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Abstract

Contrary to most experience, Estonia (as well as Latvia and Lithuania) has been able to combine, for a number of years, fixed exchange rates, financial liberalisation (prior to proper supervision) and large current account deficits without inviting speculation using large capital flows as vehicles. The standard argument is that this must be due to exceptionally sound fundamentals and great policy credibility. Without challenging this argument either generally or for the case of Estonia, Latvia and Lithuania, this paper offers a supplementary perspective. These countries did not aim at developing a full-scale national economy with a full set of financial and other markets, as they had the possibility of joining an institutionally, culturally and geographically close set of North-Western European markets. Such a strategy goes further than having the goal of "rejoining Europe" as the external policy anchor. Having well-developed domestic markets can in some cases be substituted by accessing near-by markets, thus leaving little leeway to potentially unstable capital flows. This option, however, is not open to all, and it also has its downside.

Key words: capital flows, exchange rate systems, institutional development, financial liberalisation, Baltic countries

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The prevailing view on capital flows to transition economies (and also to other emerging markets) is well captured by Lipschitz and others (2002). "Capital inflows into the CEE countries (countries of Central and Eastern Europe) reflect real factors and can be a useful servant in the process of development, convergence, and catch up. But to the extent that inflows render CEE countries vulnerable to global capital market conditions, they can also be a crual master, punishing perceived domestic policy weaknesses and responding to events beyond the control of domestic policymakers." Liberalising capital inflows, thus, is somewhat like playing with fire, a good servant but a bad master.

The three Baltic countries have been able to combine, Estonia since 1992 and Latvia and Lithuania since 1994, (1) a fixed exchange rate, (2) liberalisation of the capital account before having a well-functioning and supervised financial system, and (3) very large current account deficits.[1] At the same time they have gone through deep structural and institutional change, which has been even faster than in several other transition economies. Generally, such a combination of characteristics that is regarded inherently unstable, being a source of potentially destabilising capital flows. Opinion differs as to whether large, often short-term capital flows can as such be a source of instability, but there is no disagreement that they often act as vehicles for instability arising due to faulty fundamentals, perhaps politically induced lack of credibility and other such factors. Argentina's debacle 2001-2002 is the most recent example of the problems usually seen as likely to emerge in countries sticking to "hard" pegs, liberalised capital flows, and high current account deficits. There was some discussion on whether the perceived failure of the Argentinian currency board arrangement might contaminate the other existing currency boards in the Baltics and other countries. Such contagion did not taken place, neither was it ever likely. This article explains why the performance of the Baltic countries in combining the incompatibles has been and probably remains so satisfactory.

Most of the scholarly discussion on these issues has been recently pursued around two key terms: "sound fundamentals" and "credibility". To caricature, fundamentals are taken to be sound when the economy in question corresponds to the ideal picture drawn in standard economic textbooks (including the ones penned by this author). A sound economy has clear property rights, working other institutions, flexible markets, an open, competitive and otherwise liberalised structure and sensible macro-economic policies, including satisfactory internal and external equilibria together with prudent monetary policies. Policies are credible when they confirm to and promote sound fundamentals, at the same time maintaining stable expectations.

This paper does not attempt to challenge this standard story either generally or in the specific case of Estonia and the other Baltic countries. This paper builds upon the standard story, though it is always possible to critically contrast its somewhat simple recommendations of high principle against the successes and failures of the real world. In stead of a theoretical revolution this paper offers a novel way of looking at the conditions under which the incompatibles can be combined. The paper concentrates on Estonia, but believes

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that the argument presented is valid in cases of Latvia and Lithuania as well for reasons to be discussed below.

To understand why it has been possible to combine financial liberalisation, fixed exchange rate and major current account deficits this paper emphasises two factors. First, because Estonia is a vary small economy, it can offer few assets that could be the subject of unstable capital flows. This is the subject of the next section. Second, due both to policy design and by default, Estonia has embarked upon a development path that does not aim at having a full set of financial markets. There is little public debt, the banking system is safely in foreign hands and capital markets are dormant. Thus, most markets through which instability could spread hardly exist. The Russian crisis of 1998, which is discussed next, offered a stability test for Estonia which further served to strengthen the development path of repressed or missing markets. Even before that, the mini-boom of 1997 signalled the dangers that full financial development might entail. The concluding chapter argues that Estonia early aimed not at developing a full set of markets but rather at becoming a region inside a foreign-based set of markets. The risks still involved in this strategy are finally characterised.

Common features of the Baltic countries

Though each with its own identity, historical background and endowments, the three Baltic countries are exceptionally similar among the transition countries.[2] They are of somewhat similar size, they became newly independent at the same time as the USSR collapsed, they all opted for radical reforms and fast integration with European institutions. All strive to join the European Union in the course of the next few years, and they are among the more successful accession countries. Some further common features pertinent to the purpose of the paper are outlined below.

First, they all opted – Estonia in June 1992, Latvia and Lithuania in early 1994 – for fixed exchange rates. Estonia and Lithuania have been on currency board regimes. Latvia has a fixed peg, which in the Latvian practice does not differ much from the currency board arrangements. In fact, the Latvian Central Bank calls it a “currency board like arrangement”. They also all decided to liberalise their capital accounts since 1994, before they had a fully developed and supervised financial system. And, they have all been running very large current account deficits. In this respect, they do not differ too much from most other transition countries. But the size and persistence of current account deficits in the Baltic countries definitely distinguishes them from other transition countries. Since 1996, current account deficit has been in none of the countries ever smaller than 3.3% of GDP, often larger than 10% of GDP. It is generally known, however, that for these countries current account deficits may well overstate the true extent of external vulnerability (Lipschitz et al, 2002). External debt, in particular public one, remains small as countries started with zero debt.

[2] The legitimacy of the term “Baltic countries” is often denied due to these differences. Here the usage is just a matter of convenience.

Table 1. Current account balances in the Baltics, 1994-2001 (per cent of GDP).

	1994	1995	1996	1997	1998	1999	2000	2001
Estonia	-7.2	-4.4	-9.2	-12.2	-9.2	-4.7	-6.4	-6.5
Latvia	-0.2	-3.6	-4.2	-6.1	-10.6	-9.6	-6.9	-10.1
Lithuania	-2.1	-10.2	-9.1	-10.2	-12.1	-11.2	-6.0	-4.8

Source: Bank of Finland Institute for Economies in Transition, BOFIT

Second, they are very small, even miniscule, with population ranging from less than 1.5 million inhabitants in Estonia to more than 3.5 million in Lithuania. In terms of GDP, the minimal size of these countries is as evident. In 2000, the GDP of Estonia, Latvia and Lithuania were 5.0, 7.2 and 11.2 billion US dollars respectively. That is less than or in the case of Lithuania at most 0.5 per cent of the German GDP. Put otherwise, the combined nominal GDP's of the Baltic countries amount to the size of the Luxembourg economy. Even on purchasing power parities, the ratios to Germany remain as low as 0.6, 0.9 and 1.2 per cent.

Third, these are very open economies. All three countries run some of the most open trade and investment regimes in the world. The trade-to-GDP ratios (goods and services) are very high, ranging from 186.0 per cent in Estonia through 120.6 in Latvia and to 89.9 in Lithuania. These countries also opted for privatisation primarily by sales to outside strategic investors. Their banking industries are also predominantly foreign owned.

Fourth, the Baltic countries emerged re-independent from the USSR just little more than ten years ago. They had few institutional and natural resources at independence. But given that Russia adopted the foreign assets and liabilities of the USSR, the Baltics also emerged independent without any foreign or domestic debts. They were able to regain some pre-Soviet foreign assets, like the eleven tonnes of pre-war Republic of Estonia gold first used – together with IMF credits – to back up the Estonian currency board in 1992. The original zero debt level has facilitated running quite sizeable foreign deficits without overly loss of credibility. Relative to GDP, Baltic foreign debts have risen since. The ratio of foreign debt to GDP was in 1994 16.5 per cent for Estonia, 22.6 per cent for Latvia and 12.4 per cent for Lithuania. The figures had risen to 60.9, 70.9 and 43.8, respectively, by 2001. Most of this debt is private. Still, the debt burden relative to export revenue remains very modest in all countries. External debt service cost relative to current account revenue was in 1994 1.6 per cent in Estonia, 3.9 in Latvia and 2.3 in Lithuania. In 2001 the figures were 7.2, 14.7 and 28.0 per cent, respectively (EBRD, 2002). Foreign direct investment (FDI) has often been more than enough to finance the current account deficit.

In this respect, Lithuania has been somewhat of an exception. Due to larger budget deficits, the country has bigger government t-bill markets than its northern neighbours. Also, until 1998 the country was less able to finance its current account deficit by direct investment, and consequently accumulated a bigger foreign debt. Later, largely due to accelerated privatisation to foreigners, the situation changed.

Table 2. General government budget balances in the Baltics, 1994-2001 (per cent of GDP).

	1994	1995	1996	1997	1998	1999	2000	2001
Estonia	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4
Latvia	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-1.8
Lithuania	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-3.3	-1.4

Source: Bank of Finland Institute for Economies in Transition, BOFIT.

Size and structure of financial flows into the Baltics

Overall, the structure of gross capital inflows into the Baltics is different from the structures observed in other transition countries (see Table 3).

Table 3. Structure of Gross Capital Inflows into Selected Transition Economies, 1990-1999

	FDI	Portfolio Investment	Other Investment
Estonia	41.8	17.1	41.2
Latvia	37.7	4.5	57.8
Lithuania	34.9	13.1	52.0
Mean First Round Accession Candidates	57.2	22.4	20.4
Mean Second Round Accession Countries	4.7	8.3	87.0

Source: International Financial Statistics in Buch and Heinrich, 2001.

Table 3, adapted from Buch and Heinrich (2001), compares the structure of capital flows into the Baltic countries with those of two peer groups, the first round EU accession countries (among whom is Estonia) and the second round EU accession countries, among them Latvia and Lithuania).[3] Estonia's capital flow structure is quite similar to that in the peer group, though the share of "other investment" is notably high. It consists of items like trade and bank credit, which are usually short-term and might be regarded unstable. In the Estonian case, however, much and probably most such credit is handed by a foreign owner to an Estonian-based daughter company or might at least be explicitly or implicitly guaranteed by such a foreign owner. There is thus no reason to regard such credits as being necessary any less stable than those statistically recorded as being long-term. The stability of such "other investment" might well be comparable to foreign direct investment. On the other hand, even long-term credits or FDI created property can be sold fast, if secondary markets exist. This has not been a problem for the Baltic countries, but it underlines that equating statistical short-term flows with potential instability and long-term flows with stability is not really justified.

[3] This division into two groups of accession countries is no longer relevant, but it does depict the prevailing interpretation at the time to which the statistics refer.

Such factors also shed some light on the issue of the relation between capital inflow and real appreciation. It is often argued that a fixed exchange rate has to break down due to high inflation in face of large capital inflows, especially if the share of short-term inflow, used more generally for consumption than productive investment, is large (Lipschitz et al, 2002 is a recent example). This should be particularly so in the case of currency boards, where sterilisation through monetary policy is by definition not even attempted. There is also very little if any evidence of attempted sterilisation in the Baltic countries by other possible means (Sutela, 2001). But one should remember that short-term capital inflow of the kind just described can be as well efficiency-enhancing as foreign direct investment. There has been much real appreciation due to catch-up and there may have been some small misalignments of real exchange rates in the Baltic countries, but only for short periods (Bitans, 2002; Randveer and Rell, 2002, Vetlov, 2002). They should not be a concern to policy-makers.

The structure of capital flows into Latvia (and also to Lithuania) is more like that into Estonia than that into their peer group, the second round accession candidates. The share of other investments (bank loans and trade credit) is particularly in Latvia even greater than in Estonia. That at least partly reflects the traditional role of Latvian banks in channelling Russia and other CIS monies into international financial markets. The high share of other investments into Lithuania is more difficult to explain, but may well reflect foreign bank finance in the absence of domestic supply.

In USD terms, financial flows to Baltic countries peaked in 1997 (Sutela 2001, 2002). This was a rare year of an equity market boom in the Baltics. Actually, 1997 was the year when the Baltic countries might have embarked on a course of high capital flows and instability. Having more than doubled from 1995, capital flows into each of the three countries topped 1.2 billion USD. But in 1998, capital flow into Estonia more than halved, and has remained around 600-700 million USD annually since. Flows into Lithuania only peaked in 1998, and then came down to 1.2 billion USD in 2000. Like in the case in Estonia, flows into Latvia peaked in 1997. They collapsed in 1998, but have since recovered and reached in 2000 again the 1997 level. In no case was the flow even nearly negative.

If the annual flows have not been too variable, on a quarterly level there is much more variation. This is partly due to the small size of the economies. Relative to the GDP, quarterly financial flows have often been very high, and even a single investment or credit can move the curve quite violently. Thus, Estonia has major quarterly peaks in 1998 and 1999. They are both due to money injected by major Swedish banks into Estonian banks the control of which they had just acquired.

Most of the variability in quarterly financial flows is actually not due to speculative portfolio investment. In fact portfolio investment is quite modest in size, usually less than ten per cent of GDP. There may be more variability in FDI, as one would probably expect in case of very small countries. To understand the discussed peculiarities of financial flows into the Baltic countries, one should look into the particulars of Baltic financial markets.

Low supply of government debt

All Baltic countries try to follow restrictive fiscal policies (which of course is partially though not wholly a consequence of their exchange rate regimes[4]). In Estonia the central government cannot, by law, propose a budget with a deficit to the parliament, which has obviously helped to keep also actual deficits small.[5] Even general government deficits have been quite well under control in Estonia and Latvia, though less so in Lithuania (Table 2, above). The present value of public debt is less than 50 per cent of fiscal revenue in all the Baltic countries. In Estonia, general government external debt (excluding assets held abroad) peaked in 1996 at 5.2 per cent of GDP. By end-2000, this was down to 3.1 per cent. Total general government debt was just slightly larger, 5.7 per cent of GDP, in 2001. Most of the foreign debt is development bank co-financing for large infrastructure projects, and thus not market-forming. In Latvia public debt peaked in 1995 at 16.1 per cent of GDP, came then down to 10 per cent, and was increased to 13 per cent as a reaction to the Russian crisis in 1999. General government debt was 13.8 per cent of GDP in 2001. Some two thirds of that was external debt. As mentioned, Lithuania has been less able to balance its budget. General government debt rose to 22.8 per cent of GDP in 1998 and 29.1 per cent in 2001.

As the Baltic countries started without any foreign debt the role of public foreign debt still remains very minor. Estonia's and Latvia's public foreign debt as share of GDP is in single digits, and even Lithuania's is no more than 17 per cent. These are very low figures. Within private foreign liabilities, foreign direct investment dominates. The local debt and equity markets are still quite undeveloped. The share of portfolio investment is highest in Lithuania, where the stock of foreign portfolio investment is 17 per cent of all foreign liabilities. The share of FDI in all foreign liabilities at the end of 2000 was 35 per cent in Lithuania, 49 per cent in Estonia and 34 per cent in Latvia. These countries are thus not very exposed to short-term capital flows. The small existing debt markets are strongly dominated by treasury bills. At end-2000, foreigners owned just 3 per cent of Latvian and 1.1 per cent of Lithuanian treasury bills. Overall, one cannot expect much foreign investment into Baltic public debt markets, as they hardly exist. There is that much less room for speculative financial flows. But perhaps Baltic banks have provided better assets?

[4] In a currency board arrangement, the monetary authority stands ready to exchange local currency for another (anchor) currency at a fixed exchange rate without quantitative limits. Thus, a given monetary aggregate has to be fully covered by foreign exchange; the credibility of the arrangements must be ensured legally; and the monetary authority cannot create money for the purpose of smoothing liquidity or support domestic financial institutions, unless it has sufficient excess reserves. On the other hand, the monetary aggregate covered is usually much narrower than total money supply, and the currency board arrangement itself does not prevent fiscal deficits financed in non-monetised forms. This has been the recent Argentina case.

[5] On the other hand loans are counted as revenue in Estonian budgets, and the balanced budget constraint is therefore not as stringent as it seems.

The banking sector: safely foreign-owned

By 1992 the Baltics had a total of 122 separate banks. The number of banks has since declined through bankruptcies and particularly through consolidation to 42 at end-2000. At the time the two biggest banks accounted for 83.5 per cent of Estonian and three biggest for 51 per cent of Latvian bank assets. All banks have been privatised in Estonia. In Latvia, only one relatively small bank is still majority state owned, and in Lithuania the remaining major state-owned banks were privatised in 2001 and 2002.

Not all banks service a large clientele. It is informally estimated in Latvia that ten of the existing 22 banks are very narrow based institutions, which basically accept liabilities from the area of the former Soviet Union and place them into third countries. This is not regarded a systemic risk, as these banks are usually very small. Still, this raises the issue of sufficiency of supervision.

At the same time, the share of foreign ownership in the banking sector has ballooned. By early 2001, measured by capital, the share of foreign owned banks was in Estonia about 90 per cent, almost 70 per cent in Latvia and 58 per cent in Lithuania. Two Swedish banks, Swedbank and SEB, control five of the biggest banks in the Baltics. They have a combined market share of 51 per cent of bank assets and 60 per cent of all bank loans in the Baltics. Banking consolidation was greatly facilitated (1998-99) by the effects of the Russian crisis.

Fries and Taci (2001) have compared banking sector development in transition economies with a benchmark provided by a peer group of market economies on a comparable income level. In general, monetisation remains quite low in transition economies. Virtually all transition economies remain below the market economy benchmark for the ratio of domestic credit to GDP. Moreover, there is little convergence toward the benchmark from 1994 to 1999. Estonia is a notable exception. The ratios of total credit to GDP are also in the Baltic countries still 2-3 times lower than what one should expect on the basis of the benchmark. Further, there is no convergence from 1994 to 1999. Contrary to most transition economies, in the Baltics the public sector has borrowed clearly less than the private sector.

These results partially reflect the impact of the Soviet hyperinflation in 1990-1991, but partially also the recurring banking crises in the Baltic countries in the 1990´s. As so much investment is financed by incoming capital flows, one may question the need to have high domestic saving ratios. They have indeed been relatively low without a clear rising trend in all the Baltic countries during the late 1990's. Latvia´s saving ratio may have been (early statistics are though very uncertain) as high as about 28 per cent in 1993. The ratio slid to 10.7 in 1995 but has since recovered to about 18 per cent. Estonia's saving rate was 26 per cent in 1993 but just 18 per cent in 1999, while Lithuania started at 16 per cent and slid to 12 per cent in 1999. These developments have many reasons. Enterprises simply have little demand for domestic savings if that have ample access to foreign finance. This will be reflected in lukewarm bank demand for savings. But there are also other reasons, among them the loss of bank credibility after the banking crises in mid-1990s, low income levels and the hugely improved post-socialist supply of consumer goods, whose prices tend to be relatively high. High prices – together, from the point of view of the credit institution, with the lack of suitable collateral - have also contributed to the popularity (mainly in Estonia) of leasing as a form of non-banking (but often bank-owned) financial institution. But, finally, low saving ratios are also a consequence of underdeveloped financial markets. Not only foreign investors, but also domestic savers have very few assets to choose from.

The Fries and Taci (2001) comparison refers to 1999. Baltic monetisation levels have risen since. In 2000 Baltic banking grew fast. Bank credits increased by 28 per cent both in Estonia and Latvia. Authorities see this as a long-expected catching-up process, not as the creation of a potential bad loans problem. Indeed, the share of bad loans is low by international standards in all three countries (around 5 per cent or lower). Fast growth has continued into 2001. Growth was 19 per cent in Estonia and as high as 51 per cent in Latvia. In Lithuania, where growth of lending was just 4 per cent in 2000, it accelerated to 12 per cent in 2001.

Under the Baltic monetary arrangements, central banks have accumulated excess reserves backing the monetary base at well over 100 per cent: the currency board rule has only determined the upper limit of money supply. In addition, the central banks are able to change the reserve requirements of banks, thus affecting both money supply and bank solvency. Although in the past the central banks frequently provided liquidity to support problem banks during banking crises, generally they follow the tough line of liquidating the most insolvent (domestically-owned) banks. As far as the foreign-owned banks are concerned, these rely on their mother companies abroad. Rather high shares of "other investment" in the overall gross capital inflows into the Baltic countries represents loans from the overseas mother companies to their Baltic daughters. This applies to banking in particular. Now that most Baltic banks have been sold to solid foreign owners, their credibility has been much improved.

At the same time interest rates have come down to the degree that the remaining interest difference against the euro region is hardly enough to attract major deposits into Baltic banks. Thus, while monetisation has risen, offering new banking assets also for foreign financial flows, declining interest rates and the foreign ownership of banks have made speculation through this sector less probable. From this point of view, Estonia, Latvia and Lithuania can now afford financial deepening better than before.

The modest role of domestic credit in investment finance is not only a Baltic phenomenon. Krkoska (2002) has analysed financing indicators in three subgroups (Central and Eastern Europe and Baltics, South-Eastern Europe and CIS) of European transition economies in 1996-1999. In the first two groups, foreign direct investment is the most important financing source (omitting retained earnings). In CIS, foreign credit dominated, and stock market financing came next. In the first two groups, foreign credit was the second most-important source of finance, followed by state subsidies. Stock market financing was the least important source of finance in Central and Eastern Europe and the Baltics, just below domestic credit, while in South-Eastern Europe domestic credit was actually strongly negative during these turbulent years. Overall, thus, foreign sources have provided most investment finance. Capital markets have remained dormant in the Baltics as well.

Dormant capital markets

Because of very small absolute sizes of their economies, the Baltic countries' financial markets are also quite tiny. With quite or very low equity market capitalisation, there is very little scope for major short-term financial inflows. Due to the fixed costs involved in entering any market, there will be only a few possible market counterparts in dealing with Baltic assets. More importantly, given the small equity markets and the total or near-absence of government bonds or bills, there are simply very few assets available. The amounts of certificates of deposit are also very minor. The ratios of domestic to German equity market capitalisation were in end-2000 0.14 per cent for Tallinn, just 0.04 for Riga and 0.13 per cent for Vilnius. Sweden, on the other hand, reached 25.8 and even Poland 2.2 per cent of the German capitalisation.

Lithuania was the first Baltic country to establish equity markets (see Sutela, 2001). The Vilnius stock exchange was opened in 1993 with a large listing of privatised and new companies. However, there was practically no trade in the vast majority of these companies until much later. The stock exchange took off in 1996 and the Litin index peaked in early 1997. After that, the index has declined steeply in 1998 and later stagnated so that in 2001 it just reaches the starting level of January 1996. The market has remained highly illiquid with a very low turnover. Market capitalisation has fluctuated between 10-20 per cent of GDP and the annual trading value has been just a couple of per cent of GDP. Most trade has been in treasury bills issued to finance the budget deficits.

The picture is very similar in Latvia. The Riga stock exchange was established in March 1995, and it also experienced a boom in 1996-97. After a drop in 1998, the Riga index has also stagnated at a low level. At just over 5 per cent of GDP, the Riga market capitalisation is even lower than in Vilnius, and trading value has been similarly low. In 2000, the Riga index rose by 60 per cent, as Latvijas Gaze was privatised through the stock exchange. The market capitalisation of (almost exclusively government) bills is lower than that of equities. Still, in Riga as well as in Vilnius most trade is in treasury bills, which are primarily owned by Latvian banks and the central banks. At end-2000 foreigners owned just 3 per cent of treasury bills.

The Tallinn stock exchange was only established in May 1996. The stock exchange went through a boom in 1997, followed by a bust in end-1997. As elsewhere in the Baltics, the Tallinn index has stagnated since 1998. Market capitalisation is at 35 per cent of GDP, which is however much higher than in Riga or Vilnius, but the trading value has recently dropped to around 5 per cent of GDP. The explanation is simple: as Estonian banks have been sold to foreigners, the availability of assets has declined. Bank (and telecoms in Estonia and Lithuania) shares dominate all three Baltic equity markets. As the Estonian central government's deficits have been almost non-existent, no treasury bills are available. The Bank of Estonia issued until 2000 modest amounts of 28-day bills for liquidity management purposes, but their auctions attracted only little interest. Recently, Tallinn stock exchange was sold to the Helsinki stock exchange. There are hopes that this would attract more trade to Tallinn. (The Riga stock exchange is expected to follow the example, and the Vilnius one is in negotiations with the Warsaw stock exchange.) In the end of 2000, foreigners owned 76 per cent of the market capitalisation of listed companies. Only four shares are traded continuously. Two of them accounted in February 2002 together for 84 per cent of total market capitalisation. Both companies are majority foreign-owned, and their stock may well be withdrawn from the market in not too distant future. While Estonian banking supervision is nowadays regarded strong, supervision of the little equities markets there exist is weak and lacks credibility. Calculations for 3 June 1996 – 26 January 2001 show that the Tallinn capital market is not efficient (Listra and Rahu, 2001).

Privatisation creates the basis for equity markets in economies in transition. All three Baltic countries have implemented small-scale and most banking and industrial privatisation. In Estonia, the privatisation agency was closed in 2001, after railway privatisation was completed. In Latvia privatisation has been slower and complicated. Even now, the privatisation of shipping and telecoms is still underway. In Lithuania industrial privatisation is still under way, and infrastructure privatisation has hardly been started.

All in all, dominance of foreign ownership is not conducive to a further expansion of the domestic equity markets. Foreign-owned firms operating in the Baltics are often in no need to tap local markets for funds, though they naturally can and quite frequently do so. Nor do they need hold foreign assets themselves. Assets management may be conducted at lower cost by their mother companies abroad. Overall, there is clearly very little room for speculative capital flows to and from the Baltic equity markets.

The impact of the Russian crisis in 1998

Even with sound fundamentals, policy credibility and little financial deepening countries can be exposed to instability for a number of reasons. Among them is geographical proximity to other, unstable markets. Estonia is not only a neighbour of Russia, it has also been seen as trade dependent on it. The Russian crisis of 1998 was therefore a stability test. The crisis had an immediate impact on the Baltic countries via foreign trade, as Russia has historically been an important trading partner for these countries. The Russian share in exports before the crisis was 24 per cent for Lithuania, 21 per cent for Latvia and 15 per cent for Estonia. It was also a major source of imports, and handling the transit of Russian trade goods was a major – though easily exaggerated (see Laurila, 2002) – business for all the Baltics. All the three countries slid into a recession, which however proved a short one. Estonia resumed growth in early 1999, Latvia in mid-1999 and Lithuania in end-1999.

The impact via the current account, direct investment, the banking sector and securities markets was however much less than could have been expected. The Baltics had largely escaped from the shadow of Russia. Estonia's liberal economic policies and prospect of relatively fast EU membership had made it a favoured destination of foreign direct investment. The Russian crisis had little impact on either FDI or the banking sector, which was receiving major investment from Sweden. Only 0.1 per cent of Estonian banks' assets were in Russia. Some indirect impact came through the declining profitability of enterprises exporting to Russia, which in some cases led to problems in servicing loans. There was a short shock in the Tallinn stock exchange, and the one-month Talibor interest rate almost doubled from about 10 in August to over 18 in end-1998. These were short-term impacts, which disappeared in 1999.

In Latvia, the banking sector was much worse hit, as Latvian banks had some 8 per cent of their assets invested in Russia, about 40 per cent of that in short-term government bonds, GKO's. Two banks were declared insolvent by the central bank, but both were later successfully rehabilitated. Many others suffered heavy losses. The stock exchange was heavily hit. There was some pressure against the lat both in late 1998 and again in the second half of 1999, but the turbulence was short-lived. It was ended by the government's announcement of expenditure cuts in 1999. Like in Tallinn, the one-month Rigibor doubled after the crisis, from 5-6 to 11 per cent.

The Russian crisis had no serious impact upon Lithuanian banks. Total banking sector exposure to Russia in the beginning of September 1998 was just 1.4 per cent of total assets. However, there was a major indirect exposure through Lithuanian export companies, as Lithuania was more dependent on CIS trade than its northern neighbours. This lead to quite large losses for some banks. As in the other Baltic countries, money market rates about doubled.

In retrospect, and from the point of view of this paper, one can argue that the Russian crisis was a blessing in disguise for the Baltics. The previous year had seen the first boom and bust pattern develop in Baltic financial markets. Borrowing by banks from abroad surged and credit grew fast. The door to a path of very high growth, instability and destabilising short-term capital flows was open. The Asian crisis of late 1997 gave an important warning signal of the dangers involved. The sharp decline in exports into the former Soviet Union further forced a scaling down of growth expectations. The ensuing bank crisis left selling financial institutions to foreigners as the remaining logical alternative. The Baltic countries were firmly logged into their development pattern of financial shallowness again.

Handling of excessive expansions

But, if in spite of all this, there is a crisis, how does the Estonian system react? Autumn 1997 gives the most prominent example of the functioning of the Estonian system in a crisis. As already pointed out, 1997 was an exceptional demand driven boom year in Estonia. GDP grew by 10.4 per cent. This was the highest growth in Europe that year. The current account deficit was record high at 12.2 per cent, while general government recorded an exceptional surplus of 2.2 per cent of GDP. Inflation, though on a downward trend, was still 12.5 per cent. Bank credit increased from January to October by 70 per cent and the production of financial services by 30 per cent. Industrial output surged in second quarter by 17 per cent. Financial flows to Estonia were at an all-time high. Meanwhile, turbulence increased in international markets starting with turmoil in Asia. Long-term flows had financed about 70 per cent of the Estonian deficit, and creditors started wondering whether much of the flow had been consumed, not invested.

In the end the boom met with liquidity constraints. Interest rates started to increase in October, while the stock market index, which had risen by some 400 per cent since June 1996, declined, to collapse by 19.4 per cent on 10 November. Banks started calling back credit issued with securities as collateral. In late October the central bank took decisions to constrain credit expansion, primarily by increasing liquidity requirements. Even before that, in April 1997, the central bank had increased the capital adequacy requirement, and the new requirement came also in force in October. On 7 November the government and the central bank announced an economic policy programme for 1997-1998. Citing generally sound fundamentals but pointing out the current account deficit and fast credit expansion as problems, the authorities argued that interest rate growth and stock exchange depression were an adequate correction, not a crisis of confidence. They assured that the existing principle of policies, including the currency board would be maintained while the stability of the financial sector would be strengthened by, for instance, further increasing capital adequacy requirements, which had already been raised in October. The general government would maintain a surplus in 1998 as well. (This failed to materialise, as 1998 was a year of banking and Russian crisis.)

On 7 November Estonia also requested and soon signed a stand-by arrangement with the IMF. The decline in stock prices stopped by the end of the year, and lending rates declined, though remained higher than before the Autumn. The combination of reasserting liberal principles, financial restraint, monetary stringency and continued structural reform had turned the mini-crisis back. No restrictions had been imposed on capital flows, and the central bank had fully used the policy possibilities that the currency board arrangement provided for. There had reportedly been some short-selling of the kroon by foreign banks in early November, and the press spread devaluation expectations, but the actual extent of speculation remains unclear. The speculative pressure, anyway, was very short-lived.

Concluding remarks

How, then, have the Baltic countries managed to combine fixed exchange rates, liberal capital movements regime and large current account deficits without inviting destabilising capital flows? The answer suggested by this paper is not that there has been a particularly clever management or control of financial market. Rather, the Baltic countries have lacked several such markets that might be sources of instability.

The Baltic countries have actually been protected by their very smallness. There is simply very little place for speculation. The vehicles needed are almost absent: domestic and foreign debt is small and markets thin and illiquid. Stability has been supported by generally responsible fiscal policy. Labour markets are regarded very flexible.

After the boomlet of 1997, the Baltic stock exchanges have generally hibernated. Banking sector, right now dominated by foreign owners, has not had the time to develop a potential for a major crisis. There are very few assets which any speculative capital flows could target.

The success of the Baltic countries in maintaining the fixed exchange rates, free capital movements and high current account deficits reflects also "sound fundamentals" - primarily the policy of fiscal restraint. Besides, it is an outcome of policy decisions which, under specific circumstances, have proved quite fortunate. One cannot expect the Baltic countries' experience to be easily repeated elsewhere in the transition countries. And, there is no guarantee the "Baltic model" will remain successful indefinitely.

Maintaining visible trade deficits of 15-20 per cent of GDP is only feasible as long as rich transit and tourism revenues are forthcoming. Maintaining current account deficits of six per cent of GDP is only sustainable as long as foreign direct investment flows continue. The continued viability of the "Baltic model" will depend on the size and purposes of the FDI inflows. FDI has, so far, contributed greatly to external viability. In the short run FDI may increase current account deficit by increasing the demand for imported capital goods, but over a longer time increased export potential should compensate for that. This is very much the prevailing thinking in Estonia. Only in a few cases – mainly banks and telecoms – is FDI based on access to the small Baltic markets, and even then it is typically import substituting. Generally in transition economies, foreign-owned companies are more export oriented than domestically owned companies. Given the small size of the domestic market, this is even more so in the Baltics. The share of foreign owned companies in exports is higher – and increasingly so – than in total sales.

But, for a small country, this may also pose risks. Dependence on a single or very small number of exporters, in particular if they are in forward processing of cyclically sensitive goods, risks sharp fluctuations in export revenue and therefore potentially in money supply. Perhaps a less understood problem is that of an emergence of a two-tier economy. If domestic savings and financial inter-mediation are substituted by an access to foreign finance, such access will not be available to all economic agents similarly. There is a danger that the existing mostly foreign-owned banks and other financial institutions will concentrate on serving only the upper end of the market. Lack of retail banking, especially in the countryside, and in particular lack of micro and small-scale finance for start-ups may hamper both households and the development of a healthy small-enterprise sector. Partially at least, this is already seen as a problem, and modern technologies like internet banking will only partially address these problems.

Obviously, this is not a model that most other countries could or even wished to follow. It is, though, interesting to note the contrast between Czech and Hungarian developments. The Czech Republic opted, starting with privatisation, modes of reform that aimed at developing a complete national economy. Hungary has performed much better by coming close to following the same model as the Baltics. The probability is that the three Baltic countries will be able to maintain their very specific models until the not too distant day when the Economic and Monetary Union will irreversibly abolish any residual worries of external instability there might be.

One final question remains: to which degree did the Baltics choose their model by design, to which degree by default? Choosing to become “as if” regions in a much larger system of North-Western European markets is perhaps not the conscious decision one would expect from peoples whose admired nationalism made such an impact on the dissolution of the whole USSR. But Baltic nationalism, one should argue, was always overwhelmingly of a defensive and cool-headed kind, aimed at escaping from the Soviet Union. The natural way to do that was to come as close to North-Western Europe as possible, in fact becoming "as if" regions of Europe even before formal integration. Fixed exchange rates, external and internal liberalisation, invitation of foreign direct investments and any number of other policy decisions in these countries can and probably should be seen in this light. The goal of "rejoining Europe" has been a common external policy anchor for all the most successful European transition economies. This paper has argued that the three Baltic countries went actually even further. This is a distinction between them and the Central European countries that tends to get blurred in general discussions about the "more" and "less" successful transition economies (Berglöf and Bolton, 2001).[6]

Also, there was an early understanding that decisions demanding a full set of markets and "thick" institutions were often not feasible simply due to small size and lacking resources. One example of a technical decision made presumably on these grounds is the 1996 decision by the Bank of Estonia not to charge any fees neither impose spreads on the foreign exchange operations between the kroon and Euro area currencies (during 1996-1999 between the kroon and DEM). As a result, credit institutions can exchange funds from Euro area currencies to the kroon and vice versa at no transaction costs. This has motivated them to manage their liquidity through their foreign reserves rather than through kroon funds. Consequently, domestic money markets are that much smaller – and interbank markets actually do not exist – but liquidity management does not suffer. Actually, liquidity management is more efficient, as foreign markets provide far more possibilities for portfolio diversification than any domestic markets could.

But finally, partially this has also been a strategy by default. Lacking bank credibility, which has played its role in preventing excessive capital flows, was surely not designed. Future historians will debate the relative role of these two factors, and final consensus may never arise.

[6] But Berglöf and Bolton (2001, 35-36) raise very pertinent questions that are particularly relevant for these countries: "The remarkable presence of foreign commercial banks in the transition economies in central and eastern Europe integrates these national financial sectors into the global strategies of a small number of large financial institutions. What is the role of Hansabank and Unibanka, commercial banks active in the Baltic states, in the strategies of their Swedish parent banks? To what extent can we talk about domestic financial intermediation when external finance for investments come mostly from foreign savings? What influence do domestic regulators and regulation in transition economies have on the behavior of these institutions with global reach? These are some of the new questions for financial development posed by the current trends of world financial integration."

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