Introduction

Eesti Pank’s working hypothesis is to be ready for accession to the European Union. This is also an objective to be ready to join the association of the most developed countries in the world. Joining to the European Union is opportunity to develop entirely new environment together with the states with which we share similar basic values. Banks and other financial institutions established in Estonia can freely operate throughout the European Union and their counterparts in Member States will provide services in Estonia without any authorization from Estonian state agencies. The common financial services' market will create new opportunities to invest savings and cut interest rates. The following article describes the position of Estonia as one of the candidate countries to the European Union. The first part gives theoretical part, then an overview of the monetary policy and banking development in Estonia over the recent years. The second part focuses on the eurozone impact to Estonia economic linkages.

1. Development of monetary system and banking sector

1.1. Central Bank and Monetary policy in a Transitional Economy

Monetary policy is comprehended as a series of actions taken by the central bank in order to affect monetary and other financial conditions in pursuit of the broader objective of price stability (Zeljko, 1998). But, there is no unique definition of the target of monetary policy. So, central bank in one country can have one objective of monetary policy, while others are set multiple tasks. In performing monetary policy the central bank should affect financial markets, i.e. their yields. In this manner monetary policy is transmitted from the instruments of monetary policy to the financial markets, and from the financial markets to the rest of economy.

The central bank has its objective, but it must be more precisely defined in a way that can be realised. It can target: 1) volume of money supply; 2) prices at which gold or foreign currency are convertible into domestic currency; 3) interest rate variables, such as the minimal market rate or real interest rate and 4) other variables such as the balance of payments, or GDP. Usually the target choice is mainly a political question. It is proposed to take into account the possible magnitude of financial and/or real shocks in the economy when deciding on the intermediate target (Buch, 1995).

The central bank pursues monetary policy, using the monetary instruments, which can be direct and indirect. But this, in fact, implies that the central bank can affect the monetary situation in two basic ways, using its regulatory power (authority given by the law), or
acting in the financial market as a (principal) player. Direct instruments of monetary policy are: 1) interest rate control and 2) credit control, while indirect instruments of monetary policy are: 1) reserve requirements; 2) open market operations and 3) central bank lending. In a transitional economy the central bank will opt (and has opted) for direct monetary instruments, because it is easier to implement them, and also evaluation of results is not sophisticated (Buch, 1995).

1.2. Estonian Monetary System

For transition economies the choice of monetary policy sets the basic conditions for transition from its early stage. Monetary stability is one of the most important preconditions for successful reforms in other areas of economic policy. The main aim of Estonian policy is to continue preparations for the integration with EU. From strictly monetary policy point of view, Estonia has been a de facto member of the Euro zone for already ten years. The monetary policy is based on a currency board arrangement. There are 24 % of countries (1999) which have similar currency board arrangements around the world (see figure 1), including Bulgaria and Lithuania in Central and East European countries. Since 1 January 1999 the exchange rate of the Estonian kroon has been fixed, not only vis-à-vis the Deutsche Mark, but also vis-à-vis the other legacy currencies of the countries participating in Stage Three of Economic and Monetary Union (EMU) in accordance with the exchange rate of the Deutsche Mark vis-à-vis these currencies (ECU 1 = EEK 15.6466) (ECB Blue Book, 1999).

Figure 1. Exchange rate arrangements around the world

Source: IMF 2000. p.141-143

The basic features of Estonian monetary system are (1) fixed exchange rate, (2) absence of traditional monetary policy instruments, and (3) free capital movement. Therefore, the first link in the transmission chain is the link between domestic and foreign money markets.

The monetary reform and decisions taken in the banking policy enabled Estonia to create an efficiently functioning economy and society. The monetary reform provided with a reliable national currency and a system. The stable kroon is not the only basic value the monetary reform established ten years ago. The stable currency set an environment suitable for the banking reform. Today Estonian banks are the
largest in the Baltics and among the most reliable in the EU candidate countries. The rating agency Moody's has recently informed of considering raising the rating of several Estonian banks above country rating. “I have often summarized that our currency and banking have been part of Europe's common monetary area and financial system for years already. I have always concluded that our currency and banking are ready to accede to the European Union” (Kraft, 2001). All European partners – the Council of Ministers, the European Commission and the European Central Bank – have confirmed that the monetary system based on the fixed exchange rate and currency board arrangement basically complies with the requirements set to Member States prior to joining the Eurosystem.

The current interbank payment system was established in spring 1992, just before the launch of the monetary reform in Estonia. The main objective of the current interbank payment system is to have a reliable infrastructure for payments made in Estonian kroon. In 1997, Bank of Estonia started to design a new interbank payment and settlement system. (Estonian..., 1999). The objective of the new system is to improve the efficiency of money circulation and to reduce settlement risk through a shorter settlement cycle, and to provide a modern and reliable infrastructure that supports the development of financial intermediation. New systems will be compliant with EU requirements.

Eesti Pank does not participate actively in the interbank money market and it does not initiate daily open market operations. Ordinary central bank refinancing facilities are non-existent. Consequently, the most important channels for stabilising the liquidity in the economy are the standing facility provided by Eesti Pank in the foreign exchange market and the reserve requirement, which has to be met on a monthly average basis. Eesti Pank’s reserve requirement, including the temporary additional liquidity requirement, is the most important instrument for providing immediate domestic liquidity and settlement buffers. Banks are required to fulfill the requirement on a monthly average basis. The reserve requirement currently amounts to 13% of banks’ deposits, debt securities issued, net liabilities to foreign credit institutions and financial guarantees to financial institutions (Ross, 2000). Here it is important to note that the reserve requirements are higher than in the eurozone (2%).

Eesti Pank provides commercial banks with the possibility of buying or selling foreign exchange to adjust their kroon liquidity. All transactions are initiated by commercial banks. For licensed credit institutions, Eesti Pank is obliged to exchange US dollars, Japanese yen, Swedish kronor, pounds sterling, euro and the EMU legacy currencies for Estonian kroons and vice versa without limits. There is no spread between the buying and selling rates of the domestic currency against the euro and the EMU currencies.

1.3. Banking development in Estonia

The introduction of the euro affects many industries, including also financial services. Restructuring the banking sector was part of the integration programme of the Central and East European transition economies with the European Union. The
first phase of financial reforms, as in other transition economies, started with the demolition of mono-bank system and establishing a two-tier banking system. New banks were set up and existing Soviet banks were broken-up and transformed into independent banks as joint stock companies. The liberalization and decentralization of the economy accompanied by lax monetary and fiscal policies contributed to overly fast growth in both the volume of credit and the number of banks. Given extremely low barriers to entry the number of banks increased dramatically in the beginning of 1990’s. By the end of 1992 there were more than 40 banks operating in Estonia (Estonian…, 1999).

Estonian banking has changed dramatically after the introduction of strict economic and legal framework. The number of credit institutions had dropped dramatically from 42 banks in 1992 to 11 by end-1997. Whereas private banks took the leading position in 1994, the banking sector was completely in private hands by end 1997 when the share of the public sector in total capital was ca 4%. Formerly state-owned banks were privatized or merged with other institutions or were declared bankrupt. At the same time, the foreign ownership in Estonian banking system had increased steadily and reached 42% from total capital by end 1997.

The changes in external environment and the respective policy stance adopted by the authorities set the background for further consolidation of the financial system. The 1998 became the year of so-called second-wave restructuring in the banking sector. Increased competition resulted in several major mergers as well as the exit of weaker and inefficient institutions from the market. As today 7 credit institutions are licensed in Estonia of which one is a fully-fledged branch of a foreign bank. About 85% of the Estonian banking, 90% of the leasing and 30% of the insurance market became concentrated into two major financial groups. Consolidations were followed by the inflow of foreign capital from Scandinavia. Swedish banks acquired majority stake of two biggest Estonian banks, whereas Merita Nordbanken had established a branch in Estonia already four years ago.

The Estonian banking sector achieved the desired standards, competition tightened in the banking market, banks developed new banking services and products and paid more attention to servicing private clients. The developments in the banking sector have been rapid, indeed, and the increased stability, integration and efficiency are important factors for sector’s further progress.

2. Potential impact of euro

Eesti Pank has a firm position that, in compliance with the current EU accession negotiations, the best and economically soundest scenario for introduction of the euro would be participation in EMU according to the three-stage scenario:

1. Estonia’s economic and monetary policy preparations to accede to the European Union (from an applicant country to full EU membership)
2. Estonia as a European Union Member State: period from the accession to the European Union to joining the euro area;
3. Estonia joins the euro area: Estonia will participate in the formulation and implementation of the EU monetary policy (i.e. the central bank will implement ECB monetary policy guidelines and manage the circulation of the cash and account money in euros) (Ross, 2000).

Estonia has extremely large direct and indirect exposure to economic developments in European Union and in eurozone. Therefore, introduction of euro creates for Estonia, like for European Union itself, new opportunities and new risks. Following, some of impact to monetary policy and banking will be discussed in more detail.

2.1. Direct monetary link

EU candidate countries are obliged, after accession to the European Union, to make all preparations necessary to become a member of the European Monetary Union (EMU) and introduce the Euro (no opting-out possible). A common currency means a loss of monetary policy independence, but it brings many benefits. Among main benefits from EMU membership it is possible to name:
- trade creation
  - reduced transaction costs,
  - reduced costs of exchange rate volatility and hedging,
- reduced risk premium and therefore real interest rates (especially: no fear of devaluation),
- import of low inflation, therefore reduced uncertainty and low nominal interest rates,
- disappearance of asymmetric financial market and money shocks.

Therefore, Estonian monetary conditions have been and will continue to be directly influenced by three factors: (a) interest rate movements in euro area, (b) implied country risk, i.e., the general risk level of financial investments made into Estonian economy and (c) by the strength of euro on the global foreign exchange markets.

Enhanced currency stability among European countries improves the effectiveness of our present currency board-based monetary policy framework. As the base-currency area is coming bigger the transmission mechanisms of monetary and exchange rate policy should be even better understood by market participants.

It is also important, that as European Central Bank is committed to ensure low and stable inflation in the euro area, the potential volatility of interest rates and capital flows could be lower, as well. The existence of a stable inflation and interest rates in the euro countries can also be significant to Estonian monetary conditions as a stabilising factor.

The introduction of euro means to increase the macroeconomic stability of the member countries of the Union and to create more favourable conditions for the economic growths.
2.2. Effect EU on banking system

The financial sector, and particularly the banking system played an important role in the process of transition and economic recovery in Central and Eastern European countries (CEECs). Banks and other financial institutions are a unique set of business firms which assets and liabilities, regulatory restrictions, economic functions and operations establish them as an important subject for the study.

There are three main factors that will influence Estonian banking system over medium term as a result of the introduction of the euro. Firstly, the effects of the access to euro financial markets will further increase over time the number of domestic enterprises searching for direct financing. As a result, the customer base of domestic banks will change. Secondly, European banks will most probably enter local markets more actively. As a result, the influence of economic integration in Europe as a whole will further increase the supply of international financial services in the 2000s and beyond. And thirdly, both these developments may change the customer base of local banks even more towards retail banking and SME financing.

References

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Kokkuvõte

MONETAARSÜSTEEM JA PANGANDUSE ARENG EESTIS EUROTSOONI TEEL

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