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Banking and Finance in the Baltic Countries

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Tuuli Koivu^{*}

Banking and Finance in the Baltic Countries

Abstract

The financial sectors in the Baltic countries have developed quite rapidly over recent years and there are currently no immediate threats to their stability. However, the Baltic financial sectors are still below the level of development of the financial sectors in EU countries. The difference is remarkable both in the level of financing but also in the variety of instruments available in the markets. Even the banking sectors, which dominate the financing in the Baltic countries, are relatively small. The Baltic security markets are lagging behind the other EU accession countries and the development of that sector has been stagnant even during the recent period of growth.

Key words: financial systems, banking, Estonia, Latvia, Lithuania

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1 Introduction

The Baltic countries started to construct their financial sectors ten years ago almost from nothing. The work was not easy and all three countries experienced banking crises in the 1990's. At that time, the biggest shortcomings in the sector concerned the functioning of institutions, legislation and the lack of human capital. In the second half of the 1990's, the Baltics started to reorganise and reform their financial sectors to make them more efficient and reliable. Privatisation was speeded up and new legislation and supervision institutions were put in place. As a result, the financial sectors in the Baltic countries have developed quite rapidly over recent years and there are currently no immediate threats to their stability. In general, confidence in the stability of the sectors is increasing.

Despite positive developments in the last few years, the Baltic financial sectors are still clearly below the level of development of the financial sectors in EU countries (Caviglia et al. 2002). Also the banking sectors, which dominate the financing in the Baltic countries, are still relatively small. The Baltic security markets are lagging behind the other EU accession countries and the development of that sector has been stagnant even during the recent period of growth.

After privatisation and a number of mergers, the banking sectors in the Baltic countries have ended up highly concentrated and largely foreign-owned. The concentration has not only happened inside the countries but also at the Baltic level. Foreign owners control nearly all sizeable banks in the Baltics and most of these banks are operating in all three countries. The presence of foreign banks has certainly balanced the financial sectors in the Baltic countries. In addition to stability, foreign banks have brought efficiency to the Baltic banks through the introduction of new technology.

In this paper, we present a short analysis of the Baltic financial markets and we concentrate very much on describing the situation in the banking sectors, as they are dominant in the market. Our aim is to give a general overview of the current size and channels of financing in the Baltic countries. In particular we focus on the three typical aspects of the Baltic banking sectors, namely high concentration, large foreign ownership and the fast growth of bank loans that has occurred over the last few years.

2 Financial markets in Estonia

If compared to the financial sectors in other EU candidate countries, Estonia's financial sector is relatively well developed. It has developed quickly since the downturn in the aftermath of the 1998-1999 Russian crises. In recent years, its development has reflected the favorable overall economic development in Estonia but also the approaching EU membership encourages investments in the economy and stimulates the financial sector.

The Estonian financial sector is dominated by banks. The banking sector, which is mainly foreign-owned, seems to work quite properly and also its size is close to the average of the candidate countries. At the same time, the security market in Estonia is small and not a popular arena in which to search for financing. Thus, besides the banking sector, the other main channels of financing in Estonia are international capital flows and companies' own cash flows. The international capital flows increase the competition in the financial market, as competition is not limited to locally licensed institutions and hopefully this is making the domestic sector more competitive. On the other hand, the international capital

flows can restrict the development of the domestic financial sector, as the biggest and most reliable firms seek financing directly from abroad.

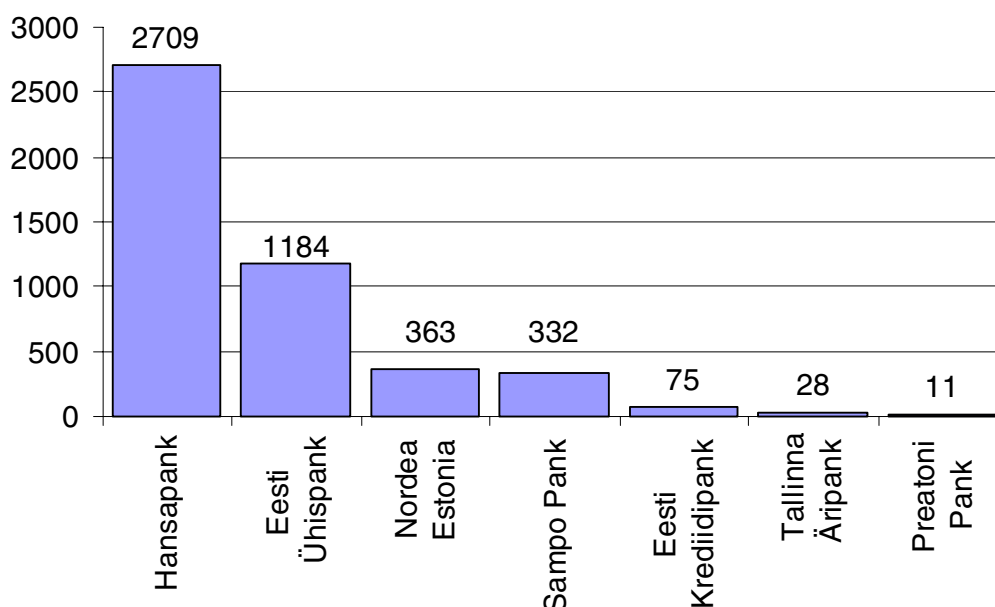
2.1 Banking sector

Estonian authorities were forced to restructure the banking system after the two banking crises in the second half of the 1990's. As a result, the number of banks dropped significantly and the market became characterized by high concentration and large foreign ownership. The reconstruction consolidated the sector and the amount of non-performing loans decreased rapidly. During recent years, the favorable economic development has accelerated the development further and the size of the banking sector has grown rapidly.

Currently, the deposit banks' total assets amount to almost €5 billion, or 80% of GDP. This is almost 50% more than two years ago. The ratio of total domestic credit to GDP is close to 50%. The Estonian banking sector, as measured by its size, is close to the average of EU candidate countries but still far behind the level of EU countries.

The Estonian banking sector is very concentrated. There are seven banks working in the country but the two biggest of them – Hansabank and Eesti Ühisbank – control about 80% of the sector's total assets (Chart 1). Besides high concentration, another typical characteristic of the Estonian banking sector is its very high share of foreign ownership. Over 85% of the share capital of banks belongs to foreign investors and the banks in which foreign investors control the majority stake form 98% of total bank assets. Two Swedish banks control the biggest banks. Swedbank owns the majority stake in Hansabank and SEB owns the majority share in Eesti Ühisbank.

Chart 1. Total assets of Estonian banks (in million euros) at the end of March 2002.



Source: Bank of Estonia

The volume of loans has grown steadily since the beginning of 2000. The growth of loans has been supported by strong economic growth and a decline in interest rates. During the first half of 2002, banks granted 15% more credit than a year earlier. When the maturities

lengthened at the same time, the loan stock was 21% larger at the end of June 2002 than at the end of June 2002. Loans to individuals and financial institutions have increased most.

Currently, almost a quarter of loans are granted to individuals (Chart 2). The major share of these loans consists of housing loans, which have increased remarkably during recent years. The amount of housing loans totaled €500 million at the end of June 2002. Loans to commercial undertakings comprise more than 40% of the banks' loan stock. The majority of these loans are granted to enterprises working in manufacturing or in real estate, renting and business activities. Loans to other financial institutions, mainly to banks' leasing firms, have increased significantly during recent years. The banks encourage leasing financing mainly because under a leasing contract, the collateral can be seized more easily.

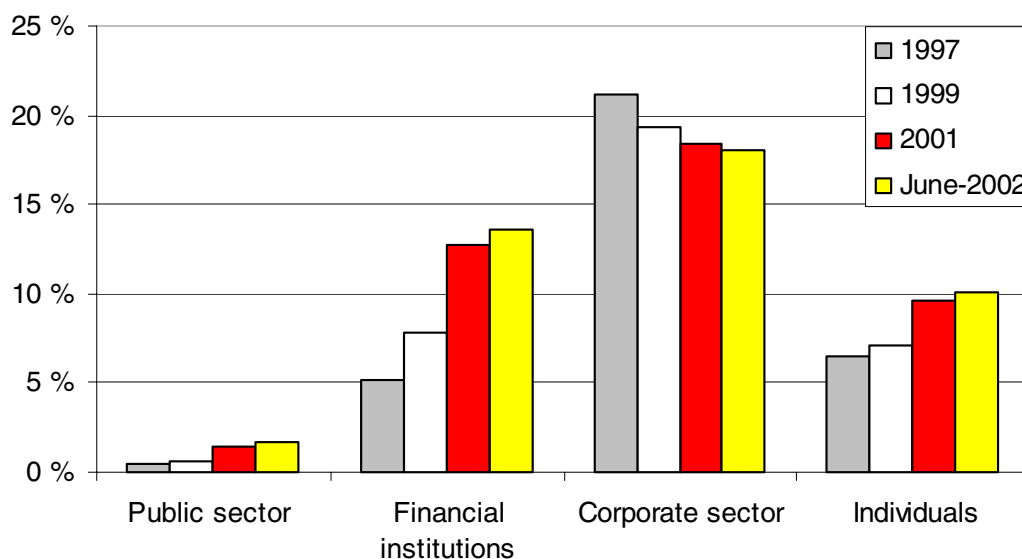
In Estonia, loans to the public sector have always been miniscule. There are basically two reasons for this. Firstly, when the Baltic countries regained their independence they did not have any public debt. Secondly, the public sector deficit has been under control in Estonia. Since 1994, the general government budget has been close to balanced, except for the year 1999. The government is even required by law to balance the state budget.

The trend in interest rates has followed closely the development in the euro area. As seen in Appendix 1, the interbank interest rates fell steadily last year and rates have stayed low in 2002. Currently, the 3-month euribor rate is about 0.5 percentage points below the talibor.

The interest rates on currency loans are continuously lower than on kroon loans. Over the last two years, the loan rates on currency loans have dropped more than the rates on kroon loans. As a result, the share of currency loans of total loans has increased and is currently 82%. The majority of the currency loans are in euros.

As a result of the stabilisation in the banking market and the overall economic development in Estonia, the average maturity of loans has lengthened since 1999. Nowadays, short-term loans (12 months and less) comprise about 20% of loans. Loans with a maturity of 10 years or more total a fifth of all loans.

Chart 2. Credit by sectors (as % of GDP) at end of period.



Source: Bank of Estonia.

The growth of loans has been faster than the growth of deposits in Estonia over recent years. At the end of June 2002, the stock of deposits was 16% higher than a year earlier. Demand deposits by individuals increased 22% and they made up almost a half of all deposits. The savings rate in Estonia increased in 2001 to 20%. However, foreign depositors, mainly private corporate clients, are still important financiers of Estonian banks, holding 14% of total deposits and a quarter of all corporate deposits.

Despite such rapid growth, the loan portfolio of the Estonian banks shows good quality. The share of non-performing loans of total loans is currently less than 2%. One reason for this is the recent economic growth, which has improved the quality of clients. At the same time, the diversification of products and services has reduced the concentration of instrument-related risks, and banks' monitoring work has become more efficient.

The Estonian banks are not taking that many risks either. Approximately a third of deposit banks' assets are invested in liquid instruments in the central bank and abroad. 60% of assets are invested into the domestic real sector. The capital adequacy of the banking sector has been sufficient in Estonia during the whole period starting from the beginning of the 1990's. At the end of June 2002, the average capital adequacy ratio was 14.7% and thus was well above the limit of 10% settled on by the Bank of Estonia in 1997. The capital adequacy ratio of Estonian banks is considerably high when compared to the BIS recommendation of 8%. One could even argue that Estonian banks are not taking enough risks to support economic growth. This could be a result of the foreign-owned banking sector as outlined in Box 1.

The efficiency of the Estonian banking sector has improved remarkably during the last decade. As a sign of this, the margin between the lending and deposit rates has declined (see Appendix 2). The main reason behind the improvement is the reconstruction of the sector. The new owners have introduced a lot of new technology in the sector and as a result, the relative wage costs have declined. In fact, the Estonian banking sector is one of the forerunners in IT banking.

Estonian banks have yielded profit every year starting from 1999. Last year, the profit was the highest ever, €110 million. The most important source of financing is interest income but last year the profits from subsidiaries were also remarkable. The good performance of Estonian banks has also been noticed by international rating agencies. The credit rating agency Moody's upgraded its financial strength rating for Hansabank to C and for Ühisbank to C-.

2.2 Non-banking sector

As mentioned already above, the financial sector in Estonia is very much dominated by the banking sector, while the security market remains small. The development of the security market has been limited by a lack of institutional investors and the general unawareness of different forms of saving among the Estonians. Quite often people could not even afford investing in securities, as the wage level is low. Another reason behind the small market could be taxation, because income from bank deposits is tax-free while investment income from other sources is taxed at the prevailing rate of 26%. This can lead to distortions in investment decisions.

In coming years, both pension reform and EU enlargement are expected to brighten up the market. The new pension system creates both obligatory and voluntary pension funds. The contributions to compulsory funds started in July and voluntary funds have already been working for a few years. Although there is a law limiting the investment decisions of the funds, it is expected that the new funds will increase investments in the do-

mestic financial market and will partly remove the problem of non-existing institutional investors. EU enlargement is expected to increase the interest of foreign investors in Estonian securities, as it might improve the Estonian business environment in general and also facilitate the trading of securities between countries.

Stock market

The Tallinn Stock Exchange was founded in 1996. At the moment, 14 enterprises are listed on the market. Stock market capitalisation amounts to €1.9 billion, or to almost 30% of GDP. The turnover of the TSE was €0.3 billion in 2001 and trading was concentrated on the shares of a few enterprises.

Although the stock market capitalisation (as a share of GDP) of Estonia is among the highest in the EU candidate countries, when considering the small size of the economy and the small number of listed firms, one could question the need for the country to have its own stock market in Tallinn. A natural answer to the question was the purchase of TSE by the Helsinki Exchange Group (HEX) in 2001. HEX bought a strategic holding in TSE and connected TSE to the HEX trading system in February 2002. The Estonian shares are now traded in euro prices and traders have the option of using Estonian brokers or HEX member brokers with membership in TSE. The reform is expected to promote interest in the shares of Estonian companies and make the market more liquid. Already at the end of 2001, non-resident investors owned 76% of the stock market capitalisation.

Bond market

Bond market capitalisation has been traditionally very low in Estonia due to the lack of government bonds. The debt market has developed only according to private sector instruments and needs, being mainly a primary market and only a modest secondary market. The main issuers of the market are Nordic financial companies, which are major stakeholders in Estonian banks. Currently, the capitalisation of the bond market amounts to about €6 million. Maturities are mainly short-term.

Insurance and investment funds

The Estonian insurance market is still very much undeveloped. Foreign-owned companies control over 80% of the market. Gross collected premiums amounted to €110 million at the end of 2001.

Also the investment funds in Estonia are very small. In 2001, however, the brisk economic growth boosted the volume of the funds rapidly and at the end of the year, the volume of investment funds was €190 million. The pension reform is also expected to accelerate the development of investment funds.

Leasing

The Estonian leasing market has developed rapidly during recent years. The total volume of the leasing portfolio had increased to €950 million by the end of July 2002. It is already an important funding alternative to bank loans, both for enterprises and private individuals. Leasing financing is encouraged because of collateral ownership reasons. A large portion of leased goods consists of real estate and cars. Banks control 99% of leasing action; leasing is an important way for the banks to increase their profits.

Box 1. *The concentration of the banking structure*

The banking sectors in the Baltic countries are very concentrated. The concentration is strongest in Estonia, where three banks control 93% of total assets. In Lithuania, the three biggest banks control 80% of total assets. In Latvia, the concentration rate is somewhat lower, and the three biggest banks own 54% of total assets. However, the concentration is expected to increase further also in Latvia, because the large banks are currently growing more rapidly than the small banks. The concentration has not only happened within each Baltic country but the biggest players in the Baltic banking sector - two Swedish banks – own notable banks in every Baltic country. Thus, the high concentration of the market has led to a suspicion that there may not exist enough competition in the Baltic banking sector.

In a couple of empirical studies, economists have found evidence that banking concentration can be harmful to economic growth. Cetorelli and Gambera (2001) found evidence that banking sector concentration can have a depressing effect on growth, which impacts all sectors and all firms. Drakos (2002) researched the effect of banking sector concentration in transition countries and his results indicate that a competitive banking sector can accelerate economic growth.

To our knowledge, there is only one empirical paper on the competitiveness of the Baltic banking sector. In their study, Philippatos and Yildirim (2002) found evidence that the banks operating in the Latvian banking sector are working under conditions of perfect competition. According to the results of the study, the banking markets in Lithuania could be characterized as monopolistic and in Estonia, there is monopolistic competition in the sector. However, the period during which Philippatos and Yildirim studied the Baltic markets ended already in 1999. The situation in the Baltic banking sector has changed noticeably since then and thus their results may not be consistent with the current market situation.

In any case, the Baltic countries are small and it is thus natural that a few banks are controlling the market and it does not have to mean that the market is not competitive. Despite the decrease in the number of banks, there are signs in the Baltics that competition in the banking sector is becoming stronger as, for example, the interest rate margins are getting smaller (see Appendix 2). There has also been tightening competition noted at least in the mortgage loan market, where loan rates have dropped due to active marketing strategies. The banks are reforming their organisation very thoroughly in order to improve their efficiency and profitability.

At the moment, the banking sector is clearly dominating the financial market and one possible way to increase competition in the market would be to develop the domestic capital market, so that it would compete with the banking sector and provide an alternative means of financing, particularly for medium-sized companies. Closer integration into EU markets will increase competition outside the domestic market area. In the future, technological advances will allow both banks and single persons or enterprises to operate internationally and the role of the domestic financial sector will further diminish.

On the other hand, there are also analysts saying that increased competition can be harmful to economic development. It can, for example, lead to the deterioration of banks' credit portfolios if banks start to compete for customers and grant credit with very elastic conditions. One disadvantage of the concentration of banks is that they can become "too large to fail". This can lead to suboptimal behavior among these banks and puts prudential regulation and supervision in a very important position. In the Baltics, one possible threat to financial sector stability is that the banks can have a dominant position in the entire financial system, as their subsidiaries are very active in other segments of the financial sector. For example, the leasing market is currently in the hands of the biggest banks.

3 Financial markets in Latvia

The Latvian financial sector is very much dominated by the banking sector and its size is close to the average level of the candidate countries. However, some of the functions of the Latvian banking sector are related to its role as an intermediary between Russia and Western Europe and not all Latvian banks service local customers. Thus, the volume of credit in Latvia remains relatively modest.

The other parts of the financial sector are much less developed than the banking sector and their significance in the economy is rather small. The stock market in Latvia is small and illiquid when compared to other EU candidate countries. The debt market is very much concentrated on government debt securities. There are not many enterprises using the security market as a channel of financing.

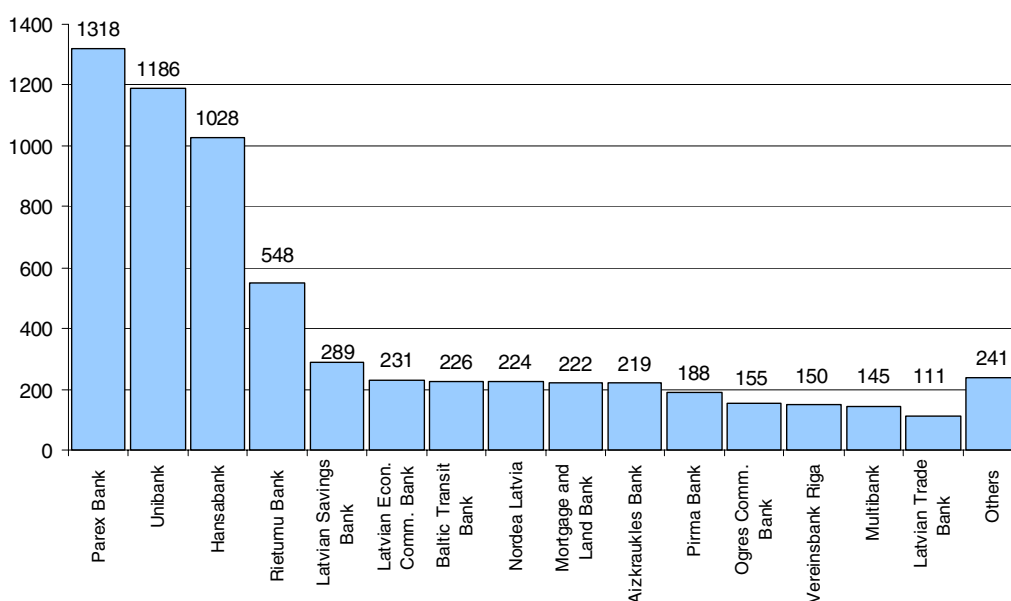
The Latvian banking sector has been booming since 1999. Very rapid economic growth has increased both investments and household consumption and has led to a brisk growth of loans. Like in the other Baltic countries, mortgage loans have increased extremely rapidly. So far, the growth has not led to any worsening in the quality of the loan portfolio and the proportion of non-performing loans is low.

3.1 Banking sector

The Latvian banking sector is different from those in Estonia and Lithuania in various ways. First of all, there are more banks in Latvia than in Estonia or Lithuania. Currently, 22 banks and one branch of a foreign bank are operating in Latvia. The high number of banks is partly explained by the fact that ten of the banks deal primarily with nonresident transactions, meaning investing Russian money in Western Europe.

Following from the high number of banks, the Latvian banking sector is not as concentrated as in Estonia or in Lithuania and there are many active banks in the market. The three biggest banks – Parex Bank, Unibank and Hansabank – control slightly more than half of all commercial bank assets (Chart 3).

Chart 3. Total assets of Latvian banks (in million euros) at the end of June 2002.



Source: Association of Latvian Commercial Banks.

Another difference when compared to Estonia and Lithuania is that the share of foreign ownership is lower in Latvia than in the other Baltic countries. The biggest bank in Latvia, Parex Bank, is domestically owned. Foreign shareholders hold a majority stake in ten Latvian banks and 68% of the total capital of Latvian banks is owned by foreigners. The biggest investors in the market are two Swedish banks: SEB owns Unibank and Swedbank controls Hansabank.

Thirdly, Latvia is the only Baltic country where the banking sector is not yet completely privatised. The Latvian state owns completely Mortgage and Land Bank and holds a 32% stake in Latvian Savings Bank, which is the fifth largest bank in Latvia. These holdings together account for 5% of the total share capital of Latvian banks. The government is planning to sell its stake in Savings Bank but the privatisation is not expected to happen soon, as the bank is the most important holder of the privatisation voucher accounts in Latvia and they will be used for remaining privatisations.

Fourthly, the Latvian banking sector has close connections to the CIS countries. For many Latvian banks, receiving deposits from the CIS and reinvesting them in Western Europe is an important business activity. In small banks, which are specialised in these non-resident transactions, the nonresident deposits can amount to as much as 90% of the total deposits of the bank (IMF 2002). Although the banks have announced that most of the investments in Western Europe are in liquid form and with small maturity mismatch, there is a risk that some occasions can lead to a large deposit outflow from Latvia and this could be harmful at least for some Latvian banks. Another harmful thing related to these CIS deposits is the possibility of a bank losing its reputation due to the fact that some of these deposits could come from suspicious sources.

The banking sector has grown rapidly in Latvia since 2000. At the end of June 2002, the total assets of the sector amounted to €6.2 billion, or 79% of GDP, and were a fifth higher than in June 2001. The main reason behind the development has been brisk economic growth, which has increased investments and also accumulated savings in Latvia. Private consumption has increased, which has increased consumer credits, and the mortgage loan market has developed fast as well.

Both the stock of loans and the stock of deposits have enjoyed rapid growth. In June 2002, private sector deposits were up 27 % year-on-year. Half of the deposits in Latvian banks come from abroad, mainly from the CIS. During last year, both domestic private deposits and foreign liabilities increased by a quarter.

At the end of June, the stock of domestic loans rose to €2.8 billion and amounted to 35% of GDP. The growth of credit has been very rapid during the last year. The growth has been driven by brisk economic growth but also by strongly declining interest rates (see Appendix 1). In June, the stock of loans granted to domestic enterprises and private persons was 41% larger than a year earlier. The increase in mortgage loans has been particularly strong. The majority of loans are currently issued to the private sector (Chart 4). Of the economic sectors, trade and manufacturing have received the most loans.

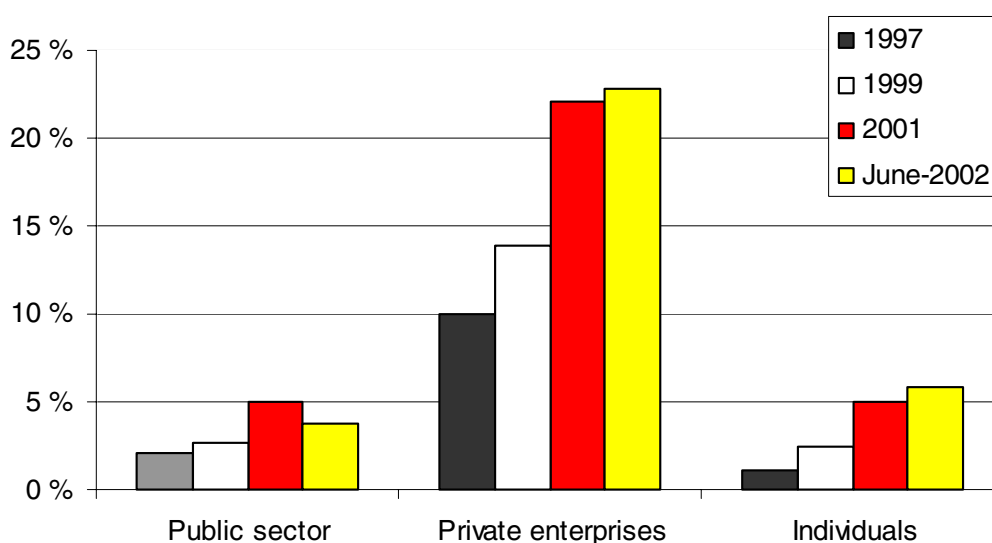
Despite the rapid growth of loans, the quality of Latvian bank assets continues to improve. The share of non-performing loans of total loans has declined steadily since 1999 and they currently amount to about 3% of all loans. The average capital adequacy ratio of the Latvian banks had risen to 14.9 % by the end of March 2002. According to law, the capital adequacy ratio may not fall below 10 %.

Like in the other Baltic countries, the maturity of loans is lengthening as long-term loans are increasing faster than short-term loans. Currently, loans with a maturity of over 5 years form about a third of the loan stock. During recent years, more than half of loans have been granted in foreign currencies. At the end of March, the share of currency loans was 58%. The most popular foreign currency is the US dollar. Also deposits in foreign

currencies, mainly in US dollars, form an essential part of domestic deposits. Interest rates have normally been a couple of percentage points lower on loans and deposits in a foreign currency than on loans in the domestic currency. Currently, the difference in long-term loans is around 1.5 percentage points and during recent months short-term loans in lats have actually become cheaper than loans in foreign currencies.

Although Latvian banks are not yet efficient by EU standards, their profitability is improving. As in the other Baltic countries, the technological development of the sector has been accelerated through foreign investors and that will promote many efficiency improvements in the banks also in the coming years. In 1998, Latvian banks suffered relatively large losses due to the Russian crises but since then the banks have been profitable every year. In the first half of 2002, the profit in the Latvian banking sector was €40 million, an increase of 17 % compared to the same period of the previous year.

Chart 4. Credit by sectors (as % of GDP) at end of period.



Source: Bank of Latvia

3.2 Non-banking sector

As already mentioned earlier, the Latvian financial sector is very strongly dominated by the banks. The other forms of financing have not become that common and only for a very few enterprises does the security market offer a viable option for financing. In the future, co-operation with other stock markets is expected to brighten up the sluggish Riga Stock Exchange and the on-going pension reform will bring institutional investors into the market.

In Latvia, the third pillar of the new pension system (voluntary pension fund) has been working since 1998. However, it has not been popular to augment the funds voluntarily. At the end of 2001, only 17,000 employees participated in these funds. In July 2001, the second pillar, or the mandatory pension funds, started to operate. Everyone under 30 years old has to participate in these funds. At the moment, there are four pension funds with 14 different options working in Latvia.

Stock market

The development of the Riga Stock Exchange (RSE) was stagnant in the 1990's, and its activities really started to work only in 2000, when capitalisation of the market doubled and the total turnover of the market became eight-fold. Currently, there are only three shares on the official list and the total number of listed shares is 63. The market capitalisation of RSE amounted to €740 million (10% of GDP) at the end of June 2002. In 2001, the total stock market turnover amounted to €180 million. This year the turnover of shares has been somewhat lower than a year ago.

Non-residents own more than half of the shares in RSE and more active international cooperation is expected in the future, as the HEX group - the owner of the Helsinki Stock Exchange - bought 93% of the RSE in August 2002. Like in Estonia, HEX ownership is expected to increase interest and liquidity in the market.

Bond market

The Latvian security market consists mainly of the stock market and government debt securities. The private debt securities were valued at less than €40 million at the end of June 2002. At the same time, the nominal value of government securities was €450 million. Most of the bonds are three or five year T-bonds. Like in the stock market, the trading in the debt market really started only in 2000. One reason was that the trading started with government securities on the official list at the end of 1999. In 2001, the turnover of debt securities amounted to €720 million.

Insurance and Investment funds

The structure of the scattered insurance market has been reformed in recent years. At the end of 2001, there remained 21 insurance companies working in Latvia. Non-resident investors own more than half of the paid share capital in the insurance companies. Although the insurance market in Latvia is larger than the one in Estonia, it is still very much undeveloped when compared to EU countries. Gross collected premiums amounted to €160 million in 2001.

Assets in investment funds started to grow rapidly from the beginning of 2001. By the end of March 2002, the assets of investment funds had grown to €18 million.

Leasing

The leasing market is growing very fast in Latvia. The leader in the market, with 42% of the market share, is Hansa Leasing, a subsidiary of the Hansa Group. In 2001, the leasing market grew 62% and amounted to €500 million. Often leasing financing is channelled for purchases of cars and real estate.

Credit Unions

There are 22 credit unions operating in Latvia. At the end of March, their assets amounted to €3 million. The main type of credit union activity is providing short-term and medium-term loans to their members, mainly for the purchase of consumer goods. The share of loans issued to members comprised almost 80% of assets. The credit portfolio has grown rapidly (48% in 2001).

Box 2. *Is the rapid growth of the loan stocks in the Baltic countries sustainable?*

The favorable macroeconomic development and decreasing interest rates have accelerated the growth of the loan stocks in the Baltic countries since early 2000. The credit growth rate has been fastest in Latvia, while Lithuania suffered longer than its neighbors from Russian crises (Chart 5). At the end of June 2002, the amount of credit to the private sector was up y-o-y 23% in Estonia, 42% in Latvia and 23% in Lithuania. The high growth rates have raised the question whether or not such a rapid growth of credit is still sustainable.

So far, the Bank of Estonia has been the only one that has announced to be worried about the rapid loan growth. The loans growth has increase domestic consumption and simultaneous difficulties in the export sector have led to relatively rapid growth in current account deficits, particularly in Estonia. During the first half of 2002, the deficit amounted to 12% of GDP in Estonia and 6% in both Latvia and Lithuania. This has been expected to cause some instability in the market and in September the Bank of Estonia announced that it will restrict loan growth by shifting €64 million of the government's deposits with commercial banks to the central bank. Otherwise, the reactions to the rapid growth of loans have been moderate.

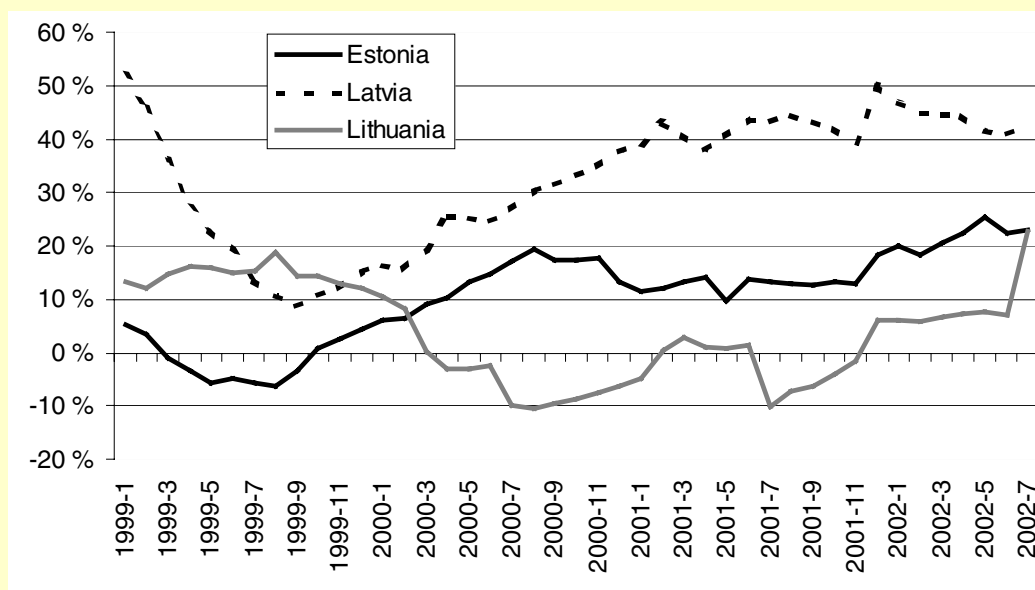
The current development have often be seen as a natural phase in the economic development of these countries and as a convergence with the EU market area as the level of credit in the Baltic countries is still low compared to the credit level in the EU area. At the end of June, the credit allocated to the private sector amounted to 31% of GDP in Estonia, 32% of GDP in Latvia and 12% of GDP in Lithuania. Another fact that defends the sustainability of high credit growth in the Baltic countries is that the amount of non-performing loans has stayed very low in Estonia and Latvia and is still declining in Lithuania. At the end of March 2002, the share of non-performing loans of total loans was about 2% in Estonia, 3% in Latvia and 7% in Lithuania. Also inflation rates and interest rates have remained low. The fact that the majority of the providers of loans are foreign-owned banks, which have strong financial backing, sound corporate governance and expertise on risk management, makes such growth more sustainable. The banks have not seemed to take many risks either, as their average capital adequacy ratios are in all three countries well above the legal limit of 10% and the 8% recommendation of the BIS. The IMF has analysed the financial system both in Latvia and Lithuania in 2001-2002 and according to these reports, there appear to be no immediate threats to financial system soundness.

The growth of loans has dispersed to numerous sectors of the economy. In all three Baltic countries, the mortgage loan market has grown the fastest. This has also accelerated growth in the construction sector and the prices of real estate have slightly risen in some areas. There are also signs that the conditions for mortgage loans have been loosened in some cases. On the other hand, the fast rise in apartment prices in Tallinn last year has turned to a fall this year and also in Riga the price level has remained relatively stable. In any case, the level of mortgage loans in the Baltics is still relatively low and the market was practically non-existent in Lithuania a couple of years ago. Thus, high growth rates in this case seem to be part of economic development.

In addition to the mortgage loans, another kind of lending to the private sector has increased as well. Both the bank credit as well as the leasing financing for household consumption is growing. At the same time, investments have grown briskly and loans to private enterprises have increased about a quarter y-o-y in all Baltic countries. The growth of loans has been strong in nearly all economic sectors. The loans granted to the public sector have noticeably increased only in Lithuania. While the state budgets are relatively well balanced, a few municipalities are running large deficits and are looking for financing.

However, the fact that is worrying authorities particularly in Estonia, is the debt of households. Currently, the loan stock of households is growing more rapidly than their deposits. Thus, continued close monitoring is required. New supervision organisations started their work in Latvia and Estonia last year. The legislation and many practices have been carefully put in place together with foreign experts. These institutions seem to work well but there is still a possibility of a lack of resources. When the loan stock is growing as fast as it is at the moment, one can ask if there is still a sufficient number of capable supervisors to do the monitoring work in these countries.

Chart 5. Credit granted to the private sector. Y-o-y growth.



Source: The central banks of the countries

4 Financial markets in Lithuania

The Lithuanian financial sector is one of the smallest among the EU accession countries when proportioned to the size of the economy. During the last decade, the rearrangement of the sector lagged behind the development in the other Baltic countries. Privatisation was carried out later and as a result, foreign investors arrived a few years later in Lithuania than in Estonia or in Latvia. As the other sectors of the economy, the Lithuanian financial sector started to recover later after the Russian crises than Estonia or Latvia. This was due to the fact that Lithuania had closer trade relations with Russia and other CIS countries than the other Baltic countries. While the loan stocks of Estonian and Latvian banks started to grow again already at the beginning of 2000, it was not until the end of 2001 that the volume of loans started to grow again in Lithuania. One more reason for this relative lack of development is that there are still many Lithuanians who do not trust the local financial sector and keep their savings in cash. Stable, foreign-owned banks will presumably take care of this problem in coming years.

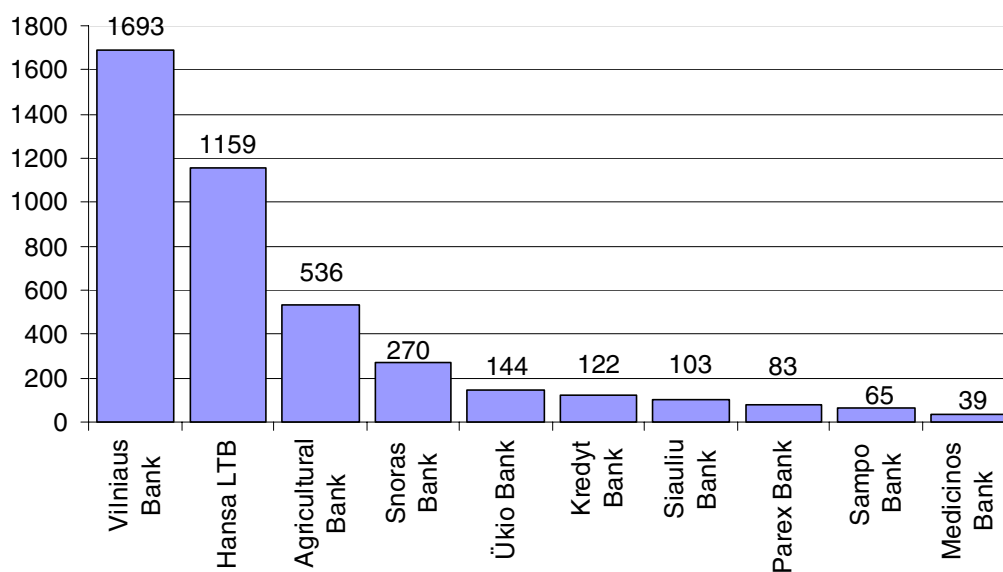
Just like in the other Baltic countries, the Lithuanian financial sector is dominated by the banking sector. The other channels of financing are modest. Thus, the lack of financing particularly for small- and medium-sized enterprises seems to be a real hindrance to economic growth in Lithuania, as also the banks have been relatively strict in their credit policy. Probably closer integration with Western European economies will accelerate the development in the coming years and also the problem of the lack of financing will be removed. Currently, a large share of investments is financed from enterprise cash flows.

4.1 Banking sector

Banks are the most important intermediators of financing in Lithuania. Although the banking sector, as well, is still small and the volume of the financing that the banks are offering is modest, brisk development is expected to happen in the near future, because the sector has undergone many structural changes in recent years. Privatisation was completed at the beginning of 2002, when Lithuania sold its last state-owned bank, Agricultural Bank, to a German bank. As a result of privatisation and mergers, the Lithuanian banking sector is nowadays very much owned by foreign banks. This has led to a pulling down of extra capacity and many efficiency improvements in the sector. New owners have brought new technology to the sector and increased the variation of services and products in the market. In parallel, favorable economic development and approaching EU membership have increased investments and the demand for financial sector services this year and the development is expected to continue.

Currently, there are ten deposit banks and four branches of foreign banks operating in Lithuania. The sector is very much concentrated and the two biggest banks – Vilniaus Bank and Hansabank – control almost 70% of the assets of the whole sector (Chart 6). Foreign ownership in the Lithuanian banking sector is very large. Swedish SEB owns Vilniaus Bank (the biggest bank in Lithuania) and Estonia's Hansabank, in which Swedbank holds a majority stake, bought Lithuanian Savings Bank (the second biggest bank) in 2001. At the moment, the share of foreign capital in Lithuanian banks is estimated to be 89% and foreign banks have the majority power in seven banks.

Chart 6. Total assets of Lithuanian banks (in million euros) at the end of May 2002.



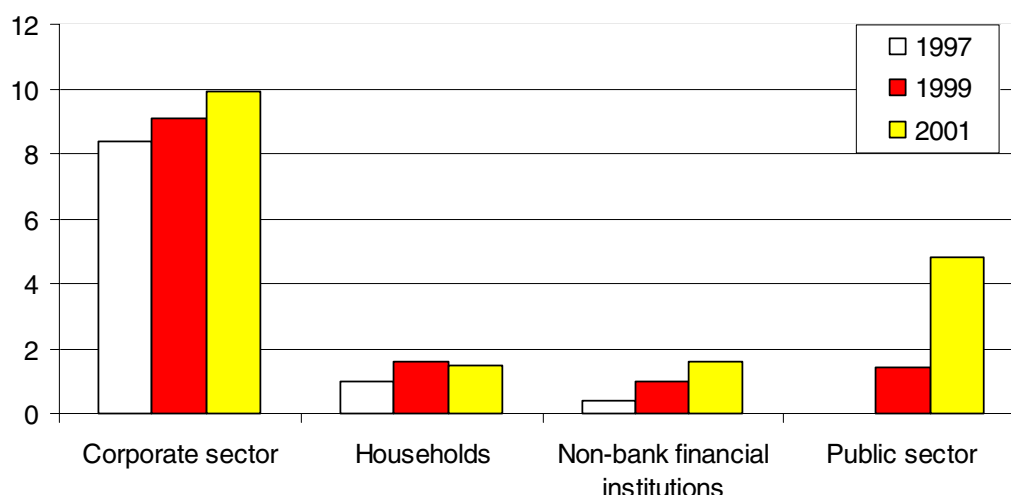
Source: Bank of Lithuania

For the reasons mentioned above, the Lithuanian banking sector is considerably smaller than the sectors in Estonia and Latvia. At the end of July 2002, the banks' total assets were €4.5 billion, or about 32% of annual GDP. Total assets were up 16% y-o-y.

After the Russian crisis, the amount of credit started really to grow in Lithuania only at the end of 2001. At the end of July 2002, the total amount of credit was €2.9 billion, or 21% of GDP, and it was 23% larger than at the end of July 2001. Loans granted to the private sector and central government have increased most (Chart 7). Almost 60% of loans

are granted to the private sector, mainly to private enterprises. Loans to households have actually started to increase only this year and, for example, the mortgage loan market was practically non-existent earlier. In the first half of 2002, the amount of mortgage loans doubled.

Chart 7. Credit to economic sectors (as % of GDP) at end of period.



Source: Bank of Lithuania

More than half of the loan stock is comprised of loans in foreign currency. Traditionally, such loans have been granted in US dollars. Lately euro loans have also increased in popularity and in February 2002, after the litas repeg to the euro, the amount of credit granted in euros exceeded the amount of dollar loans. The interest rates on loans in foreign currency are still slightly lower than the interest rates on litas loans. Over recent years, the maturity of loans has lengthened in Lithuania, as in the two other Baltic countries.

The quality of loans has improved significantly during recent years. In 1997, the non-performing loans amounted to 28% of all loans but by the end of 2001, the share of non-performing loans of total loans had declined to 7%. The average capital adequacy ratio in the Lithuanian banking system was 15.4% at the end of June 2002 and exceeded the minimum requirement of 10% set by the Bank of Lithuania. Also the liquidity ratio (45%) was considerably higher than the minimum requirement of 30%. The main conclusion of the FSAP report of the IMF, which was finalised at the end of 2001, was that there were no major immediate risks to the stability of the Lithuanian financial system. However, continued strengthening of the institutional underpinnings of financial stability will be important in seeking to limit the risks in the sector.

On the other hand, one could ask if the banks in Lithuania are too risk-averse and if small- and medium-sized enterprises as well as new business projects are suffering from insufficient financing. The high capital adequacy ratio and low ratio of credit to GDP may be signs of such a trend, which can be harmful to economic development.

Bank deposits have grown relatively fast during recent months. By the end of July, the deposit stock was about 20% larger than a year ago. The deposits of non-residents are important, as they comprise a quarter of deposits in foreign currencies and more than 10% of all deposits in Lithuanian banks.

The effectiveness of the Lithuanian banking sector has been lower than in Estonia and in Latvia. One reason for that is state ownership, which lasted longer in Lithuania than

in the other Baltic countries. State ownership obstructed the renovation of the sector by hindering, for example, the elimination of the too dense office network. Thus, the wage and operating costs in the sector were very high. Also the high share of non-interest bearing assets, like reserves, is a reason for the low profitability. The small size of some banks hinders them from getting any benefits from economies of scale. At the moment, after the privatisation of the last two banks in 2001-2002, the situation is changing and efficiency improvements are going on in the sector. In the first half of 2002, the profit of the sector amounted to €24 million, a third larger than a year ago. Interest income is still the main income of the sector.

4.2 Non-banking sector

In Lithuania, the role of the non-banking financial sector is small. The size of the security market is modest and only a few enterprises use the debt market or the stock market as a means of financing. Behind the backwardness of the market are very much the same factors as in Estonia and Latvia. Many Lithuanians cannot afford investing in risky instruments and for many of them, the security market is very much an unknown. The lack of institutional investors is prevalent in Lithuania. Insurance companies are small and the pension reform, which has already formed obligatory pension funds in Estonia and in Latvia, has not yet been approved by the Lithuanian parliament.

In coming years, EU membership will bring the large European markets closer to the Lithuanian markets. It is likely that the Lithuanian security market is going to follow the examples of the stock markets of Estonia and Latvia and it will also be closely connected to a larger market. This could increase interest among foreign investors in Lithuanian securities. If the favourable economic development continues and pension reform introduces lagging domestic institutional investors into the market, also the domestic demand for debt securities and stocks might increase.

Stock market

Although the stock market of Lithuania started to operate already in 1994, its poor development has been a disappointment. The number of listed companies was high in the mid-1990's (607 in 1997) because all privatised companies were taken into the stock exchange. Currently, there are only 42 listed companies in the market. In the official list, there are seven companies, out of which Lietuvos Telekomas is dominating. The capitalisation of listed stocks on the Vilnius Stock Market (NSEL) is €1.4 billion, or 15% of GDP. The capitalisation of unlisted shares is €1.5 billion.

The market is also very illiquid. In 2001, the total turnover of shares was €270 million. Only a few companies are traded gradually. In 2001, foreign investors held approximately 8% of the total listed stock capitalisation. That is more than half of the estimated total free-float capitalisation.

The Vilnius Stock Market has been negotiating with the Warsaw Stock Exchange about possible cooperation in the future. So far nothing concrete has happened and the Helsinki Stock Exchange has announced its interest in buying also the Vilnius Stock Market. HEX intends to integrate all Baltic stock exchanges by introducing a common trading system that would make them more efficient and also more attractive to international investors.

Bond market

The bond market in Lithuania is dominated by government securities. The private bond market is very small. In 2001, the government organized 52 auctions for T-bills and bonds. At the end of June 2002, the capitalisation of government securities was €0.7 billion, briskly larger than a year ago. The longest maturity of issued bonds has been 10 years.

Insurance

The insurance sector is small in Lithuania but it is currently developing significantly. The new law on compulsory transport insurance has accelerated the development this year. There are nine life insurance companies and 26 non-life insurance companies operating in Lithuania. In 2001, the total written premium for life insurance amounted to €27 million and for non-life insurance to €100 million. In the first half of the year, mainly due to an increase in motor vehicle insurance, the written premiums for non-life insurance already doubled compared to the corresponding period of last year and amounted to €100 million.

Leasing

There are nine leasing companies in Lithuania. The aggregate portfolio of the companies amounted to €380 million at the end of June 2002. The sector is growing fast and the portfolio was 65% bigger than a year ago. The major leasing objects are transport vehicles.

Credit Unions

There are 47 credit unions in Lithuania. The unions are all very small. The sector is growing and new unions are being founded. The assets of the unions more than doubled in a year and amounted to €14 million at the end of June 2002.

Box 3. Foreign ownership – pros and cons

When the Baltic countries reformed their banking sectors after the banking crises in the latter half of the 1990's, they very often selected a foreign bank as a new strategic investor. Currently, the share of capital of the sector owned by foreigners is in Estonia about 85%, in Latvia 70% and in Lithuania almost 90%. The only domestically owned notable bank is Parex Bank, which is the biggest bank in Latvia.

In all three countries, Swedish Swedbank and SEB play an important role in the market. Swedbank owns the Hansabank group, which has the biggest bank in Estonia, the second largest bank in Lithuania and the third largest bank in Latvia. SEB owns the largest bank in Lithuania (Vilniaus Bankas) and the second largest banks in Estonia (Estonia Ühispank) and in Latvia (Latvijas Unibanka). There are also considerable investments from Finland and Germany in the sector. Nordea has branch offices in all three Baltic countries. Nordea is the third biggest bank in Estonia and the eighth biggest bank in Latvia. Finnish Sampo Bank has the fourth biggest bank in Estonia and the ninth biggest bank in Lithuania.

Several economists have addressed the potential benefits of foreign bank entry for the domestic economy. It can lead to improved resource allocation and higher efficiency (Claessens et al. 1998). Levine (1996) mentions that foreign banks may improve the quality and availability of financial services by increasing bank competition and enabling the application of modern banking skills and technology, may stimulate the development of bank supervisory and legal frameworks and enhance a country's access to capital. It has also been thought that foreign bank entrants could enhance local financial stability (Crystal et al. 2001).

There are not many empirical studies on the subject. Demirgüç-Kunt and Huizinga (1997) found that foreign ownership is linked to higher proficiency and interest margins particularly in poor countries. The results of the study by Claessens et al. (1998) indicate that foreign bank entry leads to greater efficiency in the domestic banking system. They also indicate that foreign banks tend to have higher profitability than domestic banks in developing countries. In developed countries, the opposite is true. Crystal et al. (2001) studied Latin American countries and found that foreign ownership may provide important positive influences on the stability and development of emerging market banking systems. Bol et al. (2002) found that in addition to being profitable and efficient, foreign banks have been less sensitive to economic and financial crises than domestic banks in Central and Eastern Europe. According to their study, the costs of operation are slightly smaller for foreign banks than for domestic ones.

In the Baltic countries, the efficiency of the sector as well as the quality of loans have improved significantly during the last few years, when large foreign ownership has been present. The banking sector in these countries used to be very inefficient due to exhaustive branch networks and high wage costs. Yildirim and Philippatos (2001) concluded as such when studying the efficiency of banks in transition countries. According to their study, the cost efficiency in the Baltics was very low in 1993-2000. When measuring profit efficiency, Estonia and Latvia were doing fine already in the studied period. However, the reconstruction has led to a more efficient banking sector and the reforms are still going on in Lithuania and also in Latvia some reorganisation of the sector is still expected. The banks in the Baltic countries have invested very strongly in new technology and Internet banking is already working in these countries. At the same time, the financial sector supervision has been developing and one sign of the success of the sector during last year has been the decreasing margins between deposit and lending rates and low non-performing loan rates.

However, it is difficult to say if the development would have happened in any case after the banking crises when there was a need for reconstruction. The improvement in the quality of loans may have simply followed the beneficial economic development in the Baltic countries and the fast development in legislation and progress in financial supervision is mainly due to the closer integration with the European Union and other international institutions.

On the other hand, it would have been very demanding for domestic investors to commit to all the reorganisation and improvements in such a short time period that the foreign banks used for this task. The Nordic banks reorganized the Baltic banks very quickly and improved the efficiency of the sector. The modern technology, particularly Internet banking, which is already in place and widely used in the Baltics, is certainly a result of the entry of the Nordic banks. The technological applications have been easier and cheaper to make since the system has already been working in the same bank group in other countries. Also the increased consolidation of the sector has arrived along with the solid investors. Larger organisations behind the small Baltic banks have facilitated the introduction of a large number of new products in their relatively small markets. The human capital in the Baltic banking sector has certainly increased after the arrival of foreign owners.

But one can also find disadvantages following from the foreign ownership of banks in the Baltics. One could, for example, disagree with Levine's comment on the availability of financial services. In all three countries, foreign ownership has also meant very large cutback in branches and thus the availability of services may have decreased in some areas. Even the development of Internet banking may not have recovered this loss. Some analysts also argue that the insufficient financing to SMEs is a result of foreign ownership. It has been thought that the foreign banks are not so enthusiastic about taking risks related to SME financing and they have established tighter relationships with big enterprises. Clarke et al. (2001) found the same kind of phenomenon in the Latin American countries.

5 Conclusions

The financial sectors of the Baltic countries are currently stable and no immediate threats are apparent. However, the level of financial sector development in the Baltic countries is still lagging clearly behind the sectors in the EU countries. Although the sectors, particularly the banks, are developing rapidly at the moment, the difference is remarkable both in the level of financing but also in the variety of instruments available in the markets. At least in some cases, insufficient financing may work as a hindrance to economic growth in the Baltics. Small and medium enterprises and new projects seem to suffer most from the situation.

One reason for the small assortment of financial instruments in the market is certainly the small size of the economies. It would be unrealistic to expect that the size of the domestic security market would suddenly grow remarkably. Thus, the integration of the Baltic stock markets, which has partly already been realized, is a much more reasonable path of development. The closer cooperation can render local markets liquid and an eligible option for financing. Currently, the Baltic economies are very much dependent on external financing. A large share of investments is continuously financed by foreign investors and enterprises. Also cash flows are an important means of financing in the Baltics.

The banks are dominating the domestic financial sectors in the Baltic countries. Over recent years, when economic development has been brisk, the banking sectors have grown rapidly. The growth has been speeded up by the large structural reforms that started after a few banking crises in the second half of the 1990's. These reforms decreased the number of banks in the countries, ended the privatisation in the sector and most of the banks were transmitted into the hands of foreign banks. The reforms have stabilized the market and also the general trust in the stability of the system has increased among the citizens. In ad-

dition, the foreign owners have introduced many efficiency improvements in the sector. The newest technology is widely used in the Baltic banks and Estonia is one of the leading countries in Internet banking. Decreasing interest margins are one sign of the improved efficiency in the sector. Also the maturity of loans has lengthened.

So far, the rapid growth of loans has been sustainable. The growth has been supported not only by brisk economic growth but also by the decreasing interest rates. The loans are dispersed to the various sectors in the economies and the growth can be seen as a part of the economic convergence towards the EU area. High growth rates in loans to households are partly explained by the birth of real estate markets and brisk economic development together with the approaching EU memberships, which have increased the investments in the economies. The price level has remained stable, interest rates have stayed at a low level and overall, the level of loans is still relatively modest. Also as a sign of stability in the banking sectors, the amount of non-performing loans has remained low and the high average capital adequacy ratios are indicating the risk aversion of the banks. Thus, no large disturbances can be seen in the market. There are even skeptical analysts who argue that the Baltic banks are hindering economic growth when not taking enough risks and being too strict on crediting the small and medium enterprises. However, the close monitoring work by the supervisory institutions is of course essential in the coming years.

In the future, the approaching EU memberships and closer international co-operation are expected to diversify the channels of financing in the Baltic countries. All the Baltic countries have already accepted the legislation of the European Union concerning the financial sector and related to that, no major changes are expected. The biggest effect could be related to an improved business environment and increased investments, which could lead to a larger demand for financial services in these countries. Closer integration will also make it easier for foreign banks and financial institutions to start up operations in the Baltic countries and this might increase competition in the financial sector. The pension reform, which will create more pension funds in the Baltic countries, will partly relieve the lack of institutional investors in security markets. There are also new, partly public projects, which try to find risk financing for new enterprises. This is important, because although integration and globalisation are removing many hindrances to finding financing from abroad, it is still often too expensive for small enterprises.

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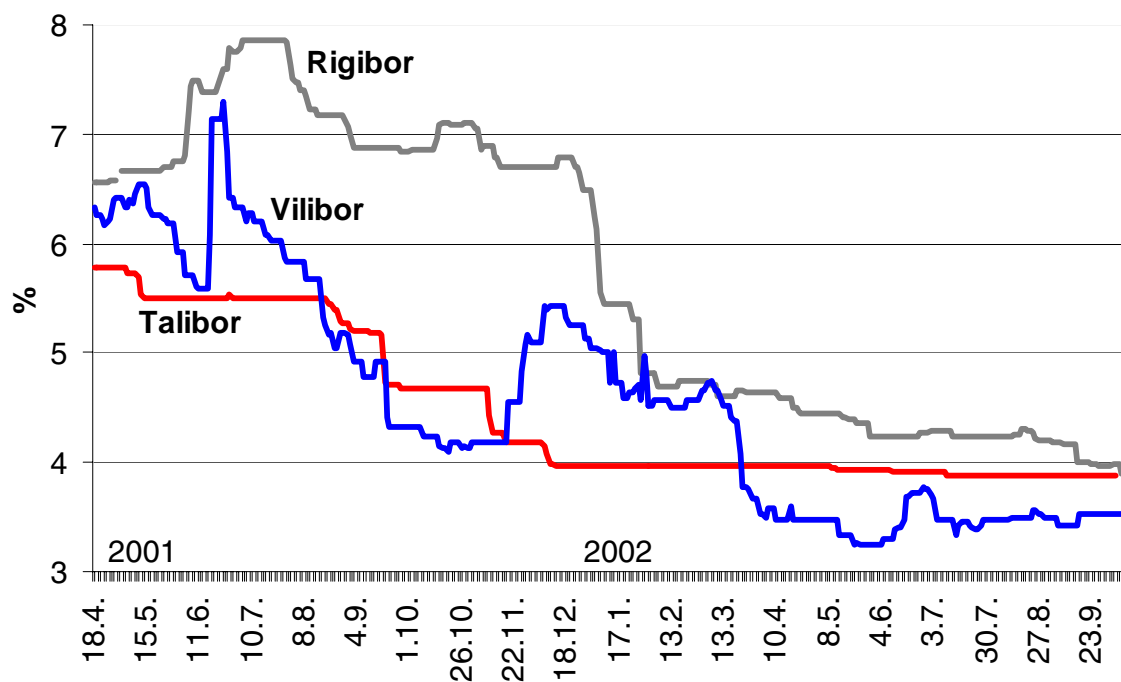
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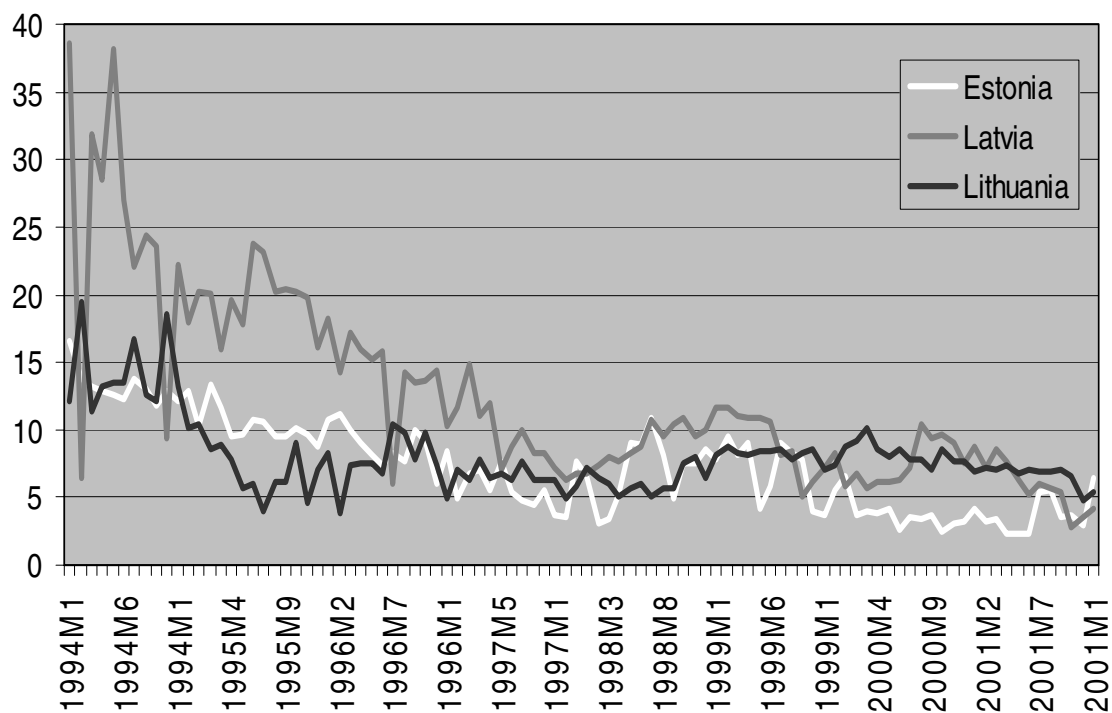
Appendices

Appendix 1. Three-month interbank interest rates, %.



Source: The Central Banks.

Appendix 2. Margins between lending and deposit rates, percentage points



Source: IFS/IMF

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