FINANCIAL ISSUES OF TRANSITION ECONOMIES

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FINANCIAL ISSUES OF TRANSITION ECONOMIES

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PREFACE

Estonia started with its economic reforms more than 5 years ago. In its finance policy the country intended to emphasize fixed exchange rate and currency board principles, nonprogrerssive taxrates and balanced national budget.

Estonia has well succeeded in its economic reforms. This fact has lead researchers and politicians to confirm that owing to the successful currency reform in 1992 the foundation for Estonian`s economic development and integration into international cooperation structures could be laid.

On May 1994, an international conference on theme "The Theory and Teaching of Finance and Accounting in the Transition Economy" took place in Tartu. The conference participants asserted the need to continue the research on financial issues of transition economies. A collection of reports and theses hold on the Second International Conference on Transition Economies is published. The theme of the conference was "Financial Issues of Transition Economies and it took place in Tartu on April 16-17, 1995.

According to the opinion of the conference organizers the undertaking was a success, which was mainly thanks to the interesting and substantive reports, a numerous audience (over 80 students and more than 40 scientists and lectures) and active discussion. It is hoped that useful knowledge and arisen ideas will find extensive application in advancing Estonian economic policy and education.

Lots of friends and collegues were involved in organizing the conference. Special thanks to the organizors prof. Vambola Raudsepp, assist. prof. Toomas Haldma and secretary for the Conference Mrs Ülle Vaaks. Thanks from all our hearts to Estonian newspaper Postimees, founded in 1857 for substantial financial support.

With best wishes and hope for further meetings in Tartu.

Prof. Mart Sõrg
Chairperson of the Conference Steering Commitee

THE ESTONIAN PAYMENTS SYSTEM: AN APPRAISAL

George A. Hachey, Karin Liikane, Priit Koit

The purpose of this paper is to review and evaluate the progress Estonia has made in reforming its payments system. The evaluation of the system will be made against a background of the reforms other transforming economies have had to make in their transition from the Soviet centralized economic system to the market based economic system. Given this, we will determine if Estonia has introduced certain key institutional features which typically enhance payments efficiency and we will analyze data provided by Eesti Pank (the central bank; in English it is Bank of Estonia and hereafter will be referenced as BOE) to test some simple hypotheses of expected changes in variables related to the development of the system.

The paper is organized as follows: Section I discusses the role and importance of payment systems in both a centralized and a market economic context; Section II presents some guideposts for the development of payments systems and interbank money markets drawn from previous research, including an extended discussion of central bank float; Section III provides an overview of the Estonian payment system and interbank market; Section IV analyzes the available data to attempt an assessment of the progress made by the Estonian payments system; Section V offers a summary and conclusions.

I. The Importance of Payments in Financial Systems

Under the centralized economy of the Soviet Union, a system for making payments efficiently and effectively was not needed. The Soviet financial system was based on the activities of a monobank which functioned as both a central bank and as a commercial bank. Its activities were supplemented by a number of specialized banks {in Estonia, these were Hoiupank (savings bank), Valismajanduspank (foreign economic bank), Agrompank (agriculture bank) Sotsiaalpank (social bank), and Toostus ja Ehituspank (industry and construction bank)}. Individual enterprises were assigned to a particular bank depending on the nature of their economic activities. This structure limited the volume of interbank payments and the amount of competition in the financial system. Enterprises simply borrowed unlimited amounts from the bank to which they were assigned in making transactions authorized by the central plan. It was not urgent for these enterprises to have funds available in their accounts to make authorized expenditures. There were no financial penalties imposed and no threat of bankruptcy; banks functioned merely as book keeping entities with little or no real economic function. [7, p. 855]

However, the subsequent breakup of the monobank system in the early days of economic transformation (in Estonia, this actually occurred before independence) made intrabank settlements into interbank payments and makes the speedy and effective functioning of the payments system take on much greater importance. [7, p. 856]

A payment system capable of speedy settlement of transactions in goods, services and basic securities is a critically important component of a well-functioning market economy. [7, p. 849] Measures to ensure the integrity of the payment mechanism and eliminate long and uncertain delays in settlement are therefore an essential part of the financial system reform in formerly centrally planned economies. [1, p. 385] The efficiency and certainty of clearing and settlement systems affects the demand for bank reserves held in the central bank and other clearing centers, which are the ultimate means of noncash settlement for payments. At the same time, the level of development of the payments system influences the nature and activity levels of money markets, which are, among other things, a vehicle for obtaining and trading settlement balances. *Ceteris paribus*, the higher is the level of development of the payments system, the lower will be the level of excess reserves and the greater will be the volume of interbank activity.

II. Operational Guideposts

An effective payments system has two vital elements. The first is trust among the participants, expressed as a willingness to postpone settlement of an obligation in good funds. Banks may extend credit to each other to meet payment imbalances rather than insisting on settlement in currency or central bank deposits. [7, p. 849] The second vital requirement is discipline. [7, p. 850] Transactors could use the system to incur unsustainable balances between their payments and receipts. Discipline requires that they manage their liquid assets effectively so that settlement in good funds can be made at sufficiently frequent intervals.

Failure of either trust or discipline can impair the efficiency of the payment system, and indeed of the financial system as a whole. If banks distrust each other, they will insist on settlement in central bank deposits; banks will then hold large amounts of reserves or of securities that the central bank will discount and will intermediate far less between private borrowers and lenders. More transactions will require settlement in central bank liabilities, and the central bank will have to intermediate between borrowers and lenders. Such a system is usually characterized as illiquid and this illiquidity can have a substantial negative impact on economic growth and development.

A failure of discipline can also undermine the payment system. Financial discipline tends to be weak when market participants come to expect to be bailed out for their excesses and mistakes. If transactors ultimately expect to be indemnified for any losses resulting from bad debts, they have no incentive either to insist on settlement in good funds or to monitor the creditworthiness of their counterparties. In this case, the arrears in payments will continue to mount, both within the banking system and elsewhere in the economy. If the creation of credit through the payments system is unchecked, it frustrates the system's purpose of facilitating the exchange of objects of value; it may instead become a mechanism through which transactors try to obtain a larger share of the eventual bailout.

Payment systems are afflicted with two basic types of risk. The first is liquidity risk or the risk that a participant, although solvent, might be unable to make a timely transaction because of a lack of readily available means of payment. The second is credit risk. In event of bankruptcy of one of the participants, others would be faced with losses. Most payments systems can withstand occasional occurrences of both. However, the major fear is that the system may be so fragile that these occasional occurrences might mushroom and become systemic. [7, p. 860]

Inadequate supervision and regulation can exacerbate the dangers from liquidity risk and solvency risk. If weak banks are allowed to have direct access to the interbank payments system, they create severe risks of nonsettlement. This can easily lead to systemic breakdown. The management of settlement risk requires the effective implementation of strong regulations limiting the amount of credit implicitly extended through the payment system and clear rules stipulating when a payee can gain access to funds.

To see how the various parts of the system fit together, we provide a brief discussion of the Finnish payments system. Our intent is to use it as a basis for the discussion of how a developed payments system engenders trust and discipline among the participants and also how it manages the tradeoff between settlement risk and efficiency. This discussion of the general principals found in all payments systems will also serve as a point of departure for the examination and evaluation of the Estonian payments system.

Any payments system experiences a tradeoff between the allocation of risk in the system, which affects discipline, and the system's efficiency in effecting payments. [7, p.863] The Bank of Finland (hereafter BOF) has recently been grappling with just this problem in the context of a modernizing financial structure characterized by increasing volumes of large value interbank payments. In particular, this central bank, like central banks elsewhere which have to cope with the requirements of sophisticated financial markets, institutions and transactions has been quite concerned with the problem of daylight overdrafts. [For the case in the US, see 10.] These overdrafts are deficits in the reserve or settlement accounts of eligible financial institutions with accounts at the central bank. They arise in the process of settling interbank claims when the central bank debits the account of the remitting bank and credits the account of the receiving bank. This transfer from the remitting bank becomes final when the receiving bank is informed of the payment request and cannot be revoked by the central bank even if the remitting bank does not have a sufficient balance to cover the transfer. The latter need post sufficient funds only at the end of the day. So, if its reserve balance turns negative during the day, the result is a type of loan from the central bank to cover the deficit which exposes the central bank to settlement risk in the event the negative balance is not covered. [8, p. 8] The problem is, however, that there is an expectation that the central bank will provide this credit and take this risk in order to keep the payments process functioning smoothly. The alternative is to delay payments until they are funded by receipts, but the minimization of the time lag between initiation of the payment instruction and final settlement is increasingly important. [8, p. 9]

When Finland's interbank clearing system was introduced by the BOF, access to these daylight overdrafts was without limit and without cost. Subsequently, however, borrowing limits were imposed and banks using the system had to post collateral equivalent to 25% of their overdraft limits. This reduced the risk exposure of the BOF and did not appear to reduce the system's efficiency. [8, p.10] Moreover, since July 1992, the BOF has paid market interest rates on excess reserves (call money). As a result, there has been a significant increase in the level of excess reserves in the system and this has also tended to reduce liquidity risks in the payments system.

Thus, an important element in the assessment of Estonia's payment system is how the Bank of Estonia approaches this tradeoff given its stage of development and given the type and volume of transactions which must be settled.

Moreover, inefficiencies and uncertain delays in clearing and settlements in other transforming economies has resulted in payments system gridlock - an accumulation of unprocessed payment orders due to insufficient funds in the payers account, possibly triggered by delays in the receipt of funds. Such a situation could contribute to large interenterprise arrears which end up being treated as nonpaying financial assets on enterprise books. This condition can also reduce the desire to use bank services and delay the widespread movement from a cash society to a more efficient payment systems. Delays in receiving payments can also erode the real value of these payments during sharply inflationary periods and increase the demand for credit by both governments and enterprises. [1, p. 387]

Operational breakdowns in the payments system become more likely when the increase in the number of payments (due to a larger number of banks and emergence of financial markets) puts pressure on existing payment processing arrangements. A buildup of backlogs in the processing of payments would raise the size of float, and affect the systems liquidity. The resulting delays in processing and verification of payments create opportunities for fraud. Fraudulent payment transfers could profit from delays in verification and poorly designed security features, and could result in major losses.

A problem which vexes all payment systems concerns float. The large size and variability of payments float complicates monetary policy and compromises economic growth. Float refers to amounts that have been debited (credited) from (to) a payer's (payee's) account before the corresponding credit (debit) entry has been posted in a payee's (payer's) account. It reflects differences in timing between crediting and debiting of accounts caused by delays in the transmission of payment information and in the subsequent registration of accounting entries. Large and variable lags between the time of debiting and crediting bank accounts with the central bank (bank float) or customer accounts with banks (customer float) could arise from a lack of operating standards in the processing of payments, inadequate or poorly enforced rules and regulations on clearing procedures and settlement methods, and unreliability of systems used for the transport and delivery of payment information. [1, p. 385]

Debiting (crediting) of a bank settlement account before crediting (debiting) the receiving (sending) bank leads to a withdrawal (supply) of liquidity; variable lags in such debiting and crediting could result in large day-to-day variations in the size of reserves or deposits, both in the aggregate and in individual banks. This forces commercial banks to hold large levels of excess reserves or rely on central bank accommodation. The factors that cause large and variable float also exacerbate payment risks. [1, p. 386]

It is true that the more important linkages are between float and various aspects of central bank money management policies. This is not so important in Estonia given the currency board framework for monetary policy. The Bank of Estonia does not operate on the size of reserves in the banking system to affect interest rates, for example. But there are still some important considerations that should be examined especially with regards to the efficiency of the payments system and the consequent impact on economic growth.

Large and unpredictable variations in the amount of float distort liquidity management by both central bank and commercial banks. If banks must hold large excess reserves as a buffer against the variability of reserves, then this affects the demand for various money market instruments. This can also undermine the development of well functioning interbank markets in both domestic instruments and in foreign exchange.

Consequently, an important indicator of progress in the reform of the payment system is a reduction of the level and variability of float both among commercial banks and the central bank and between and individual bank and its customers.

There are a number of different reforms that a central bank should implement early on in the transformation process to enhance the proper functioning of the payments system. In the medium term, it can introduce gross settlement arrangements for large-value transactions that require finality, a high degree of security, and immediate, same-day, or value-dated settlements, as well as net settlement arrangements through clearing houses for smaller payments. Finality of settlement means that once a payment message is sent, it is certain that the payee will receive good funds that cannot be reversed, even if the payor subsequently becomes insolvent. This risk is not eliminated by proper procedures, rather it is shared in varying degrees by the central bank, the clearing house, the participating commercial banks or the unsecured creditors of the defaulting party. [1, p. 388]

A related issue has to do with the technology used to process these payments; efficiency is enhanced when the processing is done electronically rather than by hand. During the early days of commercial banking in Eastern and Central Europe, bills trading frequently required the physical transfer of paper from one window to another at the central bank. Also, primitive telecommunications facilities hindered payments transfers by phone and also the use of more sophisticated electronic funds transfers.

In most countries in Eastern and Central Europe, the initial structure of the payments system was one of gross settlements, but based on slow paper-based clearing procedures and lacking any explicit credit or guarantees to support settlement. A gross settlement system without some sort of credit facility as discussed above for the case of Finland typically requires a larger amount of settlement balances than a net settlement system. It can also lead to gridlock if settlement balances prove insufficient.

Another problem that appeared in Central Europe during the early days of commercial banking is that each branch of some banks had their own accounts with the central bank. If a branch had a negative balance with the central bank, then it had to get funds from the refinance facility at penalty rates even if the bank as a whole had a net positive balance. Also, banks had to use central bank facilities to make intrabank transfers and made up a lot of the transactions carried over the telegraphic transfer facilities. These branches must be consolidated in order to treat each bank rather than each branch as a unit. The alternative is a situation where each bank must have multiple clearing accounts.

The legacy of the Soviet financial system also makes current central bank refinancing activities suspect and dangerous. Under the monobank system, account overdrafts were frequent and of little consequence. The problem which has emerged in Russia and other CIS countries is that overdraft coverage by the central bank can become open ended and lead to excess liquidity, lack of payments discipline and inflationary pressures. Access to this overdraft protection may also be done on a preferential basis to support preferred enterprises and activities. [7, p. 859]

III. Estonian Payments System and Interbank Money Market

Estonian Currency Board

Any discussion of money systems in Estonia must include a discussion of the currency board system. However, in the context of the present paper, this discussion will be brief. The currency board is discussed in much detail elsewhere [2, 12], and the role of the currency board for Estonia's payments system and interbank market is somewhat tangential. Here, only two aspects are worth mentioning: first the imposition of reserve requirements and the second is the fixed exchange rate with the German deutschemark.

The fact that BOE has established required reserves distinguishes its variant of the currency board from the classical version because changes in the reserve requirement allow it more control over the money supply than just the authority to convert foreign currencies into Estonian kroons.[1] Required reserves for Estonian commercial banks are set at 10% and were originally established partly because there was no effective system of interbank clearing in place at the time and to ensure that commercial banks held precautionary balances against unexpected cash outflows. [2]

Secondly, the explicit fixed exchange rate link with the deutschemark has eliminated the currency risk for Estonian commercial banks who want to invest in short term deutschemark denominated deposits. This is the bulk of the entries on their balance sheets which are entered as "claims on foreign banks in foreign currencies".[2] This practice is so common, that the Estonian interbank rate (explained below) tracks very closely the DEM deposit rates (discussion with Märten Ross of BOE). Yet, the low interbank rates are disconnected from the much higher customer lending rates posted by banks. This is because BOE carefully examines banks before allowing them to access the system and continues to monitor their positions at short intervals. As a result, the risks of interbank lending are much less than the risks of customer lending, given

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[1] There is another reason why the Estonian Currency Board is a modification of the classical conception and that is because if is a department of BOE and not a separate entity.

[2] Foreign deposits are especially attractive to banks with underdeveloped treasury departments. Other deposits are made in US dollars, especially in Latvia and with correspondent accounts in the United States. Most of these deposits are demand deposits.

the operating risks and information deficiencies which afflict the enterprise sector. (Discussion with Kaja Kell of BOE).

The Development of the Estonian Payments System

Estonia began to move away from the Soviet monobank system in December 1989 as Eesti Pank became once again Estonia's central bank. For a time, however, both BOE and the Soviet Union's Gosbank were operating until the latter was closed down in early 1992. [9, p. 91]

Consolidation of bank branches also quickly occurred in Estonia, but in a way different from other countries. At first, branches of several of the old Soviet banks split off and became independent. But of course, this had the same effect on the payments system as having branches of a given bank using the clearing center to transfer balances among one another. But the problem did not last long as the Bank of Estonia began to close many of these small banks by establishing minimum capital requirements defined not as a ratio, but as a minimum amount of capital invested. It also refused to renew the licenses of several small banks and to grant licenses to new applicants. However, to this day, few banks have correspondent accounts with each other and therefore all use the Clearing Division of the BOE for settlements.

BOE began to require from March 10, 1992 that all banks must complete payment transactions in 48 hours or face a late charge. This was done to challenge the banks and to force them to recognize the importance of efficient clearing for their customers. It also probably reflects the fact that one of the banks involved in the banking crisis of early 1993, Union Baltic Bank, sometimes took weeks to clear transactions.

At the present time, all settlement is done electronically and the system has the capability to clear within 24 hours. For example, Sociai Bank operated with seven branches In Tallinn, Parnu and Tartu. For interbranch clearing, an offline electronic system was used. Payment orders were sent from the branches to the main office in Tallinn once or twice each day and cleared the next day. Transactions with the main office cleared in the same day. There were plans to put all the branches on line to effect same day clearing throughout the bank, but Social Bank was forced into bankruptcy before this could be implemented. Hansapank has an online system for interbranch clearing. Hoiupank has an online system for its Tallinn branches and is in the process of extending it to its branches throughout Estonia.

In 1993 and for most of 1994, banks were promoting themselves to customers on the basis of their ability to clear transactions in 24 hours. Recent increases in the amount of float in the system indicate that some banks are delaying payments to the full 48 hours allowed. (Interview with Vladimir Mihailov, Head of the Clearing Division, BOE). With the improvement of the current system to one which allows real time settlement, large value transactions will be settled on a net basis. That capability is not currently present. (Interview with Vladimir Mihailov, Head of the Clearing Division, BOE).

BOE Supervision and Regulation of the System

BOE has established several rules which bear on the issues of payments system trust and discipline and also attest to its activity in managing settlement risks.

Of primary importance for the stability of the whole system is the establishment of prudential ratios announced on April 13, 1993. These include an 8 percent capital ratio based on risk adjusted assets and off balance sheet items; a 30 percent liquidity ratio; and restrictions on insider loans, the maximum amount to be lent to one client, etc. Moreover, there are minimum EEK capital requirements as well. As do other central banks, BOE establishes criteria for being given a license to establish a bank. It also has an on-site inspection program as part of its overall supervisory responsibilities.

To directly manage settlement risks, BOE requires that commercial banks settle all transactions within 48 hours and that they have sufficient balances in their clearing accounts to meet payment obligations.

BOE has also established procedures for determining whether banks can apply for liquidity assistance (from June 15, 1992. This assistance is not like the Federal Reserve's discount window. It is more limited than that. Banks having difficulty meeting their short term settlement requirements and which cannot obtain funds through the interbank market (discussed below) can borrow against their required reserves. Thus, as of July 27, 1993, banks which have concluded a clearing contract with the Bank of Estonia are automatically granted settlement credit in case the balance of the bank's correspondent account in the BoE falls below the level of required reserves. The settlement credit can be used on a maximum of five banking days during ten successive banking days. The maximum size of the clearing credit was then 20 per cent of the bank's required reserves. If the balance of the bank's correspondent account drops below the required reserves level on more than five banking days out of the ten successive banking days, the payments from this bank's correspondent account are stopped on the next day until a decision of a credit commission. The interest rate for credits amounting up to 10 percent of the required reserves is 25 percent and for credits amounting to more than 10 percent of required reserves is 50 percent. This was amended on December 30, 1993. On that date, the terms were liberalized to allow maximum borrowing equal to 30% of required reserves and with interest rates of 15% for amounts borrowed equal to less than 15% of required reserves and rates of 25% for greater amounts.

The implication of these requirements is that BOE cannot provide unlimited liquidity to the banking system in order to prop up weak banks. The amount of liquidity that a bank can obtain to handle settlement and solvency difficulties is limited to the total reserves of the system as obtained through the interbank market and by borrowing on its own required reserves while paying a very high interest rate. These restrictions plus BOE's rather aggressive actions to impose moritoria and eventual bankruptcy on noncomplying banks suggests that the Estonian financial and payments systems are quite disciplined. Banks must exhibit great care in granting loans and in monitoring their customers because there are no doubts but that the failure to do so can ultimately result in their bankruptcy.

There are also terms and eligibility requirements for banks to participate in the interbank money market.

The Estonian Interbank Market

Since the stuff of interbank deals is excess reserves, this section begins with the rules used to determine a banks required reserves. Reserves must be held against demand, savings and time deposits in both domestic and foreign currency. The determination of required reserve levels has changed three times over the past two years: on March 31, 1993, April 15, 1994 and . The March 31, 1993 provision required that "the obligatory level of required reserves for the next month is calculated as an average of the three 10-day periods of the previous month". This was changed to "the required reserves level for the next 10 days must be calculated as the average of the end of three preceding months". Currently, required reserve levels are based on the average deposit balances for the first, tenth and twentieth days of the preceding month. The required reserves level for the next month will take place on the 5th workday of each month. Throughout the period studied in this paper, required reserves were set at 10% of bank deposits.

In late 1992, officials at BOE began to notice large holdings in correspondent accounts (excess reserves). To put these reserves to more productive use, BOE launched a short term money market project in January 1993. The objective of this project was to allow banks to sell short-term cash surpluses to the market and also obtain them in the event of liquidity problems. In so doing this, it was hoped that a rudimentary money market would emerge.

The early results were somewhat disappointing as commercial banks were slow to use to use the market. There were four primary reasons for this:

1. Banks were informed of their end-of-day balance in correspondent accounts at BOE only at 5 pm. Lending money before this endangered client payments received after the loan was made because banks simply did not know balance. But after 5 pm, banks were closed and could not make deals.
2. Many managers simply felt that large excess reserve balances were a sign of a bank's strength. They had developed no understanding of opportunity costs. This attitude is a characteristic of the transition from the former system and is due to the carryover of managers from the old system who have not had much training in basic financial principles. [1]
3. Banks had internal control systems which limited the money manager's ability to transact in the market. For example, one bank required its money manager to get the bank president's signature before completing any transaction. This requirement was eased in March 1994.
4. A more important reason was the mutual mistrust among banks regarding each others solvency. As a result, most preferred to keep excess reserves in zero interest accounts rather than lend to other banks.

These fears were not unfounded. Shortly after the Monetary Reform was initiated, Estonia experienced its first banking crisis. This was related to the failure of the Russian Vnesheconombank (Soviet Foreign Economic Bank) which led to the freezing of clearing balances of certain Estonian banks which were financing trade with Russia. This resulted in the restructuring of two banks, Union Baltic Bank and North Estonian Bank, Ltd. into North Estonian Bank. At the same, Tartu Commercial Bank

[1] Moreover, Social Bank, which was the largest bank as measured by total assets in Estonia, held most deposits of the central government and did not pay any interest on them. Consequently, the management felt no incentive to invest these funds in interest earning assets and had large amounts of cash and excess reserves.

failed due to mismanagement and bad loans. In January and February, the licenses of seven banks were not renewed, two banks had their licenses revoked and one had a moratorium (the step prior to declaring bankruptcy) placed on it.

To remedy these problems, BoE took two actions:

1. BOE began to require banks to send money orders of their clients to the clearing center by 2 pm. This is called the initial clearing. BOE would then electronically transmit to each bank the balance of their correspondent accounts by 3 pm. Interbank deals typically take place by phone among bank money managers between 3 pm and 5 pm although BOE allows 24 hour trading in the market. In fact, given the small number of banks in the market, most activity is concluded in approximately five minutes.
2. BOE began to issue short term certificates of deposit with 100,000 EEK face value and a 28-day maturity. These CDs were sold at auction every two weeks. Commercial banks could then make deals in the secondary market with these BOE CDs. This arrangement creates virtually risk free interbank loans. Banks can sell these CDs back to BOE or can use them as collateral in repo deals with other banks.

The first auction occurred on May 4, 1993. BOE offered EEK 5 million of CDs and half were sold that day with the remainder sold on May 5. A second auction took place on May 18; 19 bids were made and the entire issue promptly sold out. (EEK 10 million were offered). However, several large banks did not participate. [6, pp. 36-37].

By the spring of 1994, activity in the interbank market was building and apparently banks were willing to deal directly with each other and without collateralizing their deals. This is evidenced by the fact that commercial banks became less interested in BOE's CD auctions and would not buy out the entire issue. A factor contributing to this imbalance between supply and demand was the fact that BOE began to double the amount of CDs offered and held the auctions weekly. After some readjustments, the July 1994 auction sold out.

May 1994 saw some additions to the list of money market securities as the city of Tallinn offered EEK 20 million in six month notes (interest rate of 10%) and then did so again in June (interest rate of 10.5%). At about the same time, other commercial banks began to issue their own CDs with varying degrees of success. [3, p. 54-55].

IV. Analysis and Evaluation

In this section we analyze institutional developments and data trends in the Estonian liquidity and payments system to determine the progress that has been made since independence in August of 1991. In this context, we think of progress as those institutional developments which have been put in place to enhance the efficiency and proper functioning of the payments system and also certain favorable trends in the behavior of commercial banks.

Based on the material discussed in Sections II and III above, we can establish the following institutional developments in the Estonian financial system:

1. Abolition of the monobank - specialized bank system to be replaced by a central bank and competing commercial banks. Accomplished by early 1992.
2. Consolidation of commercial bank branch accounts into one, unified system of accounts. Accomplished by central bank action to reduce the number of small banks that were branches of the former Soviet banks.
3. Establishment of clearing centers and other institutional arrangements to facilitate interbank payments. Few banks have correspondent accounts with each other and therefore all use the Clearing Division of the BOE for settlements. There are plans to set up a Clearing Center, which might be independent of the central bank.
4. Replacement of paper based settlement procedures with electronic settlement. All settlement is done electronically and the system has the capability to clear within 24 hours. There are plans for real time settlement of accounts which banks will provide their customers for a fee.
5. Replacement of gross settlement procedures with a net settlement procedure. With the improvement of the current system to one which allows real time settlement, large value transactions will be settled on a net basis. That capability is not currently present. (Interview with Vladimir Mihailov, Head of the Clearing Division, BOE).
6. Indications that the central bank is actively engaged in supervising and monitoring the system. Briefly, BOE grants operating licenses to banks, has established prudential ratios, conducts on-site supervisory visits, has established required reserve ratios and has an array of reporting requirements that banks must adhere to. It has forced banks which violate its rules into bankruptcy.

7. Evidence that the central bank has developed procedures to deal with settlement risk.

This is probably the most crucial institutional development in a payments system because it directly addresses issues of systemic risk. BOE monitors the banks with regard to the ratios listed above to maintain the solvency and stability of the system. Other relevant items are that BOE:

- provides limited liquidity assistance, not in the form of loans
- does not pay interest on reserves
- requires settlement within 48 hours
- restricts the amount of reserves available for interbank lending

Also based on Section II, we would expect the following trends in data related to the payments system:

1. Reductions in the level and volatility of net float relative to bank reserves.

Figure 1 presents the behavior of the net float (debit float minus credit float) to total reserves ratio and compares it to the monthly percentage change in total reserves. All data are measured as of the end of the month. The volatility of the reserves measure seems to abate somewhat in 1994 over 1993. A comparison of the basic statistics for the reserves data series is:

	1993	1994
mean	1197.56	1218.96
std. dev.	167.16	116.75
Coefficient of Variation	.14	.10

The net float to reserves ratio increases dramatically in the second half of 1994, however, with one peak occurring in July and another in December. Several factors seem to be at work here. The first is continuing payment delays by Social Bank as it goes through its final death throes. This was certainly the case in July which was just prior to BOE imposing a moratorium on the bank and probably also true in December when BOE denied Social Bank further access to its liquidity facility. The second possible explanation is that more banks are delaying payments for the full 48 hours allowed them. A third reason is just a large increase in the volume of transactions processed through the system. Such an increase has steadily occurred over the past few years. Data on this trend was not available from BOE.

2. Increased activity in the interbank money market.

Figure 2 shows the time series behavior of the basic money market assets available to Estonian commercial banks. Reserves refers to excess reserves calculated simply as the difference between total reserves and required reserves. Loans refers to the level of interbank loans. Claims are claims on foreign banks, predominantly hard-currency deposits in German and American correspondent banks.

After a slow start, activity in the interbank market picks up dramatically and peaks in July 1994. During this period, Social Bank was very actively borrowing from other banks because of its own liquidity problems. In July, for example, Social Bank's borrowing accounted for 59% of the market's activity. The bank could not satisfy its liquidity needs in this market and began to draw upon BOE's liquidity facility. A moratorium was declared in August and lifted in September.

Three facts account for the large drop in interbank activity in August. First, Social Bank could no longer access the market. Second, BOE allowed banks to count vault cash as satisfying up to 50% of their reserve requirement. Thus, liquidity needs dropped dramatically. Third, BOE significantly reduced the amount of funds that banks could lend in the market. To see this requires a brief explanation of how BOE determines daily, commercial bank settlement balances. After the initial clearing takes place at 2 pm, BOE calculates two numbers and transmits them to the banks. The first number represents the bank's balance on account. The second number indicates balances that are owed but which paying banks cannot cover because of insufficient balances. This balance can arise when a borrowing bank cannot repay its overnight loan by the 1 pm, next-day deadline. The deficit bank can ask the lending bank for an extension on repayment until the next day. Until July 1994, the sum of these two amounts, if positive, could be lent in the interbank market. After that date, only the first could be lent. The sum total of these two changes effectively provided additional liquidity to the system and at the same time reduced the amount of reserves available for interbank lending at a time when there was substantial risk to the system.

3. Reductions in excess reserves as a percent of total reserves (reduction in reserve ratio - total reserves as a percentage of total deposits).

Figure 2 also shows a steady decline in the level of excess reserves. This is definitely an indicator of increased payments efficiency. Still, as a percentage of total reserves, the excess reserves held by Estonian banks amounted to 56% December 1994. In developed, western economies this excess reserve ratio is less than one percent.

To see if there was a relationship between decreases in excess reserves and increased interbank activity and increased amounts of foreign deposits, a regression was run on the levels of these variables. The period included was restricted to October 1993 through December 1994, which includes the start date for interbank market activity. The results of this regression appear below (with t-statistics in parentheses):

variable	coefficient
intercept	381.08
interbank loans	-.076 (-3.44)
foreign deposits	-.030 (-.888)

Both variables display the correct signs, but only the interbank market variable is significant. Thus, it seems that the introduction of the interbank market is associated with a decline in the excess reserves held by the banking system. Changes in foreign deposit balances are related to factors other than substitution among money market assets. Some of these are the increased amount of international trade activity enjoyed by Estonian enterprises and the relatively poor quality of the domestic lending market coupled with BOE's monitoring activity and liquidity requirements. (Interview with Kaja Kell of BOE). Any conclusions must be carefully advanced, however, because of the small sample size available.

V. Conclusions

It appears that the Estonian payments system is suitable for the current level of development of the Estonian financial system. We may characterize this level as one where significant levels of trade and business activities occur but where the financial markets have developed in only the most rudimentary fashion. As a result, the Estonian system does not have to handle the large volume of large valued transactions associated with more developed financial systems. Nevertheless, the system quickly developed the institutions necessary for an efficient settlement of payments; has adopted procedures by which the central bank can manage settlement risk due to either liquidity problems or solvency problems; and has made some progress in stabilizing the level of float, reducing excess reserves and developing a relatively active interbank market. And the BOE, as managers of the system, are planning on introducing improved technologies which will make the system ready for more advanced clearing requirements.

The distortions in the data associated with Social Bank's liquidity problems in 1994 certainly make any conclusions about the "normal" functioning of the system problematic at best. In particular, it is not clear whether a more pronounced substitution of interbank loans for excess reserves would have happened if Social Bank had not run into difficulties. It is also difficult to assess whether this disruption in the interbank market effectively reduced the volume of enterprise loans. And, whether or not BOE chose the most cost effective way to resolve the crisis is a subject of continuing debate.

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FISCAL PROBLEMS OF TRANSITION ECONOMIES

Robert W.McGee

This paper discusses some of the fiscal problems faced by any economy that is attempting to make the leap from central planning to a market economy. Although all economies have fiscal problems, transition economies have special problems. Not only must they deal with the normal problems faced by a market economy; they must also replace major portions of their existing system of public finance with systems that are more suited to a market economy at a time when the market economy itself is not fully in place. This paper outlines some of the problems faced by an economy in transition and suggests approaches and solutions.

All economies have fiscal problems. The tax base is too narrow. Tax rates are too high. The system can't collect enough revenue to cover government expenditures. The collection and administrative systems are too burdensome. There is too much evasion. The rules are not clear. The rules are too complex. The system is perceived as being unfair. Economies that are in transition from central planning to a market system have these problems, too, only for them the problems of implementing and administering a system of public finance are much more difficult and complex.

Fiscal Revolution

Economies in transition do not have the luxury of finetuning their fiscal system. Countries that have had a market economy for decades already have a fiscal system in place that more or less does what it is intended to do. Some systems are better than others, but the basic system has been in place for a long time. Improvements to the system can be small and gradual. Economies in transition need to have a fiscal revolution. Their entire system of raising revenue must be changed, and they must find or train people who can administer the new system. A large segment of the population must be educated to understand the basics of the new system. Business owners have to learn how to keep records in a manner that tax officials can understand. Workers must get accustomed to having taxes taken out of their paychecks if the fiscal authorities decide to adopt a payroll tax.

Under central planning, where the government owned all the income-producing assets, there was no need for an income tax or a sales tax. Fiscal authorities merely appropriated the surplus they needed from the various state-owned businesses and transferred it to the treasury.[1] As state enterprises are turned over to the private sector, the government's tax base shrinks, and the government's revenue sources are not immediately replaced because there is no market-based fiscal system in place, at least not in the early stages of transition. As a result, there can be a sharp decline in the amount of revenue available to the government. Of course, as assets are transferred from the governmental sector to the private sector, and as the market takes over functions previously done by the state, there is also less need for the government to have revenue. But revenue can drop faster than the need for it shrinks, leading to a deficit. Some governments offset this deficit by printing money or expanding credit, which leads to inflation. The market economy is often blamed for the resulting inflation, when in fact the inflation was caused either by credit expansion or the printing press, both of which are controlled by the government. Attempts to control inflation by instituting price controls retard the growth of the market, since the price system is a signalling mechanism, and price controls distort the signals being sent, resulting in misallocation of resources and a dampening of the incentive to invest.

Lack of Clearly Defined Rules

When a country's fiscal system changes from one based on central planning to a market system, there are no clearly defined rules. New rules have to be made, almost instantaneously, and the rules have to be disseminated, both to the fiscal authorities, and to the people and enterprises that will be taxed. The changes to the fiscal system must also be coordinated with other changes that are being made in converting to a market economy. To make matters worse, there is no cookbook to guide the authorities as they attempt the conversion to a market system. As a

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[1] McKinnon 110-111.

result, every country that is attempting the conversion is taking a different path. Some methods work better than others and there are bound to be mistakes as fiscal and political authorities attempt to lead their country into the new system.

Nobody Knows What the Rules Are

When new rules are formulated, another problem becomes apparent. No one knows what the rules are. The people in positions of authority have to be made aware of the new rules as they are made so they can start implementing them. Oftentimes, the new rules are not clearly written or complete. One reason for this phenomenon is because it is impossible to anticipate each and every question that might come up when implementation is started, especially if the people who wrote the rules are unfamiliar with the market system. Even policymakers in countries that have had a market system for generations often do not do a good job of writing rules on the first attempt. As a result, changes have to be made as questions and problems arise. Ideally, a group of experts will first consult to determine what changes need to be made before amendments to existing rules are issued. But time pressure does not always allow for this luxury. In cases where decisions about rule changes have to be made rapidly, perhaps one or two agency officials are assigned the task of fixing any gaps, inconsistencies or unclear provisions. Because the dissemination of knowledge in society is diffused,[1] it is impossible for one or two individuals, no matter how intelligent, to be able to construct perfect rules, no matter how much time they have to do it.

Some transition economies are working around the fact that nobody knows what the rules are by making private deals with taxpayers. In China, for example, a foreign company that wants to establish itself in China enters into discussions with local, regional and/or national officials to negotiate tax payments. Rather than assessing the tax as a percentage of profits, Chinese officials and foreign businesses sometimes agree on a flat payment amount regardless of profit levels. The advantage of this approach is that everyone knows what the tax liability is, thus eliminating some uncertainty. The problem with this approach is that western corporate officials are not accustomed to this kind of negotiation, and some of them shy away from it. Another problem is that corporations are liable for payment of the tax even if they don't make any profits, so the tax bite could be more than 100% of profits. A third

[1] For discussions of this point, see Hayek; Sowell.

problem is that Chinese officials sometimes try to squeeze extra revenue out of the corporation after the amount of tax liability has been agreed upon. There is no rule of law. Decisions are made by individuals, who may be corrupt, and there is no recourse.

The Rules Change Too Frequently

Transition economies have a tendency to change tax rules too frequently. It is not unusual for the tax rules to change each year, or even more frequently for awhile, until the tax authorities settle on a policy that they feel comfortable with. This phenomenon of frequent tax law changes is not confined to transition economies, however. Western democracies engage in this practice, too. In the United States, for example, Congress has made significant changes to the tax law almost every year since 1981.

While it is generally a good idea to replace bad tax policies with better tax policies, problems result when the changes are too frequent. For one thing, it is difficult for both government officials and individuals in the private sector to keep up with the changes. The time and effort they spend learning new tax laws could be better spent creating wealth. Frequent changes also have an adverse effect on investment. Frequent changes increase investment uncertainty and obscure business planning. Investors will hesitate to invest if they don't know what the rules of the game will be a year or two down the road. Business people who are already in the marketplace also have a difficult time planning for the future if they don't know what rules they will be operating under in the future.

Collection Problems

All governments have some problems collecting taxes. But transition economies have an even tougher time because their tax system is new and not fully in place. There is ample opportunity for taxpayers to evade taxes, especially in the case of small businesses or businesses that deal primarily in cash. The taxpayers themselves often do not keep records that are detailed enough to determine what their tax liability is, especially in the case of an income tax that has complex, obscure and frequently changing rules. Government officials often do not know that certain businesses exist, which makes it impossible to collect the tax unless the taxpayers in question volunteer to pay, which is usually not the case.

Taxes are especially difficult to collect if the citizenry perceives the system to be unfair. Dozens of tax collectors in China have gone into the countryside to collect taxes never to be seen again. There are widespread rumors that the peasants kill them when they try to collect. The Chinese tax system is riddled with corruption and local government officials sometimes try to collect more than what is due so they can skim some revenues off the top to pay for foreign cars and other luxuries. Chinese peasants are also upset because they feel that they pay more taxes than city people, and they don't see any benefits coming back to them.[1]

Basic and Strong Distrust of Government

Another phenomenon that permeates all transition economies is the widespread distrust of government. This basic distrust is by no means confined to transition economies, however. People in every country have a certain distrust of government and government officials. People in Switzerland and the United States have perhaps less distrust of government than people in Latin America and Eastern Europe, but the perception that government is, at times at least, an enemy rather than a friend of the people, exists in every society to a certain extent.

This perception becomes important when government officials attempt to collect taxes. Where there is a strong distrust of government, people have less tendency to comply with the laws voluntarily. They often feel no moral duty to pay taxes to what they consider to be a corrupt government.[2] This feeling, coupled with the absence of a mechanism set up to collect tax revenues, makes it especially difficult for governments in transition economies to collect the revenue they need to pay for the costs of government.

The Welfare State Mentality

Economies can have fiscal problems not only because they cannot collect enough revenue to pay for the costs of government, but also because government expenditures are higher than the amount of revenue that can easily be collected. In economies that were formerly centrally planned, or even in market economies that have relatively large governments, there is a tendency for people to think that government

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[1] WuDunn,.

[2] For a discussion on the moral aspects of tax evasion, see McGee.

should provide a wide range of services. Many people, even in market economies, think that government should provide them with cradle to grave health care. They think that government should provide them and their children with free education, pensions, child care, paid leave for having children, payments while unemployed (or a guaranteed job for life in economies like Russia that formerly had no official unemployment). In other words, many people have a welfare state mentality.

The problem is worse in transition economies where government has been providing these services for a generation or more. People either do not realize that the market can also provide many or all of these services, or else they do not want to pay the market rate for these services, in the mistaken belief that government can always provide the service more cheaply. Numerous privatization studies have shown that the private sector can provide just about any service cheaper than government.[1] Even in the United States, where government, at the lower levels at least, is perceived as being relatively efficient, these studies have found that the private sector can provide equivalent or better services at about 40% to 70% of the cost of government.

The problem is one of perception. People who send their children to "free" government schools think they are getting a good deal because they do not see the full cost of the service they are receiving. In Newark, New Jersey, USA, for example, it costs $10,000 a year to educate one high school student in a government school. Parents pay nothing because the school expenses are paid for out of tax revenues. Private schools in the Newark area can educate a high school student for about $4,000 a year. Yet private schools are perceived as being more expensive than government schools because parents can see how much it costs for a private education - because they have to pay for it - whereas they do not see that government schools cost much more because they never see the cost figures. They complain that their taxes are too high, but they do not see the connection between the size of their tax bills and the cost of providing "free" education.

Another factor that is involved here is that, in the case of private education, the only ones who pay for the service are the ones who use it -- the parents of the students who attend private schools. Government schools, on the other hand, are paid for by all taxpayers, whether they

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[1] For summaries of some of these studies, see Fitzgerald; Goodman; Savas; Poole; PRIVATIZATION.

have any children in school or not. Thus, the cost of providing a "free" government school education is spread among the whole taxpaying community, whereas the cost of providing a private school education is borne entirely by the users of the service.

As long as people think that they are getting services they do not have to pay for, there will be a demand for services. If government attempts to provide all the services that are demanded, it naturally will have to collect more tax revenues to pay for the services it provides. Thus, the welfare state mentality is partially responsible for the fiscal problems that all welfare states have.

Structural Problems

As a country becomes more developed, its birth rate declines and its people live longer because of better nutrition and health care. People in many countries are tending to retire at an earlier age, too, at least when the government provides pensions and health care services that allow them to retire early.

As a result of this trend, the number of people paying for benefits is declining over time while the number of people taking benefits out of the system is increasing. Furthermore, as life expectancy increases, people take benefits out of the system longer. That, plus government inefficiency, is causing the fiscal solvency of many social security and health insurance systems to erode. In some cases, where these benefits are paid out of payroll taxes, the taxes needed to fund the system amount to more than 50 percent of payroll.[1] As a result, companies are hesitant to hire anyone because the wages they pay the employees are only a small percentage of their total payroll costs. The result is structural underemployment.

The demographics in each transition economy are different, so the extent to which this phenomenon is a structural problem will vary. Countries that have a higher birth rate are producing more people who will eventually be able to pay into the system to provide for the retirement and health care costs of their parents and grandparents. Economies with lower birth rates will face a crisis sooner.

In what was the former East Germany, the birthrate declined sharply as soon as mothers were no longer paid to stay at home to raise children. As

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[1] For the exact percentages for many countries, see Coopers & Lybrand.

the population ages, there will be fewer people contributing into the system and the babies who were born during the high birth rate years may not be able to receive as much benefits as their parents did as the members of the younger generation reach retirement age. In Romania, the situation is worse. Under the communist regime, families were encouraged, even pressured, to have large families and abortion was illegal. Now, there are many young people, but the birth rate has since declined markedly, so as these young people approach retirement age there may not be enough members of the younger generation to pay for the benefits the older generation will receive.

A Choice of Tax Systems

While much has been said about the extra problems that transition economies face, such economies do have at least one distinct advantage over their older, market-based neighbors. Transition economies can start from scratch. They can replace their old system with a new one, whereas mature market economies do not have this option. Mature market economies cannot revolutionize their tax systems because of inertia. At best, all they can hope to do is finetune what has evolved over decades.

Transition economies can take a more revolutionary approach because their old system must be replaced, nearly in toto. Thus, they have the advantage of examining existing market economy systems and selecting the parts that have worked, while rejecting those parts that have not. As a result, it is possible for a transition economy to construct a better fiscal system than any that now exist in the mature market economies. They need not repeat the mistakes that western economies have made. They can bypass the structural deficiencies that western governments are burdened with and create systems that are sleek, less complex and relatively efficient. In the long-run, after these sleek systems are established, transition economies can have a competitive advantage over the mature western economies because they will not have the weight of the overly complex and inefficient western tax system to burden them. Overly burdensome tax systems retard economic growth. Implementing less burdensome systems will enhance economic growth.

Some words of warning are appropriate at this point. As transition economies look to the west for guidance regarding their tax system, they should not be too quick to adopt western systems. Just because they are western does not mean they are good. All western systems of taxation can be improved, some more than others. No western tax system should be adopted in its entirety. The fiscal authorities in transition economies should select only the parts of western tax systems that have proven their worth over time. They should feel free to reject whatever portions of western tax systems that have failed, no matter how strongly western tax advisors try to convince them. It should be remembered that many of the western tax advisors they are consulting with are partly responsible for the inefficient and burdensome tax systems they are trying to convince emerging economies to adopt. The pressure to adopt western tax systems is increased by the fact that many policymakers in transition economies want to harmonize their tax policies with the European Union in the belief that having a similar tax system will enhance the prospects of doing business with the west. Although there is some truth in this idea (just as there is some truth in most false ideas), they should not lose sight of the fact that a rightly-constructed tax system can make them more competitive. The goal should be to adopt policies that result in enabling them to collect the revenue they need with a minimum of economic distortion. That means the system they adopt will have to look much different than any western tax system now in existence. The last thing they should do is try to mold their tax systems in the image of the west.

Some Suggestions

Not all tax systems are alike. Some are much better than others. When policymakers look to the west for guidance and advice about tax systems, they should be extremely wary about the advice they receive. Many of the people who will be giving them advice are the same people who caused the problems with the tax systems in the West. There is no reason to expect that the advice they are giving to transition economies will be any better than the advice they have given to officials in their own countries in the past.

One temptation to be avoided is the belief that a tax system should be used as a tool of social engineering. The tax system should have just one goal -- to raise the revenue the government needs to function. It should not attempt to alter the behavior of its citizens or to subsidize some groups at the expense of the general public. Yet all western tax systems incorporate some amount of social engineering into the structure. In the United States, for example, there are special subsidies for homeowners, families, single individuals, parents, farmers, capital intensive industries, and so forth. Other groups are punished, including those who earn above-average incomes, those who use alcohol and tobacco, older individuals who have part-time jobs, and so forth. Incorporating social engineering into the tax system is seen as inherently unfair (if all people are to be treated equally) and they add unnecessary complexity to the system.

A tax system that does not punish capital investment is critical for a transition economy.[1] Transitional economies have had their capital base eroded by decades of central planning. In many cases, the capital base that remains needs to be modernized. In some cases, capital assets need to be replaced. There is a shortage of domestic capital, and whatever domestic capital that does exist can be sent out of the country if the tax system is too unfriendly. A tax system can also discourage foreigners from investing their capital in the domestic economy if tax rates are punitive or if there are exchange controls that restrict the movement of capital. Policymakers who want to attract foreign capital and keep domestic capital within its borders must adopt tax policies that are more attractive to investors than the policies of other countries. If they don't, they will not be able to attract the capital they need for economic growth.

Two major, and often competing sources of revenue are the income tax and some form of consumption tax. There are benefits and dangers to either approach. Furthermore, these two approaches are not mutually exclusive. A country can, and often does, resort to both methods to raise revenue. One advantage of using both approaches is that it enables rates to be lower, provided spending does not increase to absorb whatever is collected. The problem with using both an income and a consumption tax is that spending does have a very strong tendency to rise to match whatever level of revenue is collected. In countries that have both taxes, taxpayers pay more in total taxes than in countries where there is only one tax. Thus, more money is drained out of the private sector, the sector that produces economic growth.

If policymakers want to limit the amount of government spending, it would be better to have either just an income tax or just a consumption tax. That way, the government will be able to reach into just one pocket instead of two, and more money will be left in the private sector, which is where real economic growth lies. With only a single tax, taxpayers will start screaming if rates get too high, which acts as a governor on the system. With both a consumption tax and an income tax, the rates of each can be kept low enough that this screaming phenomenon is never triggered, which may come as good news to government officials, but a double tax would be harmful to taxpayers, since they will be able to keep a lesser percentage of their money if government has its hands in two

[1] Harberger.

pockets instead of one. If government is seen as the servant of the people and not the master, it is not appropriate for government officials to attempt to fleece the taxpayers for all they can extract.

Of the two approaches -- income taxation and consumption taxation -- the consumption tax is to be preferred. There are several major problems with the income tax. For one, it dampens the incentive to work hard and produce wealth, since a portion of whatever is earned will be taken away, thus retarding economic growth. Another negative aspect of income taxation, perhaps less visible but more important, is the adverse effect an income tax has on human rights.[1] In the United States, for example, tax officials can confiscate property and sell it to liquidate tax liabilities that may not even exist. Homes can be invaded, searched, confiscated and even sold with little or no due process of law, and taxpayers have little recourse. Thus, the system invites abuse. Taxpayers' privacy can be invaded and rights violated at the discretion of the Internal Revenue Service.

These problems are practically nonexistent with a consumption tax because the tax is not based on income. So there is no need for IRS officials to break into homes and confiscate the records of private individuals to attempt to prove that income has been hidden. Consumption taxes are assessed at the business level, so individuals' human rights stand less chance of being disparaged.[2]

Some consumption taxes are better than others. The value-added tax (VAT), for example, is assessed at each stage of production. The tax is passed on to the ultimate consumer in the form of higher prices, so it is ultimately the consumer who pays the VAT.[3]

There are several problems with the VAT. For one, the tax is hidden, since it is passed on to the consumer, who does not know how much of the purchase price is attributable to the cost of the product and how

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[1] Advocates of a single-rate flat tax have said that the civil rights abuses inherent in the current income tax system could be reduced by implementation of a flat tax, since the possibility of evasion would be curtailed. But the danger would not be eliminated. For a discussion on the merits of a flat-tax, see Hall and Rabushka.

[2] For some horror stories revealing how tax officials in the USA have abused their power and trampled on the rights of citizens, see Hansen; Burnham.

[3] For discussions on the merits and detriments of the various kinds of consumption taxes, see OECD; Weidenbaum, Raboy and Christian; McLure.

much to the tax. Visible taxes are to be preferred to hidden taxes because taxpayers should know what they are paying for government. The cost should not be hidden from them, yet it is hidden if the consumption tax takes the form of a VAT. Another problem with the VAT is that it takes an army of accountants to administer the tax and calculate what employers at various stages of production owe. These people could be better employed at some activity that creates wealth.

Both of these problems can be avoided by a consumption tax that is assessed only at the retail level. Such a tax would basically be a national sales tax. Consumers would know precisely what portion of the product's purchase price is attributable to taxes because they would pay it up front to the seller, who would then remit it to the tax authorities. And since the tax would be computed only once, it would not be necessary to hire an army of accountants to compute the tax liability at each stage of production.

Payroll taxes to pay for pensions constitute a major tax in most mature economies. As previously mentioned, social security taxes can constitute more than 50% of payroll costs, thus dampening the incentive to hire new employees, since the total cost of hiring a new employee includes not only wages but the cost of making social security payments. That, coupled with the fact that the social security system is not set up as a trust fund, but rather as a means of transferring wealth from present workers to retired workers, makes the present social security system especially undesirable for any transitional economy that needs to accumulate capital to fuel economic growth.

The social security system should be privatized. Peru has done it and a number of other countries are looking into the possibility. There are several advantages to having a private social security system. For one, individuals would have a vested right to a pension. Under the present system, they must depend on government for their social security pensions. Under a private system, the money would be set aside for them in private investments, earning interest and growing with each passing year. There would no longer be a need to depend on government, and the younger generation would no longer be forced to pay for someone else's retirement. They would be able to set aside funds to pay for their own retirement rather than being exploited by the older generation.

Another advantage of a privatized system is that the funds collected would be invested and would accumulate, rather than being immediately transferred to someone else, who would then spend the money. Over the course of a generation, a vast amount of capital would be accumulated, which would provide the funds needed to fuel economic growth. Under the present system this pool of funds does not exist and cannot come into existence.

One criticism of a privatized system has been "what do we do with the people presently receiving benefits?" This is a valid question. Those presently receiving benefits from the system are not paying into the system any longer. If the younger, presently working generation were allowed to make their payments into a private pension fund instead of the present social security system, there would be no money available for those who are already retired.

But such is not necessarily the case. Most transition economies are also in the process of selling off state assets as they privatize their economies. If the proceeds from these asset sales were placed into private pension plans, the proceeds could be used to support the people who are now drawing social security benefits. Transition economies that have buildings, factories and other state enterprises, minerals and forestlands could sell them and have more than enough to fund a privatized social security system.

Voluntary forms of raising revenue are to be preferred over coercive means. The income tax is highly coercive. Any kind of income tax invites abuses. Consumption taxes are also coercive because they, too, take people's property without their consent. But they are usually viewed as less coercive than an income tax. Yet they are both coercive means of raising revenue.

There are at least two ways for governments to raise revenue without resorting to coercion -- user fees and lotteries. If the goal is to minimize the amount of coercion in society, one way to approach that goal is to make full use of noncoercive means of raising revenue whenever possible. No one is forced to purchase a lottery ticket. Lotteries are completely free of coercion. And they can raise a large amount of revenue.

User fees can be implemented in a number of ways. Those who use the government school system could be assessed a fee. Those who use other government property, such as roads, parks, museums, and so forth could also be charged a fee as a condition of using government assets. In the case of roads, the user fee could be added to the price of gasoline, so there would be no need to have toll collectors at the end of each street. User fees are seen as one of the most fair means of raising revenue because only those who benefit by using the service have to pay for it. Those who don't use the service are not forced to pay to subsidize someone else's use.

Policymakers must not forget the other side of the equation -- spending. Any government must raise the funds needed to pay for government services, but determining how to raise the funds is only part of the solution. One must also determine how much is needed. That means spending will have to be controlled. If a goal is to keep tax rates low, it will also be necessary to keep government expenditures at a level that will permit rates to be low. One cannot have high spending and low taxes without resorting to deficit financing or printing more money, both of which have highly negative effects on the economy.

It is not possible to solve all of a transitional economy's fiscal problems within the space of a short paper. However, once the major problems have been identified and a few solutions hinted at, it may be possible to make some progress in that direction.

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PRINCIPAL DEVELOPMENT FEATURES OF ACCOUNTING SYSTEMS IN ESTONIAN COMPANIES

Toomas Haldma

INTRODUCTION

Successful run of business depends on vitality and ability of the management to prepare and manage the financial desicions. An entire accounting system of enterprise is a prerequisite for objective desicions and a tool for introduction of accounting reform in practice. To introduce the present situation of management accounting process in the Baltic States - Estonia, Latvia and Lithuania -,earlier as parts of the Soviet Union, we should take into consideration some historical aspects, which have still a great impact on the present accounting practice. Present stage of management accounting in Estonia is influenced by following features from the past:

- Long-term isolation from market economy and development of economic thought (due to the restricted cooperation with economists from market economy countries);
- During the Soviet era the main objective for enterprise managers was the organizing of fulfillment of manufacturing plans designed by central ministries;
- In the period of centrally planned economy the predominant purposes of accounting were the following:
    - * centralized control over the achievements of plan targets through the economic use of resources;
    - * protection of socialist property.

During the Soviet era and also during the last years company accountants were mainly regarded as book-keepers and their prime responsibility was to ensure that accounting was compiled with appropriate laws and regulations. The accountants were generally not involved in desicion making or in monitoring profitability and budgets. As accounting was and in many enterprises still is not a management tool, the responsibility, orientation in market circumstances and ability to prepare or to make financial desicions are not the main features of an accountant at large. Ability to fulfill the requirements and commands of upper manager were more important characteristics. Accounting is still a determinated system and consequently subjective elements are removed from accounting function. The accountant was and in many enterprises still is accustomed to rely upon detailed instructions and guidance in all aspects. Rapid changes in business environment (growing competitions, development of marketing strategies of corporations etc.) transform the requirements for company accounting system and accounting profession.

I ACCOUNTING ENVIRONMENT

Need for the conscious shaping of business targets and results and system of its implementation expands the scope of accounting in practice and lays emphasis on the role and responsibility of chief accountant and financial director in the preparation of financial desicions. In the process of transformation of book- keeping systems to accounting systems we notice a certain progress, mainly through the changes in state of mind.

The first step towards the formation of accounting environment of market economy was made through Estonian Accounting Act in 1991. The introduction of subjective elements (depreciation rates, inventory valuation methods etc. decided by enterprises) in the accounting practice and formation of particular accounting policy is a big change of philosophy. The change from cash-basis accounting to accrual-basis accounting, the introduction of some important (unfortunately, not all, but proceeding from particular circumstances, it's also intelligible) underlying accounting principles - realization principle, matching principle, historical cost principle - and also inter-relation between the various elements of the financial statements has posed problems for a large number of accountants. The next step of accounting reform, corresponding to the Estonian Accounting Law since 1995, consists of the following main items:

1) introduction of remaining international underlying principles, recommended in International Accounting Standards (IAS) and in 4-th EC Company Law Directive,
2) two formats of Income Statement and
3) other accounting elements. It will put even greater demands on the profession.

Since the adoption of Accounting Act in 1991 till the enforcement of Accounting Law in 1995 the main issues and practical needs in everyday operating of accounting departments in companies have been changed and developed to be more conceptual. The evolution of accounting field in Estonian enterprises can be divided into the following large stages:

I Transition from cash-basis accounting, used in centrally planned economy, to accrual-basis accounting, implementation of international accounting principles, mentioned above, and recording and posting the transactions in conformity with this transition; also compiling annual accounts (balance sheet, income statement and statement of changes in financial position) according to accrual-basis principles;

II Implementation of Financial Statement Analysis methods;

III Separation of Taxation field (tax return treatments and presentation requirements) from Accounting;

IV Producing a familiarity with a whole complex of international accounting principles;

V Introduction of internal accounting system, e.g. in the area of cost and managerial accounting, through the solution of practical tasks. The main emphases are undertaken in such important areas of practice as budgeting, cost-volume-profit analysis, cost allocation etc.

As we see, the main direction is developing from single to general, concerning as financial as managerial accounting. In different companies the stages, mentioned above, are developing in parallel.

The questioning carried out among administrative staff (general directors, financial directors, chief accountants etc.) of more than eighty Estonian firms in spring 1994 demonstrated that only in 3% of enterprises the accounting emphasis as "hot points" has remained on the compiling of financial statements. For 75% of firms it has removed to the area of cost and managerial accounting. Financial statement analysis served as target in 22% of the total amount of firms.

In circumstances of expanding competition the role of accounting and accountant in the process of preparation the financial decisions will rapidly become more important. But some obstacles are making it more difficult to ensure mentioned direction:

1) Undeterminated allocation of responsibilities in financial activities in companies, principally between financial directors and chief accountants;

2) Continuously changing and improving national business legislation. As a result of that the accounting departments have to rearrange the operating and concentrate often on particular details. In such conditions it is difficult to lay stress on design of the accounting information system. Still we can observe sufficient progress in this item during last three-four years.

The financial accounting framework will be fixed by accounting legislation. The Estonian Accounting Law will help the integration of Estonia into international economic environment. Additional to the formation of legal accounting framework according to the market economy, a new accounting law has essential role in the process of transformation of state of mind in the field of accounting, including also some initial positions for cost and management accounting. The implementation of the second format (cost by functions) of Income Statement will change the widely distributed understanding about the substance and formation of product unit cost. Estonian Accounting Law specifies that selling expenses, administrative expenses, research and development expenses are period expenses. These expenses are not included in the values of inventories and are therefore not part of cost of goods sold in Income Statement second format and following in product unit cost. It is a conceptual difference in comparison with the total cost methods used in centrally planned economy.

II MANAGEMENT ACCOUNTING PRACTICE

The particular financial results, expressed in financial statements are shaped through the management accounting systems and based on achievement, coordination and reasonability of Budgets. In the period of centrally planned economy, cost and management accounting had not been treated as an independent branch of accounting but only as an integral part of unitary financial accounting. Therefore, it is difficult to speak about real management accounting in Estonia yet, although cost accounting and cost analysis were and are practiced extensively, but mostly by administrators and technocrats. Conceptual changes in this field are also necessary.

Management accounting is primarily concerned with providing information to internal managers who are charged with planning and controlling the operations of the firm and making a variety of management decisions. As it is used internally, management accounting is not regulated by legal requirements and it is not a subject to Accounting Law. For a large number of accountants it has posed problems, because they are used to operate according to legal instructions. The process of development and implementation of management accounting system in companies seems to be a competition between the traditional customs and knowledge from centrally planned economy, from one side, and needs for solutions of practical tasks in every-day management operating.

The most conceptual initial problems concern the following aspects:

1) Undefined primary goals of company. Often the top-managers do not fix the particular goals for particular time-periods (market segment to be achieved, expansion of market through new regions etc.). It concerns both strategic and operative line. Consequently, it is difficult to fix targets also for lower level of management. As a result, the company business figures will be formed by chance and subjective factors;
2) The budgeting systems do not constitute a composite whole. The internal coordination within the planning and control system is in most cases lacking. The different parts of budgeting process would be carried out separately without general coordination between different activities and plans. It means that the submits do not work as one cohesive unit and company's overall objectives cannot be met. Nevertheless, in our questioning 17% of administrators saw the main problem in drawing up and coordinating of operating and financial plans. Unfortunately, many manufacturing firms lay their emphasis on manufacturing process and do not pay enough attention on sales;
3) Undeterminated cost concepts. Accounting by cost elements will be, to a great extent, too unilateral to handle. In practice, cost will be classified on the basis of formats of Income Statement (cost by types, cost by functions). Costs will be much less classified by their behavior in accordance with changes in activity (variable costs, fixed costs, mixed costs), by traceability to a particular object of costing (direct costing, indirect costing) or by their relevance to control (controllable and noncontrollable costs). It complicates the implementation of cost-volume-profit analysis into the financial management practice.

Even if the cost-volume-profit analysis is used in the company practice, it will be limited to break-even analysis and determination of break-even sales. Such necessary applications in profit planning and short-term decision making as "what-if" scenarios will be used only in single enterprises. These initial aspects for management accounting system have direct negative impact on the following items. Detailed classification of costs in practice and apprehension of their behavior at different activity level will serve as objective basement for break-even analysis, cost analysis for cost centers and segmental cost allocation.

III COST ALLOCATION

The problem of objective allocating costs to various products, divisions, departments etc. becomes more and more essential. In our questioning about 24% of administrators pointed out the cost allocation as the main problem-area in cost and management accounting.

ALLOCATION TO PRODUCTS. The cost allocation between products depends on the cost classification and cost calculation methods. Different categories of expenses, as mentioned above, are mainly classified according to the formats of Income Statement. For example, in manufacturing, costs are often classified as follows:

- Materials and supplies,
- Purchased inventories,
- Fuel and energy for technological purposes,
- Direct labor,
- Indirect labor,
- Social security deductions,
- Maintenance of equipment,
- General manufacturing overhead,
- Nonproduction overhead,
- General overhead etc.

The first five items consitute direct cost. All other costs are indirect costs. The methods of calculating cost per unit used today in Estonia are very close to them, used in centrally planned economy. In the Soviet Union the full cost principle (including almost all costs) has been adopted officially. This method is still very widely used by accounting departments of the companies of independent (since 1991) Estonia. By this method, indirect costs are allocated to direct costs in proportion to one of the basis, usually direct labor. As a result, costs are higher for labor-intensive products and lower for technology and capital-intensive products. This unified method could be convenient for officers of ministries to distribute the resources in Soviet era, but unmanageable by company managers in Estonia today.

ALLOCATION TO DIVISIONS. During the last years the cost allocating to divisions was developed in the following direction:

1) Unitary internal cost accounting. The nonmanufacturing direct and indirect costs will allocate to manufacturing departments in pro-

portion to one of the plant-wide or departmental rate basis, usually direct labor, labor hour or machine hour basis.

2) Internal cost accounting based on transfer prices. According to this approach the goods and services from different departments are valued at transfer prices. The transfer price consists of raw product cost, manufacturing or operating costs and planned "profit" of the department. The "profit" is a markup to planned or norm costs of the manufacturing or operating department. At the end of the accounting period will be computed the internal "profit" for each structural unit. The amount of profit determines the salaries of the employees. The problem is that internal accounting becomes somewhat independent from the operations of the overall companies. Quite frequently, the total amount of internal "profits" exceeds the amount of the company's profit.
3) Segmental allocation through the contribution-margin income statement. This approach is used only in a small number of enterprises because it depends on how the costs are classified according to their behavior. As it was mentioned above, such approach to cost classification is not widely used.

IV ORGANIZATIONAL AND EDUCATIONAL PREREQUISITES

The design of systematic management accounting system in Estonian companies requires some organizational and educational prerequisites to be achieved. Among the organizational aspects we would like to point out the following ones:

1) Redesign of organizational structure of management. Quite frequently, some financial tasks are handled in parallel. Particular financial responsibilities are also not fixed, which makes the implementation of responsibility accounting quite complicated.
2) A number of accounting software packages are oriented just for compiling the financial statements. The packages do not include the tools to fix some necessary items, for example, the cost and revenue centers, for following cost and management accounting.

The introduction of a complex accounting system in Estonian companies, involving both financial and management accounting, requires a complex and systematic approach on top-management level. Unfortunately, we can meet an integral and entire approach to the organizational, managerial and accounting structure (departementalization) relatively rarely. Only 7% of the firms, that have been taking part in our questioning, considered it to be imparative to redesign companies accounting system.

Problematic areas mentioned above set up particular conceptual requirements on the accounting training and retraining organized for practioners. The main objectives of retraining process to be achieved are the following:

1. Systematics and comprehensiveness of accounting education;
2. Transition from stereotypes of central planned economy to the state of mind and skolls used in market economy;
3. Connection with current situation in accounting environment and practical demand - to build the bridge between former accounting environment to the new one;
4. Incorporation into the international accounting environment.

All these items have to be taken into consideration simultaneously.

The most convenient and useful organizational form for retraining is so called "on-the-job training", when the seminars would be held by experienced academicians or practitioners of the firms. These seminars mainly concentrate on conceptual and practical questions of management and cost accounting.

INVESTMENTS, CAPITAL MARKET AND COST OF CAPITAL IN ESTONIA

Kaia Klink, Vambola Raudsepp, Danel Tuusis

I Introduction

Problems concerned with the investments have many aspects. We have tackled only the investment environment, investing in securities and the cost of capital in Estonia in this research paper.

Estonia is an excellent investment area for small, medium and large businesses. Estonia has a favourable investment climate and a sutable place for the following reasons: •favourable geographical position on the Baltic Sea, good communication with East and West; •relatively stable political and economic situation (recovery from the production decline and growing GDP); •long traditions of industrial production, high educational level, European cultural environment, skilled labour; •a strong energy base, many local mineral and forest recources; •relatively good infrastructure (ports, roads, telecommunications, building capacities); •establishment of enterprices has been made as simple as possible; •foreign investors have the unrestricted legal right to own land or assets, also the same rights and liabilities as Estonian citizens or legal entities.

II The Environment of Investments in Estonia

Estonia needs hundreds of billions of kroons to modernize its industry, agriculture, trade, transport, housing economy, social- and technical infrastructure. The local investment resources are very limited and more international funding is needed, thus it is important to attract as many investments as possible.

The Estonian parliament adopted the Foreign Investment Law on 10 September 1991 and since then has been carrying out liberal policies of foreign investments. The Estonian environment is especially favourable for foreign investments as the country's economic development is geared to the open market system. Foreign investors have no restrictions for making investments.The fourth part of the Foreign Investment Law stipulates that the Republic of Estonia provides full political guarantees for foreign investments, and according to the law, no restrictions can be imposed on enterprises operating on foreign capital. All foreign investments into Estonia get full legitimate guarantees against attempts to nationalize, forcibly appropriate or confiscate any investments made by any citizen or company abroad.

The country has a relatively highly developed production potential, with the high share of industry - 32, 6% of the working age population was engaged in this branch. The recovery from the decline and active privatization creates preconditions for the growth of investments, including foreign investments.

The main features to attract foreign investors are: •lower priced but at the same time relatively qualifyed (highly-skilled) working power (may be also the absence of acceptable activity of trade unions); •favourable geografical position between Riga and St. Petersburg and also icefree ports with the outlet by sea to Finland, Sweden and other countries; •Estonian national currency is freely convertible; •relatively low production costs; •existence of the new and rapidly developing market (also the market in the East); •it is possible to use already existing production power; •relatively well-developed telecommunications network (including mobile phone facilities) and infrastructure (the network of roads); •European environment of culture; •stable economic growth and well-balanced political developments in and from the country; •the existence of many natural resources.

Besides, foreign companies have a possibility to penetrate into the enormous Russian market more securely with the help of Estonian firms, who have already business experience with Russians.

But there are also some possibilities to be mentioned, as they may cause risks: •incomplete legislation; •nonfavourable taxation policies; •some restrictions when buying land (the absence of real estate market); •volatile inflation rate; •long break-even period of projects; •low equity of local banks, enabling them to invest into small projects; •in addition there is a need to tighten security in the country and can consolidate the cooperation with Latvia and Lithuania.

The Estonian's securities market also needs to be reconstructed in order to attract both Estonian and foreign portfolio. Firstly, today invesments are made directly to the companies. Secondly, many local investors prefer making investments abroad. The reliable securities market in Estonia can attract them invest locally.

The Agency for Estonian Foreign Investments into Estonia came into operation in the spring 1994 with the aim to attract foreign investors to make direct investments into Estonian economy. Up to now the main investors to Estonia are from Finland, Sweden, Russia, Denmark and Germany. For other countries (for example the USA) Estonian's potential is too small because of the small market.

III Foreign investments analysis in Estonia in 1994

Last year 3,2 billion kroons of foreign capital was invested into the Estonian economy. The total amount of investments increased in 1994 by almost twofold as compared with 1993. Of the total 2,2 billion kroons was invested into the capital stock of new and already operating enterprises. 846 million kroons were invested in new and 1,3 billion in existing enterprises. Investors are interested in increasing their capital in Estonia rather than repatriate profit.

The number of new enterprises with foreign partnership established in 1994 was 1451. The largest amount of foreign capital invested into the capital stock came from Russia (35 million DEM or 26%), Finland (14,9 million or DEM 11, 2%) and Sweden (12,6 million DEM or 9,6%). The outflow of Estonian direct investments into foreign countries was 3,6 million DEM.

Since Estonia regained independence 65 million DEM worth of foreign capital has been invested into the capital stock of new and operating enterprises in Estonia. According to the data of the Estonian Enterprise Register, as of 1 January the largest number of firms with foreign partnership established were with Finnish firms (52,2% of the firms and 22% of the foreign capital). Next came Russia (respectively 12,5 and 12,2%), Sweden (11,1 and 27,6%), Germany (4,3 and 4%) and the United States (3,8 and 7,3%).

Last year foreign investors preferred to invest into Estonian industry (91,5 million DEM), trade (8,6 million DEM) and business services, transport and communications, hotels and restaurants, agricultural enterprices and building.

According to the Estonian Enterprise Register the largest foreign investments were made into CEOCIL (60 million DEM, Russia and the former Yugoslavia, raw materials for detergents), Eesti Telefon (22,5 million DEM, Sweden, communications), Eesti Tubakas (15 million DEM, Sweden , tobacco products), Kunda-Nordic Tsement (15 million DEM, Finland, cement), Eesti Coca-Cola Joogid (9,4 millon DEM, Austria, soft drinks) NITROFERT (7,5 millon DEM, Russia, cemicals), Pakterminal (4,4 million DEM, Netherlands, warehousing services), Leibur (3,8 million DEM, Finland and Sweden, bakery), Põltsamaa Felix (3,8 million DEM, Sweden, processing of fruit and vegetables).

The bulk of the last year's foreign investments went as previously into Tallinn and Harju County (158,4 million DEM). May be, because the majority of Estonia's industry is concentrated in those areas and the wages and salaries of people are well above average there. Next came the town of Kohtla-Järve (8,8 million DEM), Jõgeva County (3,9 million DEM), the town of Narva and Võru County (both 2,5 million DEM).

IV Estonian capital market

The corner-stone for Estonian capital market was the law of securities' market in June, 1993. Despite that fact first issues had been done already in 1992.

The law of securities' market and establishment of new institutions - specially after the passing the statute of investment funds in Aug. 1994 - has been caused many new issues and has been raised activity on capital market dramatically.

Since Jan,1995, 24 issues were registred in Estonia, the structure of these issues is as following:

Estonian government bonds	300 000 000
local government bonds	75 000 000
corporate bonds	40 000 000
bonds of financial institutions	41 000 000
corporates' common stocks	109 924 470
stocks of investment funds	152 000 000
preferred stocks	38 000 000
mutual funds' units	191 000 000

Main activity in capital market is given by companies' bonds and governments' bonds. All these issues are quite short-run (2...5 years). Amount of loans per issuer are also above average loans' amounts - by these securities' issuers have reached cheaper loan up to 4%. Issuers normally have low rate of debts - around 50..60% - and sufficient pledges. These securities are hold mainly by banks. Due to the high face value - up to 10,000 kroone - these securities are not traded in open secondary market.

The market for stocks is also quite active. Successful offering have achieved by those investors, who already have some results and experiences in business - mainly they have tried to capitalize their expansion through the open market. Other group of firms, which are smaller and not so well-known, have difficulties to capitalize themselves through the open market. Widely used strategy is to sell off stocks before the registration of issue - this strategy gives for issuer 100% of quarantee to sell fixed amount with certain costs. As our personal experienses have showed, only every tenth small company have got investors enough to register issue and to public themselves. Even that these issues are usually hold by banks and by few companies and are not traded actively in the secondary market.

Interesting group on that field are stocks of investment funds - closed-end funds. Since April 20, 1995, three investment funds have got required licencies and have completed their first public issues. Success of these issues can be explained by the fact, that these issues have been quite proper to have good liquidity in the secondary market - big issues, low face values, many companies and persons have bought these securities. Important fact is that two of these funds are privatization-investment funds, they offer good opportunity for private persons to diversify their savings and vouchers.

Turnover of the secondary market in 1994 was around 1,000,000,000 kroone, which was the highest in Baltic States.

Most tradeable and liquid sequrities have been privatization-vouchers on the form of electronic deposit on accounts of special register. At the beginning of April 3 000 000 000 voucher-kroones have been deposited. Unlike Russian or Checz or Polish privatization systems privatization-vouchers are given to compensate nationalised property in 1940, 1944 and to compensate unpaid salary during the soviet time. The owner of these vouchers can privatize land, apartments and some state firms or part of these. Since Aug 1994 up to April, 1995, turnover of these vouchers has been 1,243,094,000 voucher-kroones.

Some researches have been done to explain the nature of the Estonian securities market. Instruments in capital market are not related with instruments in money market. It can be explained by excessive liquidity assets of Estonian banks and non-accessibility to money market instruments by other investors. Banks have strict restrictions given by the law to keep liquidity and to weight riskiness of each asset on their balance. It has caused the effect of overheating in Estonian capital market - financial institutions do not care of interest payments and do not evaluate properly riskiness of capital instruments.

We have recently done some researches to enlighten the nature of the vouchers' market in Estonia. Due to convenient conditions and the structure of investors, results can be generalized to all securities market. The research was concentreated on the structure of the market information and how investors process information. The main difference of investment models is the assumption concerning the amount of information conveyed by price and what information sets traders base portfolio decision.

Results of the research strongly support the noisy rational expectations model. This implies that there is considerable noise in the market, but not enough to dilute the information contenet of prices completely.

Results of this research can be interpretated as the fact, that in Estonian securities market stable and trusty information set to evaluate public firms and securities has not been formed yet. Remarkable is also big variation of price changes and price-marginal changes on different period of the time. This shows differences in expectations and using information among traders.

We have to stress again that fact - the basis of the research was only the market of vouchers in Estonia.

By these results Estonian securities market does not differ from the securities markets of other states of the world.

The behaviour of the capital market is following the same pattern as capital markets in other states. The main difference between the capital market in Estonia and other capital markets is the participation of foreign capital. There is many explanations for that and the future of the Estonian capital market will be strongly influenced by the inflow of foreign capital into that part of the economy.

V Cost of Capital

At present the interest rates on bank loans for Estonian firms are 25 % to even 40 %. Unfortunately this fact is true - the demand for loans is far greater than supply. Only the specialists of finance understand the meaning of this fact. Estonian politicians and financial directors of firms, on the other hand, have apparently not understood it.

Estonian firms are underfinanced and it is almost impossible to find any other source of capital besides bank loans, whose minimum price according to the post-tax basis is 35% x (1-0,26)=25,6%. Would it be possible to accept profitable projects taking into account the above mentioned level of capital cost? Certainly not, the firms will go bankrupt in the nearest future. According to business theory the firms are not able to survive in these conditions, but the Estonian firms still exist.

Besides questions about firms based on domestic capital, many questions arise about the firms with foreign capital.

According to the data from 1 October, 1994, the number of firms with Finnish capital is the greatest (4,190 firms with the foreign capital amount of 827,000,000 EEK), the next biggest share belongs to Russian firms (979 firms with 473,000,000 EEK), then come Sweden (875 firms with 1,051,000,000), Germany (319 and 126,000,000) and the USA (287 and 276,000 EEK). The greatest share of foreign investment overall capacity belongs to Sweden (1,051,000,000 EEK).

But at the same time it is very surprising that we do not know anything about the cost of inflowing capital. It seems that nobody pays attention to this cost. Still, during the last nine months 1.3 billion kroons of foreign capital have been invested into new and already existing enterprises.

Foreign investment allocation is also quite interesting in Estonia. Foreign investors prefer the following branches of economy: wholesaling and retailing, transport, storing and communication, while industry is somehow at the end of the list.

Investors try to avoid competition and sell the goods directly to the consumers, in order to leave some room for prices to be increased - especially transport and communication.

Observing the situation in industry, we may say that the low capital cost of Japanese firms prevail in the world economy, only the great states of Western Europe and USA are able to compete with them. Foreign investors should find the possibilities to invest in industrial branches in Estonia using cheap labor forces and raw materials.

The most foreign investments are invested in Greater Tallinn and in the region surrounding it, the investments into Pärnu, Tartu, Viljandi, Jõgeva and Lääne Districts are also considerable.

There is a great need for foreign investments in southeast and northeast Estonia. But it would be politically naive to think that these regions will become important tourism or commercial centers. It will be possible to speak about the commercial center only when there are people with high purchasing power in the society.

A large part of the investment at the moment is reinvestment of retained earnings. Estonia has not advertised its advantages sufficiently - cheap, qualified workforce, cheap local raw materials, manufacturing management experience and proximity to the Eastern market. In sectors where manufacturing has been reinvigorated, it must be borne in mind that Estonian firms would not wish to have more foreign competitors.

In order to channel investment into regions of Estonia outside Tallinn, the Economics Ministry is going to have to take initiative in management. Local government funds and management skills are also needed.

Analyzing firms the main attention has been paid to the cost of long-term credit so far. There are three main sources that constitute the cost of long-trem credit. These are bonds, preferred stock and common stock. At the same time, approximately 70 % of the firms' capital (inventory) is made up of the sources of short-term credit in Estonia. Therefore the sources of short-term credit need to be investigated more thoroughly in Estonia.

As for the short-term credit itself then the situation in Estonia is a paradoxical one where the short-term loans are more expencive than the long-term loans whereas the practice in developed countries proves the opposite. Why? Short-term loans are given by the domestic commercial banks with the average interest rate from 25 % to 40 % while the long-term loans are given in the process of an international assistance, mainly by World Bank. The average interest rate of these loans is between 11-18 %.

The capital cost and loan interest show that the firm and the bank both accept the risk. The bank tries to get compensation for the high risk and forms the loan portfolio taking into account maximum compensation. Only when there is a bankruptcy threat, do banks speak about bad loans.

The loans with interest rate of 60 % are bad loans. Firstof all, they are bad for firm, and they are bad for people who buy the products of that firm and also bad for the banks. High risk and great earnings are connected with risk premium, risk in economy means that the organization might loose money.

Failed banks have lost their money, others will too if the price of loans does not decrease.

VI Conclusion

1. Estonian has been successful in attracting foreign capital so far. Analysis shows that foreign investors have been increasingly interested in Estonia. Increase can be noticed both in the number of new enterprises and in total amount of investment.
2. The Estonian securities market has not been formed the stable and trusty information set to evaluate public firms and securities yet. The behaviour of the capital market is following the same pattern as capital markets of other states. The main difference between the capital market in Estonia and other capital markets is the participation of foreign capital. There is many explanations for that and the future of the Estonian capital market will be strongly influenced by the inflow of foreign capital into that part of the economy.
3. The cost of capital in its classical form is hard to examine because of the transition economy. The cost of equity can be evaluated when the secondary market functions perfectly. The sale of long-term bonds is complicated as the demand for preferred stock is also very low.

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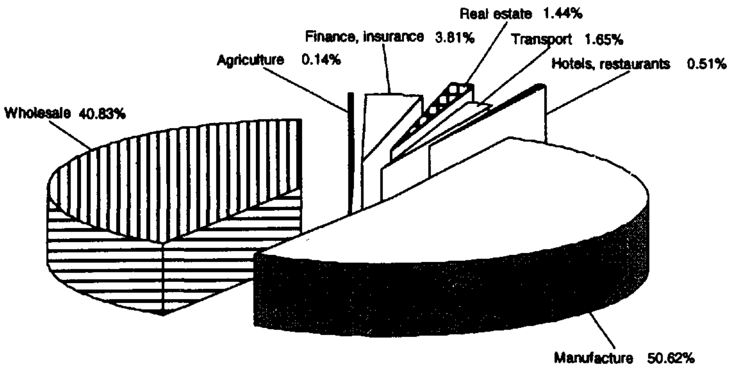


Figure 1. Inestments by economic branches in 1994

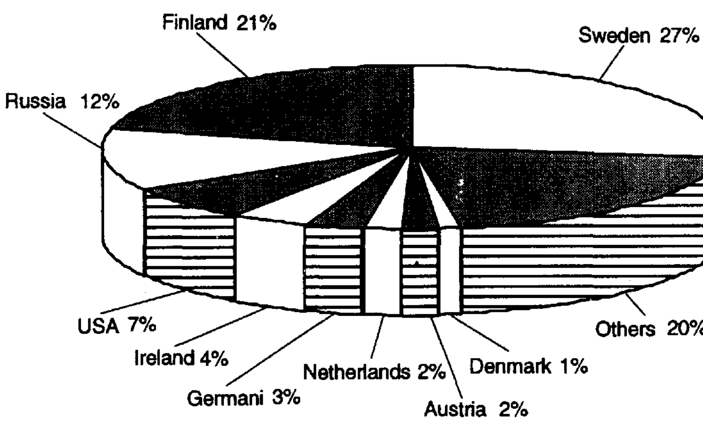


Figure 2. Distribution of foreign investments in Estonia by states

ENTREPRENEURAL TRANSITION IN ESTONIA AND ITS IMPACT ON OVERALL TRANSFORMATION PROCESS - SPECIAL EMPHASIS ON THE FOREIGN DIRECT INVESTMENT

Kari Liuhto

1. Introduction

The former Soviet republics are striving for a common goal - a transition from the planned economy to a market economy - but from quite different paths. These different paths have been affected, not only by the political decisions, but, more fundamentally, by the economic resources as well as various social and cultural factors of each country.

Estonia was opted as the object of this research because of this guiding role. The fact that Estonia paved the way for transition does not necessarily imply that all the other former republics would follow in her footsteps, but even then the Estonian experiences can offer an interesting perspective into the study of the economic transition in other post-Soviet republics as well. The special role of Estonia becomes further stressed in the evaluation of entrepreneural transition, as Estonia can be regarded as the cradle of private entrepreneurship in the Soviet Union (Lugus et al., 1991, 3-6).

Workers' cooperatives can be considered the first steps taken in private entrepreneurship after the NEP period. In July 1987, Soviet Estonia had more registered cooperatives per inhabitant than any other Soviet republic. While Estonia had one cooperative per 20 000 people, the Soviet Union had one cooperative serving an average of 80 000 people (Slider, 1991, 797-821). Moreover, the significance of Soviet Estonia as the cradle of private entrepreneurship in the Soviet Union is emphasised by the active operation of foreign companies there. In order to analyse the present entrepreneural transition, the past of the Estonian entrepreneurship must be surveyed briefly.

2. Historical View on Entrepreneural Transition

As Estonia separated herself from the Russian empire in 1918, her economy and enterprises were in ruins as a result of the World War I, the October Revolution and the following social upheaval within Estonia. The impact of these years of unrest upon the Estonian economy has been aptly summarized by Raun (1987, 125), who states that "Estonia's industrial sector faced tremendous problems after nearly six years of upheaval and uncertainty in 1914-1920. To the obvious physical destruction was added the flight of capital and the elimination of traditional markets in the Russian hinterland." In addition to the loss of Russian markets, the extent of the loss suffered by the Estonian industry was huge: in 1920, for instance, Estonian metallurgy was functioning only with one-fifth of its pre-war capacity (Hinkkanen-Lievonen, 1984, 251).

Business activities in Estonia were largely concentrated on the hands of the dominating foreign elite and the fairly small local bourgeoisie (Hinkkanen-Lievonen, 1984, 179). Alongside with this traditional aristocracy-bourgeoisie distribution, a private cooperative movement sprang up in Estonia. In 1939, approximately 300 consumer and producer cooperatives in banking, insurance and trade had a total membership of 270 000 and a total turnover that exceeded the state budget by half (Van Arkadie - Karlson, 1992, 96).

On the whole one can state that the expansion of Estonian entrepreneurship can be accounted for mercantilism rather than industrialization. The basis of entrepreneurship was formed from a large number of small and medium-sized enterprises, which operated in the manufacture and sale of agricultural products, as well as in the sale of consumer goods. Contributors to the growth of industrial enterprises, on the other hand, were mostly foreign companies and the Estonian state, which had the sufficient capital for investments.

Summing up the entrepreneural transition of the 1920s and the 1930s, the Estonian enterprise sector can be seen to have developed considerably throughout the independence era, excluding the recession years of 1929-1933 in the world economy. The entrepreneural transition of Estonia became to a halt as a result of the "visible hand of socialism", which meant the deprivatization of industrial enterprises and banks, and the nationalization of foreign-owned companies. After this large-scale deprivatization, small private enterprises and agricultural enterprises began to be seized for state ownership (Raud, 1987, 91-94; Raun, 1987, 151). According to Van Arkadie and Karlson (1992, 117), "by 1950 the three [Baltic republics] were barely distinguishable in their economic organisation, and in their political system, from the other Soviet republics."

From the viewpoint of the Estonian enterprise sectòr, the following decades were extremely stable, or even immobile; the state simply had a monopoly over all entrepreneurship. The state monopoly over entrepreneurship continued throughout the pre-perestroika years. Private entrepreneurship did not come into being until the mid-1980s, when the reforms of perestroika sowed the seeds of private entrepreneurship. These reforms included self-employment (Law on Individual Labour in 1985), cooperatives (Law on Cooperation in 1987) and foreign-owned companies (Decree on Joint ventures in 1987).

But the development of private entrepreneurship was far from being straightforward: the first problem was the neglect of the private enterprises in the state plans, which in practice meant that private enterprises were often forced to obtain their supplies in the grey or black markets with an extremely high price, compared to what the state enterprises paid (Xueref, 1988; Cockburn, 1989, 176-179). However, entrepreneurship in Sòviet Estonia managed to survive these tightened measures and began a new rise in mid-1990. In the background of this new growth was the construction of the foundations for the joint-stock company legislation, which generated a registration boom of companies in Soviet Estonia. During 1990 alone, 4 790 new companies were registered, of which 80 per cent were joint-stock companies (Liuhto, 1992, 31; Björk et al., 1993, 5).

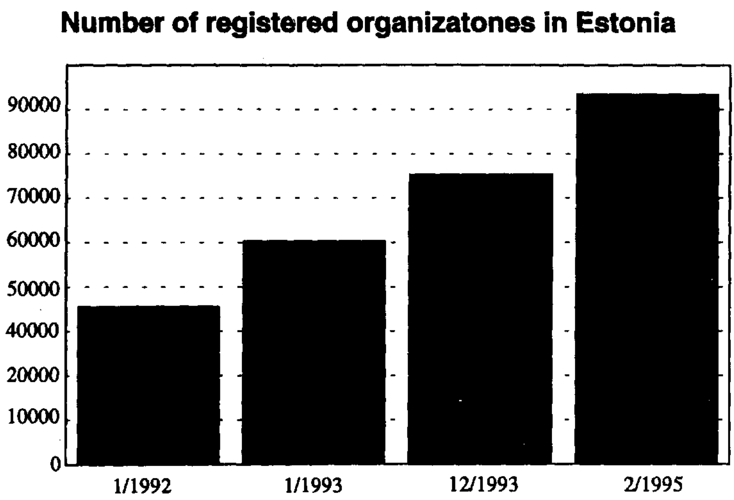
The registration of new companies doubled during 1991. All in all, during that year, 11 369 new Estonian organizations were registered. Approximately 600 of these new companies were foreign-owned. The significance of this increase becomes evident when compared to the number of foreign companies registered - 414 - in Soviet Estonia during January 13 in 1987 and December 31 in 1990 (Liuhto, 1994, 11).

One can conclude that the seeds of the current private entrepreneural transition in Estonia were sown before the independence of Estonia, but began to grow only when Estonia had declared her independence from the Soviet Union. The following chapter will concentrate on investigating, on the basis of statistics, the development of the Estonian enterprise sector since the independence of Estonia, until the beginning of 1995.

3. Statistical View on Entrepreneural Transition in Independent Estonia

The importance of Estonian independence for the expansion of the Estonian enterprise sector cannot be undermined. As early as the end of 1991, a real registration boom of organizations began in Estonia, resulting in the total number of enterprises exceeding the level of 35 000 organizations at the beginning of 1992. Since then the pace of organization registration has settled to an annual rate of about 15 000 new organizations. By February 1995, the total number of registered organizations already exceeded 83 000 (see Figure 1.).

Figure 1. Entrepreneural Transition in Estonia



However, one must once again point out that a large part of these 83 000 registered organizations have never begun their operations at all. The fact that over 56 000 registered organizations have no employees indicates of the vast number of non-operating organizations. Furthermore, when estimating the size of the Estonian enterprise sector, one must take into account that only 57 144 of the registered 83 000 companies were real enterprises - the rest being farms and various kinds of associations. These combined, it may be assumed that at the beginning of 1995 the number of active enterprises in Estonia is only about 25000.

The statistics from February 1995 show that the size of the registered organizations in Estonia is very small; all in all, 80 per cent of them have less than 5 employees. Similarly, companies with more than 100 employees represent only 4 per cent of the Estonian enterprises. As the small-sized companies appear to employ more registration officials than actual workers, the employing capacity of all the Estonian organizations dropped from 833 000 to 669 000 (see Table 1.).

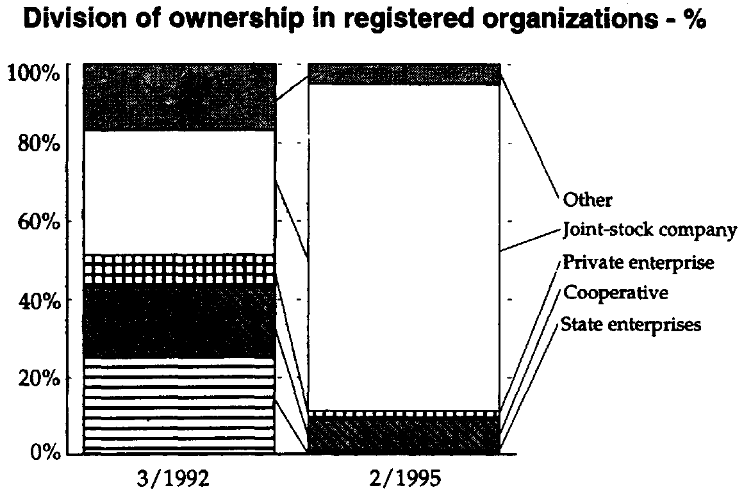
Table 1. Transition of Registered Organizations by Personnel Size

Size of personnel	01.01.1992		01.02.1995	
	Number of organ. (share %)	**Employed workforce (share %)**	**Number of organ. (share %)**	**Employed workforce (share %)**
0-4	24 041(67.72)	20 484 (2.45)	68 195 (81.41)	27 696 (4.14)
5-9	3 523 (9.92)	22 761 (2.73)	5 715 (6.82)	37 589 (5.62)
10-19	2 563 (7.22)	35 143 (4.22)	3 968 (4.74)	53 499 (8.00)
20-49	2 608 (7.35)	80 009 (9.60)	3 360 (4.01)	102 645 (15.35)
50-99	1 207 (3.40)	81 933 (9.83)	1 368 (1.63)	92 897 (13.89)
100-199	662 (1.86)	92 285 (11.07)	662 (0.79)	90 960 (13.60)
200-499	598 (1.68)	186 722 (22.40)	360 (0.43)	107 223 (16.03)
500-999	205 (0.57)	141 656 (17.00)	93 (0.11)	62 416 (9.33)
over 1000	93 (0.26)	172 485 (20.69)	50 (0.06)	93 875 (14.04)
TOTAL	35 500 (100)	833 478 (100)	83 771 (100)	668 800 (100)

The loss of 164 000 jobs in an economy the size of Estonia has serious implications. This loss should have contributed to a corresponding increase in the rate of unemployment, which should be about 15 per cent. The official Estonian statistics on employment give the impression of the rate of unemployment being less than 2 per cent in Estonia (Aro, 1994, 14). The lack of logic in this statistical detail may be explained by many workers, young in particular, having temporary jobs, rather than registering themselves unemployed.

So far the transition in the Estonian enterprise sector has not been able to introduce exclusively positive results. But one of its positive effects is the disintegration of the state monopoly, which is demonstrated in the falling share of state and municipal enterprises - from one-fourth at the beginning of 1992 to a mere one per cent this year (see Figure 2.).

Figure 2. Transition of Ownership in Registered Enterprises in Estonia



The fact that the reality is barer than the picture provided by the statistics seems to apply in this context as well. In other words, the share of state enterprises in the total employment and production remains very high. The investigation of the real ownership in the Estonian enterprise sector is further impeded by the question mark that still follows the ownership of joint-stock companies. When analysing the distribution of ownership in the Estonian enterprise sector, one must not forget the role of foreign ownership. At the moment, the share of foreign-owned companies in Estonia is nearly 15 per cent of all the registered companies. The foreign share has increased sharply from its 5 per cent at the beginning of 1992.

All in all, the impact of foreign companies upon the Estonian enterprise sector is many-sided. Foreign companies have introduced both positive and negative features. Examples of the more positive effects are the partial compensation for the collapse of Estonia's own manufacturing, the improvement of the variety and supply of services, as well as the increasing of management know-how. Thus the role of foreign companies in the Estonian entrepreneural transition should not by any means be undermined.

On the other hand, the impact of foreign company activity upon Estonia also has its negative implications; first of all, larger resources of foreign companies may impede the development of the local enterprises. Secondly, several Western companies have rather maximized than optimized their output. This is to say that certain foreign companies have unscrupulously taken advantage of the insufficient control and the transition conditions in Estonia. Thirdly, those "speculative foreign companies" that operate wavering somewhere between legal and illegal activity were among the first to rush forward and spread the "Western market economy doctrines" to Estonia, just as happened during the 1920s (see Chapter 4.).

The analysis of the Estonian enterprise sector by branch shows that half of the organizations registered in February 1995 concentrate on wholesale and retail trade. During 1992, their share was only one-fifth. All in all, this means that the number of organizations in wholesale and retail trade was multiplied by six times during the last three years, approaching the level of 40 000 companies (see Table 2.).

This trade orientation has also its negative features. Several of the organizations registered in statistics as retail trade shops have not begun their operations. According to some estimates, thousands of non-operating companies were registered in retail trade. Secondly, a part of these organizations were established only for the purposes of one particular project. The large number of these "project companies" may perhaps refer more to the semi-legal markets than to real business activity. Thirdly, the majority of these companies in retail trade are very small, or even kiosks. This type of "miniature" entrepreneurship is by no means rare in Estonia. Even during the 1920s and the 1930s, a large number of shops - one shop per hundred people - was a predominant feature in Estonia. At the moment Estonia has 2.5 retail and wholesale organizations registered per hundred people.

Table 2. Transition of Registered Organizations by Branch

BRANCH	01.01.1992		01.02.1995	
	NUMBER OF ORG.	SHARE (%)	NUMBER OF ORG.	SHARE (%)
1	2	3	4	5
Agriculture & forestry	4 517	13.03	10 727	12.87
Fishery	116	0.33	260	3.12
Mining	45	0.13	83	0.10
Industry	4 638	13.37	8 793	10.55
Energy	140	0.40	430	0.52

1	2	3	4	5
Construction	2 754	7.94	4 205	5.04
Wholesale and trade	7 213	20.80	39 958	47.93
Hotel and catering	2 504	7.22	3 678	4.41
Transport. & comm.	1 599	4.61	3 081	3.70
Finance	307	0.89	740	0.89
Real estate & bus. ser.	4 219	12.17	8 985	10.78
Social insur.&soc. ser.	6 626	19.11	12 335	14.80
TOTAL	34 678	100	83 371	100

Regionally viewed, the Estonian enterprise sector is highly concentrated on the capital city of Tallinn and the surrounding Harju county, which together had half of the registered companies at the beginning of 1995. Surprisingly, the central position of the capital region has even strengthened since 1992, when "only" 40 per cent of the companies were registered there (see Table 3.).

Several factors seem to support the central position of the capital. To begin with, a large part of the Estonian manufacturing is concentrated on the capital region. The shares of Tallinn and two northeastern towns, Narva and Kohtla-Järve, account for about 70 per cent of the economic activity (Kilvits, 1993, 4). Secondly, the administrative organs important for business are situated in Tallinn. Thirdly, those Estonian companies operating in foreign trade or with foreign companies benefit from a location in the capital region, where over 60 per cent of the foreign-owned companies are registered (Liuhto, 1994, 28).

Table 3. Transition of Registered Organizations by Location

	01.01.1992		01.02.1995	
	Number	Share %	Number	Share %
	1	2	3	4
Harju county	14 472	40.77	39 093	46.89
Tallinn	11 861	33.41	33 891	40.65

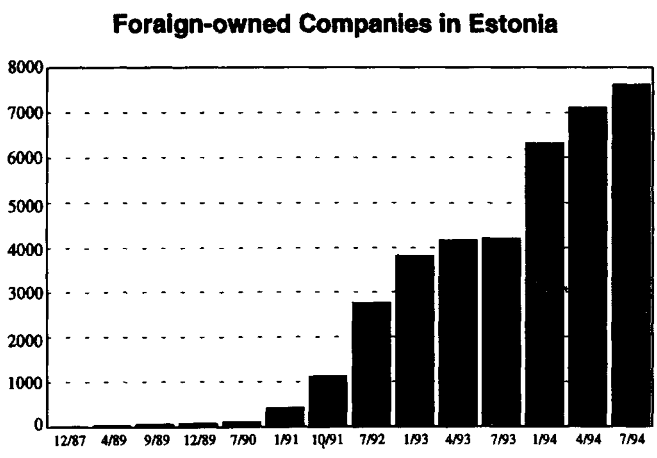
	1	2	3	4
Hiiu county	484	1.36	751	0.90
Ida-Viru county	2 935	8.27	5 712	6.85
Kohtla-Järve	921	2.59	1 453	1.74
Narva	1 132	3.19	1 808	2.17
Sillamäe	100	0.28	492	0.59
Jõgeva county	1 036	2.92	1 941	2.33
Järva county	1 380	3.89	2 094	2.51
Lääne county	879	2.48	1 994	2.39
Lääne-Viru county	1 375	3.87	3 368	4.04
Põlva county	686	1.93	2 454	2.94
Pärnu county	2 831	7.97	5 520	6.62
Pärnu	1 199	3.38	2 765	3.32
Rapla county	814	2.29	1 741	2.09
Saare county	989	2.79	2 210	2.65
Tartu county	4 057	11.43	8 790	10.54
Tartu	2 358	6.64	5 732	6.88
Valga county	775	2.18	1 999	2.40
Viljandi county	1 992	5.61	3 493	4.19
Võru county	795	2.24	2 211	2.65
TOTAL	35 500	100	83 371	100

4. Foreign investment activity in Estonia

Preconditions for the development foreign-owned company actitivity in Soviet Estonia were created in the beginning of 1987. The Joint Venture Act allowed Western companies to return to the Estonian territory after an absence of almost fifty years. During the first year, only thirteen foreign-owned companies had been registered in Soviet Estonia. The registration pace remained similarly low in 1988 (see Figure 3.).

Joint venturing began in full speed only in 1989, when 60 new joint ventures were established in Soviet Estonia. Despite the fast increasing number of joint ventures in 1989 compared to the previous years, this group of about 80 companies was still a very modest result from three years of joint venturing. With the enactment of the new joint stock company law, foreign companies became more eager to enter the Soviet Estonian market. A rush of foreign companies into Estonia began when Estonia gained her independence during the coup the etat which led to the disintegration of the Soviet Union. During the first months of independence, the registration rate of foreign-owned companies was almost 200 per month. The total number of joint ventures exceeded 2500 already in the summer of 1992. In June 1992 Estonia introduced her new currency: the kroon (Eesti kroon). During the first half of 1994, about 1300 new foreign-owned companies had been established, and their total number in July 1994 had risen to 7612 companies.

Figure 3. The Number of Foreign-owned Companies in Estonia

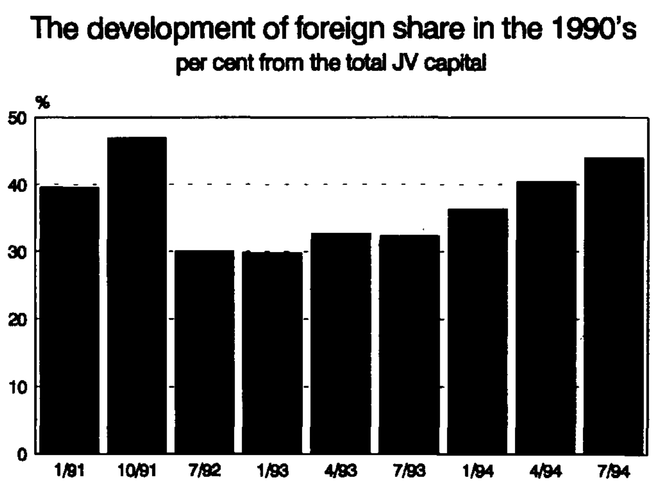


The statistics published by the Estonian Ministry of Economy indicate that foreign investments have increased by over one billion kroons per year (1 July 1993 - 1 July 1994). This is a significant rate indeed if we compare it to the 300 million kroons which was the increase in foreign investments in the previous year. On the whole, foreign investments had by July 1994 ascended to 4.1 billion kroons (see Figure 4.)

Figure 4. Foreign Investments in Estonia

The total capital stock of foreign-owned companies had increased to almost 9.4 billion kroons by July 1994. The share of foreign investments has increased from 30% to 40% during the two years following July 1992. When studying foreign shares, however, one has to remember that the shares were higher in October 1991 than they are at the present - the foreign investments comprised then nearly 50% of the total investments (see Figure 5.).

Figure 5. The Development of Foreign Share in the 1990s (per cent from the total JV capital)



From the group of major investors, two countries - Sweden and Finland - clearly distinguish themselves. The total investments made by these two countries rose to 2 billion kroons by July 1994 and comprised 45% of all the foreign investments. These Nordic countries are followed by the CIS countries and the former Yugoslavia. Together the latter two form one fifth from the total foreign investments. The sectoral investigation shows that in the first six monts of 1994, a half of the foreign investment was directed in industry and 40% in retail and whole sale (see Table 4.).

Table 4. The Distribution of Foreign Investment by Branch in the First Half of 1994

Branch	Investments (mn kroons)	Share (%)
Industry	718	51
Retail and wholesale	568	41
Finance	53	4
Transport	23	2
Estate and commercial services	20	1
Hotel and catering	7	0
Agriculture	2	0
Others	11	1
Total	1402	100

The eight years of foreign companies in Estonia can be summarised in the following way:

1) Foreign companies were established fairly hesitantly in Estonia until the middle of 1990 when foreign-owned corporations were allowed to be registered.
2) The second boom in foreign company registration began in the latter half of 1993.
3) Also foreign investments have begun a steady increase in the latter half of 1993.
4) The share of foreign investments has grown substantially from July 1993 onwards.
5) The number of totally owned subsidiaries grows strongly.

6) The number of registered foreign-owned companies increases faster than foreign investments, which is reflected in the decrease of the average size of foreign investments.
7) Sweden has been the largest single investor in Estonia since 1991.
8) Finnish companies have been the most active founders of companies in Estonia since 1987.
9) Companies from Western Europe and USA rush to the Estonian market.
10) The shares of several countries have first collapsed and then begun to rise again. Such countries are, for instance, the former Yugoslavia and the former Soviet Union.
11) The sectoral distribution has remained fairly stable during these eight years: industry has attracted highest foreign investments, and services and sales the largest number of companies.
12) Tallinn and its province, Harju, have attracted most of the investments and half of the registered companies.
13) A considerable amount of registered companies has not begun to operate at all. However, the share of those operating has started to rise.
14) The average size of the personnel in foreign companies remains low.
15) The business activities of foreign-owned companies rises steadily both inside the Estonian market and abroad.
16) The role of foreign trade is not as central as it was in the 1980s because companies can now change the kroons they earn in the Estonian market into hard currency.
17) The business environment has developed considerably thus supporting foreign company activity in Estonia.
18) The Estonian business legislation is one of the most developed ones in transition economies despite its few inadequacies.
19) An increasing number of companies are using Estonia as their foothold for other Baltic markets.
20) The statistics on foreign-owned companies are inadequate and differ widely from one another.

5. Conclusion

Most of the researches dealing with transition economies stress the uniqueness of transition process. Naturally, in a context as wide as this, world history does not recognize any analogous phenomena. But at least in terms of economic transition alone, the phenomenon is not entirely unique. The economy and business activities of Estonia studied in this article experienced a transition similar to the present circumstances already during the 1920s and the 1930s, when Estonia declared her independence from the Russian Empire. These two eras share, for instance, the loss of Eastern markets and manufacturing contacts, strong orientation to West, increase in foreign investments, need for a construction of national economy, and the increasing reflection of national culture in business and the management culture of companies.

The second lesson to be learned from the present transition of the Estonian enterprise sector is that an enterprise sector will rapidly develop from selling from suitcases to trade in kiosks, and from shops to industrial manufacturing. A similar course of events occurred very rapidly during the NEP period in Soviet Russia.

The example of Estonia also indicates that a small nation at least is able to change the economic structures rapidly without upsetting the social foundations or resulting in an overheated economy. The progress of the Estonian transition has also been affected by a strong sense of shared national spirit and strive for constructing an independent nation. Various psychological factors play an equally vital role in the construction of an economy as the cold economic facts do.

Thirdly, the transition of the Estonian enterprise sector can provide an interesting view on the development of entrepreneurship in other transition economies. The majority of companies in Estonia, as in many other transition economies, operate in four subareas: trade, supply, services and small industry. These four straws of entrepreneurship have the potential for becoming the supporting pillars of a healthy economy.

The experiences of the Estonian enterprise sector prove that foreign companies can both rehabilitate and damage the development of these infant industries in transition economies. The Estonian example shows that a more liberal policy toward foreign companies gains better results than an environment which could only attract speculators from abroad or keep even them outside the borders.

In addition to the factors mentioned above, the study of the transition in the Estonian enterprise sector will inevitably reveal the fact that the statistics and monitoring system of companies have failed to follow on the heels of skyrocketed entrepreneurship. On account of insufficient registration and control, many transition economies loose annually more in tax income than a construction of a functioning monitoring system would cost.

The transition economies are well aware of this particular situation, but their problem is the existence of dozens of various other targets which are even more important than the improvement of the enterprise registration. To correct these particular defects, the Western countries could lend a helping hand to transition economies, as their efforts would pay them back very soon. Moreover, this way the statistical chaos in the transition economies could be shaped into information for analyses, which could further help in directing financial aid to suitable targets and decrease the present misuse.

It seems appropriate to end this article with a few words by Kozminski, where he underlines the role of the enterprise sector in the implementation of transition. According to Kozminski (1993, 145), "managers of post-communist enterprises have to assume this leadership role in the milieu of sudden discontinuity and dramatic change. They are the only ones potentially capable of translating changes in the macro-economic environment into corresponding micro-economic behaviour of the firms. Otherwise, transformation to a market economy will not happen."

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BANKING RISKS OF TRANSITION ECONOMIES: THEIR SPECIFICITY AND MANAGEMENT

Mart Sõrg

The economy today is characterized by rapid changes. Besides other important reasons these changes have also been caused by the collapse of socialist economic system and by the attempt of the reforming countries to introduce a capitalist economic system and integrate into the world economy. In the present situation the task of banks to evaluate the risks has become crucially important. Walter Wriston, chairman and chief executive of Citicorp between 1970 and 1984 has said: "The fact is that bankers are in the business of managing risk. Pure and simple, that is the business of banking." (1, p.3) His remark has been gaining acceptance in recent years.

Banking risks in transition economies are similar to those in developed countries. But in transition economies the level of risk is much higher, the causes are different and the possibilities of risk management are more limited than in stable market economies. Proceeding from these differences the profits of bank owners might be enormous, but the price of failures might also be very high. The experiences of the Estonian banking industry have shown that the risk of the owners and clients to lose their money is more probable in transition economies than in stable market economies.

The essence and characteristic features of banking risks

Scientists usually mention three to ten different banking risks in textbooks. The textbook Commercial Bank Management presents ten important banking risks: credit risk, liquidity risk, market risk, interest rate risk, earnings risk, solvency risk, inflation risk, currency or exchange rate risk, political risk, and crime risk (2, p. 140-145). The first six are considered to be the main types of risk and the last four are other forms of risk in the banking industry. We could say that the last four of them are especially important for banks in transition economies as they operate mainly at the domestic level, so dividing risks according to their importance is relatively subjective.

Another textbook, Commercial Bank Financial Management, presents only three types of banking risk. " Bank risk managment focuses on three key portfolio risks: credit risk, interest rate risk, and liquidity risk. These risks arise from unexpected changes in borrowers' abilities to repay loans, unexpected changes in interest rates, and unexpected changes in balance sheet flows, respectively." (3, p.380)

Most monographs and textbooks present the number of risks between the above given limits. Scientists do not often consider solvency risk a separate risk factor but as part of liquidity risk. Some textbooks dealing with international banking introduce the term country risk. The above given treatment of banking risks do not answer the question why the level of risk in the banking industry is higher than in other fields of entrepreneurship. The next part of this paper deals with that issue.

Our position is that the level of risk in the banking industry is higher because of the contradictory aims of banking activities, the profit and service objectives of the banks and the peculiarities of the bank's balance sheet structure regarding the many different risks that are concentrated in banks.

Banks fulfill two contradictory social tasks. On one side, the bank is a business and its aim is to produce capital profit. On the other side, the bank is an important part of the state's infrastructure, the centre of issuing the medium of exchange (money), the circulation channel and reservoir of money. Because of the essential role of banks in the economy, governments try to regulate and control them more severely than other businesses. We may see that there exists two contradictions in banking: 1) between the aims of banks and their social functions, and 2) between liberty for banking enterprises and other fields of entrepreneurship. These contradictions very often cause risk.

The services (production) of banks include transportation of money from one owner to the other and issuing additional means of exchange with the help of credit. The value of a concrete currency depends greately on the amount of trust in it. Banks, even the central bank, are only to a certain extent able to guarantee the trustworthiness of a certain currency. Guaranteeing the trustworthiness of currency, and influencing the value of currency are to a great extent beyond the power of banks. Even great well-developed countries are helpless when the trust in their currency is decreasing. E.g. the rapid decrease of the value of the US dollar versus the Japanese yen in the beginning of 1995. The risk level of money is comparable to that of agricultural production. The latter is influenced by weather, natural catastrophies, diseases, etc. Most countries have implemented the system of supporting agricultural production. Different measures have been used for that purpose - subsidies, loans, etc.Attempts to defend the value of currency by reducing salaries, social costs and other economic-political measures are very often not appreciated by people. That is why only insufficient monetary measures are often used (decreasing the money supply).

The high level of risk in the banking industry is also caused by the differences between banks and other businesses. In banks, equity is minor part of a bank's assets. In business the share of equity should be much greater than the share of borrowed funds and the banks use credit requirements in lending to companies in order to control the debt-to-equity ratio. As it was mentioned earlier, it is possible to earn high profit in banks. As the owners' equity is many times smaller than the sum of money that could earn great profits in banks, the owners have a great temptation to risk this large sum to increase profit, earned with the help of using the money that belongs other to people. The simple calculations show that if the capital stock is 10% and the net profit of using the bank assets is 10%, the owners' profit ratio is 100%.

Compared to other areas of the economy, the level of risk is one of the highest in the banking industry. In transition economies, where economic risks are enormous and trust in currency is insufficient, the possibilities to lose or to win are especially great. That is why the banks in transition economies attract owners who are willing to take a risk. After liberalization of the banking system the boom of establishing banks usually begins. E.g. after liberalization of banking the number of banks operating in Poland mushroomed. At the end of 1990, there were already 75 nationwide banks (including 30 with a majority share of private capital), 104 cooperative banks that broke away from BGZ and 1,562 small cooperative banks affiliated with BGZ (4, p.15). The situation was similar in Estonia. At the end of 1993, the number of commercial banks was 42, or one bank per 40,000 people.

The effect of a transition economy on the banking risks

The peculiarity of a transition economy is that the processes of dismantling the old economic system and creating a new one are simultaneous. The former structures do not function successfully any more and the new ones are not able to function properly yet. This situation has a negative influence on the economic environment and it results in an economic crisis. The situation is as uncomfortable as living in a house that is being renovated. Many people do not think that the falling living standard and the decrease of social guarantees are unavoidable in transition economies. They try to find solutions to these problems with the help of the former communists, who gain power again and stop the reforms. Doing this, the risk of banks increases. The risk is connected with a decrease in the production of goods and services, replacing old markets with new ones, having a high inflation rate, insufficiencies in legislation, a high rate of delinquency etc..

One of the greatest risks in banks is the political risk, meaning changes in reform policy. Such changes influence the business environment and might bring about great losses to banks. E.g. One part of the party (Koonderakond) that won the elections on March 5, 1995 in Estonia introduced a bill to the newly elected Parliament to temporarily suspend the reforms. If Parliament had passed the bill, the banks that were oriented more to the new market economic structures (e.g. that had bought the privatization vouchers) would have suffered great losses. Life has shown that the reform process in post-socialist countries has its recessions and it is very difficult to forecast them.

Economic decline increases the risk to the banking industry. As we can see in Table 1, GDP in Estonia, Latvia and Lithuania decreased by half between 1989 - 1993.

Table 1. Real GDP (%) (5)

	Hungary	Poland	Slovakia	Lithuania	Latvia	Estonia
1989	100	100	100	100	100	100
1990	96	88	97	95	96,5	96,4
1991	86	81	82	82,2	88,5	84,3
1992	81	82	77	51,5	58,5	62,4
1993	...	...	...	43,3	46,9	58,7

The decrease in GDP means that cash flow decreases and banks have difficulties repaying loans. The future prospects of many enterprises are not the best, and their motivation to pay the loans back is very weak, as it is impossible for them to get new loans. Banks might handle a single case of a delinquent borrower, but it would be in difficulties with many delinguent borrowers.

Economic rearrangements and restructuring during the transition period make it very difficult to forecast the risk. On one hand, restructuring is connected with the establishment of a number of new firms. Many old organizations are privatized or are on the edge of bankruptcy. On the other hand, the economy has to reorient itself from old markets to new ones. In some cases the reorientation is very rapid and abrupt. Table 2 shows us that after gaining independence in 1991 Estonia lost many trade partners in the East (mainly Russia) and had to replace these relations with western economic ties.

Table 2. Structure of Estonian foreign trade in 1990-92 (%) (6, p.173)

Country	EXPORTS			IMPORTS		
	1990	1991	1992	1990	1991	1992
USSR (former)	94.1	94.7	41.8	82.0	84.8	40.9
Rest of world	5.9	5.3	58.2	18.0	15.2	59.1
Russia	55.0	56.5	18.1	51.8	45.9	32.5
Ukraine	13.2	12.9	5.7	7.7	7.9	2.3
Byelorussia	4.6	4.1	1.1	4.4	4.9	1.7
Latvia	5.7	7.7	10.0	4.7	5.1	1.4
Lithuania	3.1	3.8	1.3	3.2	6.3	1.7
Finland	1.1	2.3	22.4	1.6	2.0	29.4
Sweden	0.4	0.5	9.0	0.1	0.8	6.6
Germany	0.3	0.2	4.3	0.1	0.8	7.6
Netherlands	0.06	0.3	5.0	0.2	0.1	1.6
U.S.A	0.2	0.1	2.0	0.9	3.5	3.2

Estonia was successful in reorienting its economy, the foreign trade capacity increased two times in 1993 and the growth continued in 1994 (according to the data of the Estonian Bank it was 71%). The situation was favorable to those commercial banks that had forecast such development (e.g. Hansapank) and caused much difficulties to those who hoped that the trade relations with former socialist countries would be reestablished.

Proceeding from the situation described above, the banks have difficulties in longterm forecasting, as it is almost impossible to get comparable statistical data. The new economic system requires rearrangements in statistics, but the data collected according to the old system are not comparable to the new data. The problems in transition economies are also connected with the developmental models. Very often the models offered by western economists do not suit the rapidly changing situation (e.g. as it was in 1993 in Estonia, where the foreign trade capacity increased two times). Banks also have difficulties drafting the longterm interest rate policy, as the inflation in transition economies is rapid and volatile (Table 3).

Table 3. Monthly inflation rate in the Baltic states in the first half of 1994 (the change (%) in comparison with the previous month)

	Estonia	Latvia	Lithuania
January	5,5	3,8	4,8
February	5,2	3,4	2,9
March	8,9	1,7	3,3
April	3,1	2,7	1,6
May	1,1	0,2	6,2
June	0,7	2,0	2,1

The other peculiarities of transition economy banking are connected with the fact that legislation does not correspond to the new economic situation. It is also typical to the situation that the Central Bank's supervision and control are weak. Very often drawbacks and weaknesses found in the work of one bank might cause panic among the clients of other banks, as clients lack reliable information about the financial status of their bank. Banks are also annoyed by the high level of delinquency, as state power is rather weak and the banks are not well protected.

The effect of the developmental level of banking on risks

In postsocialist countries banks have changed a lot. The aim of banks in socialist countries was to serve the command economy, but in the market economy their aim is to make a profit. During the transition period the old banking system was dismantled and the new one established and this situation brings about additional risks. As an economy in transition is in crisis and there are problems in preserving the value of money, it is very likely that not all banks are able to survive. The reasons are structural, financial and educational.

The essential structural reason is the fact that at the beginning of the transition period too many small banks were established and their locations do not correspond to the needs of entrepreneurship. The international auditing company Price Waterhouse concluded in its published banking survey for 1993 that the banking density is quite high in the Baltics; highest in Latvia. Estonia has 21 banks for a population of 1,6 million, Lithuania has 24 banks against 3,7 million people. And Latvia has a whopping 60 and a population of 2,8 million. Many of the banks are rather small, and the survey predicted it is likely that the banking industry will be affected by major restructuring (8). We may add that before the banking crisis the banking density in Estonia was comparable to that of Latvia - at the end of 1992 there were 42 commercial banks in Estonia.

Financial problems of banks are mostly connected with the fact that the banks are rather small, they have existed for a short time and many loans might be called "bad." Mr. Olari Taal, the Executive Chairman of the Estonian Savings Bank (Eesti Hoiupank) describes the so called vicious circle situation as following: "The average loan interest rate is not falling this year, although according to our countryrisk the average interest rate should be 14-15%, but it is 21-22%. The reasons for that are the following:

- the number of banks is too big, meaning that the banks try to buy up money "at any price" and pay high interest rates;
- bad loan portfolios and the wish to compensate for future losses (giving credit with high interest rates is connected with high risk). The specialists think that about 12-14% of all bank loans are so-called "bad" loans. Taking the situation of the Social Bank (Sotsiaalpank) as an example, we should admit that it is not an exaggeration;
- the loan interest rate and inflation influence each other."(9)

The profit of small banks is rather small. The profit is used for covering the personnel costs, costs of implementing modern banking technology and also loan losses. There will not be much left for equity growth and for establishment of a reserve fund.

The short history of market economic banking industry has not been able to teach banks to cooperate in order to find ways to minimize the risks. E.g.large loan losses have forced Estonian banks to create the system of registrating "bad" clients (Creditinformation). Most banks are already connected to that system. But because of the opposition of large banks it has not been possible to create a system of savings insurance. It is understandable, as the large banks are afraid of being forced to pay for the risks of small banks.

Educational problems are caused by the fact that Estonia lacks old banking traditions. The old staff of banks is clinging to the old working methods and the new staff has not obtained the principles of risk management yet.

Risk in banking is also caused by the bank owners' misunderstandings about investment in banking. Two kinds of problem are connected with that statement. First, as the future of the bank and the investor are unpredictable, the investor wishes to get the maximum earnings per share. E.g. the highest earning per share (60%) in Estonia in 1991 was in the Tartu Commercial Bank (Tartu Kommertspank), but this bank went bankrupt in 1992 and the depositors did not get back all their savings. The Estonian Social Bank (Eesti Sotsiaalpank) paid 40% per share to their shareholders in 1993, although the problem of loan losses was already acute then. Second, banks' shareholders try to buy the essential part of shares in order to become a member of the board and to the gat loans that are greater is amount than their capital stock invested in the bank. Most banks in Estonia have given large loans to the bank owners, and the loan terms have been very favorable (some gave the loans without interest).

The effect of the attitude of banks' clients on the banking risks

Everybody in transition countries was used to the fact that depositing in banks was totally free from risk. The state banking system and strict regulations in banking guaranteed that depositing was riskless. After establishing commercial banks and the structural reform in the economy it became clear that people might lose their money even in banks. The clients started to insist on risk insurance. Many enterprises turned back to cash turnover (for small entrepreneurs it is possible to hide their taxable profit this way). That is why the deposits are rather expensive to the banks. The annual interest rate on term deposits is still often 15% or more in Estonia. Nevertheless the amount of cash circulating outside the banking sector is increasing more rapidly than recent money supply (table 4).

Table 4. Location of the issued cash in Estonia (mln. EEK) (10, p. 69)

Date	Total	in	
		Commercial banks	Economic circulation
01.07.1992	366	108	258
01.01.1993	1228	151	1077
01.01.1994	2730	350	2380
01.04.1994	2731	311	2420
01.07.1994	2983	327	1656
01.10.1994	3153	323	2830
01.01.1995	3512	440	3072

High risks connected with domestic currency and domestic banks have forced the owners of money to use more stable currencies. Ratna Sahay and Carlos A. Vegh have presented the facts that the dollarization ratio (the ratio of foreign currency deposits to broad money, inclusive of foreign currency deposits) has been rather high in all transition economies, not only in the postsocialist states. In the Baltic states, the dollarization ratio peaked at around 60 per cent in Estonia (second quarter of 1992), 50 per cent in Lithuania (first quarter of 1994), and 35% in Latvia (first quarter of 1993). These three countries successfully implemented disinflation programs during 1993, leading to a substantial reduction in the dollarization ratios in Estonia and Lithuania (11, p.37). The dollarization ratio is a negative criteri on of the trustability of currency. The experiences of Slovenia, Poland, Latvia and some other countries have shown that even a low level of inflation is not always able to reduce the dollarization ratios.

The conclusion is that risk for banks is increasing when clients do not trust domestic currency. The banks should take into account that the number of dishonest clients is greater in transition economies than in stable market economies. That is why it is impossible to use measures for simplifying and of reducing the cost credit and settlement.

Because of the fall of living standards and the economic crisis in transition economies bank clients are rather poor and change very often. Banks waste much time obtaining information about the clients' financial background and evaluating their future prospects. The banks' possibilities to do research in this field are limited as the competition between banks is very in tense and because of the difficulties in obtaining necessary information.

In conclusion, it is necessary to stress that the level of risk in the banking industry in transition economies is much higher than in stable market economies and the possibilities for risk management are also limited. Because of the specific features of risk and of the scarce bank and governmental resources the risk management experiences in transition economies are absent. The intuition of politicians and bank leaders serve as the main instrument of avoiding the risk. It is also possible to learn from mistakes, but it means that the depositors, owners and taxpayers pay for these lessons in risk management.

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INVESTMENT FUNDS AND THE ESTONIAN SECURITIES MARKET

Piret Reinson

The first steps of creating a capital market in Estonia were made in 1991 when the first shares were issued. The first investment fund was founded in 1993 - that was Eesti Börside Investeerimisfond - an open-ended fund, the purchase and sale of the fund's shares is intermitted by the Securities Board at the moment. Besides the fund hadn't a lisence yet. The first government bonds were also issued the same year that is 1993. During the last two years 18 investment funds have been established in Estonia, 11 of them are of open-end type. One can suppose that new investment funds will be established and that some of them will leave the market.

It's really difficult for open-ended funds to exist in our securities market and to allocate their resources in compliance with the legislation. Only closed-ended funds and privatization funds can survive in our securities market today. It's not a lack of discipline or supervision. Firstly the Estonian capital market is too small, secondly we don't have sufficiently securities that can guarantee liquidity and thirdly we haven't an active secondary market. Our Investment Fund Act is being really often discussed these days. The fund managers have said that the easiest and perhaps the only possible way of making the portfolio of an open-ended fund in compliance with the Investment Fund Act is to invest in western countries that have a great variety of securities. Thus - our legislation favours the export of capital. Also has been said that investment funds could specialise (by market sectors, securities etc.) but there aren't so many opportunities to specialise in Estonia.

According to experts the volume of a securities market should be at least 10-15 billion kroons in case we want it to be normally functioning that is approximately 13 times bigger than now. So, the annual volume of new issues has to be more than 900 million kroons. At the end of 1994 there were securities worth of 950 million kroons in our securities market from which bonds constituted 48,2%, shares 31,6% and shares of open-ended funds 20,2%. ("Äripäev", 20.01.95)

Theoretically can this 900 million kroons really achieved but for that we need a lot more foreign investments and the money invested abroad should be brought back to Estonia. But I just drew your attention to the fact that open-ended funds can survive only by investing in foreign markets. Besides our political and economic risks are too high for the most of foreign investors especially after the elections. The Estonians blew the fear of left-wing government too big thus influencing foreign investors who hadn't come here yet.

The crisis in some open-ended funds brought out the weaknesses of the Securities Board as well. The Securities Board is the regulatory agency responsible for the oversight of the securities market and its professional participants. As it often happens in Estonia the main energy is put on consequences. It's the proper time to think of educating professional fund managers and analysts. It seems that privatization funds have a future in our capital market as the privatization vouchers embody an invaluable potential and enlivens the Estonian capital market and the whole Estonian economy.

The establishment of the Estonian Central Depository in 1994 had a very positive impact on the development of privatization and closed-ended funds and in the long run on the whole of the securities market. In essence, it's the secondary market for the shares of privatization and closed-ended funds. It's of a high probability that because of the peculiarities of our securities market there will be no traditional Stock Exchange in Estonia at all.

Small investors as a class will survive only through privatization funds. As of today there are 3,6 billion opened EVP-accounts (privatization voucher accounts). The majority of the shareholders of the EUF (Privatization Trust Fund) are civilians, altogether 1257 shareholders. The first emission lasted from the 2nd of January to the 31st of March. Approximately 3/4 of the shareholders are 50 years old and older. The average amount of the shares bought was 1700 10-kroons worth shares. The development of privatization funds is immensely important for the Estonian economy and therefore should be supported. The biggest danger at the moment is the attitude of a new government. If the government will change the course of privatization then the results are unpredictable and that means instability.

THE PRECONDITIONS AND HINDRANCES FOR MODELLING OF TRANSFORMING PROCESSES

Tiiu Paas

In order to understand and predict the development of economic processes as complicated dynamic systems it is important to use the possibilities provided by economic and econometric modelling. The importance of modelling increases in situations and periods where and when great economic and political restructuring is taking place. Political and economic decisions have to be empirically checked and generalized. Economic and econometric models with concurrent infosystems are important tools for successful co-operation and integration for countries with developed markets economies as well as for those with transforming economies.

The most important precondition for modelling of transforming processes is the real need to generalize in quantitative terms the transforming processes and to support the policymakers in evaluation of different policy proposals from local, subnational and international agencies. Not only the extremely difficult task of governing the economy in transitionary countries, but also the more modest ambition of monitoring the development is seriously impeded by the virtual absence of analytical tools and systematic collection of relevant data in a consistent framework.

Positive preconditions for the econometric modelling of transforming economies are based on comparatively good education of economists of post-socialist countries in mathematics and statistics, and on the comprehensive experience in elaborating and using macroeconometric models for planning and analyzing economic development in the former Soviet Union and other socialist countries of Eastern and Central Europe.

The most important hindrances for successful modelling is due lack of reliable and comparable statistical data, especially time series needed to elaborate applied econometric models for transition countries, and due to absence of a basic development strategy for transforming economies. The process of economic transformation and restructuring is bound to be long and complex. The experience has showed a delay between the time the decision for a transformation program is taken, and the time its implementation begins. Some essential political and institutional reform measures have not yet been implemented, and other still possess their centrally planned character. Those factors also aggravate the elaborating and implementing of econometric models for transition period.

In view of elaborating and implementing econometric models in order to generalize transforming and integration processes the collaboration between economists from different countries is indispensable. The most important fields for this collaboration are the development of modelling paradigms and creation of internationally comparable information systems for analyzing and modelling of economies with different political background.

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ESTONIAN SECURITY MARKET: PRESENT STATE AND DEVELOPMENT

Ljudmila Šorikova

The re-establishment of Estonian security market started in 1992, when the government decree no. 6 was adopted (on Jan. 9, 1992). This decree served as a basis for standardisation of security market activities and creating legislation concerning security market.

Characterising the situation in security market in 1992-1995 and comparing it with the situation in developed countries, where the infrastructure and legislation has been formed already , Estonian security market was still in the developing stage. In 1992 there were ten organisations who dealt with security brokerage and auctions. It was only in April 1995, when the real electronic security exchange that met the international requirements was established in Tallinn. The Tallinn Securities exchange was established by 23 financial organisations and its capital cost was 2.300.000 EEK. The Central Depository and Central Register of Privatisation Securities plays an important role in the Estonian security market infrastructure. Its main aim is to escrow the securities and to fix the deals about property rights. In order to create the perfect infrastructure, more attention should be paid on the development of broking. Hansapank and company Pindi Invest are the dominating markers in Estonia, they also deal with the securities of other issuers. Market is supervised and controlled by Board of Securities of Ministry of Finances. We may say that the security market infrastructure in Estonia has already been established.

Total turnover of the Estonian security market in 1994 was the largest in the Baltic countries - $ 82.000.000 (In Latvia it was 23.000.000 and in Lithuania 38.000.000).The turnover has grown due to the large scale issuing of securities by the trustworthy issuers. The role of bonds at the market in 1994 was 48,2%, followed by the role of stocks (31,6%) and shares of mutual fund (20.2%). The securities sold for the privatisation vouchers dominate at the primary security market. The secondary market is unstable and small scale. At present there are three types of securities in Estonia that are sold at the secondary market: the equities of Tallinn

Kaubamaja and the bond of Hüvitusfond (Recoupment Foundation). The secondary market is not very active as most of the stocks are inscribed and the stock holders can not realise them. The reason for that lies in legislation but also in the strategies of companies.

One of the essential problems at the security market is the trustworthiness of the quotations. Different banks and brokers offer different quotations to the one and the same tool. They proceed from their strategic aims but not from the real market demand and supply. We hope that the quotations of the Tallinn Securities Exchange LTD. will serve as examples for others.

The package of laws, introduced in 1993-1994 was an important stage in the development of Estonian Security Market, but because of the contradiction and low quality of these laws, they also create several problems.

The development of Estonian Security Market is mainly connected with improving its legislative basis and brokerage, introducing new financial tools increasing the market turnover and making the controlling more efficient. Despite these problems, we can say that the security market in Estonia is existing. For developing it into a well-functioning and useful system, the process should be conscientiously managed.

CERTIFICATION OF AUDITORS IN THE REPUBLIC OF ESTONIA

Enn Leppik

With the development of market economy the necessity for certified auditors is increasing.

The Government of Estonian Republic has sanctioned a provisional decree about audit services and according to this decree the Board of Audit Activities has been founded to administrate, co-ordinate and control these services. One aim of the Board of Auditing Activities is auditors certification.

In Estonia the person who has higher business or juridical education, experiences in accounting, controlling or economics and who has obtained the certificate about his qualification, has the right to become an auditor.

To get the certificate about qualification the person has to take the exam according to the requirements set by the Board of Audit Activities. In 1991 first auditors were certified according to these requirements. People have different possibilities to prepare for this exam: they learn independently, participate in certain programs or courses, take part in practical training in audit firms.

The exam consists of different questions concerning audit arrangement, financial statement, management accounting, taxation, corporate finance and business structure (legal and organisational).

In certification of auditors and in audit arrangement the Estonian Auditing Standards play an important role. At present the following audit regulations are in force: Audit and the other functions of auditor; the basic terminology in auditing; relations between clients and auditors; audit planning; audit performance; auditor's documents, auditor's reports; ethic principles of auditor's work.

Auditors' certification examinations are held two times a year (in spring and in autumn). Up to now 50 - 70% of people taking the exam have passed it. At the beginning of this year, there were 272 certified auditors in Estonia.

NEED OF SUPPLEMENTAL KNOWLEDGE ABOUT FINANCIAL MATTERS FOR MANAGERS

Jüri Rünkla

Transition from the environment of planned economy to market economy is a very complex process of conversion. Besides the jurisdictional and economic rearrangements during the process it is necessary for all members of community to have an opportunity to revise and reorganize their minds according to the changed conditions. Unfortunately the mental readiness to understand the necessity for acquiring new knowledge and attitudes is not self-evident and rapid one.

The education and practical experience for major part of business managers comes mostly from socialist economic environment. The basic difference between the latter and market economy from the point of view of an employee lies in following three points:

1. The initiative of every person is becoming significat, because the dynamic business environment offers more opportunities than the previous static and suppressing one.
2. The accurate performance by an employee according to centralized plans is replaced by the need for competent and rapid decisions in changing economic situations.
3. The personal responsibility of everyone for economically effective results is growing with the transition from the relatively risk-free environment to the challenging one.

The executives and managers have to be competent in financial problems, which were under-estimated in the conditions of the previous system. Financial accounting in socialist enterprises was mostly for registration only and not a management tool. Entrepreneurial profit-earning firm has to manage current financial and market information for decision-marking on the real-time basis and according to it the corresponding professionals have to possess the required knowledge and skills. Unfortunately the employees even with the university degree in economics with a quarter of a century active working career ahead of them have very poor readiness for fulfilling these new tasks. There is a great deficiency in understanding financial matters and know-how. Managers can leam from making business, but such lessons are very expensive. Transition process needs an efficient system of adult economic and managerial education on a wide basis. It is not possible to wait until the new generation comes and takes over all jobs. A lot of trends may by themselves lead to unwanted results not to be reversed in future. And the community has no rational purpose to throw thoughtlessly away a great part of existing professional know-how of educated and experienced members because of the lack of some specific knowledge required in changed economical situation.

Organizing supplemental managerial refreshing courses needs exact goalsetting, determination of target group, drawing up rational programs, selection of lecturers with practical experience in both economical systems, readiness of managers and specialists to accept and apply new way of thinking and financial support to provide such courses for adult professionals on a wide basis. Up to the present the supplementary courses for financial and accounting professionals are going on without the support from state budget. The courses are mostly carriend out by different educational institutions as brief making the acquittance with requirements of new laws at the expense of interested firms and some funds. The needs of transition processes in economy require a much greater attention and systematic approach to adult supplementary studies. In connection with new European integrity it is not only a local Estonian problem, but a regional one. It is necessary to find support from some specific fund for converting the East-European economy and apply a specific project as soon as possible. Such a solution is evidently suitable not only for Estonia, but is acute in other Baltic and East-European states too.

THE POSSIBILITIES TO FUND THE ESTONIAN FIRMS WITH THE HELP OF BRIDGE LOANS

Nadežda Ivanova

One of the most important issues in the development of Estonian entrepreneurship is the problem of finding long-term financial resources. The main sources for funding business are: share issue, bond issue, bank loans, and profit.

After establishing the Estonian security market, large businesses will have the possibility to get loan capital from the security market. In comparison with the bank loans the advantage of the issuing the share of a firm is the lower price of money. On the other hand the issuing of share has been standardised and this process is more complicated and time-consuming.

Bank loan is very flexible financial tool. At the present situatsion in Estonia, it is rather difficult to get the loan; taking into account the high interest rate, bank loan is not favourable for the developing firms. (The role of long term bank loans has been increasing, especially due to the foreign loan. In the February 1994 the share of foreign loans in kroons was 15,6 % but in the February 1995 it was already 30,5 %, it has grown from 67,7 million EEKs up to 114,3 million EEKs.The average interest rates on long term loans have increased from 16,20 % up to 16,70 %).

In the present conditions our firms are interested in the system of combined financing,widely spread in well-developed countries, i.e. bridge loans. Bridge loan is a short term loan used forimplementing business projectonly in its first stage, later the firm will use shares or bonds in order to return the loan. These loans may cover almost half of the firm's investments, but in case the borrower has not got the guarantee from the bank about redemption of the securities, the loan might become risky. That is why the commercial bank as a rule agrees to give bridgeloan only in case the borrower firm has a contract with the underwriter about buying the remaining securities after the public sale.

FOREIGN DIRECT INVESTMENTS IN TRANSITION ECONOMIES

Eve Parts

Central and Eastern Europe (CEE) region has a long-run potential to become an important and stable part of the world market, if political and economic transformation will be successful. Therefore CEE is also assumed to have an increasing importance as a host region for foreign direct investments (FDI). According to IMF estimations, cumulative FDI flows to this region could rise to exceed $50 billion during the 1990s. By world standards, the inflows into region remain small. In 1986-1990 CEE countries received about 0.1 % and in 1992 3% of global FDI inflows. In present, this upward trend is slowing down because of (a) recession in FDI home economies and (b) transitional problems in CEE economies.

Considering the structure of the FDI in CEE, we can first notice considerable gap between registered and operational investments. Second trend is the concentration of FDI in a small number of countries (Hungary, Russia, Poland, Czech Republic), which reflects the degrees of liberalisation of regulatory regimes for FDI, as well as the differences in their location advantages. Third, with few exceptions, investors in the CEE economies tend to be small or medium-sized firms. Most investments range from $45 000 to $1.5 million.

Leaving aside the external influencies and concentrating on internal determinants of FDI, the following common problem areas concerning the investment climate can be identified:

1) Regulatory conditions - the instability in the legal conditions for FDI (including the matter of property rights) has in itself constituted a major deterrent to foreign investors.
2) Economic conditions - the CEE economies are passing through a severe economic crisis reflected in sharp declines in industrial output, the collapse of traditional export markets, rising unemployment and strong inflationary pressures. The Central European

Economies may recover sooner, but the deep structural roots of the crisis suggest that it will be of a prolonged nature for all.

3) Political conditions - governments face serious economic and social problems. The collapse of communist monolithic, one-party rule has initiated process that have led to the disintegration of federal structures in some countries of the region. As result, foreign investors often find themselves enmeshed in jurisdictional conflicts among competing authorities.
4) Institutional conditions - the process of marketization, privatization and reintegration into the world economy will inevitably be long and difficult. Meanwhile, the inadequate institutional legacies create obstacles to FDI: underdeveloped markets (especially capital markets), inefficient state sector, weak domestic currencies and foreign exchange controls, a fledging commercial banking system, insufficient telecommunication facilities and management and accounting practices that differ significantly from international standards.

In the long run, if above listed bottlenecks would be eliminated, the probable changes could occure because the CEE countries are potentially very attractive to foreign investors. The advantages of the region that could entice investments in the framework of regional core network strategies of TNCs are following:

- high industrialization levels
- European traditions and historical links which promote human relations and understanding in transnational firms (despite the lack of western business culture)
- highly developed human resources combined with relatively low labour costs
- quite large domestic markets with unsatisfied demand
- geographical proximity to the EU market
- availability of abundant natural resources in some countries, especially energy sources
- privatization of state enterprises, the process which accounted for 67% of the total FDI inflows to EEC in period 1988-92.

Last but not least, there is an aspect of the role of FDI in the transition process which has received little attention: for the countries of CEE to become competitive in the world economy, it is not only important that they attract FDI and benefit from the assets associated with it. They also need to insert themselves actively - and competitively - in the world market and the emerging integrated production system by undertaking their own FDI.

DEPOSIT POLICY

Angelika Kallakmaa

Deposits are these, what make bank an owner of the finance. Deposits are most important source of the bank.

Deposits are the base of the profit. How to manage deposits? In this field banks have two questions:

1) what kind of deposits help to minimize expenditures when bank increases its resoceres,
2) how can bank increase amount of deposits to obtain the protected capasity of loans and take into account other financial aims.

General demand for deposits determines the structure of the deposits in the bank. It`s almost for a single bank impossible to increase demand for deposits.

Bank can influence the structure of the deposits by the deposit policy. Deposit policy accounts different factors:

- interest rate level
- base of calculating interest rates
- different types of deposits
- different terms of deposits
- advertising the depositing prospects
- Service fees

Bank mus create different deposits for different groups of depositors. For that banks need regular market researches and analyses to do timely supply.

Savers can be divided as following:

1) liquidity-oriented (short term deposits)
2) future-oriented (long term deposits)
3) income-oriented (high intrest rate deposits)
4) objective-oriented (deposits, which help to get set objective).

Taking into consideration all these aspects bank can form its deposit policy.

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