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Private Sector Development and Liberalization in the Baltics[1]

1 Introduction

The key component of a market economy is private enterprise operating in a competitive environment. This makes the ownership of companies one of the basic issues in the transition to a market economy. Thus, in the former socialist countries it is crucial to encourage private initiative and replace state ownership by private ownership.

But allowing private entrepreneurship is not sufficient. Fundamental changes are needed in the way the surrounding economy operates. This includes essential changes in the financial sector, as well as in the fiscal and budgetary areas. Markets must be created and private companies must be disciplined by market forces. Promoting competition requires new codes of conduct, legislation and bodies for law enforcement. Markets also need organizations to supervise the activities of the private participants.

The aim of this paper is to discuss the current stage of economic transition in the Baltic states, with special emphasis on the development of private sector activities and the preconditions for such activities. Baltic countries have had considerable success in several areas of their economic transition, and especially Estonia can become a model case of transition.

In general, the transition process in the Baltics follows the same lines as the transition in the other former socialist countries. The problems encountered are the same, and the approaches taken are in most cases well-known from other countries. The Baltic countries, however, provide a very interesting case study for economic transition. These countries are the first former republics of the Soviet Union to launch a genuine transition to a market economy, and they have done it in very difficult circumstances. In addition, they have made some rather unusual choices concerning their economic policies.

In examining the Baltic countries, one should bear in mind that the Baltic area indeed consists of three separate and in many aspects differing states, which should not be simply grouped together as a single entity. These countries naturally share common features, stemming mainly from the Soviet era, but as time goes by their individual characteristics become more salient.

The general aim in every Baltic country is the transition to a market economy. However, due to political, cultural, ethnic and perhaps some other differences, the practical means of achieving this aim have been quite different in each of the countries.

[1] The views expressed in this paper are those of the author and do not necessarily reflect the views of the Bank of Finland.

2 Developments in the Baltics

2.1 Political Factors

The essential ingredient for economic transition in every former socialist country is the commitment and will of its political leaders. The Baltic countries present three widely differing cases, as is reflected in the progress of transition in each country.

Estonia is clearly the leader in the transition process. It appears that the Estonians are firm and unanimous in their support of the reform. At least until now, the people of Estonia have been ready to make sacrifices in order to promote the building of their national economy. The majority of the seats in Parliament are held by members of right-wing parties, who have joined with social democrats to form the Government and are strictly committed to reform.

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

The situation with respect to reform in Latvia and Lithuania is somewhat less clear than in Estonia. Latvia is troubled by its large minority – almost a half – of people of other nationalities (mainly Russians). Latvia was the last of the Baltic countries to organize free parliamentary elections in June 1993, and the old parliament that functioned until that time was not capable of deciding on any major reform measures. In the new parliament, the majority of the seats went to centrist parties, two of which formed a minority Government. The ruling coalition is pushing for reform, and certain major steps have been taken since summer. However, actual progress has been quite limited due to the reorganization of ministerial and other governmental structures after the election. The fact that the ruling coalition has only a minority in Parliament may hamper the push for reform.

Lithuania's political situation is quite different from that of both of its Baltic neighbours. The ruling political force consists of former communists, that make up the Lithuanian Democratic Labour Party, which won a majority of seats in the parliamentary elections of autumn 1992. Despite of their political past, they have proclaimed their support of and intention to push on with reform, and in several areas reform measures have been taken. The greatest difference here compared to the other Baltic countries perhaps lies in the unclear commitment to reform of the Lithuanian political leaders. This is demonstrated by the sometimes contradicting statements of the leaders as well as by inconsistencies in the reform measures that are taken.

2.2 Private Sector Activities and Privatization

The development of private activity has been exceedingly pronounced in the Baltic countries during the past couple of years. This concerns mainly the small-scale service sector, such as catering and retail trade, where in Estonia and Lithuania about 80 to 90 per cent of former state owned firms have been privatized, most often by selling them to the management and employees. Latvia, on the other hand, is clearly lagging behind its neighbours in respect to privatization, although also there small-scale privatization has made progress.

Private initiative is even more apparent in the creation of new enterprises, which abound in the capitals and larger cities of the Baltics. In addition to daily services, trading as well as financial and other services rendered to the enterprise sector are areas in which new companies have been active.

The privatization of large state owned companies has proceeded rather slowly in the Baltic countries – as in all the other countries in transition. It is quite difficult to find buyers for these companies; there is not enough financing available in the domestic markets, and foreign investors are not very interested in acquiring them, except perhaps for a few of the best such companies available.

One solution to the problem is to distribute the ownership of these companies to the population for free with the help of various voucher schemes. Lithuania has used this method for some years already, and now Estonia and Latvia are introducing their variants of voucher privatization. In addition to such so-called mass privatization, the Baltic countries are also employing other methods.

The Baltic states have put a clear emphasis on privatization in their economic development programmes, and they have all recently launched new privatization schemes and restructured their privatization policies. This may be an indication that these countries believe that a significant part of state enterprises is actually viable and worth privatizing. The other option would be to let those companies die a natural death and sell the machinery and buildings that are of some value.

One special factor retarding privatization in all the Baltic countries is the question of restitution for property that was confiscated after the annexation of the Baltic countries to the Soviet Union. The Baltic countries have chosen to honour the requests of former owners to return such property. This hampers privatization because new investors cannot be certain about the true ownership of the property when they buy it. In Latvia, for example, the period for filing restitution claims for land in towns and cities is ten years. Recently, however, proposals have been made to revise the restitution law so as to move up the deadline for claims.

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

Estonia has been most active in offering its companies in international tenders. In 1993 it organized three rounds of tenders in which about 130 companies were offered to both domestic and foreign buyers. So far, more than 30 deals have been concluded[2]. The exact number of foreign investors that have

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[2] Delovoy Mir, 24 December 1993.

been involved is not known, but at least a few companies have been sold to foreign firms or to joint ventures formed between Estonian and foreign enterprises.

In November 1993, of the 48 thousand enterprises registered in Estonia, apparently more than 60 per cent were privately owned. (The number includes 5 thousand private farms.) This share reflects the rapid emergence of new private companies more than the privatization of medium and large scale enterprises. This is evident if one compares the above number of registered enterprises with the corresponding number at the end of the previous year, some 34 thousand[3].

The growth of new private initiative is also obvious from the fact that Estonian business life is dominated by smallscale entrepreneurship; about 95 per cent of all companies employ a maximum of 50 persons, and of these companies the share of those employing no more than 4 persons is as high as 82 per cent. The share of companies that have not yet commenced operations is quite high; according to some estimates it amounts to one third of all newly established enterprises and is concentrated in the small companies. These inactive enterprises have been most often formed in order to be sold[4].

Privatization of medium and large scale enterprises has proceeded most rapidly in Lithuania, where the process was started as early as 1991. Lithuania has from the very beginning applied vouchers which are distributed to all citizens and which can be used in buying housing, land, and companies or their shares. Employees of the companies to be privatised are in an exceptionally good position in Lithuania; they currently have the right to acquire up to 50 per cent of the shares at a discount. Additionally, 11 per cent of the shares remains with the state. These large portions may hinder outside investors in acquiring ownership of enterprises, and there are plans to reduce the portion of shares offered to employees. Lithuania has also offered enterprises for privatization to foreign investors, but the response has been muted.

In Lithuania currently about 70 per cent of all state companies by number and 35 per cent in terms of combined capital have been privatised.[5] It is obvious that the rapid speed of privatization has affected the outcome of the process. It is widely rumoured that authorities have not been able to control the process of privatization and that illegal money is used extensively in buying companies. There are also problems regarding the use of monopoly power by some privatized companies in certain markets as an inheritance from the Soviet era. Companies were not restructured before privatization began, markets are not functioning properly, and state control over monopolies is not yet very effective.

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

[3] Riigi Statistikaamet, Eesti Statistika 1992, Kuukiri nr. 11. Riigi Statistikaamet, Eesti Statistika 1993, Kuukiri nr. 10.

[4] Urve Venesaar, Endel Vitsur, Development of Entrepreneurship in Estonia (Estonian Academy of Sciences, Institute of Economics, Reform Round Table, Working Paper No. 1, Tallinn, October 1993).

[5] Baltic News Service, 4 October 1993.

fear that other nationalities would acquire the country's wealth, and this is one reason for the rapid progress that has been made in Lithuania.

Privatization has been slowest in Latvia, where privatization of medium and large scale companies has hardly begun. One reason for this is the problematic nationality structure of the country's population with the large minority of foreign ethnic groups. Final adoption of the citizenship law, which is slated for spring 1994, should clear up the situation.

The Baltic countries are eagerly waiting for Western investors to establish operations in the area and to take part in privatization. At the same time, there is a fear in these countries that Russian money is entering in large quantities – most often through third country intermediaries – and gaining a grip on the Baltic economies. Understandably, no exact figures on invested money of Russian origin can be found, but there is speculation to the effect that a considerable share of "Western" investment is actually Russian. Most recently, during the governmental crisis in Estonia, President Lennart Meri accused the Government of not being active enough in stopping the flow of Russian capital into Estonia.

One important consideration for the Baltics in privatization is the question of land ownership. In Estonia legislation concerning the ownership and sale of land and real estate was passed in the Parliament during the spring and summer of 1993. These laws institute private ownership of land and real estate for Estonian citizens and enterprises. A foreign enterprise is allowed to acquire land or premises that are necessary for its operations, with the permission of municipal authorities. As the legislation concerning sale procedures is currently being drafted, the sales activity is only in the beginning stage.

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

Lithuania allows private ownership of land only for Lithuanian citizens. There has been discussion about extending ownership to domestic legal persons as well, but it is unclear whether that has been done yet. In October 1993 Parliament rejected a bill that would allow the sale of land to foreign enterprises, whose only alternative now is a long term lease. In Lithuania by the beginning of 1993 about 10 per cent of the land area had been returned to its previous owners.

3 Prerequisites for Private Sector Development

Liberalization of the economy from the old administrative methods is a prerequisite for the transition to the market economy. This is an area in which the Baltic countries have made considerable progress; Estonia in particular has moved with surprising dispatch. The speed of progress in this area is underlined by the fact that the Baltic countries gained full economic independence as late as summer and autumn of 1992, when they discarded the Russian rouble.

3.1 Price Liberalization

When the former administrative price setting mechanism is abolished, prices regain their function as an allocative instrument. Technically, it is quite simple to lift price restrictions, but the problem concerns the political and social acceptability of the measure. As regards consumer prices, their liberalization must be coordinated with adequate social policy measures, such as aid for the poorest strata of the population. In the Baltic countries prices were liberalized within a relatively short period of time, without serious public opposition.

Estonia started to dismantle its administrative economic mechanisms in late 1989, when price liberalization was initiated. At the beginning the aim was to use higher prices to protect local markets from an onslaught of buyers from other parts of the Soviet Union who might readily empty the relatively well-stocked Estonian shops. The majority of prices were liberalized by the end of 1991, and at the beginning of 1992 the rationing of most of the important goods was disbanded. The results were quickly apparent, as by the end of the same year the Estonian market had ample supplies[6].

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

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

[6] Ants Kala, Customs Policy and Development of Foreign Trade in Estonia (Estonian Academy of Sciences, Institute of Economics, Reform Round Table, Working Paper No. 2, Tallinn, October 1993).

In Latvia and Lithuania the situation regarding existing price controls is about the same than in Estonia. Household energy prices and prices of municipal services are the most important items still under regulation. In all the Baltic countries household energy prices have been raised considerably during the past few years. The aim is to raise these prices to world market levels, and to pay compensation to the most vulnerable parts of the population as a part of the social safety net.

Liberalization of energy prices, which used to be heavily subsidized during the Soviet period, is of utmost importance for the efficient allocation of productive resources. There still seems to exist some control over energy prices for industry in the Baltics, chiefly as regards natural gas and electric energy. In Estonia in addition to these, the price of oil shale, the important domestic energy source, is controlled[7].

3.2 Foreign Trade Liberalization

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

The small economies of the Baltic countries are dependent on foreign trade, and the opening of their economies during the past couple of years has had a marked effect on their development.

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

Estonia is the leader among the Baltic countries in foreign trade liberalization. Estonia is aiming at a very liberal foreign trade regime, and has indeed largely achieved that goal already. Estonia currently has one of the most liberal foreign trade systems in the world, and certainly the most liberal one in Europe.

In Estonia there is currently no import licensing, and import tariffs are levied only on a few items considered luxuries, such as furs, cars, and motor boats. The Estonian government's viewpoint is that it is in the Estonian consumers' interest that the state does not protect domestic producers from competing imports.

Estonia is one of the few countries that does not have any import protection regarding agricultural products. This liberal policy has caused problems, as grain has been imported from Russia at very low prices. In order to put a stop to these exceedingly cheap imports the Estonian Government imposed a 70 per cent duty on them in August 1993. As this led to a sudden rise in the price of wheat

[7] Koidu Tenno, Ellen Veski, Energy Saving Program and Restructuring of Energy in Estonia (Estonian Academy of Sciences, Institute of Economics, Reform Round Table, Working Paper No. 4, Tallinn, November 1993).

products and rechannelling of the imports through third countries, the Government decided to lift the duty in December[8].

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

The trade regimes adopted in Latvia and Lithuania resemble more closely those in Western countries rather than that of Estonia. Both of these countries exert import protection with tariffs in varying degrees. Unlike Estonia, Latvia and Lithuania have imposed effective tariff protection against agricultural imports.

Latvia has moved ahead considerably in liberalizing and introducing market economy elements into its foreign trade. Quotas have been abolished almost totally except for a few export items. During the past few years Latvia has introduced a system of import tariffs, which it applies to most industrial products, but not to raw materials. Latvia has levied import tariffs on agricultural imports as well. The amount of the tariffs varies between 15 and 20 per cent. Latvia is currently trying to streamline its tariff system, after several ad hoc decisions during the past year involving new protective tariffs have made the system rather complicated[9].

Lithuania has been the slowest of the Baltic countries in developing a foreign trade system suitable for a market economy. The last administrative quotas and licensing requirements were abolished only in summer 1993, and were replaced by tariffs. The rate of import tariff varies from 5 to 15 per cent, but a higher rate is applied to some foodstuffs and a few industrial goods. Lithuania also taxes exports, but the aim is to dismantle these taxes.

One problem in liberalizing foreign trade is related to the formation of supervisory organizations, which is a lengthy process. Latvia and Lithuania are currently just in the process of building up their customs operations, and the effectiveness of their border control – especially as regards the border with Russia – may still be questionable. The Estonians repeatedly referred to this problem, primarily concerning Lithuania, during negotiations on the Baltic Free Trade Zone.

The Baltic countries are interested in developing their trade ties with Western European countries, and according to official statistics they have already been quite successful in this regard. The leader again is Estonia, whose foreign trade with Russia (formerly its main partner) now accounts for just under 20 per cent of the total[10]. For Latvia and Lithuania Russia still is the most important single trading partner, accounting for about 30 and 60 per cent of total foreign trade respectively[11].

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[8] Baltic News Service, Baltic Business Weekly, 29 November–5 December 1993.

[9] Baltic News Service, 22 December 1993. Baltic Observer, 6–12 January 1994.

[10] 'Eesti vahetab kaupu üle 140 riigiga', Kaubalehe ärilisa, 23.12.1993–3.1.1994.

[11] State Committee for Statistics of the Republic of Latvia, Bulletin of Latvian Economic Statistics, January–June 1993. Baltic News Service, Baltic Business Weekly, 13–19 December 1993.

But this is only what the official statistics tell us. It is obvious that a considerable part of the Baltics' foreign trade takes place outside of customs control or statistical records, and this part could alter these shares – by increasing Russia's share – if it were included in the official figures.

As regards trade policy, the Baltic countries have been quite active in building their relations with Western countries. The Baltics have concluded free trade agreements with several EFTA countries: Finland, Sweden, Norway, and Switzerland. The Baltic states are also interested in a free trade agreement and, eventually, membership in the European Union, and they have started negotiations on a free trade agreement with the EU.

The EU has stressed the importance of reliable border control on the Baltic countries' Russian borders as a precondition for free trade agreements. Otherwise there is the danger that the free trade area would unilaterally cover Russia as well.

As a sign of joint cooperation, the Baltic countries in autumn 1993 formed a Baltic Free Trade Zone. Pressure for this action came rather from outside than inside the region. The Baltic countries themselves have not been especially interested in mutual cooperation, as they regard themselves more as competitors than partners in the world markets. It is the EU which has stressed the need for cooperation among the Baltics as a prerequisite for wider cooperation with the Union. Baltic area trade currently accounts for about 10 per cent of the total foreign trade of each of the Baltic countries[12].

3.3 Currency Convertibility

In addition to lifting administrative foreign trade barriers, the Baltic countries have made progress in the area of international economic relations by moving forthrightly to making their currencies convertible. Since leaving the rouble zone in the summer and autumn of 1992, they have made advances in convertibility that can be described as the greatest success to date in their transition. This achievement also stands out if we make comparisons with any of the other former socialist countries.

In Estonia the national currency, the kroon, is practically convertible for current account purposes. In connection with the capital account, convertibility is still somewhat restricted. The reasons for this have been the underdeveloped state of the financial system and Estonia's desire to avoid possible destabilizing currency flows. As the position of the Estonian kroon has strengthened, the central bank has, in course of 1993, gradually eased capital restrictions. A proposal by the central bank to abolish the last major restriction concerning the prohibition of natural persons from opening foreign currency accounts will be presented to Parliament in the near future. A similar ruling pertaining to legal entities was lifted earlier[13].

Since its introduction, the Estonian kroon has been tied to the deutschmark at the rate of 1:8. Instead of having a fully fledged central bank, Estonia has opted

[12] The Baltic Observer, 24 December 1993 – 6 January 1994.

[13] 'Estonia to Lift Last Foreign Currency Restriction', Baltic News Service, 22 December 1993.

for a currency board arrangement in which the central bank has a very limited monetary policy function[14].

In Latvia and Lithuania the national currencies are convertible for current account purposes and to a large extent also for capital account purposes. Both foreign currency accounts and borrowing from abroad are permitted. Latvia in particular has indicated a will to maintain a very liberal foreign exchange system with practically no restrictions. The policy pursued in Latvia and Lithuania concerning currency convertibility has been quite different from the very strictly administered system applied in Estonia. One reason for this less restrictive policy might be the limited possibilities for the authorities to exert control due to a lack of expertise and organizational structures. In this situation one alternative is to let the system develop on its own.

In Latvia and Lithuania the national currencies – the lats and the litas respectively – are floating, although central banks regularly intervene in the foreign exchange markets. The lats has been appreciating continuously, and the litas has also strengthened since the spring of 1993.

Although the Lithuanian litas has been strengthening, there are fears in the country that it may be difficult to adhere to a tight monetary policy in the future. Obviously for this reason the Lithuanian Government has recently submitted a bill to Parliament that would peg the litas to a foreign currency and put in place a currency board rule similar to that of Estonia[15]. However, it is doubtful whether a law would be helpful when the actual policy pursued depends on the will of political decision makers, who can alter the regulations at any time.

The Baltic states have been able to maintain the convertibility and external value of their currencies owing to a steady inflow of foreign currencies. That is due mainly to their large volume of exports to Western countries which is, however, to a large extent made up of reexports of metals and other raw materials from Russia.

Convertibility of the national currencies of the Baltic countries may be regarded as internal in the sense that these currencies are not used outside these countries to any significant extent. The Bank of Finland is the only Western central bank that quotes the Estonian kroon. Cash kroons are traded in Finland and Sweden, and payments may be transferred in kroons to and from these countries. The Latvian and Lithuanian currencies are not quoted or traded in any Western country.

3.4 Changing the Financial System

One of the basic tasks in making markets function in the former socialist countries is to scrap the old financial system, which distributed state financing to companies irrespective of the results of their operations. This task is again a huge one, and includes such measures as abolishing the system of automatic budgetary financing

[14] See Seija Lainela, 'Currency Reforms in the Baltic States', Communist Economies & Economic Transformation, Vol.5, No. 4, 1993.

[15] BBC, Summary of World Broadcasts, Third Series SU/1880, 24 December 1993.

of companies, introducing financial discipline to companies with the help of bankruptcy legislation, establishing commercial banking structures, and building a new tax system.

The pace of development of the financial system has varied among the Baltic states.

The introduction and implementation of bankruptcy procedures is the main tool in changing the behaviour of enterprises. In Estonia – unlike the other Baltic countries – bankruptcy procedures have been initiated and several companies have been declared bankrupt since September 1992, when the Bankruptcy Law came into force. These firms include, among others, large state-owned companies in the wood processing and chemical industries, as well as some private banks. These measures have clearly helped Estonia to achieve a degree of financial discipline in the enterprise and banking sectors. As a result of the real threat of bankruptcy, enterprises' tax arrears have started to decline. In 1993 they declined by one-quarter in value terms[16].

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

There may be several reasons for this behaviour. One reason is clearly that it takes time to draw up concrete regulations for the implementation of bankruptcy legislation and to organize courts and train personnel to handle bankruptcy cases, even though the legislation is in force. Further, certain necessary elements, such as accounting practices, are still incompletely applied in Latvia, and in Lithuania the accounting system is not even in place yet. Another reason may be that in Latvia and Lithuania state enterprise managers still comprise a strong pressure group in the economy, and they may be able to influence the financial decisions of the state and state banks. Finally, enterprises may still believe that the state will eventually step in to rescue them and their debtors.

Interenterprise arrears are a typical feature of the former planned economies, including the Baltic states. By running up mutual debts, enterprises try to reduce the need for restructuring, which the state attempts to force upon them using its financial discipline. Particularly in Latvia and Lithuania arrears have swollen considerably, as these countries have not yet established functioning bankruptcy procedures.

In order to improve the implementation of bankruptcy law, Latvia is currently reshaping its legislation by reducing the number of criteria that are needed to declare bankruptcy.

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

The Baltic states have inherited local branches of the five specialized banks of the Soviet Union, and most of these are still operating. These banks used to distribute state credits to the industries they served. The major problem connected

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[16] Baltic News Service, Baltic Business Weekly, 13–19 December 1993.

with these old banks is now the poor quality of their loan portfolios. These comprise loans granted to state companies that will never be able to pay them back. In most cases nothing has yet been done regarding their restructuring. This is an issue that is facing the authorities in all these countries.

The role of the old specialized banks is somewhat unclear. It is probable that these banks or their successors still continue their former functions, i.e. crediting state companies with money allocated from the budget. This could be the case at least in Lithuania, where the state still supports enterprises. In principle, the same thing is not likely to happen in Latvia due to the pursuance of tight monetary and fiscal policies. In Estonia the state does not, as a rule, subsidize enterprises through the budget or by granting preferential credits.

Another and more dynamic segment of the banking sector is represented by the new private banks. They have emerged in the Baltic countries in large numbers during the past few years. In Estonia there are currently more than 20 such banks, in Latvia more than 60 and in Lithuania about 30[17]. These banks are small, and in Latvia and Lithuania most of them started their operations as currency exchange offices.

The underdeveloped state of the banking sector is one factor hampering the advancement of private entrepreneurial activity in the Baltics. This concerns both financing and other services rendered by the banks. Currently, it is practically impossible to obtain long term financing, as private banks concentrate on short term trade related financing and currency exchange operations, which secure them the biggest profits. One additional factor contributing to the lack of long term financing is, of course, the still relatively high rates of inflation prevailing in the Baltic states.

Another problem is posed by the low quality of other banking services. Payment transfers are effected slowly, and banks are not always reliable intermediaries. It is partly for this reason that in Latvia and Lithuania – and perhaps to a lesser extent in Estonia as well – a considerable share of payments between enterprises are effected in cash, most often in dollars. One unofficial estimate put the share of cash payments in Latvia at the beginning of 1993 as high as 90 per cent of all interenterprise payments.

Part of the solution to improve banking services is the establishment of an efficient banking supervision mechanism, which is an essential element of state control in all market economies. In Latvia and Lithuania banking supervision is still quite underdeveloped. Supervision is a function of the central banks, which started their central banking operations from scratch for only about a year ago. During this time the central banks have established basic rules for commercial banks, such as minimum capital requirements, capital ratios, lending risk criteria, etc.

The degree to which commercial banks adhere to these rules is not known. There may be reason to believe that banking supervision is not very effective because of the lack of expertise, personnel, and other resources. Moreover, it is not always even the intention of the officials to establish control systems. In Latvia, for example, there is no supervision concerning foreign currency operations of the banks.

[17] Bank of Lithuania, Bulletin of the Bank of Lithuania, September 1993, No. 1.

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

4 Concluding Remarks

Liberalizing the Baltic economies from the former administrative structure has proved to be fairly easy. The successful liberalization of prices and foreign trade as well as the introduction and stabilization of own currencies have gone a long way to promote the emergence of markets and competition.

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

The ailing progress of structural reform has contributed to the decline of economic activity in the Baltic countries. Their economies do not respond fully to market signals, and they have not been able to completely absorb all the international financial assistance that has been made available.

Another problem is that weak state organizations increase the risks of private enterprises and compel them to adopt inefficient and expensive practices to protect themselves. As an example of this, one could cite the above mentioned large share of cash payments between enterprises.

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

The Baltic countries are to an increasing extent following their own roads to economic transition, and as a result of this the future development of their economies may take widely diverging paths. Each of the Baltic countries has its special features, and it is not that clear that the experience of other former socialist countries is always valid in the Baltics. Finally, it is obvious that more information is needed on the actual functioning of the economies of the Baltic countries.

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