4 shows, the total number of banks declined from 22 at end-1994 to 12 at end-1996. This evidently reflects the different treatment of the above-mentioned large troubled banks compared to other banks. The different treatment can at least partly be explained by the systemic importance that the authorities attached to the large banks ("too big to fail"). Contrary to most comparable measures in the other Baltic states, as a rule creditors as well as shareholders were bailed out in

Table 5

Overview: Banking Crises in the Baltics (1992 to 1996)

	Estonia	Latvia	Lithuania
Time of crisis (year)	**First crisis: 1992–93; Second crisis: 1994–95**	**1995**	**1995–96**
Economic importance of banks affected	**First crisis:** three largest commercial banks, accounting for almost a third of the combined balance sheet of the banking sector at the time of crisis, plus a number of smaller banks **Second crisis:** Social Bank (Estonia's largest bank at the time of crisis)	**Bank Baltija:** largest commercial bank, holding 30% of all bank deposits; about a dozen **other loss-making banks,** comprising 20% of deposits of the sector	Affected **larger banks** accounted for two thirds of all commercial banking assets
Causes of crisis	Lack of professional banking know-how, insider lending practices, initially weak supervision, fading of earnings from currency speculation and financing of trade deals between Russia and the West		
	First crisis: strong initial transition recession, increase of minimum capital requirements, external factors **Second crisis:** connected lending practices, withdrawal of state accounts from Social Bank	**Bank Baltija:** aggressive and risky commercial bank expansion strategies; **Other loss-making banks:** requirement to release IAS-based financial statements	**Larger banks** (state as well as privately owned): high-risk lending operations, unrestructured economic activities **Smaller banks:** tightening of prudential regulations
Ways of solution	**First crisis:** a number of bank liquidations with no or only modest reimbursement for depositors and creditors, some banks recapitalized **Second crisis:** initial generous liquidity support, later withdrawal of license and full compensation of depositors and creditors	**Bank Baltija:** initial liquidity injections, then negotiations on restructuring plan, then arrest of chairman for fraud, then renationalization of bank, finally declaration of bankruptcy **Other loss-making banks:** after some hesitation bankruptcy proceedings without compensation	**Larger banks:** initial liquidity assistance, then arrest of directors for fraudulent activities, passage of emergency partial deposit insurance law, state guarantees for creditors, recapitalizations (except for one major liquidation) **Smaller banks:** revocation of licenses, closures
Estimated fiscal and quasi-fiscal costs of crisis in % of GDP[1])	**1.9**	**2.7**	**3.1**

[1]) Tang, Zoli and Klytchnikova (2000, p. 34–36). The authors refer to fiscal costs borne by the government in terms of bonds issued, interest payments on bonds, purchases of bad loans, recapitalizations, cash and property transfers and to costs borne by the central bank, including losses on credits extended to banks, transfers of assets to banks. These costs are predominantly incurred for restructuring banks and (partially) compensating depositors and creditors.

Lithuania. The bank restructuring measures were supported by the IMF. As a

1 *Pautola and Backé (1998, p. 85–86).*

result of the restructuring, the state reinforced its dominating position in the commercial banking sector and controlled institutions accounting for about two thirds of all deposits. All in all, the slow resolution of the crisis by the authorities delayed the recovery of public confidence in the Lithuanian banking system, while the bailouts of large credit institutions raised questions of moral hazard.[1])

The rather severe banking crisis appears to have had even less impact on overall economic development than the crisis in Latvia. After a sizeable contraction in 1994, GDP growth was positive in 1995 and even accelerated in 1996. But recapitalization moves may have substantially contributed to the high Lithuanian (general government) budget deficits (of about 4% to 5% of GDP) that occurred during these years. Given weak FDI, rising current account deficits and growing foreign exchange reserves were reflected in swiftly expanding indebtedness (although from a low level of departure). Up to end-1996, foreign participation in enterprise privatization was minimal. Most large privatized companies continued to be owned by worker collectives; cash privatization was only slow to gain momentum.

5 Recovery and Temporary Stability (until Late 1997)

5.1 Estonia

In the years following Estonia's banking crises of 1992–94, but preceding the impact of the Asian and Russian financial crises on the Baltics (1998–99), the country's banking sector witnessed an impressive expansion of activity, reflecting considerable progress in financial deepening. Domestic credit grew from 16% of GDP in 1995 to 29% in 1997. In the same period, total banking sector assets almost doubled to 60% of GDP. Deposits increased from 14% to 24% of GDP. This remarkable development, signaling a first breakthrough in financial intermediation in Estonia, can largely be explained by growing confidence in the national economy.

This confidence is reflected in the confluence of a number of factors: The transition recession was finally over and strong economic growth started in 1995. Annual GDP growth accelerated to over 10% in 1997. Monetary policy was kept tight, and inflation fell from 29% in 1995 (year-end) to 13% in 1997. This encouraged a decline of lending rates (see table 1). Estonia had weathered its initial banking crises (and was the first Baltic country and one of the first transition countries to do so). A new Credit Institutions Act became effective in January 1995 and reinforced prudential regulations and banking supervision. The Act made financial statements based on international accounting standards obligatory for banks in Estonia (table 6). Bankruptcy procedures were implemented more rigorously than in most other transition economies, which strengthened creditor rights. Large-scale enterprise privatization to strategic investors was successfully wrapped up in mid-1996. And the overall very liberal economic policies of the government, including its foreign trade regime and its full liberalization of current as well as capital account transactions in 1994, attracted investors and capital inflows.

1 *Psalida (1998, p. 50).*

Buoyed by the general emerging markets euphoria of the time, these capital inflows gathered momentum in 1996 and 1997 and were largely intermediated by Estonian commercial banks. Bank-intermediated capital flows are reported to have grown from 1% of GDP in 1995 to about 10% of GDP in 1997.[1]) The growth of credits to enterprises was surpassed by the expansion of loans to households and nonbank financial institutions (in particular leasing companies), as banks aggressively sought new business.

As a result of increased confidence, the maturity of banks' balance sheet liabilities as well as of their loans grew. As of mid-1997, about four fifths of all credits reached maturities exceeding one year. While this dynamic expansion of activity was welcome in an economy with a huge catching-up potential like Estonia, Eesti Pank was concerned about the prudence of lending operations. Also, in the course of 1997, international economic uncertainty increased, particularly vis-à-vis emerging markets, culminating in the Asian crisis in the fall of that year. Therefore, Eesti Pank took measures to rein in credit growth. In July and in November 1997 it raised and tightened reserve requirements. In October 1997 Eesti Pank moved the minimum capital adequacy ratio from 8% to 10% of risk-weighted assets, thus (formally) going beyond Basel Committee recommendations.

Contractionary measures were also merited by the mounting external disequilibrium, which partly reflected the capital inflow-supported credit boom. Pushed by strong import growth, the current account deficit reached 9% of GDP in 1996 and 12% in 1997. Since FDI was insufficient to cover this gap, most of the shortfall was financed by expanding debt. In the two years to end-1997, Estonia's foreign liabilities drastically increased, rising from 18% to 56% of GDP. However, it appears that a predominant part of the new debt went to financing investments, not into a consumption binge. In an effort to counter the external deterioration, fiscal policy was substantially tightened in 1997.

Influenced by successive increases of minimum capital requirements, the concentration process in the Estonian banking sector went on: the total number of banks fell from 22 at end-1994 to 12 at end-1997. Despite aggressive competition, real deposit rates remained negative through 1997. Spreads shrank somewhat.[2]) In 1997 Estonian banks increased the stakes they already held in nonbank financial institutions, in particular in leasing firms, investment funds and insurance companies. Shares of Estonian credit institutions accounted for the lion's share of Tallinn Stock Exchange capitalization, which had jumped to about a quarter of GDP by mid-1997.[3]) The securities and asset management arms of the banks came to dominate the market.

In early 1997, Eesti Ühispank agreed to take over North Estonia Bank, which had run into difficulties associated with the quality of the loans originally transferred to it from the Social Bank in 1995. In order not to undermine the viability of Eesti Ühispank following the takeover, the authorities completely wrote off their capital participation in North Estonia Bank and injected addi-

1 *OECD (2000, p. 198).*

2 *Spreads for three to six month maturities shrank to 6% in December 1997. (IMF 1998b, p. 23.)*

3 *The Tallinn Stock Exchange was opened in May 1996.*

tional resources into the entity.[1]) Some leading Estonian banks started to extend their operations to neighboring Latvia, Lithuania and Russia by opening subsidiaries or acquiring stakes in financial institutions in those countries. As of end-1997, about 40% of the Estonian banking sector (measured by capital) was foreign-owned. At the same time, the state had fully dispensed with its majority ownership shares in Estonian banks. But some banks remained vulnerable because of a high proportion of bad credits or because they were too small to compete effectively.

5.2 Latvia

Latvia's banking sector experienced a slower recovery from crisis than Estonia's banking sector did. Although progress in financial deepening was achieved, it was less pronounced. Domestic credit grew only slightly to 15% of GDP in 1997, which corresponds to about half of the level attained in Estonia that year. Domestic credit to the private sector grew somewhat more quickly, namely from 7% to 11% of GDP, as shown in table 2. Deposits stagnated at a level of about 16% of GDP. Total banking assets expanded vigorously and exceeded 50% of GDP in 1997. The reasons why financial intermediation developed less dynamically in Latvia than in its northern neighbor despite an almost equally strong economic expansion (GDP in 1997: +9%), appear to be mostly structural. Fiscal policy was tightened and persistently restrictive monetary policy brought annual inflation down to single digits for the first time in the 1990s in Latvia.

Enterprise privatization proceeded more hesitantly, and strategic investors were only welcomed at a later stage, so that serious enterprise restructuring took place later than in Estonia. Bankruptcy proceedings, including access to collateral, were insufficiently implemented until a new, more comprehensive bankruptcy law came into force at end-1996. Therefore, contract enforcement and creditor rights were only in the process of strengthening in the Latvian enterprise sector, whereas they had already developed to some degree in Estonia. A "cyclical" argument contributing to explaining the slower banking recovery in Latvia is of course the fact that Latvia's banking crisis (of 1995) came to an end around a year later than Estonia's.

On the other hand, one of the factors driving the Latvian banking recovery was the considerable, if temporary, attractiveness of placing funds in risky destinations abroad, including Russia, Ukraine and other CIS countries. The expansion of Latvian banking activities was also favored by capital inflows, though to a lesser degree than in Estonia.[2]) A number of Latvian banks had established extensive information and business networks in Russia and were exploiting interest rate differentials between the domestic and Russian markets. Russian federal and local government bonds offered high returns. According to central bank estimates, about 8% of total assets of the commercial banking sector as of end-1997 were invested in Russia, and GKO treasury bills accounted for about half of this share. Moreover, some Russian and CIS companies seem to have used

1 The combined cost of this operation to the government and to Eesti Pank is estimated at around 0.3% of GDP (Zavoico, 1999, p. 28).

2 In Latvia, current and capital account transactions were also fully liberalized in 1994.

the Latvian banking sector as a perceived safe financial conduit for their core activities.[1])

The banking recovery was supported by an improved legal and regulatory framework for credit institutions. A new Banking Law became effective in January 1996, and prudential regulations and banking supervision were strengthened. In 1997, capital adequacy requirements reached 10% of risk-weighted assets (table 6). Latvijas Banka established a rigorous bank auditing and inspection regime. Credit institutions were made subject to several audits a year, including at least one complete on-site inspection, and questionable banks are watched even more closely.[2]) In 1996 and 1997 the second-largest remaining state-owned bank (as measured by capital), Unibanka, was privatized through sales of majority stakes to a number of foreign investors, including the EBRD. The privatization of Latvijas Kraibanka (the Savings Bank) started through a public offering in 1997.

The total number of Latvian credit institutions fell from 42 at end-1995 to 32 at end-1997, 15 of which were foreign-owned. The share of foreign-owned banks in total bank assets grew to over 50% in 1997, the share of state-owned banks declined to 7%. The rapid disinflation process and increasing competition brought about a decline of lending rates and spreads.[3]) The average maturity of bank loans went up in 1996 and 1997. Latvian banks also played an important role in the development of nonbank financial intermediaries, especially of leasing firms and the stock market, which had started to operate in 1995. But the Riga Stock Exchange remained of modest importance, compared to its Tallinn counterpart. Despite the progress mentioned above, many Latvian credit institutions continued to be poorly capitalized and saddled with significant amounts

Table 6

Prudential Regulations and Deposit Protection in the Baltics as of End-1997

Type	Requirement		
	Estonia	Latvia	Lithuania
Minimum capital requirement	EEK 75 million (ECU 5 million)	LVL 1 million (ECU 1.4 million)	LTL 24.2 million (ECU 5 million)
Minimum capital adequacy ratio	10% of risk-weighted assets	10% of risk-weighted assets	10% of risk-weighted assets
Maximum lending to a single borrower	25% of bank's capital	25% of bank's capital	25% of bank's capital
Maximum foreign exchange exposure (overall open position)	from 1996, there are no special limits	20% of bank's capital	30% of bank's capital
Deposit protection (guarantee)	–	–	up to LTL 25,000 (ECU 5,165)
IAS: year of introduction	1995	1995	1997

Source: Psalida (1998, p. 51); various IMF country staff publications.

1 *OECD (2000, p. 111).*

2 *IMF (1998c, p. 12).*

3 *Spreads for three to six month maturities shrank to 7% (slightly above the equivalent Estonian spread) at end-1997 (IMF 1998b, p. 23).*

of nonperforming loans. Some, in particular small, banks actually were more of the nature of finance companies attached to certain enterprises than institutions interested in mobilizing household deposits.

5.3 Lithuania

Lithuania had little time to recover from its banking crisis of 1995–96 before the Asian and Russian financial crises started to affect the Baltics. Public confidence was slow to return to the Lithuanian banking sector in 1997. After contracting during the crisis, domestic credit as a share of GDP stagnated in 1997 (11%) and showed clear signs of recovery only in the following year. Total banking sector assets rose modestly to 24% of GDP in 1997. Likewise, average capital adequacy only slightly recovered that year.[1]) Thus Lithuania lagged somewhat behind Latvia in the degree of financial intermediation reached by 1997. The relative weakness of the banking sector did not appreciably impact overall economic growth, which accelerated in 1997 (to +7%). Fiscal policy was tightened and monetary policy remained tight in 1997, reducing inflation to single digits (year-end inflation: 8%). Pushed by rising imports, the current account deficit kept growing, and although FDI started expanding vigorously, it could not prevent the further increase of external debt.

Lithuania introduced International Accounting Standards at the beginning of 1997 and raised minimum capital requirements to EUR 5 million that year. The Lithuanian banking sector suffered to an even greater degree than its Latvian counterpart from the sluggish privatization of the real sector, a lack of real enterprise owners and weak corporate governance. A new, more effective bankruptcy law finally came into force in October 1997. The total number of banks remained at 12 in 1997, four of which were in foreign ownership. Banking concentration increased. The top five banks controlled about 85% of total assets and deposits of the sector at end-1997.

Unlike in Estonia and Latvia, the sector continued to be influenced by three large state-owned banks (Savings Bank, Agricultural Bank and State Commercial Bank), which accounted for almost half of total assets and deposits. Structural weaknesses remained focused in the state-owned banks. The State Commercial Bank, which had traditionally been the source of commercial credit to state-owned enterprises, experienced severe liquidity problems and losses during the crisis of 1995–96. After delays, several attempts to privatize the credit institution failed in 1997. The Agricultural Bank was heavily involved in special lending programs to benefit farms. The Savings Bank, the largest retail credit institution in Lithuania, was also the largest holder of treasury bills. All three big state-owned banks were exempted from meeting capital adequacy requirements by parliament in 1997, pending their planned privatization.[2]) Notwithstanding difficulties of comparison, the share of nonperforming loans in total loans remained much higher in the mid-1990s in Lithuania than in the other two Baltic states (table 4).

On the other hand, the aggregate statistics appear to hide the improved performance of a number of private banks. As table 7 shows, the two biggest

1 *OECD (2000, p. 105).*

2 *IMF (1998d, p. 22, 28).*

Table 7

Top Baltic Banks as of End-1997 (Measured by Capital)

Rank	Estonia				Latvia				Lithuania			
	Credit institution	USD billion		Capital adequacy (in %)	Credit institution	USD billion		Capital adequacy (in %)	Credit institution	USD billion		Capital adequacy (in %)
		Tier 1 capital	Assets			Tier 1 capital	Assets			Tier 1 capital	Assets	
1.	Hansapank	79	1,007	11.9	Parekks-Banka	55	501	22.3	Vilniaus Bankas	41	459	14.0
2.	Eesti Hoiupank (Savings Bank)	71	643	20.9	Latvijas Unibanka	52	420	18.1	Bankas Hermis	31	288	23.0
3.	Eesti Ühispank (Union Bank)	40	722	10.5	Rietumu Banka	30	312	28.0	Lietuvos Zemes Ukio Bankas (Agricultural Bank)	18	363	. .
4.	Tallinna Pank	31	336	11.8	Rigas Komercbanka	25	245	26.0	Lietuvos Taupomasis Bankas (Savings Bank)	17	460	12.3
5.	Eesti Forekspank	14	177	14.0	Baltijas Tranzitu Banka	21	114	. .	Siauliu Bankas	8	32	43.8

Source: The Banker (October 1998, p. 50-52); Eesti Pank (1998, p. 45).

Lithuanian credit institutions in 1997 in terms of capital were privately owned: Vilnius Bank and Hermis Bank. Strategic investors acquired majority stakes in both banks, and both banks stepped up competition for individual and private enterprise customers. In 1996 and 1997, Vilnius Bank and Hermis Bank doubled their respective shares of total deposits. Most of the other remaining credit institutions were small and tended to serve specific niches. As of end-1997, foreign investors accounted for about one third of the share capital of the banking sector. Unlike in the other two Baltic countries, most commercial banking assets in Lithuania remained concentrated in short-term maturities.

In June 1997, amendments to the deposit insurance law were passed to provide for equal partial protection of depositors at state-owned banks as well as at private banks. Thus, the (implicit) full deposit guarantee for accounts held in state-owned credit institutions was abolished, and all banks were put on a level playing field with respect to depositor protection.

6 Summary and Conclusions

This article deals with the development of banking in the Baltics from the collapse of the USSR up to the point in the second half of the 1990s when, after having weathered their first profound crises, market-oriented banking sectors with some degree of stability appear to have emerged. Although Estonia, Latvia and Lithuania arguably set out from much the same point of departure as other countries that formerly belonged to the Soviet Union, the Baltic countries have witnessed impressive progress and today are among the most advanced transition countries with respect to banking reform.

Perestroika and the weakening of Soviet power were quickly seized upon by the authorities of the Baltic republics to reestablish their autonomy. Central banks were recreated in 1989–90. Increasing macroeconomic instability and lax or nonexistent banking regulations and supervision were accompanied by the multiplication of newly founded private banks, which often engaged in foreign currency speculation and short-term foreign trade arbitrage transactions

between the former USSR and the West. In many cases credit institutions were also established to arrange cheap financing for their owners, thus practicing connected lending. On the other hand, state-owned commercial banks continued to allocate credits to their traditional clients – with scant regard for profitability.

After independence had been achieved in 1991, the collapse of remnants of the centrally-planned economy and the foundering of ties with the former Soviet Union contributed to some of the most precipitous economic declines experienced by transition countries. Estonia was the first Baltic country to break with the ruble and to install its new currrency, the kroon, in the framework of a currency board in 1992, linking the kroon to the Deutsche mark. For the banking sector, this meant that the lender of last resort function was strongly restrained. Flanked by strict fiscal policies, the currency board was successful in combating inflation and in macroeconomic stabilization. Privatization and hard budget constraints were quickly introduced. In Latvia, the lats became the sole legal tender in 1993, and the authorities were successful in implementing macrostabilization. In the same year, Lithuania introduced the litas. But disinflation and fiscal tightening came somewhat later than in the other two countries, and privatization lagged behind.

Given the lack of experience in market-oriented banking, the quality of human capital was relatively modest in all three Baltic states at the beginning of the 1990s. In Estonia, the successful currency reform and the introduction of hard budget constraints decreased the opportunities for quick profits from speculative activities. In the fall of 1992 Estonia experienced its first banking crisis, which was also one of the first such events in any transition country. In response, Eesti Pank, the Estonian central bank, moved quickly to close one of the country's three largest commercial banks. Depositors received only modest reimbursement. Prudential regulations were subsequently tightened, triggering further bank closures. In 1994, a second – smaller – crisis followed, triggered by the decision of the state treasury to withdraw deposits from a former state-owned credit institution. But this time, Eesti Pank reacted differently. It attempted to recapitalize the bank in question, but later changed its mind and repealed the bank's license. Creditors were fully compensated by the government. Commercial banks started to focus on short-term lending to the real economy.

Since 1994, Latvijas Banka (the Latvian central bank) has applied a fixed exchange rate regime, linking the lats to the SDR. The major Latvian banking crisis broke out in 1995 and focused on the country's biggest bank at the time, as well as on a number of smaller institutions, which had engaged in overly risky behavior. The authorities responded relatively slowly and were not able to prevent some asset stripping. In the end, depositors hardly received any compensation. In 1994 Lietuvos Bankas (the Lithuanian central bank) instituted a currency board regime, pegging the litas to the U.S. dollar. Monetary tightening and the stepping up of prudential regulations set the stage for a banking crisis in 1996, involving privately-owned as well as state-owned banks. Two large private credit institutions failed, one of which was liquidated. In 1996, an emergency partial deposit insurance law was enacted. The government decided to recapitalize the country's three large majority state-owned banks.

In the years immediately following its crisis of 1992–94, Estonia's banking sector witnessed an impressive expansion of activity, reflecting progress in financial deepening. Commercial bankers gathered experience and know-how. Growing confidence in the national economy contributed to a first break-through in financial intermediation in Estonia. Strong economic growth started in 1995. Prudential supervision was strengthened, International Accounting Standards became obligatory for banks in Estonia. Bankruptcy procedures were implemented more rigorously, and strategic investors took over many large-scale enterprises. Fueled by capital inflows, banks aggressively sought new business, expanded lending to households and took stakes in leasing firms and insurance companies. Deposit and loan maturities increased.

Latvia's banking sector experienced a slower recovery than Estonia's did. Progress in financial deepening was less pronounced. Enterprise privatization proceeded more hesitantly, and strategic investors were only welcomed at a later stage. The same goes for the strengthening of creditor rights. On the other hand, the Latvian banking recovery was stimulated by the considerable, if temporary, attractiveness of placing funds in risky destinations abroad, including Russia and other CIS countries. The authorities improved the legal and regulatory framework and established one of the most rigorous bank inspection regimes. Lithuanian banking suffered even more than its Latvian counterpart from sluggish restructuring of the real sector and weak corporate governance. However, supported by strengthened supervision, private banks improved their performance after the crisis; structural weaknesses focused on the relatively large state-owned banks. Most commercial banking assets remained concentrated in short-term maturities.

The Baltic countries' experiences in creating market-oriented banking systems may yield some of the following conclusions:

– Compared to Central European transition countries, the Baltic states were confronted with more adverse initial conditions. They overcame these by determined commitment and sustained economic reforms.
– Given that Estonia opted for the earliest and most radical reform efforts, including privatization to strategic investors and effective bankruptcy rules, it took the lead among the Baltic reformers. Lithuania was the latest of the three countries to initiate serious restructuring efforts.
– Although a currency board regime all but eliminates monetary policy instruments and constrains the lender of last resort capacity of the central bank, the Baltic experience shows that it need not be prejudicial to the banking sector. By creating a clear and simple environment for financial actors, a currency board may contribute to improving incentives and combating moral hazard.
– Successive banking crises in all three countries (Estonia: 1992–93, 1994–95, Latvia: 1995, Lithuania: 1995–96) turned the Baltic banks into much more prudent lenders. After the crises, the granting of credits slowly recovered and steadily expanded, but on a sounder basis than before.
– With economic stabilization and falling inflation, deposit and lending rates have contracted in all three countries, whereas spreads have declined to a greater degree in Estonia and Latvia.

– Comparing enterprise and banking reforms, the latter often proceed more quickly, given that the banking sector is smaller, its structure differs, and therefore restructuring efforts, albeit painful, are less complex.
– However, banking reform measures can only give rise to an increase in sound lending activities to the real sector once enterprise reforms, including the strengthening of creditor rights, catch up.
– Recapitalizing banks and (temporarily) dispensing them from fulfilling prudential requirements should be carried out with caution, since it may create a moral hazard situation and put off pressure for restructuring.
– Swift divestiture of state ownership may stimulate a more dynamic development than a situation where state ownership lasts for several more years.
– Baltic countries – particularly Estonia – were among the first transition countries to witness a breakthrough to successful mobilization of domestic and foreign savings for productive purposes.

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