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FOREWORD

The present issue of the "Kroon & Economy" will start a new series of articles dedicated to the recent history of Eesti Pank. The first article is by Mart Sõrg, former member and Chairman of the Supervisory Board of Eesti Pank, who covers the history of the Board during the years of Estonia's regained independence. This is an overview of the five compositions of the Supervisory Board from 1990 until 2009, when the current, the sixth composition of the Board was appointed to office.

The issue also gives an overview of the foundations and developments of the Estonian monetary system. In addition, you can find a detailed chronology of the development of the monetary policy framework as well as the legal framework and regulation of the Estonian banking system.

DEVELOPMENT OF THE SUPERVISORY BOARD OF EESTI PANK SINCE THE RESTORATION OF INDEPENDENCE IN ESTONIA

Mart Sõrg

This piece of writing is a retrospect of five compositions of the Supervisory Board of Eesti Pank. It is based on my own memories and on the reminiscences of other Supervisory Board members, especially Uno Mereste and Raimund Hagelberg, as well as on archival records from this period. My treatment of the matter may be subjective and not fully coincide with the viewpoints of others. For that I apologise in advance.

The first part of the article is an overview of the Supervisory Board activities by its memberships and the second part attempts at identifying trends that can be observed when analysing the 18-year history of the Supervisory Board of Eesti Pank.

FIVE COMPOSITIONS OF THE SUPERVISORY BOARD OF EESTI PANK

Eesti Pank was re-established on the basis of the Estonian Soviet Socialist Republic Bank Act adopted in December 1989 during the Soviet regime. The law stipulated that the Governor and the Supervisory Board of Eesti Pank were appointed for a term of five years by the highest governing body in the state. The first Governor of the re-established Eesti Pank, Rein Otsason, was appointed on the day the law was passed. The Supreme Soviet of the Republic of Estonia approved the first Supervisory Board, which consisted of five members, on 22 January 1990. Both the Governor of the central bank, as well as the Minister of Finance (Endel Mändmaa) belonged to the Supervisory Board by virtue of office.

The three other members were Siim Kallas, Chairman of the Estonian Central Association of Trade Unions, Raimund Hagelberg, Advisor to the Chairman of the Presidium of the Supreme Council and Valentin Porfirjev, Manager of the Estonian SSR Bank of the Foreign Economy Bank of Russia. The latter was the main author of the draft Bank Act. He belonged to the Supervisory Board only until 26 March, because he was about to set up a commercial bank (Balti Ühispank) and, according to law, could therefore no longer be in the central bank's Supervisory Board. I was appointed as his replacement. There was no excessive red tape at the time. I was doing my secondment at the Bank of Finland, when I received a call from Heldur Meerits from Eesti Pank (he was at the time Head of the Economics Department), who asked whether I agreed to apply. And my word was enough.

This composition of the Supervisory Board was put together following to some extent Soviet traditions. In addition to experts, the board had to include the executive power, the trade union and the party representatives. Since the Communist Party had a very poor reputation, it was decided not to invite their representative.

THE FIRST COMPOSITION – THE RECONSTRUCTION BOARD

The first composition of the Supervisory Board held its first meeting on 6 February 1990. The Supervisory Board was able to function for just ten months. At a meeting where just three members attended, there was a voting with results 2:1. So the question arose whether two votes are sufficient to make the central bank's strategic decisions. The Estonian Soviet Socialist Republic Bank Act adopted in 1989 did not specify the number of Supervisory Board members, thus it was easy for the Supreme Council to adopt the decision to expand the Supervisory Board membership.

The first composition can easily be referred to as the **reconstruction board**, since the bank started from practically zero in three rooms of the parliament's building. The first important task they faced was to prepare the Statute of Eesti Pank. The Supreme Council approved it already on 15 March 1990. In addition to the statute, also decisions concerning the supplementation of the Bank Act and the regulation of the establishment and functioning of banks were passed. The Supervisory Board also had tasks that are now carried out by the central bank's Executive Board. This is why the structure and organization of Eesti Pank were treated at Supervisory Board meetings. I remember I was the curator of the Human Resources Department and had several personnel policy related disputes with Peeter Grass, Head of the Department.

At that time the tasks of Eesti Pank were not clearly defined. The Supervisory Board took the decision to lend money to public and private-sector enterprises. The deadlines of these loans were later extended because of a sharp recession. Some uncollectible debts were even written off. The Governor of that time was of the opinion that one of the larger commercial banks should be joined with the central bank to make the latter financially stronger and less dependent. But the Supervisory Board strongly objected to that idea. However, the Tallinn department of the USSR Foreign Economy Bank was turned into Eesti Pank's Foreign Operations Administration. Later, after the monetary reform, it formed the basis for Põhja-Eesti Aktsiapank.

The first composition worked very intensively. Its 10-month lifespan included 18 meetings with 66 agenda items discussed. The period also denotes the separation of the positions of the Supervisory Board Chairman and Governor of Eesti Pank. This was carried out by an amendment to the Bank Act on 28 June 1990. I think one of the reasons this decision was made was the aggravation of dissentions between the Prime Minister and the Governor of Eesti Pank. One of the bones of contention was the preparation for the monetary reform. There were two commissions working simultaneously – one with Eesti Pank, the other with the Prime Minister. After the positions of the central bank's Governor and Supervisory

Board Chairman had been separated, the meetings of the Supervisory Board were chaired by a member of the board on rotation basis. The secretary of the Supervisory Board was Iigar Braun whose importance rose significantly with the absence of a Supervisory Board Chairman, since someone had to decide on the discussion of extraordinary agenda items or on the time of the meetings and the preparation of draft decisions.

THE SECOND COMPOSITION – THE MONETARY REFORM BOARD

The composition of the second Supervisory Board was approved on 15 November 1990 and included also the previous members. Rein Miller belonged to the board as the new Minister of Finance, and when a new government assumed office on 21 October 1992, he was replaced by Madis Üürike. On the proposal of the Supervisory Board, the Supreme Council appointed Ants Veetõusme Chairman of the board as from 13 May 1991. Other new members were Rudolf Jalakas, a Swedish banking expert, Ivi Proos, scientist of the Economic Institute, and Ülo Uluots, member of the Supreme Council.

The Supervisory Board worked for only 31 months instead of the designated five years. This was the period when Estonia restored its independence and several important changes took place as regards the employees of Eesti Pank. In September 1991, Rein Otsason was released from office on the proposal of the Supervisory Board. The official reason was retirement. On 23 September 1991, the Supreme Council elected Siim Kallas Governor of Eesti Pank and Uno Mereste entered the Supervisory Board as his replacement. On the basis of the implementation law of the Constitution, Uno Mereste was appointed the new Chairman of the Supervisory Board on 16 December 1992. Thus, both the Governor and Supervisory Board Chairman changed during the term of office of this Supervisory Board.

The second composition continued the reconstruction of Eesti Pank. The work organisation principles and the procedures for remuneration and reimbursement of the members of the Supervisory Board were approved in January 1991. In 1992 work schedules were started to be compiled and followed. On 29 November 1991 the Supervisory Board adopted the next year's work schedules of Eesti Pank, Governor of Eesti Pank and the Supervisory Board of Eesti Pank. In January 1992 it was decided to establish Banking Supervision the statute of which was approved at the end of February. At a meeting held in June 1992 the Supervisory Board discussed the need for the Executive Board of Eesti Pank, but it was formed during the term of office of the next composition (the decision was adopted on 21 December 1993).

The second Supervisory Board focused its attention on making preparations for and implementation of the monetary reform and on the coordination of the banking sector after the reform. Preparations for the monetary reform included the development of draft acts and Monetary Reform Committee's[1] draft decisions, organisation of banknote printing, obtaining reserves backing the kroons released into circulation, etc. These tasks were completed more or less on time, though there were problems. For example, the goal was to increase the reserves backing the kroon to 120 million US dollars by the time of the changeover, but the actual amount collected was smaller. Finishing the printing of banknotes on schedule created problems as well. The 1-kroon and 2-kroon notes produced by the USA Banknote Company were of lower quality than the other nominations printed in Great Britain. The USA counterparty justified the delay in carrying out the contract by Estonia's failure to make the agreed advance payments. But these were to be paid in dollars, which were not allocated on time by the government. (*Sic!*)[2]

The monetary reform denoted a significant change in banking as well. The Monetary Reform Committee decided to annul the licences of all the banks which had not started operating. Eesti Pank was given the right to extend licences until the end of 1992. The minimum rate of commercial banks' share capital was raised to six million kroons (compared to the earlier

[1] In the summer of 1990 the Supreme Council assigned the government and Eesti Pank the task of submitting to the parliament a specific conception and action plan for the monetary reform by 15 November. To this end, Eesti Pank formed eight working groups on 19 July. These did not include any government members. In September, the government set up their own commission for organising the monetary reform. It was still too early to suggest specific principles and action plans, but a lot of problems that needed solving were identified. Both the government and Eesti Pank were of the opinion that the parliament and the government are not the most suitable institutions to prepare a detailed plan for the monetary reform. Thus, the government's conception was supplemented with the proposal to establish a Monetary Reform Committee with large-scale powers and the right to make decisions regarding practically any monetary reform related issue. It was assumed a small team of experts would be able to make faster and more efficient decisions. It was suggested the committee consist of the Prime Minister, the Governor of Eesti Pank and a "neutral arbitrator". Eesti Pank's conception included a similar proposal. On 23 January 1991, the monetary reform conceptions and draft acts were submitted to the Fiscal and Economic Commission of the Supreme Council. The commission recommended both conceptions be used as the basis of the reform and considered it purposeful to establish a Monetary Reform Committee. On 27 March 1991 the Supreme Council of the Republic of Estonia (the parliament) decided to set up a Monetary Reform Committee in the following composition: Prime Minister Edgar Savisaar (later Tiit Vähi, Mart Laar), Governor of Eesti Pank Rein Otsason, and an independent scientist (first Siim Kallas, then Rudolf Jalakas and Ardo Hansson). The committee received all the necessary powers for organising the monetary reform in the Republic of Estonia. The powers of the committee were valid until 29 June 1995 and the committee was accountable to the parliament.

[2] The total cost of printing and transporting kroon banknotes was 1.62 million roubles of Group 1 currency, which was to be paid in the course of 2.5 years (in equal quarterly amounts) starting from Q3 of 1990. The minutes of Eesti Pank Supervisory Board meeting of 15 January 1991 admit that "although Eesti Pank asked in the letter of 1 August 1990 to be allocated the currency amount needed to cover two quarterly payments, the money was not transferred to Eesti Pank by the due time and the situation of printing Estonia's currency became critical. We have not been informed why and on whose orders the fulfilment of the decision made by the Presidium of the Supreme Council was practically stopped." The money was transferred into Eesti Pank's account on 20 October. (Editor)

requirement, this was a 12-time increase)[3]. In addition to re-registering activity licences and problems arising from the increase in share capital, banks that had issued long-term credit on account of short-term resources or directing their course to currency speculations started facing liquidity problems. The difficulties of Põhja-Eesti Aktsiapank and Balti Ühispank were further aggravated by the freezing of their currency accounts with the bankrupt Foreign Economy Bank of the Russian Federation.

In the spring of 1992, the Supervisory Board discussed the banking sector situation and concluded that several banks were unable to maintain liquidity. However, they hoped the situation would improve and authorised the Governor and the Banking Supervision to find solutions to avoid the closing down of such banks. Nevertheless, problems got more and more serious and on 17 November 1992 it was decided to impose a moratorium on the activities of Tartu Kommertspank, Balti Ühispank and Põhja-Eesti Aktsiapank. The former went bankrupt, but the two latter ones were joined and reorganised into Põhja-Eesti Pank. The second composition of the Supervisory Board registered the establishment of 37 banks, but took the activity licence away from 28 banks. Six of the licences were withdrawn because banks would not start operation, but the majority were declared invalid due to the failure to meet the capital requirement.

In the beginning Eesti Pank had supported the establishment of commercial banks to shape a banking system independent of Moscow. But now the time was ripe to enhance the quality of the banking sector. In March 1993, on the proposal of Rudolf Jalakas, the Supervisory Board adopted the decision to impose a moratorium on the establishment of new banks until the end of the year. This period was much more protracted than planned and the next new licence was issued to Preatoni Pank in September 1999.

One of the most important legislative initiatives of the period was the **elaboration of the drafts for Eesti Pank Act and the Credit Institutions Act**. The Supervisory Board started discussing the draft Credit Institutions Act along with the draft Eesti Pank Act in February 1993, but the working group that prepared the project had started earlier, of course. The draft Credit Institutions Act was discussed seven times by the Supervisory Board. It was only in November 1993 that the third composition decided to pass it on to

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[3] The decision on the establishment of commercial and cooperative banks made during the Soviet time stipulated the share capital of a commercial bank has to be at least 5 million roubles and the share capital of a cooperative bank at least 1.5 million roubles. On 19 February 1990, the Supervisory Board of Eesti Pank decided that the minimum fixed capital of commercial banks must be 5 million roubles. Practically, the Soviet-time normative was not changed. Since hyperinflation had made 5 million roubles a ridiculously small amount for a bank, the raising of the minimum capital rate by the Monetary Reform Committee at the start of 1993 was definitely justified. (The author's comment.)

the Riigikogu. The process was faster in the case of Eesti Pank Act, which passed just two readings before being forwarded to legislators on 18 May 1993. The Supervisory Board does not have the right of legislative initiative, so the draft act was submitted to the Riigikogu by its member Uno Mereste.

But this was just the start of problems, as Uno Mereste colourfully describes in his memoirs “Riigikogu ja Eesti Panga aastad”. Section 3 of the project prepared by the Ministry of Justice, which stated that “Eesti Pank operates independently of other state agencies. Eesti Pank shall report on its activities to the Riigikogu and it is not subordinated to the Government of the Republic or any other executive state agency or any third person”, found excessive opposition. The treatment of the central bank as an institution independent of the government is now generally accepted and included also in the EU Treaty as one of the requirements to the Member States. But at that time lawyers were of the opinion that Eesti Pank implements executive power and should thus be subordinated to the government. The Chancellor of Justice, who was included in the dispute, ruled the point was not unconstitutional. The lawyers’ threat to take the dispute to the Supreme Court did not, however, materialise and the act was adopted by the parliament by majority vote.

The enforcement of the “The procedure for the establishment, operation and liquidation of savings and loan associations” (16 February 1993) went much faster compared with the Credit Institutions Act. Soon the Loo and Leie Savings and Loan Associations were established. By now there are already 12 such associations, which means the decision was very important to fill the gaps left by commercial banks, especially in rural areas.

Although the second composition of the Supervisory Board was able to work only a half of the five-year term of office, their work was very intensive. 48 meetings were held over that period with 371 agenda items discussed. Compared to other compositions, the second one discussed the most agenda points per meeting (7.7). The second composition was a body independent of the government that considered itself constitutionally not only justified but also obligated to advise the government on monetary and fiscal policy questions. Three days before parliamentary elections in September 1992 Tiit Vähi’s transitional administration adopted a regulation for raising minimum wages, whereas the budget lacked funds to do so. The next day (September 19), the Supervisory Board addressed the public, the government and the trade unions saying that the decision should have been preceded by finding a source for the funds needed. Taking into account the current economic crisis, a similar action might be needed, especially if meeting the Maastricht criteria is at risk.

THE THIRD COMPOSITION – THE INTERNATIONALISATION BOARD

After the adoption of Eesti Pank Act the parliament decided that a new Supervisory Board needed to be established on the basis of the Act, although the five-year term of office of the second membership was not over. The decision was justified by changes in appointing the Supervisory Board. Now the Chairman of the Supervisory Board submitted the list of member candidates to the Riigikogu for approval. From my conversations with Uno Mereste I remember that Riigikogu members were very interested in applying for these posts. However, the Chairman Uno Mereste was still able to include also scientists and the Riigikogu candidates had usually also some experience in the field of finance.

The third Supervisory Board, which came together on 16 June 1993, consisted of nine members, but had 12 members due to replacements (see Table 1). Based on the Supervisory Board's decision of 27 July 1993, the new composition abolished the post of Supervisory Board Secretary whose tasks were delegated to the appropriate departments of Eesti Pank. The position has so far not been restored. Instead, the office of the PA of Chairman of the Supervisory Board was created. It has been successfully occupied by Ülle Rohtla since 13 September 1993.

Table 1. The third composition of the Supervisory Board of Eesti Pank

Name	Occupation	Period	Reason for leaving/ becoming a member
Ants Erm	Member of the Riigikogu	16.06.93–16.10.98	
Madis Üürike	Minister of Finance	16.06.93–07.01.94	resigned from minister's position
Raimund Hagelberg	Academician	16.06.93–16.10.98	
Siim Kallas	Governor of Eesti Pank	16.06.93–21.03.95	was elected to the Riigikogu
Kalev Kukk	Member of the Riigikogu	16.06.93-03.11.95 01.12.96–16.10.96	worked as minister in the interim
Ardo Hansson	Advisor to the Prime Minister	16.06.93–16.10.98	
Heiki Kranich	Member of the Riigikogu	16.06.93–27.04.94 29.06.94–16.10.98	worked as minister 11.01.94–29.06.94
Ilmar Pärtelpoeg	Member of the Riigikogu	16.06.93–16.10.98	
Uno Mereste	Member of the Riigikogu/ President of the Riigikogu	16.06.93–21.12.97	was Chairman of the Supervisory Board for the full term of office
Vahur Kraft	Governor of Eesti Pank	27.04.95–21.12.97	was appointed Governor of Eesti Pank
Mart Sõrg	Professor	08.07.94–16.10.98	replaced the Minister of Finance who was excluded from the board
Heino Siigur	Professor	17.01.96–01.12.96	alternate member

Since Siim Kallas went into politics and joined the parliament, the Governor of the central bank was replaced during the third composition. The membership of Kranich and Kukk was suspended temporarily for the time they worked as ministers. Since Eesti Pank Act was amended, the Minister of Finance was excluded from the board and Sõrg, who had been also in the first and second composition, returned. The powers of Uno Mereste as Chairman of the Supervisory Board terminated already in December 1997. Because it was impossible to elect a new Chairman fast enough, the Riigikogu extended the Supervisory Board's powers by four months. Thus, his term of office was 64 months. 81 meetings were held over that period with 390 agenda items discussed. These record figures reflect the intensity of the period: The Supervisory Board continued the supplementation of legislation and organisation of the banking sector.

The adoption of Eesti Pank Act did not put an end to attacks against central bank independence. In November 1994, member of the Riigikogu Mihkel Pärnoja submitted a draft legislation aiming at joining Eesti Pank's and state budget. The proposal passed the voting with 21 votes in favour and 15 against. Uno Mereste calls this in his memoirs an attempt to destroy Eesti Pank's ability to back the kroon. Raimund Hagelberg, Mart Sõrg and Vambola Raudsepp addressed this idea immediately in the media, calling it unreasonable. Uno Mereste and Kalev Kukk explained the matter in the Riigikogu. This action was fruitful – 43 members of the Riigikogu were against joining the two budgets at the new voting. Pärnoja's proposal was still supported by 21 deputies, which showed this had not been a random blunder, but purposeful activity.

The third composition of the Supervisory Board continued elaborating the Credit Institutions Act. Banking legislation was also updated as regards prudential ratios, rules for calculating the reserve requirement, etc. The board prepared the Deposit Guarantee Scheme, which entered into force on 1 October 1998. The deposits of the customers of the bankrupt Eesti Maapank were compensated by the government and Eesti Pank, whereas imposing a moratorium on ERA Pank and EVEA Pank was delayed until the Deposit Guarantee Fund had been established. The Riigikogu was made the proposal (through the government) to invalidate the Foreign Currency Act. This was done in March 1994. In addition, the prevention of money laundering was set as a priority, and after the 1997 October fall in the Tallinn Stock Exchange, the reform of financial supervision became more and more topical.

The structural development of Eesti Pank continued as well. In December 1993 it was decided to set up the Executive Board and the Internal Control Department (now Internal Audit Department). However, overcoming the banking crisis was the most important task of the third Supervisory Board composition.

Already the graph of fixed and equity capital growth adopted by the previous Supervisory Board composition (see also the 1994 chronology on the development of the banking sector legal framework) had forced banks to merge in order to meet the capital requirement. Eesti Maapank, a result of this "forced marriage" was unable to get to its feet exactly because of the blending of different banking cultures and insufficient risk apprehension of the bank managers. They took also excessive stock exchange risks, since the main stock exchange list of the Tallinn Stock Exchange established in 1996 included mostly bank shares, which kept increasing in price until October 1997 (see Table 2). This, combined with the impact of the Russian financial crisis in the autumn of 1998, caused liquidity problems to several banks.

Hansapank leaders declared that crown jewels would not be sold. When it was planned to sell Eesti Investeerimispank to Deutsche Landesbank, the management of the former threatened to quit collectively, but was later forced to beg for help. During the 1998 banking crisis the Supervisory Board allowed banks to merge and to be sold to foreign capital. Smaller banks, such as EVEA Pank and ERA Pank, were unable to find foreign suitors and went bankrupt. 18 banks went out of business. Only six banks remained and most of them were foreign-owned. This was beneficial, since foreign resources were used to reorganise Estonia's banking system. We hope the same will happen during the current crisis. The disadvantage was that the extra funds received from parent banks enabled Estonia's banks to increase their loan portfolios annually by 50–60% for several years in a row. This happened irrespective of several warnings and reserve requirement increases by Eesti Pank.

Table 2. Securitisation of banks (30.06.1997)

	Equity capital (EEK million)	Securities portfolio (EEK million)	Securities portfolio	
			% of equity capital	% of assets
Tallinna Äripank	441	6.6	15.0	8.4
Eesti Krediidipank	79.6	35.2	44.2	13.9.
Eesti Maapank	143.3	179.2	125.1	20.1
ERA Pank	63.0	43.1	68.4	7.1
Eesti Ühispank	480.6	448.1	93.2	13.6
EVEA Pank	75.0	20.4	27.2	9.0
Eesti Forekspank	167.4	353.9	211.4	25.1
Hansapank	817.8	361.2	44.2	15.5
Eesti Hoiupank	423.1	232.1	54.9	16.6
INKO Balti Pank	46.1	6.5	14.1	19.9
Eesti Innovatsioonipank	59.8	61.5	102.8	27.5
Tallinna Pank	189.2	340.2	179.8	21.7
Investeerimispank	169.2	53.0	31.3	18.0
Total	2758.7	2147.0	77.8	16.2

The third composition of the Supervisory Board had to function without a Chairman for half a year. President Lennart Meri nominated Raimund Hagelberg as the successor to the position after Mereste and he was definitely the best candidate. He had participated in all the previous Supervisory Boards and since 1992, he had been a paid member, which meant daily eight-hour working days in Eesti Pank. In addition, he was an experienced university lecturer. But the Riigikogu did not approve the candidate. The media blamed Meri for the failure, because the nomination had not been sufficiently discussed with political parties. So the disapproval could have been a means of trying to tame the President. Several other candidates were considered, but some of them disagreed to apply and some were disliked by the parties. Finally I was asked to apply and exactly six months after Hagelberg's voting, my nomination was accepted by a small majority.

The third composition broke several records. It had a total of 12 principal and alternate members, it operated for 64 months and held 81 meetings. But it is recorded in history by **allowing the internationalisation of the banking sector**. The first Supervisory Board would not register Balti Ühispank before its Latvian shareholders had been excluded from the circle of founders. But things changed radically during the term of office of the third composition. By end-1988, the share of foreign banks (on the basis of assets) made up 45.5% of the banking market. With Hansapank and Eesti Ühispank having left the stock exchange and Optiva Pank sold to Sampo Group, the share of foreign credit institutions in our banking market is nearing 100%.

THE FOURTH COMPOSITION – THE BOARD ABANDONING BANKING POLICY

The Riigikogu's summer holiday delayed a rapid composition of the list of the new Supervisory Board members. I had sent letters to all the fractions already in spring, explaining the principles of composing the Supervisory Board and asking their suggestions regarding possible candidates. Twelve candidates were submitted, although I had intended to include only four members from the Riigikogu. I wished to proceed with Mereste's principle to form a mixed team of politicians and experts. It was generally agreed with, but choosing just four candidates out of twelve created a storm of indignation among those who were left out. A party chairman even called me personally after the Riigikogu voting to express his annoyance. In order for the list to be accepted, very exact calculations needed to be done as to which fractions would vote for and which ones against a candidate. The parliament members finally chosen were Ants Järvesaar, Mati Meos, Mihkel Pärnoja and Kalev Kukk. When the social democrat Pärnoja was a minister (24.03.1999–05.10.2001), he was replaced by Pro Patria member Kalle Jürgenson. The economic experts in the Supervisory Board were Professor Jüri Sepp, Director of the Estonian Institute for Future Studies Erik Terk and former Auditor-General Hindrek Meri. By virtue of office also Vahur Kraft, Governor of Eesti Pank, belonged to the board.

Raimund Hagelberg continued as Advisor and Ülle Rohtla as the Chairman's PA. But Hagelberg started to refer to his age and health, which would not prevent him from doing active work, so I started looking for a new Advisor. Ivi Proos seemed an ideal replacement owing to her experience as a member of the Supervisory Board, her education (Tartu University, Finance, PhD in Economics) and work experience (Institute of the Estonian Economy). We came to an agreement and Proos assumed the office of Advisor to the Supervisory Board of Eesti Pank on 2 August 1999. She left the position on 31 March 2009.

Although the banking crisis was almost over, the fourth composition of the Supervisory Board had to deal with its consequences. The difficulties of EVEA Pank and ERA Pank were permanent, thus their moratoria needed to be brought to a conclusion by cancelling their activity licences. Optiva Pank, the result of the reorganisation of Eesti Investeerimispank and Eesti Forekspank, was owned by Eesti Pank and had to be sold. This took place in 2000, when Sampo Group acquired it.

The banking crisis induced the Supervisory Board to improve banking legislation so that it would encompass also the experience obtained from the crisis and be better prepared for managing future crises. A new version of the Credit Institutions Act was prepared and the draft Savings and Loan Associations Act was also completed. These were adopted by the Riigikogu in February 1999.

One of the lessons to be learnt from the banking crisis was that Eesti Pank did not have a thorough overview of commercial banks' risks, since the Banking Supervision was functioning under Eesti Pank, whereas Securities Supervision and Insurance Supervision were under the Ministry of Finance. It was hoped that joining the institutions would result in synergy. Thus, the draft Financial Supervision Authority Act was prepared. The law was passed in May 2001 and the Financial Supervision Authority started working in 2002. This required also amendments to Eesti Pank Act – the tasks of banking supervision were transferred to the Financial Supervision Authority.

The amendments to Eesti Pank Act made in relation with Estonia's accession to the European Union removed development of monetary policy and laying down prudential ratios for credit institutions from the competence of the Supervisory Board. When the Financial Supervision Authority was set up, the Supervisory Board still maintained the right to nominate two members of the Supervisory Board of the Financial Supervision Authority, whereas Governor of Eesti Pank is also one of the Supervisory Board members by virtue of office. However, the decision to deprive the Supervisory Board of the right to make monetary policy decisions as from 2003 seems to have been premature, since Estonia has so far not yet joined the euro area. The positive side is the Supervisory Board no longer has to account for why price stability, the main monetary policy goal, has not been met in recent years.

The most talked-about event regarding the fourth Supervisory Board's term of office was the election of the central bank's Governor in 2000. After Kallas had left, the new Governor was elected in the Supervisory Board without debate and using public voting. This time it was wished to make the entire process very democratic, with several candidates and secret voting. The draft procedure for electing the Governor was discussed through several meetings and finally it was adopted.

At the meeting preceding the voting, Supervisory Board members nominated their candidates, who had had to give their written consent to apply and to present their programme. At the meeting where the Governor was elected it was possible to ask them additional questions and then the secret voting took place. After all the votes had been counted, they were closed in an envelope so that it was impossible to establish who had voted for whom.

At the meeting held in February 2000, Supervisory Board members nominated Vello Vensel, Professor of Statistics at the Tallinn Technical University, in addition to Vahur Kraft, the incumbent Governor. The voting held on 30 March was won by Vensel (7:2). One of the reasons Kraft lost could have been his excessive self-confidence, which is why he did not do any election propaganda, whereas his rival Vensel, who was not so familiar to the Supervisory Board, was inevitably compelled to campaign for himself. Vensel was authorised to office by President Lennart Meri on 13 April. But suddenly, on April 25, Vensel announced he would withdraw due to ill health. The president approved his resignation on the same day. Uno Mereste discusses in his memoirs the rumours spreading in relation to this withdrawal, but concludes, referring to Vensel's imminent death, that health must have been the real reason. Vensel was summoned to Kadriorg on 25 April, the day he had gone to the bank to take over from Kraft, but he never returned to collect his things. It can be assumed he was being pressured. Another fact making me doubt the official version is something President Meri said to me: "Vensel started talking too early." Now both Vensel and Meri are no more and we will never know the truth.

Vensel's resignation was a problem to the Supervisory Board, since new elections had to be held. I introduced the new candidates to President Meri and he seemed not to object any of them, including Mart Opmann. On the morning of the election day Meri summoned me to Kadriorg and proposed a foreign Estonian for the post of Governor of Eesti Pank. When I met the President's favourite, he admitted he was not familiar enough with banking to assume this position. This was one of the reasons, but the other one was our election procedure – candidates had to be nominated at the meeting preceding the election. So I had to give up his nomination.

I did brief the Supervisory Board of my meeting at the Kadriorg, but the board decided to vote nevertheless and the winner was Mart Opmann. When Kadriorg was officially notified of the election results, a prompt reply arrived saying the President would not authorise Opmann to office, since he considered him to be unsuitable for the position. Opmann's education(Tartu University Faculty of Economics) and experience (former Minister of Finance) were definitely suitable, but his weak spot was that he had once failed a breathalyzer test, so this is what Meri may have had in mind when refusing to appoint him. We turned to the Chancellor of Justice, but lost the contestation, since the President's refusal was justified. We could have turned to the Supreme Court, but decided not to go there and suggested Opmann back out, which he did.

So we were back to where we started. Negotiations with other candidates who had satisfied the President, such as former Supervisory Board member Ardo Hansson and Riigikogu member Andres Lipstok, did not end positively. One of the Heads of Department of Eesti Pank was rejected by Meri due to his belonging to the wrong party. Thus, we had to ask Vahur Kraft to apply again. His rival candidate was member of the Riigikogu Kalev Kukk. But Kukk backed out on the election day, so only Kraft was voted for/against. Kraft received the necessary five votes (and three nays). The President had no problems with reauthorising him to office.

The fourth Supervisory Board membership dealt mainly with reforming the tasks of Eesti Pank and its Supervisory Board so that these would be suitable to an EU Member State and a country using the euro.

That I was to continue as Chairman of the Supervisory Board during the new five-year period became clear at the very last minute, when I was summoned to Kadriorg by President Arnold Rüütel, who asked for my consent. Because they wanted the whole matter to go to the Riigikogu before the 2003 summer vacation, things got very busy. I had to fill in a lot of forms the same night for the Security Police to pass the security check and deliver these to Kadriorg by the next morning. The President's team had already done the work necessary for my nomination to be passed by the Riigikogu. And so it went – on 12 June 2003 the Riigikogu voted in my favour.

THE FIFTH COMPOSITION – SUPERVISORY BODY

This composition got its powers on 17 February 2004. We started working later than planned, because I was appointed Chairman on 12 June 2003 and was able to start negotiations to compose the new Supervisory Board only in autumn. In addition, preparations got longer, because all the members of the Supervisory Board had to pass the Security Police check. The question arose whether members of the Riigikogu had to do it as well, so the Director General of the Security Police submitted an inquiry to the Chancellor of Justice. The answer was that since state secrets are different in the case of Eesti Pank, the security check was necessary. This caused a conflict at the first meeting, when a member of the Riigikogu was convinced that "the security check of Riigikogu members is Sõrg's private initiative and the Supervisory Board will nail Sõrg down". Later our relationship smoothed out and now members of the Riigikogu no longer have to pass the security check.

I held negotiations with Taavi Veskimägi[4] from the Res Publica party, but I also met with representatives of other fractions. In general it was agreed with that there would be four representatives from the Riigikogu, including also opposition representative(s). The question of experts caused a lot more discussions. I wanted to pick them personally, but the coalition wanted to put in their word. This was a hidden attempt to achieve a fully political Supervisory Board. However, after several rounds of negotiations we came to a compromise with 2:1 in my favour. The new Supervisory Board included Riigikogu members Andres Lipstok, Mart Opmann, Tõnis Palts and Liina Tõnisson. The economic experts were Enn Listra, Professor of Finance and Banking at Tallinn Technical University, Jüri Sepp, Professor of Economic Policy at Tartu University, and Raul Eamets, National Economy Lecturer and later Professor. When Andres Lipstok became Governor of Eesti Pank, Harri Õunapuu entered the Supervisory Board as an alternate member. This membership included top players. Four out of the ten members (seven members, Chairman, Governor, an alternate member) were professors and the rest were ex-ministers who had either held this position repeatedly or been in some other executive position.

The Supervisory Board had great potential and mere supervision would not have made the most of it. Therefore it was agreed with Governor Kraft and later with Lipstok that all monetary policy decisions, strategic plans and draft budgets would be discussed by the board before being signed by the Governor. This procedure has been successfully followed.

The fifth composition dealt quite a lot with issues related to the preparations for adopting the euro. To this end, the central bank elaborated the monetary policy framework and considered technical preparations for launching the euro as from 1 January 2007. In order to receive a better overview of the financial sector developments, there were joint seminars with the Supervisory Board of the Financial Supervision Authority. One of the things discussed there was the development of the cross-border banking safety net in order to be ready for mitigating the impact of global financial crises. Both Eesti Pank and the Financial Supervision Authority made preparations for worse times long before the global economic and financial crisis became an issue.

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[4] The coalition agreement had granted Veskimägi the right to deal with such issues.

The Supervisory Board started early preparations for coping with a possible recession. The remuneration of the Executive Board was changed every two years. In spring 2006 their compensation was increased, but in spring 2008 it was decided to leave it unchanged. In addition, it was decided to freeze the remuneration of the members of the current and the next Supervisory Board of Eesti Pank. In September 2008, on the initiative of the new Chairman of the Supervisory Board, it was decided to cut the compensation of the Supervisory Board members.

The Supervisory Board's lawful right to carry out supervision of all the activities of the bank created a lot of debate. The Supervisory Board found the right was limited to saying what should have been done in hindsight. Therefore, nearly twenty supervisory activities were added to the Statute of Eesti Pank, which is approved by the Supervisory Board of Eesti Pank, including, of course, the discussion of strategically important projects. In spring 2008, Executive Board members started to present their management reports to the Supervisory Board.

In the meantime, the Riigikogu had become more active in selecting the Chairman of the Supervisory Board. The respective discussions started already in autumn 2007. In addition to me three candidates were considered: Supervisory Board Member Professor Enn Listra, Economics Professor Andres Arrak and Jaan Männik, who became known to the public as Chairman of the Board of Eesti Telekom. The Riigikogu fractions met with all the candidates and decided in favour of Männik, who was then nominated by the President of the Republic. This time the elections went smoothly and without hurry. Männik had enough time to settle in and to meet the Executive Board and the Supervisory Board members before assuming office. The powers of the fifth Supervisory Board members lasted until 16 February 2009.

The most important strategic decision of this composition was the election of the new Governor of Eesti Pank, since Vahur Kraft's five-year term of office concluded in June 2005. The new Governor was elected on the basis of the procedure adopted in 2000. We made only minor changes to it. Namely, candidates were no longer allowed to participate in the voting. The candidates included Governor Vahur Kraft and Supervisory Board member Andres Lipstok. Thus, there were seven voters and a positive result required five affirmative votes. Both of the candidates campaigned actively. The first round ended with the result 4:3 in Lipstok's favour. Thus, he was the only candidate to enter the second round, where he got the necessary affirmative votes. President Arnold Rüütel authorised Lipstok to office and he assumed office as Governor of Eesti Pank on 8 June 2005.

Amendments to Eesti Pank Act in July 2006 excluded Governor of Eesti Pank from the Supervisory Board. Thus, there are now just eight members in the Supervisory Board. All the Executive Board members still attend the Supervisory Board meetings and Head of the Internal Audit Department also has the obligation to participate.

Another amendment to Eesti Pank Act established that Chairman of the Supervisory Board no longer has to have a university degree in Economics or Law, just a higher education is enough. This is acceptable, since the Supervisory Board's decisions are the result of collective deliberations and its Chairman's good management skills are even more important than professional competence. In addition, Eesti Pank Act prescribes that Governor is allowed to contest incompetent decisions of the Supervisory Board in the Supreme Court. But that the requirement of professional competence was cancelled also in the case of Governor of Eesti Pank is, in my opinion, very worrying, since monetary and banking policy decisions fall under the exclusive competence of the Governor and no legal instrument provides any possibility to contest the Governor's decisions. The Credit Institutions Act prescribes that a commercial bank shall not be granted an activity licence if the bank has no competent leader. However, I hope that when the central bank Governor's candidates are nominated, both the Supervisory Board and the President of the Republic will consider their professional competence very important. Eesti Pank Act provides that Eesti Pank's Governor is appointed to office for a term of seven years and that he or she will not be appointed to office for more than one consecutive term. Thus, the new Governor of Eesti Pank will be elected in the spring of 2012.

The work of the fifth composition of the Supervisory Board went smoothly. De facto the Supervisory Board had become a supervisory body having no legally established active role in monetary and banking policy and in organising the daily functioning of Eesti Pank. However, the Supervisory Board managed to take active part in planning the bank's strategic decisions.

THE DEVELOPMENT OF THE SUPERVISORY BOARD IN THE COURSE OF THE FIVE COMPOSITIONS

The management of Eesti Pank, which had on the basis of the 1989 Bank Act lain on the shoulders of the Supervisory Board, has gradually transferred to the Executive Board. Thus, the Supervisory Board, which is, as is established in Eesti Pank Act since 1993, the highest body of Eesti Pank, has nevertheless become a supervisory body of Eesti Pank. Some of its former tasks have exited Eesti Pank in relation with the establishment of the Financial Supervision Authority in 2002. The adoption of the euro means monetary policy will be conducted by the European Central Bank in Frankfurt.

The Supervisory Board of Eesti Pank has had five memberships in the course of 18 years. In February 2009, the sixth membership assumed office. So far only the fifth Supervisory

Board has worked the full term of office – five years. The work period of the first composition remained short, because the membership was expanded. The second Supervisory Board finished earlier due to the adoption of the new central bank act. The third and the fourth memberships had to work longer than the official term of office, since it took a lot of time to appoint a new composition. The Supervisory Board has had five Chairmen during the period, whereas the tenure of both Rein Otsason and Ants Veetõusme remained rather short.

Due to legislative amendments and election complications there have been two short periods when the Supervisory Board has functioned without a Chairman. The first period lasted for nearly a year (28 June 1990 – 13 May 1991), because of the amendment prescribing the Governor could no longer be Chairman of the Supervisory Board. The second period lasted for half a year (21 January 1998 – 18 June 1998), when Mereste's term of office ended, but the appointment of a new Chairman took time. Thus, not only the Estonian economy was difficult to reconstruct, the same was true for the state as well.

The first and the second Supervisory Board started when Estonia was still part of the USSR. Estonia's independence was restored during the second Supervisory Board. Table 3 shows a total of 50 members and alternate members have belonged to the Supervisory Board of Eesti Pank. Some of them have belonged to several memberships, so the number of different people (including Jaan Männik) is 35. Four of them have already deceased. Supervisory Board members have been top-level players in Estonia. There have been 17 Riigikogu members, 17 ministers or ex-ministers, 5 former county governors or mayors, 14 members with a PhD, 8 professors and 2 academics.

Table 3. The Supervisory Board of Eesti Pank in figures

Membership	Number of members and alternate members	Period (in months)	Number of meetings	Number of agenda items	Meetings per month	Agenda items per meeting
I	5 + 1	10	18	66	1.8	3.7
II	9 + 2	31	48	371	1.6	7.7
III	9 + 3	64	81	390	1.3	4.8
IV	9 + 1	64	69	316	1.1	4.7
V	9 + 2	60	59	236	1.0	4.0
Total	**41 + 9**	**229**	**275**	**1379**	**1.2**	**5.0**

The third membership held the most meetings, but the second composition had the most agenda items per meeting, because they had to deal with the first banking crisis.

In addition to discussions and decision-making, all the compositions have educated themselves both at seminars and by visiting other countries' central banks. The first such educating trip took place to Sveriges Riksbank in 1992 and the next one to Finland. When preparations were made in Estonia for the adoption of the euro, Supervisory Board members visited the countries where conditions were the most similar to Estonia (Ireland, Slovenia).

A positive aspect to be highlighted in the work of all the Supervisory Boards is that political rivalry was left out of the meeting room and all the disputes and decisions proceeded from Estonia's monetary and banking policy goals and from the need to develop Eesti Pank and make its functioning more efficient. Supervisory Board members have followed this principle also in their public announcements and statements.

The tasks and decisions of the Supervisory board of Eesti Pank have developed hand in hand with the development of the state and its judicial area. The activities of the Supervisory Board have also had a strong impact here. For instance, the main task of the Supervisory Board during the first stage was the preparation of draft acts and other legal instruments, then the establishment and closing down of banks, but during the whole period – directing and influencing the development of Eesti Pank.

One might ask whether everything has already been done. Definitely not, since each new period sets new tasks. It can be predicted that the global financial crisis will make it necessary to review the risk management procedures and the forthcoming accession to the euro area will change the work of the central bank completely. Thus, the Supervisory Board is still necessary as an arbiter and advisor to both the central bank and the financial sector.

Supervisory Board of Eesti Pank before World War II	
1921	E. Aule, J. Sihver, L. Sepp, K. Baars, A. Janson, E. Kuusik, J. Laidoner, M. Luther, A. Teetsov, A. Uibopuu, A. Uesson, K. Wirma
1922	E. Aule, J. Sihver, L. Sepp, K. Baars, A. Janson, E. Kuusik, J. Laidoner, M. Luther, A. Teetsov, A. Uibopuu, A. Uesson, K. Wirma
1923	E. Aule, J. Sihver, L. Sepp, K. Baars, E. Kuusik, J. Laidoner, M. Luther, A. Teetsov, J. Tõnnisson, A. Uibopuu, A. Uesson, K. Wirma
1924	E. Aule, J. Kukk, T. Vares, K. Baars, J. Laidoner, M. Luther, J. Puchk, A. Teetsov, A. Tofer, J. Tõnnisson, K. Wirma
1925	A. Uibopuu, J. Kukk, P. Öpik, A. Jürmann, J. Laidoner, H. Leesment, M. Luther, J. Puhk, O. Strandman, A. Tofer, J. Tõnisson, K. Virma
1926	A. Uibopuu, J. Jaakson, P. Öpik, J. Kivisild, A. Jürmann, J. Laidoner, H. Leesment, M. Luther, J. Puhk, O. Strandman, A. Tofer, J. Tõnisson, K. Virma
1927	J. Jaakson, P. Öpik, J. Kivisild, A. Jürmann, J. Laidoner, H. Leesment, M. Luther, J. Puhk, O. Strandman (until Sept.), A. Tofer, J. Tõnisson, K. Virma
1928	J. Jaakson, J. Hansen, Chr. Kaarna, A. Kask, J. Kivisild, R. Kuris, M. Luther, G. Vestel, K. Virma
1929	J. Jaakson, J. Hansen, Chr. Kaarna, A. Kask, J. Kivisild, M. Luther, J. Puhk, J. Veske, G. Vestel, K. Virma
1930	J. Jaakson, J. Hansen, Chr. Kaarna, A. Kask, J. Kivisild, M. Luther, J. Puhk, J. Veske, G. Vestel, K. Virma
1931	J. Jaakson, J. Hansen, Chr. Kaarna, A. Kask, J. Kivisild, M. Luther, J. Puhk, J. Veske, G. Vestel, K. Virma
1932	J. Jaakson, J. Hansen, Chr. Kaarna, A. Kask, J. Kivisild, M. Köstner, M. Luther, J. Puhk, J. Veske, G. Vestel, K. Virma
1933	J. Jaakson, M. Jänes, J. Hansen, Chr. Kaarna, J. Kivisild, M. Köstner, J. Laidoner, M. Luther, J. Puhk, J. Veske, K. Virma
1934	J. Jaakson, J. Hansen, Chr. Kaarna, M. Köstner, J. Laidoner, M. Luther, J. Puhk, J. Rosenfeldt, J. Sihver, J. Veske, K. Virma
1935	J. Jaakson, J. Rosenfeldt, Chr. Kaarna, J. Hansen, M. Köstner, M. Luther, J. Puhk, J. Sihver, J. Veske, K. Virma
1936	J. Jaakson, E. Arnover, K. Kaarna, M. Köstner, M. Luther, J. Puhk, J. Rosenfeldt, E. Saar, J. Sihver, N. Teliste, J. Veske, K.Virma
1937	J. Jaakson, E. Arnover, A. Eslas, K. Kaarna, A. Kuller, M. Köstner, R. Käsper, M. Luther, J. Rosenfeldt, E. Saar, J. Sihver, N. Teliste, K. Virma
1938	J. Jaakson, E. Arnover, A. Eslas, K. Kaarna, M. Käbin, R. Käsper, M. Köstner, M. Luther, J. Rosenfeldt, J. Sihver, N. Teliste, M. Vinnal
1939	J. Jaakson, K. Kaarna, P. Kurvits, M. Käbin, R. Käsper, M. Köstner, M. Luther, J. Raudava, J. Rumberg (instead of N. Teliste), N. Teliste, A. Tõnisson (instead of M. Luther), M. Vinnal
1940	J. Jaakson, K. Kaarna, J. Rosenfeldt, P. Kurvits, M. Köstner, M. Käbin, R. Käsper, A. Tõnisson, M. Vinnal, J. Rumberg

During the period of restored independence	
22.01.1990–14.11.1990	
	R. Otsason (Governor 28.12.1989–18.09.1991), R. Hagelberg, E. Mändmaa, S. Kallas, V. Porfirjev (replaced by M. Sõrg)
15.11.1990–23.06.1993	
	R. Otsason, S. Kallas (Governor since 23.09.1991), A. Veetõusme (Chairman since 13.05.1991), R. Hagelberg, R. Jalakas (Adviser since 26.10.1993), R. Miller, I. Proos, M. Sõrg, Ü. Uluots, U. Mereste (member since 23.09.1991, Chairman since 16.12.1992), M. Üürike (since 21.10.1992)
1993	U. Mereste (Chairman), R. Hagelberg, R. Jalakas, S. Kallas, I. Proos, M. Sõrg, Ü. Uluots, A. Veetõusme, M. Üürike
23.06.1993–13.10.1998	
1993	U. Mereste (Chairman), A. Erm, R. Hagelberg, A. Hansson, S. Kallas, H. Kranich, K. Kukk, I. Pärtelpoeg, M. Üürike
1994	U. Mereste (Chairman), A. Erm, R. Hagelberg, A. Hansson, S. Kallas, H. Kranich, K. Kukk, I. Pärtelpoeg, M. Sõrg, M. Üürike
1995	U. Mereste (Chairman), A. Erm, R. Hagelberg, A. Hansson, S. Kallas (until 21.03), V. Kraft, H. Kranich, K. Kukk, I. Pärtelpoeg
1996	U. Mereste (Chairman), A. Erm, R. Hagelberg, A. Hansson, V. Kraft, H. Kranich, K. Kukk (replaced by H. Siigur), I. Pärtelpoeg, M. Sõrg
1997	U. Mereste (Chairman until 21.12), A. Erm, R. Hagelberg, A. Hansson, V. Kraft, H. Kranich, K. Kukk, I. Pärtelpoeg (Chairman after U. Mereste), M. Sõrg
13.10.1998–16.02.2004	
1998	M. Sõrg (Chairman since 18.06), I. Pärtelpoeg, A. Järvesaar, V. Kraft, K. Kukk, M. Meos, H. Meri, M. Pärnoja, J. Sepp, E. Terk
1999	M. Sõrg (Chairman), A. Järvesaar, K. Kukk, V. Kraft, M. Meos, H. Meri, J. Sepp, E. Terk, M. Pärnoja (replaced by K. Jürgenson)
2000	M. Sõrg (Chairman), A. Järvesaar, K. Jürgenson, K. Kukk, V. Kraft, M. Meos, H. Meri, J. Sepp, E. Terk
2001	M. Sõrg (Chairman), A. Järvesaar, K. Kukk, V. Kraft, M. Meos, H. Meri, M. Pärnoja (since 01.10), J. Sepp, E. Terk
2002	M. Sõrg (Chairman), A. Järvesaar, K. Kukk, V. Kraft, M. Meos, H. Meri, M. Pärnoja, J. Sepp, E. Terk
2003	M. Sõrg (Chairman), A. Järvesaar, K. Kukk, V. Kraft, M. Meos, H. Meri, M. Pärnoja, J. Sepp, E. Terk
17.02.2004-16.02.2009	
2004	M. Sõrg (Chairman), R. Eamets, V. Kraft, A. Lipstok, E. Listra, M. Opmann, T. Palts, J. Sepp, L. Tõnisson
2005	M. Sõrg (Chairman), R. Eamets, V. Kraft (until 07.06), A. Lipstok (since 07.06), E. Listra, M. Opmann, T. Palts, J. Sepp, L. Tõnisson, H. Õunapuu
2006	M. Sõrg (Chairman), R. Eamets, A. Lipstok (until 08.07), E. Listra, M. Opmann, T. Palts, J. Sepp, L. Tõnisson, H. Õunapuu
2007	M. Sõrg (Chairman), R. Eamets, E. Listra, M. Opmann, T. Palts, J. Sepp, L. Tõnisson, H. Õunapuu
2008	M. Sõrg (Chairman until 13.06), J. Männik (Chairman since 13.06), R. Eamets, E. Listra, M. Opmann, T. Palts, J. Sepp, L. Tõnisson, H. Õunapuu
18.02.2009	J. Männik (Chairman), K. Kallo, I. Kull, J. Ligi, E. Listra, T. Palts, L. Tõnisson, U. Varblane

CHRONOLOGY[1]

FUNDAMENTALS OF THE ESTONIAN MONETARY SYSTEM AND ITS DEVELOPMENT DURING REINDEPENDENCE

Pursuant to Section 111 of the Constitution, Eesti Pank bears responsibility for currency circulation along with maintaining the stability of the national currency. In addition, the central bank's mission has been phrased pursuant to this heavy responsibility: to guarantee price stability in Estonia. A stable price level offers both companies and individuals a sense of security, thus enabling them to plan their savings, consumption and investment behaviour over a long period. A stable currency is the foundation of a community's successful long-term economic development.

In the Estonian monetary system, price stability is guaranteed by a stable exchange rate. The exchange rate is managed pursuant to the principles of the **currency board**. The exchange rate of the Estonian kroon is pegged at 1 euro = 15.6466 kroons.[2] The Estonian kroon is freely convertible; i.e., there are no restrictions on the free movement of capital.

The currency board is an automatic system based on stringent rules. In order to maintain the fixed rate of the Estonian kroon, the central bank's liabilities (incl. the monetary base in the economy) must be fully guaranteed by foreign exchange or gold reserves (see Figure 1). The Estonian currency board is not a separate institution but operates as a part of the central bank. Thus, it is not enough for Estonia to have foreign currency reserves only to back the monetary base (as is the case with some different currency boards), but all Eesti Pank's liabilities and given guarantees have to be covered by reserves too.

Eesti Pank operates independently from other state agencies. Under the currency board arrangement, the central bank is prohibited by law to directly or indirectly credit the central government and local governments. Pursuant to the Security of the Estonian Kroon Act, Eesti Pank has no right to devaluate the exchange rate of the kroon.

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[1] The current chronology largely overlaps with the chronology published in the Eesti Pank Annual Report 2008 but excludes some topics covered in the Annual Report and, in some parts, provides more details.

[2] This is equivalent to the exchange rate of the Estonian kroon to the German mark (1 mark = 8 kroons) established by the monetary reform of 1992.

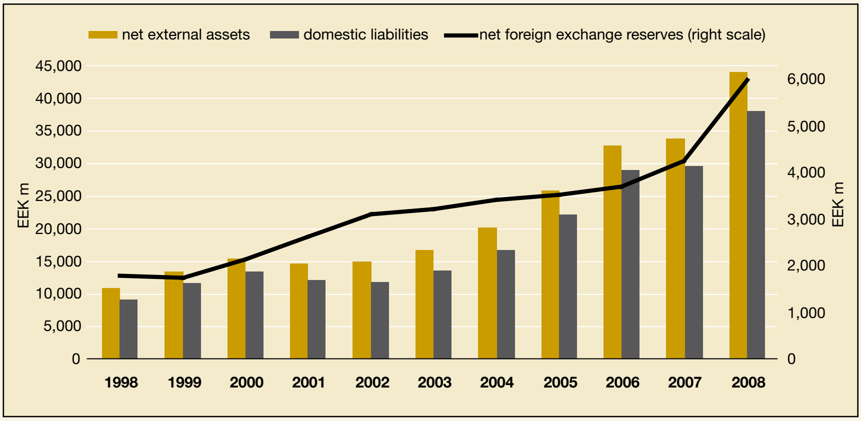

Figure 1. Net external assets, domestic liabilities and net foreign exchange reserves of Eesti Pank

What is a currency board?

Despite the relative diversity of modern currency board systems they usually have three common characteristics:

- a fixed exchange rate against the anchor currency;
- currency board obligations – cash and deposits – are fully covered by interest-bearing and high-quality foreign currency reserves;
- the currency is fully convertible for current as well as capital and financial account transactions.

Monetary policy instruments available to Eesti Pank

The **standing facility of buying/selling foreign currency (forex window)** and the **reserve requirement** for banks are Eesti Pank's key monetary policy instruments. The forex window was created to provide sufficient kroon liquidity to banks. The reserve requirement was established to regulate the liquidity reserves of the financial system.

Because of the fixed exchange-rate system, the Government's fiscal policy plays an essential role in stabilising the Estonian economy. A conservative and balance-oriented budgetary policy is thus vital to ensure the sustainability of the economy. An important precondition for the smooth operation of the currency board is the flexibility of the non-financial sector, especially the labour market. As the exchange rate is fixed, the economy cannot be balanced by exchange rate changes. Therefore, adjustments have to take place in the non-financial sector – in wages and prices.

Reserve requirement and excess reserves (deposit facility)

The reserve requirement for banks was established to regulate the liquidity reserves of the financial system. In a currency board arrangement, a sufficient liquidity reserve is the best means of hedging the liquidity risks of the settlement system and the entire financial system. Compared to other frameworks, the currency board thus gives a much greater weight to the Estonian reserve requirement instrument, which slightly helps to compensate for the lack or limited nature of other instruments.

For these reasons, in Estonia the reserve requirement rate applied under the currency board conditions – currently 15% – is higher than in other EU Member States. Reserves deposited with Eesti Pank are subject to the deposit interest rates of the European Central Bank (ECB) in order to reduce the negative impact of the high reserve requirement rate on the structure of financial intermediation, the interest margin and service charges, and to adapt the operational framework of monetary policy more to the market. In order to create a larger buffer for daily settlements that would help banks reduce the liquidity risk and stabilise the interest rates on the interbank money market, the fulfilment of the reserve requirement is based on the principle of monthly averaging.

To reduce potential market distortions while maintaining large liquidity buffers, foreign assets can be used to meet the reserve requirement. It makes no essential difference from the liquidity aspect whether the reserve requirement is met by kroon deposits or high-quality and liquid foreign assets. This also decreases market distortions, since a part of the reserve requirement is met by market instruments. Accepting foreign assets as a means of meeting the reserve requirement also helps to reduce the minimum reserve level of kroons quite easily, while maintaining sufficient liquidity buffers.

Eesti Pank's forex window

In Estonia's monetary system based on the currency board arrangement, the liquidity of banks is mainly managed via a standing facility of buying/selling foreign currency. Credit institutions holding a licence to operate in Estonia may, according to the applicable procedure,[3]

[3] Decree No. 5 of 14 March 2002 of the Governor of Eesti Pank, "Procedure for exchange transactions between Eesti Pank and credit institutions operating in Estonia".

enter into unlimited buying and selling transactions with Eesti Pank regarding the Estonian kroon and foreign currencies (currently ten different currencies). In addition, Eesti Pank may enter into buying and selling transactions with credit institutions regarding any other currencies officially quoted by Eesti Pank and the Estonian kroon or two different foreign currencies officially quoted by Eesti Pank. Banks have the facility to sell securities to Eesti Pank for kroons.[4] So far, the banks have not used that option.

To maintain the high liquidity of the Estonian kroon and facilitate the free movement of capital, there is no difference in the buying and selling rates being applied to transactions regarding the Estonian kroon and the euro. Transactions between the Estonian kroon and the anchor currency – the euro – are performed by Eesti Pank and credit institutions at the rate quoted by Eesti Pank (1 euro = 15.6466 kroons). The absence of exchange rate differences eases the creation of foreign currency liquidity buffers (and using the inclusion of foreign assets to meet the reserve requirement), stabilises interest rates on the Estonian loan market and reduces the role of the domestic interbank market. For foreign banks, the lack of a rate difference simplifies the acquisition of funds from the parent bank. Transactions with any other currencies are made based on the market rates of these currencies and the exchange rate of the Estonian kroon to the euro.

Transactions in the forex window determine the monetary base or money supply in the economy. As money supply changes, an equivalent change occurs in the central bank's foreign exchange reserves. The central bank does not establish monetary policy interest rates or otherwise manage the money supply. Under the currency board arrangement, Eesti Pank can theoretically lend money to credit institutions only from reserves in excess of the assets backing the kroon.

THE DEVELOPMENT OF THE MONETARY POLICY FRAMEWORK DURING THE PERIOD OF REINDEPENDENCE

1992: CREATING A MODERN MONETARY AND BANKING SYSTEM

The time preceding and following the monetary reform of 1992 was difficult both for the Estonian economy and financial system. The central bank's foreign exchange reserves only amounted to 2.5 billion kroons, of which the liability-free reserve contributed about 590 million kroons. The average monthly wage slightly exceeded 1,000 kroons and the

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[4] Regulation No. 15 of 29 December 2000 of the Governor of Eesti Pank, "Procedure for securities transactions between Eesti Pank and Estonian credit institutions".

inflation rate shot to 1,077% in 1992. The banking framework needed adjustments and a legal framework for market economy circumstances had to be created.

On 17 June 1992, the Supervisory Board of Eesti Pank decided to set a 15% **reserve requirement** rate for banks on all demand, time, and savings deposits. The requirement was applicable to **banks that no longer used the account plan enforced by the former State Bank of the USSR**. A separate reserve requirement was applied to the Savings Bank (Hoiupank). (With minor changes this system remained operational until the middle of 1994.)

On 18 June 1992, **guidelines for foreign exchange transactions** between Eesti Pank and licensed banks, new foreign exchange import and export regulations, and a number of other documents concerning foreign exchange transactions were approved by the decision of the Supervisory Board of Eesti Pank.

On 20 June 1992, the **monetary reform** was carried out.

By the directive of Eesti Pank, the official exchange rate of the Estonian kroon against the German mark was fixed at 1 EEK = 0.1250 DEM; i.e., 8 EEK = 1 DEM.

On the day of the monetary reform the **Foreign Currency Act**, the **Currency Act**, and the **Security of the Estonian Kroon Act** of the Estonian Republic took effect.

1992–1994: GUARANTEEING STABILITY AND DEVELOPING TRUST IN THE MONETARY SYSTEM

First years after the monetary reform

In the first years after the monetary reform the key goals were to **create a stable financial environment** and **develop trust in the financial system**, which had been severely damaged by the excessive inflation and banking crisis at the beginning of the 1990s. Guaranteeing stability was also necessary to ensure that the developing banking system would meet the requirements of the market economy.

1993

In January 1993, Eesti Pank launched **a short-term money market project**. **This** gave the banks an opportunity to offer their short-term liquidity excesses on the market and obtain short-term loans from other banks in case of need. The aim of this project was apparently to also reduce the unfounded hopes of being financed by the central bank that was so commonplace in the banking culture of the preceding decades.

To boost trust between banks, Eesti Pank started issuing **28-day discounted certificates of deposits** with a nominal value of 100,000 kroons. They were first sold at biweekly auctions. The certificates gave the banks an opportunity to perform fully guaranteed secondary market transactions and boosted the development of the interbank money market and mutual trust.

1994

The final abolition of restrictions on foreign currency transactions

The system of legal acts regulating foreign currency transactions that took effect along with the monetary reform (including restrictions on capital account transactions, foreign currency import and export restrictions, the prohibition of exchanging non-convertible foreign currencies, the registration requirement of foreign loans, etc.) was gradually relaxed and was completely abolished in 1994. In the summer of 1994, Estonia made a commitment not to apply foreign exchange restrictions pursuant to Article VIII of the Statutes of the International Monetary Fund. Estonia was one of the first transitional countries in Eastern and Central Europe that eliminated the restrictions on the free movement of capital.

In February 1994, the restrictions on the German mark's open position of commercial banks were abolished.

In March 1994, the Riigikogu repealed the Foreign Currency Act, thus abolishing the last formal restrictions on foreign currency transactions and also allowing private residents to open foreign currency accounts.

Measures to boost the efficacy and reliability of the monetary system

In order to increase trust in the Estonian kroon and minimise speculation concerning the potential devaluation of the kroon, on **4 April 1994, Eesti Pank started selling futures and swaps of the Estonian kroon and German mark with maturities of up to seven years**. These transactions ceased in March 1995, when the need for such instruments disappeared.

Amending the calculation and usage procedures of the reserve requirement in July 1994 gave banks an **opportunity to also include cash in Estonian kroons among their required reserves** in the amount of up to 50% of the total required reserves.

1995–1998: THE STABILISATION AND DEVELOPMENT OF THE MONETARY POLICY ENVIRONMENT

In 1995–1998, the rigidly fixed exchange rate of the Estonian kroon to the German mark spread the stability of international prices to the Estonian economy. Three processes played a crucial role in the development of the monetary policy environment: the continuing inflow of foreign capital, exchange rate changes in major currencies and the impact of the interest rates of the German mark on the interest rate of the Estonian kroon.

1995

With the stabilisation of the monetary policy situation, the need for Eesti Pank's **future and swap transactions** initiated in 1994 waned. Having started to limit the performance of these transactions at the end of 1994, **the execution of new transactions stopped in March 1995**.

1996

Commencing TALIBID/TALIBOR quotations

On 9 January 1996, the TALIBID/TALIBOR quotation regulations were approved.

Major conceptual changes in the operational framework of monetary policy

In the middle of 1996, Eesti Pank made several significant changes to the operational framework of monetary policy in order to boost the credibility and transparency of monetary policy, reduce the systemic financial risk stemming from the expansion of the financial sector and strengthen the liquidity system.

On 1 July 1996, the constant reserve requirement of banks was replaced by the **obligation to maintain the balance of a settlement account in Eesti Pank at a required level based on monthly averaging**. Thus, banks got a much greater monetary base buffer for daily settlements. This helped to reduce the liquidity risk and stabilise the interbank money market interest rates. In order to discipline the liquidity management of banks, 20% of the reserve requirement still remained in effect on a daily basis and this could be used only for interest penalties.

The share of cash used in fulfilling the reserve requirement was reduced to 40% of the reserve requirement.

On 1 July 1996, Eesti Pank abolished the purchase and selling rate difference in the transactions performed between the Estonian kroon and the German mark. The earlier minor exchange-rate difference mostly hindered short-term interest-rate arbitration due to greater transaction costs. As the backdrop of progressing integration, such transaction cost reductions helped to increase the currency turnover of the banking system – in December 1997, the monthly turnover of currency transactions exceeded that of June 1996 by 14 times.

In order to give banks an additional stimulus to stabilise the monetary base demand, in the second half of 1996 Eesti Pank **started offering banks a standing deposit facility** for the first time. In order to avoid market disturbances and increase the reliability of the currency board, the interest rate paid on the banks' account surplus at the end of the month was less than the Estonian money market interest rate and was linked to the discount rate of the Deutsche Bundesbank.

1997

Eesti Pank's measures to strengthen the liquidity system

In 1997, several hazards accompanying the rapid economic expansion emerged in the macroeconomic environment. The growth rate of the money supply (except cash) was relatively high; in addition, the investments of banks in domestic loans and other equal debt instruments grew quickly. This created a need to adjust the monetary policy framework. Hence, Eesti Pank adopted several measures to strengthen the liquidity system. Considering the great inflow of foreign capital, as of 1 July 1997, **the sums by which the loans of banks obtained from foreign credit institutions exceeded the sums deposited in them were included in the reserve requirement calculation base**.

In November 1997, a **temporary additional liquidity requirement** of 2% (3% in December) of the reserve requirement calculation base was imposed on banks.

In order to stabilise the banks' intra-month kroon liquidity and reduce potential settlement risks, on 1 November Eesti Pank raised the **daily reserve requirement from 2% to 4% of the calculation base. Additionally, the penalty interest rate applied upon failure to meet the reserve requirement rose to 20%**.

On the other hand, the interest rate paid on the deposits exceeding the minimum reserve requirement was also raised to the discount level of Deutsche Bundesbank (since January 1999, the reference interest rate is the European Central Bank's deposit interest rate).

1998

Until autumn 1997, the interest rate level steadily converged with German interest rates, especially the short-term rates. This trend was disrupted by the instability of global financial markets caused by the Asian crisis. The Asian and Russian crises hindered the capital flows invested in developing markets and in many countries shook the trust of foreign investors. Due to the monetary system being based on the currency board arrangement and the small scale of our money market, the short-term interest rates in Estonia responded swiftly to the changes in foreign capital flows and speculative attacks on the kroon, as the central bank did not interfere directly with the liquidity and interest rate developments in the money market. **At the end of 1997 and in August 1998, the currency board system proved its ability to persevere in an unstable economic environment.**

The rapid economic expansion and hectic growth of money and loan aggregates in 1997 was followed by a slight stabilisation in 1998 and, during the second half of the year, **a significant toughening of the economic environment**. External demand dropped, and so did foreign funding and loan supplies that had become so customary during the past period. The increases in the interest rates stemming from limited loan resources caused an increase in real interest rates along with a faster drop in inflation.

Measures for increasing domestic liquidity buffers

As an additional measure to increase banks' liquidity buffers and limit loan growth, in August-September 1998, Eesti Pank extended its reserve requirement calculation base by the sum in which banks have granted guarantees to financial institutions and non-resident credit institutions.

Considering the falling demand for cash and a need to increase settlement system buffers, on 19 June Eesti Pank reduced the banks' inclusion of cash in meeting the reserve requirement from 30% to 20%.

From 1 September, the **financial collateral** given to financial institutions and non-resident credit institutions were also fully included in the reserve requirement calculation base.

New TALIBID/TALIBOR quotation principles

On 1 September 1998, the quotation principles of the interbank money market interest rates were changed. Eesti Pank started calculating TALIBOR and TALIBID based on the quotations of three banks (Hansapank, Eesti Ühispank and Eesti Forekspank) for monthly, three-month and six-month periods. The weekly quotation and the restriction on the loan and deposit interest margin for the same period were abolished. The sum in which quoting banks were obligated to receive deposits or grant loans according to their quotations was increased from 1 million kroons to 10 million. TALIBID/TALIBOR quotations continued to be updated once a week.

1999–2004: PREPARATIONS FOR JOINING THE EUROPEAN UNION

The economic policy goals of 1999–2004 were a stable macroeconomic environment, steady confidence in the currency board and successful preparations for joining the European Union. The efficiency of the Estonian monetary and banking policy was proved by the fact that despite international crises all the international ratings given to Estonia in 1998 remained unchanged.

During 1994–2004, Estonia developed from an EU candidate country to an accession country and finally became a Member State. One of the entities responsible for the accession negotiations was Eesti Pank. The central bank had a significant role in preparing the issues addressed in chapters regarding the free movement of services and capital, the Economic and Monetary Union, institutions and statistics.

In 2002, the European Central Bank (ECB) sent an invitation to the central banks of candidate countries (incl. Eesti Pank) to participate as observers in the work of the ECB General Council and the committees of the European System of Central Banks as of the signing of the Treaty of Accession to the European Union. The non-voting observer status lasted until the Treaty of Accession took effect.

In December 2002, the European Union sent an official accession invitation to ten candidate countries. The Treaty of Accession was signed in Athens on 16 April 2003 and entered into force on 1 May 2004.

At the referendum on joining the European Union held in Estonia, 66.9% of voters favoured accession to the EU.

1999

Changes related to the beginning of the third stage of the Economic and Monetary Union

Due to the start of the third stage of the Economic and Monetary Union, on 1 January 1999, the currencies of 11 European Union states, including the anchor currency of the Estonian kroon (the German mark), were irreversibly bound to each other and the single European currency, the euro, was adopted.

On 31 December 1998, Eesti Pank fixed the exchange rate of the Estonian kroon at 1 euro = 15.6466 kroons. This equals the official exchange rate of the Estonian kroon against the German mark (1 DEM = 8 EEK).

In 1999, a new procedure for currency exchange transactions between Eesti Pank and credit institutions operating in Estonia took effect. Eesti Pank started performing purchase and sales transactions with banks operating in Estonia between the euro and Eesti kroon, and the national currencies of the euro area countries (a parallel currency system remained in effect for a while after the adoption of the euro) and the Estonian kroon without a price spread. The list of currencies in which Eesti Pank performed purchase and sales transactions with banks included all the national currencies of the euro area countries.

On 1 January, Eesti Pank started applying the European Central Bank's deposit interest rate instead of the discount rate of the Deutsche Bundesbank on banks' monthly average balance of settlement accounts in excess of the monthly reserve requirement.

Remuneration for required reserves and the central bank's profit distribution strategy

Since 1999, the stabilisation of international financial markets and waning tensions in Estonia's real economy and monetary environment enabled it to concentrate more on long-term strategic questions in monetary policy.

As of 1 July 1999, Eesti Pank started **remunerating all the funds deposited by credit institutions in the settlement accounts of the central bank**. Earlier, the central bank paid interest only on deposits exceeding the reserve requirement minimum.

In September 1999, the Supervisory Board of Eesti Pank approved **the central bank's profit distribution strategy** for three years. The strategy's monetary policy was based on the principle of avoiding an excessively rapid decrease of Eesti Pank's own capital and net foreign exchange reserves against key economic indicators before Estonia joined the Economic and Monetary Union. The Supervisory Board relied on the fact that the central bank's profit distribution principles should also support the key monetary policy goals in the future and that the distribution of profit should by no means hinder the guaranteeing of the monetary system's stability.

Daily quotations of TALIBID and TALIBOR

On 8 February 1999, **the TALIBID and TALIBOR quotation regulations were changed**. Eesti Pank started fixing the TALIBOR and TALIBID rates every working day at 11 a.m. The quoting banks also included Merita Bank Plc and Svenska Handelsbanken. The quotations of TALIBOR and TALIBID were now calculated as an arithmetic average of quotations, excluding the highest and lowest quotations. Two quotation periods were also added: nine and twelve months. In addition, the obligation of quoting banks to grant loans or accept deposits within their quotations was abolished.

2000

Reforming the monetary policy operational framework

On 25 April 2000, the Supervisory Board of Eesti Pank approved the **reform strategy of the operational framework of the Estonian monetary policy**, which prescribed a thorough rearrangement of the credit institutions' required reserve system. The most immediate goal of the reform was to guarantee the smooth operation of the pegged exchange rate within the currency board arrangement and reduce market distortions. In the long-term, this was the first step in the gradual harmonisation of the Estonian monetary policy framework with that of the euro area.

The beginning of the first reform stage, aimed at updating the liquidity system, was marked by Eesti Pank's **decision to cease arranging the auctions of certificates of deposits** as of 20 May 2000. (The certificates had served their initial purpose – to foster the development of the kroon's money market. However, due to the more efficient liquidity management of banks and the increased volume of the money market, this instrument with severe interest rate and volume restrictions was no longer suitable for balancing the seasonal deviations of the money market.)

On 1 July 2000, **the additional liquidity requirement was united with the banks' reserve requirement**. The latter increased from 10% to 13% on account of the abolition of the additional requirement. With this decision, a common legal framework and penalty mechanism was created for all the reserves kept in the central bank. (The remuneration for all reserves since 1 July 1999 had made different types of reserve requirements pointless; meanwhile, the penalty for failure to fulfil the additional liquidity requirement – the application of a triple reserve requirement during the next month – became useless in a stable environment.)

2001

Rendering the reserve requirement system more market-based

As of 1 January 2001, banks were **permitted to fulfil up to 25% of their reserve requirement with high-quality liquid foreign assets**. On 1 July 2001, the inclusion limit of foreign assets rose to 50% of the reserve requirement.

2002/2003

Converging the calculation of the Estonian reserve requirement base to the Eurosystem's framework

In 2002, Eesti Pank prepared the technical changes applied in March 2003 to harmonise the calculation of the reserve requirement base with the Eurosystem's framework (the Supervisory Board of Eesti Pank adopted this decision on 31 October 2002). Besides the **harmonisation of balance sheet items** included in the reserve requirement base, the changes also entailed the application of the principle of due date calculation: liabilities were now **categorised in terms of maturity structure** (maturity over or under two years) and **type**. In similar fashion to the Eurosystem, Estonia also basically adopted two reserve requirement rates: **the general rate** for liabilities with maturities of up to two years and a **special rate** for liabilities with longer maturities and repurchase transactions.

Eesti Pank also emphasised that the preparations for harmonising the monetary policy framework with that of the euro area are continuing, but that they primarily proceed from Estonia and the European Union's economic situations. The goal is to avoid monetary policy steps that contradict the economic environment.

New procedures for currency transactions

In 2002, new procedures for buying and selling foreign currency between Eesti Pank and credit institutions operating in Estonia came into force, based on which US dollars, Australian dollars, euros, Japanese yen, Canadian dollars, Norwegian krones, Swedish kronas, British pounds sterling, Swiss francs and Danish krones could be bought and sold for Estonian kroons.

2004

Further changes in the reserve requirement system

In March 2004, several changes in the reserve requirement system took effect, rendering it more market-based and converging it towards the Eurosystem.

Since 1 March 2004, **high-quality debt securities with floating rates were included among the suitable foreign assets that can be used to** meet the reserve requirement.

Banks **could no longer take their cash into account to fulfil the reserve requirement**. (In the Eurosystem, banks' cash is also not regarded as a part of their required reserves.)

Measures to hedge risks related to the rapid growth in loan volume

In 2004, Eesti Pank repeatedly drew the attention of the public, financial sector and the Government to the risks accompanying the rapid growth in loan volumes.

Due to the hectic growth of loan volumes and the extensive current account deficit, in 2004 Eesti Pank retained both the specific and general rate of the reserve requirement at 13%, while the general rate in the euro area was 2% and the specific rate 0%.

Together with Eesti Pank, the Government reviewed the national support policy of the housing loan market. As a result of this, the role of KredEx in fostering the availability of housing loans was specified.

Estonia joined the European Exchange Rate Mechanism (ERM II) on 27 June 2004.

2005–2007: FIRST YEARS AS A MEMBER OF THE EUROPEAN UNION

2005

In 2005, Estonia's average annual inflation rate reached 4.1%. In the context of converging income levels, the 3.4% rise in consumer prices accompanying the rapid – and, considering the increase in labour productivity, also balanced – economic growth could be regarded as natural. Nevertheless, Eesti Pank frequently drew the attention of the public, financial sector and the Government to the external and domestic risks threatening the balanced development. By external risks, the central bank mainly meant the developments related to the global rise in oil prices. As regards domestic risks, the central bank emphasised the **need to monitor the proportion of supply and demand across sectors**, both in the labour and services markets. **One of the key issues for the central bank was the ongoing rapid growth of the household debt burden.** In December 2005, Eesti Pank decided to take measures to tighten the legal framework related to housing loans.

2006

Measures for managing threats stemming from strong domestic demand

In 2006, the central bank mainly focused on **managing the threats stemming from strong domestic demand**. Eesti Pank repeatedly drew the public's attention to the hazards related to excessively optimistic consumption and loan behaviour.

Amendments to banking regulations took effect in March 2006 with an aim to reduce the risks related to housing loans (see also "The legal framework and regulation of banking").

However, as these changes did not diminish the risks enough, **Eesti Pank decided to raise the reserve requirement of banks from 13% to 15% on 1 September 2006. With this decision, the central bank also sent a clear message about the severity of the overheating threat to the economy.**

2007

In 2007, domestic demand in Estonia started waning rapidly, the growth in loan volumes halted and wage growth began decelerating. Towards the end of the year, the external balance also started improving. Meanwhile, price rise pressures strengthened remarkably during the year and the growth in wages continued to exceed that of productivity. Thus, the points of emphasis significant for monetary policy shifted during the year.

Considering the persistent great economic imbalances and high inflation, the **reserve requirement rate remained unchanged at 15% despite the slowdown in the growth in loan volumes**.

At the beginning of 2007, the **daily minimum requirement of the settlement account** that had so far been included in the reserve requirement calculation was abolished, the penalty interest for the failure to fulfil the reserve requirement was updated and the procedure for the enforcement of the reserve requirement amendments was specified.

THE LEGAL FRAMEWORK AND REGULATION OF BANKING

FROM THE BEGINNING OF REINDEPENDENCE UNTIL THE MONETARY REFORM IN 1992

Eesti Pank was re-established under the Soviet regime pursuant to the **Bank Act of Soviet Estonia** adopted in December 1989. (The central bank operated pursuant to this Act until June 1993 and the commercial banks until January 1995.) During the period preceding the monetary reform and even later, the banks adhered to the norms and account plan enforced by the State Bank of the USSR.

1992–1994: MODERNISING AND ORGANISING THE BANKING SYSTEM

The transition to new reporting regulations and prudential norms complying with market economy conditions started in the first half of 1993. This process was urgent, because according to the reporting review of seven major commercial banks conducted by the auditing company **Price Waterhouse** in cooperation with the banking supervision personnel within the PHARE aid scheme, the asset risk level of Estonian commercial banks was relatively high. Eesti Pank emphasised that the actual risk level of assets should also be reflected in the reporting of banks.

During the first years following the monetary reform, the underdeveloped legal environment was a major problem for Estonian banking supervision; the lag in preparing legal acts concerning the general arrangement of the economic environment was especially crippling. Until the end of 1994, Estonia lacked a proper modern Accounting Act and a Commercial Code (the Accounting Act took effect on 1 January 1995; the Commercial Code was proclaimed by the President of the Republic of Estonia on 8 March 1995). The minimal norm base to monitor the operation of investment funds was created by the regulations of the Ministry of Finance only towards the end of 1994. The retardation of the general economic regulatory environment compared to banking regulations significantly restricted the legal opportunities of banking supervision authorities to demand adherence to modern risk management. The outdated accounting regulations also hindered the objective assessment of the data presented in the banks' reports.

The culmination and end of this period was the enforcement of the modern Credit Institutions Act in January 1995.

1993

On 1 January 1993, new reporting procedures were laid down for Estonian banks, replacing the former reporting regulations of the State Bank of the USSR. The old reporting procedures were based on the principles of socialist planning and did not reflect the actual financial situation of the banks. In practice this meant that banks interpreted the balance sheet requirements differently, which made the comparison of data difficult.

On 16 February 1993, the **procedure for the establishment, operation and liquidation of savings and loan associations** was adopted by the decision of the Supervisory Board of Eesti Pank.

On 11 May 1993, new stricter requirements were prescribed for the minimum size of banks' share capital.[5]

The **Eesti Pank Act** entered into force on 18 June 1993.

As of **1 July 1993, new prudential norms** were prescribed for banks: the solvency rate, liquidity rate and the risk concentration limit of customers and banks. Their elaborators took into account the development level of Estonian banking as well as the norms of the European Union.

To reduce the currency risk a **limit was set on the net foreign exchange position** – the ratio of the difference between the foreign currency assets and liabilities of a bank and the transactions performed on agreed dates (for which money has yet to be transferred) to the bank's equity capital. The limit of the total open net foreign exchange position of the banks was 30%, including up to 10% with some currencies and 250% in the case of the German mark (since February 1994, the position of the German mark has been free).

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[5] Share capital had to reach 15 million kroons as of 1 April 1995, 25 million as of 1 April 1996, and 35 million as of 1 April 1997. The decision on establishing commercial and cooperative banks adopted during the Soviet regime stated that share capital had to amount to at least 5 million roubles in commercial banks and 1.5 million roubles in cooperative banks. The Supervisory Board of Eesti Pank laid down 5 million roubles as the minimum of the statute funds of commercial banks through its decision of 19 February 1990. In essence, the Soviet norms were retained. In the meantime, hyperinflation had made 5 million roubles a ridiculously small sum for banks, raising the minimum capital rate to 6 million Estonian kroons (through the Supervisory Board's decision of 7 October 1992) and laying down the schedule for further increases in 1993 was certainly justified.

1994

At the beginning of 1994, the **write-off procedure of uncollectible loans** was specified. Loans with a repayment due date exceeding 150 days had to be written off from the loan risk reserve. If this did not suffice, the sums had to be written off as the unrealised loss from revaluations. In essence, this was the first step to obligate banks to revaluate their assets.

In February, the calculation of the net foreign exchange position was changed. The most important part of the change was the **total abolishment of restrictions on the open position of the German mark**, which emanated logically from the monetary and exchange rate policy of Eesti Pank.

The Supervisory Board of Eesti Pank laid down **due dates for banks to reach the minimum amounts of own funds** through its decision of September 1994: 1 January 1996 – 50 million kroons; January 1997 – 60 million kroons; 1 January 1998 – 75 kroons. The aim was to strengthen the banks' capital base and foster intra-system consolidation, which would enable banks to fulfil the role of financial intermediaries more efficiently.

In order to avoid excessive risk concentration and decrease potential conflicts of interests, in September 1994, the **maximum allowed liabilities of a client or related parties were reduced from 50% to 25% of the own funds of credit institutions. Additional norms were also established for the so-called internal interest groups.**[6]

The legal base of banking and banking supervision was strengthened by the adoption of the **Credit Institutions Act** in December 1994 and its enforcement in January 1995. The Act was prepared on the basis of the legal acts of European Union Member States banking, but also took the development level of Estonian banking into account.

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[6] Subdivisions of credit institutions, the liabilities of parent companies and other subdivisions of parent companies could not exceed 20% of the own funds of credit institutions; the liabilities of the members of the management board or other employees of credit institutions, shareholders representing a share capital of 5% or more or representing votes, and also the liabilities of companies related to them could not exceed 20% of the own funds of credit institutions. The loan portfolios of banks had to be harmonised with the new requirements by 1 January 1996.

1995–1998: IMPROVING THE CRISIS RESISTANCE OF THE FINANCIAL SYSTEM AND FURTHER COORDINATION OF BANKING

The enforcement of the Credit Institutions Act in January 1995 entailed a need to amend the prudential norms and related reporting procedures. The capital adequacy calculation rules were thoroughly changed (market risk was included) and Tier 3 was added to the calculation.[7] All prudential norms were also applied in consolidated calculations. Meanwhile, the risk concentration rules, currency risk calculation and the reporting of off-balance-sheet items were also amended. Liquidity reporting changed significantly and investment reporting was added.

The security of information systems became one of the key goals of supervision, because the rising popularity of ATMs and the introduction of telebanking and Internet banking required increasing attention to guaranteeing high-level data protection. Thus, the obligation to perform information technology audits of and specific requirements for the information systems of credit institutions were imposed.

Procedural requirements were laid down for credit institutions to prevent money laundering.

At the end of this period the legislation applied to Estonian credit institutions was generally similar to that of more developed countries and the comparability of indicators was guaranteed. The next goal was to bring the legal framework of Estonian banking into compliance with the requirements of the European Union.

1995/1996

At the beginning of 1996, **new guidelines for the calculation of prudential norms and reporting procedures of credit institutions** took effect. The regulations on capital adequacy and risk concentration were thoroughly updated, liquidity reporting changed significantly and investment reporting was introduced.

By the Decree of the Governor of Eesti Pank, in May 1996, the **diligence and procedural requirements of credit institutions upon the application of provisions pertaining to the prevention of money laundering** took effect. (Adding a chapter

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[7] Own funds to cover the market risks of trade portfolios.

on the prevention of money laundering in the version of the Credit Institutions Act that entered into force at the beginning of 1995 was the first step in creating the framework for combating money laundering.)

1997

Of the changes that took place in 1997, the most important one was increasing **the capital adequacy minimum from 8% to 10%** on 1 October 1997.

In July 1997, the risk weight applied to Estonian local governments and their secured exposures was increased from 50% to 100%.

In October 1997, the **obligation to perform information technology audits** and the general requirements for the information systems of credit institutions were laid down.

In order to increase the liquidity of credit institutions, at the end of the year an **additional liquidity requirement** was imposed on them (remaining valid until the end of 1999). The additional liquidity requirement supplemented the reserve requirement framework, which was also developed further during that period (see also "The development of the monetary policy framework during the period of reindependence").

1998

In April 1998, the Riigikogu passed the Deposit Guarantee Fund Act, which laid the foundation for the deposit guarantee system of Estonia. This Act entered into force in October 1998. Pursuant to the Act, a fund had to be created to guarantee the payment of deposits in the amount of and according to the procedures prescribed by law in case of a credit institution's insolvency. Upon the enforcement of the Act, the deposits of both natural and legal persons were guaranteed in the amount of 20,000 Estonian kroons per depositor. The final deposit guarantee sum – ECU 20,000 – was to be reached within 15 years. (The Deposit Guarantee Fund operated until the foundation of the Guarantee Fund in 2002.)

In November 1998, the Riigikogu passed the Money Laundering Prevention Act, by which the respective provisions of the Credit Institutions Act were repealed. Pursuant to the Money Laundering Prevention Act, besides credit institutions the obligations to prevent money laundering were also extended to financing institutions, including insurance companies, investment funds and professional participants in the securities market.

The major changes of 1998 regarding the prudential norms were **the inclusion of market risk in calculating the capital adequacy indicator, the adoption of Tier 3 capital and the enforcement of prudential norms on a consolidated basis**.

The **currency risk calculation** previously applied was updated, prescribing 15% of net own funds as the limit on the joint position of the German mark and Estonian kroon, in similar fashion to all other A-zone currencies.[8]

The **reporting of off-balance-sheet items** was updated.

In 1998, an action plan to have completed preparations for the "Readiness for 2000" by mid-1999 was elaborated.

The halt in the exceptionally fast growth of the banks' balance sheet totals and the sudden plunge of the stock market at the end of 1997 caused serious problems for banks and led to extensive operational losses by the end of 1998. **An analysis of the events showed that this largely emanated from the drawbacks in the general management and internal control of banks.** The results of the analysis were reflected in the new Credit Institutions Act which was passed and entered into force in 1999.

1999–2004: DEVELOPING THE OPERATION ENVIRONMENT OF THE FINANCIAL SYSTEM BEFORE JOINING THE EUROPEAN UNION

Due to the perspective of acceding to the European Union and the improvement of international banking contacts, the priority of this period was to **harmonise the legal acts of banking and supervisory methods with international standards**.

1999

On 9 February 1999, the Riigikogu passed the **new version of the Credit Institutions Act** which entered into force on 1 July. This new version complied with the requirements

[8] The currency limit of B-zone countries remained at 5% of net own funds, with the exception of Latvia and Lithuania at 10% of net own funds. Due to the adoption of the single currency of the European Union, the euro, since January 1999 a joint position was formed by the euro and the Estonian kroon (with the limit of 15% of net own funds).

of the EU directives regulating the operation and supervision of credit institutions and expanded the rights and authorisations of banking supervision in accordance with the internationally acknowledged requirements. Banking supervisors were granted greater rights to obtain information and inspect the banks and other companies of a consolidation group on-site. The impact of the new version on the development of the modern banking environment in Estonia was remarkable and it was followed by the enforcement of several important provisions of implementation:

- Reporting procedures for the liquidators of credit institutions, interim trustees of credit institutions and trustees in bankruptcy (May 1999);
- The new version of the prudential norms of credit institutions (July 1999);
- Procedure for the application for and granting of the licence for credit institutions and branches of foreign credit institutions and the list of documents submitted on applying for the licence (July 1999);
- Procedure for applying for the obtainment of a qualified holding in a bank and requirements for documents submitted upon applying for the licence (October 1999);
- Procedure for presenting data regarding the suitability of the managers of credit institutions and other personnel employed in the positions provided for in the Credit Institutions Act as well as the procedure for the declaration of the economic interests of these persons (October 1999);
- Public reporting procedures of credit institutions (October 1999).

2000

In order to improve the credit risk management of credit institutions and obtain a better overview of the quality of credit institutions' loan portfolios, loan structures, values and the risks therein, **minimum requirements of loan evaluations and the write-off procedures of uncollectible claims** were laid down for credit institutions.

At the beginning of 2000, the **procedure for the general risk reserve calculation** that had entered into force at the beginning of 1998 was repealed. It was concluded that considering the development of the banking sector's legal framework and the improvement of the internal risk management of credit institutions, the need for a restriction determined by an estimated risk reserve had expired.

2001/2002

In order to facilitate the monitoring of the new risks accompanying the development of banking and to adopt the updated EU directives, it became essential to amend the existing procedure for calculating the capital adequacy of credit institutions that had been in effect since 1999. The amendments of the Credit Institutions Act that were necessary to adopt the new framework were passed by the Riigikogu in autumn 2001 and the **new procedure for calculating capital adequacy** entered into force on 1 July 2002. The renewed framework was in complete compliance with the updated EU directives. The most important amendments concerned the opportunity to use **netting with instruments similar in terms of maturities and other features** in order to reduce credit risk exposure. In addition, the previously non-existent risk calculation of **commodities and their derivatives** was added.

In order to improve the security network of the financial sector and increase the confidence of small depositors and investors in the financial sector, a **Draft Act on the Guarantee Fund Act** was compiled in cooperation with the Ministry of Finance and Eesti Pank in 2001. The Riigikogu passed the Act at the beginning of 2002. The Guarantee Fund was founded in July 2002.

2003

The years 2001–2003 were characterised by a more extensive involvement of foreign funds by banks and increased household borrowing. Thus, Eesti Pank considered it necessary to adopt some measures and inform the public of the potential problems. **The Financial Supervision Authority and Eesti Pank reminded banks of the risks accompanying the rapid growth in loan volumes. They emphasised the need to inform clients of the risks accompanying borrowing** and to draw the clients' attention to the potential rise in loan servicing costs in the future.

Eesti Pank made a proposal to the Government to **review the existing state-offered instruments fostering household borrowing**.

In 2003, the consolidated estimation of the currency and market risks in the banks' capital adequacy framework was amended. **The possibility of netting positions reflecting market and currency risks between subsidiaries was abolished.**

2004–2007: INTEGRATION WITH THE BANKING FRAMEWORK OF THE EUROPEAN UNION

On the one hand, this period was characterised by Estonia's accession to the European Union and the resulting developmental leap; on the other hand, it was characterised by the beginning of an economic cooling and the first signs of insecurity in global financial markets. International cooperation in financial supervision became increasingly important.

A great conceptual change in the normative environment of banking was the adoption of the framework of prudential norms based on Basel II (the updated, more risk-sensitive procedure for calculating capital adequacy).

2004

In 2004, the changes in the legal acts of banking were primarily related to Estonia's accession to the European Union. The amendments to the Credit Institutions Act were related to the harmonisation of the directive on the winding-up and reorganisation of credit institutions; the procedures for applying for activity licenses and relations between the market participants and the Financial Supervision Authority were also specified. One of the key changes was the adoption of the **single EU activity licence principle** – in the case of a credit institution's branch operating in another Member State, the requirement for the application of an activity licence was replaced by a notification requirement.

Estonia's accession to the European Union also entailed changes in banks' prudential norms. Upon calculating credit and currency risk, **all new EU Member States were included among the countries bearing a lower risk; i.e., the A-zone countries**. The earlier 50% risk weighting laid down for local governments and investment companies was reduced to 20% in accordance with the EU directive.

2005

In October 2005, the Riigikogu passed the **Electronic Money Institutions Act**.

The most important amendment to banking regulations in 2005 was the increase **of the risk weighting applied to housing loans** from 50% to 100% upon calculating capital adequacy.

2006

In 2006, the transposition of the **new EU directive on the capital adequacy calculation to the Estonian legal framework** was completed. This meant extensive amendments to the existing Credit Institutions Act and the elaboration of a new decree on prudential norms. The decree of Eesti Pank established detailed rules for the calculation of capital adequacy pursuant to the new capital adequacy calculation framework. The key difference compared to the EU directive is that **in Estonia the general capital adequacy requirement for both credit and market risks has remained at 10%**.

2007

The procedure for the implementation and calculation of the prudential norms based on Basel II that had entered into force on 1 January the same year was amended at the end of 2007. Although the growth in loan volumes was falling rapidly and the ratio of the loan burden to the disposable incomes of households was stabilising, the risks related to the rapid growth in loan burdens still remained high. Thus, **in the procedure for implementing the prudential norms based on Basel II, Eesti Pank decided to apply a risk weighting of 60% on household loans** for the year **2008**.

APPENDIX

MAIN QUARTELY INDICATORS OF THE ESTONIAN ECONOMY as at 30 April 2009

	Unit	Period	Indicator	Change compared to the previous period (%)	Change compared to the same period last year (%)	Source
Gross domestic product *						SA
Current prices	EEK m	Q4 2008	60,973.4			
Constant prices	EEK m	Q4 2008	38,345.7	-2.6	-9.7	
Production						SA
Volume index of industrial production (at constant prices (2000 = 100)	%	Q1 2009		-20.3	-29.2	
Investments in fixed assets (at current prices)	EEK m	Q4 2008	9,312	8.6	-23.8	SA
Construction						SA
Construction activities of construction enterprises (at current prices)	EEK m	Q4 2008	13,137	-12.9	-17.0	
Usable floor area of completed dwellings	thousand m^2	Q1 2009	60.7	-40.9	-60.2	
Usable floor area of non-residential buildings	thousand m^2	Q1 2009	259.9	5.5	14.1	
Consumption						
Retail sales volume index (at constant prices, 2000 = 100)	%	Q1 2009		-18	-15	SA
New registration of passenger cars	tk	Q1 2009	4,598	-41.9	-66.1	ARK
Prices						
Consumer price index	%	Q1 2009		-1.3	3.1	SA
Producer price index	%	Q1 2009		-1.4	2.1	SA
Export price index	%	Q1 2009		-2.0	-1.7	SA
Import price index	%	Q1 2009		-6.3	-4.9	SA
Construction price index	%	Q1 2009		-4.1	-4.7	SA
Real effective exchange rate (REER) of the Estonian kroon	%	Q1 2009		1.9	3.5	EP
Labour market and wages						
Employment rate (based on the Labour Force Survey)**	%	Q4 2008	62.6	63.3	62.5	SA
Unemployment rate (based on the Labour Force Survey)**	%	Q4 2008	7.6	6.2	4.1	SA
Registered unemployed (according to the Labour Market Board)	persons per month	Q1 2009	46,734	77.0	182.2	TTA
% of population between 16 years old and pension age**	%	Q1 2009	7.2	4.1	2.6	TTA
Average monthly gross wages and salaries (health insurance benefits excluded)	EEK	Q4 2008	13,117	4.8	6.9	SA
General government budget (net borrowing not included here)***						RM
Revenue	EEK m	Q4 2007	25,768.0	1.3	21.6	
Expenditure	EEK m	Q4 2007	26,887.0	30.0	17.0	
Balance (+/-)**	EEK m	Q4 2007	-1,119.0	4,759.2	-1,804.7	
Period's revenue to the planned annual revenue**	%	Q4 2007	29.1	28.8	29.5	
Transport						SA
Carriage of passengers	thousand	Q4 2008	48,237	-1.9	-13.6	
Carriage of goods	thousand tons	Q4 2008	22,094	-0.9	-14.0	

	Unit	Period	Indicator	Change compared to the previous period (%)	Change compared to the same period last year (%)	Source
Tourism, accommodation						SA
Visitors from foreign countries received by Estonian travel agencies	thousand	Q4 2008	191.4	-43.3	-32.9	
Visitors sent to foreign tours by Estonian travel agencies	thousand	Q4 2008	118.6	-22.9	1.0	
Accommodated visitors	thousand	Q4 2008	480.2	-42.3	-2.0	
o/w foreign visitors	thousand	Q4 2008	282.4	-45.8	3.1	
Foreign trade (special trade system)						SA EP
Exports	EEK m	Q4 2008	31,789.2	-7.7	-3.1	
Imports	EEK m	Q4 2008	40,390.4	-7.9	-12.0	
Balance**	EEK m	Q4 2008	-8,601.1	-9,435.7	-13,062.7	
Foreign trade balance/exports**	%	Q4 2008	-27.1	-27.4	-39.8	
Balance of payments**						EP
Current account balance	EEK m	Q4 2008	-3,324.4	-4,612.2	-10,468.0	
Current account balance to GDP	%	Q4 2008	-5.5	-7.3	-16.4	
Foreign direct investment inflow	EEK m	Q4 2008	3,369.8	4,684.2	8,338.2	
Foreign direct investment outflow	EEK m	Q4 2008	-1,385.0	-2,903.6	-2,970.0	
International investment position						EP
Net international investment position	EEK m	Q4 2008	-193,431.0	-0.8	7.7	
Direct investment in Estonia	EEK m	Q4 2008	182,251.5	-2.2	2.8	
Net external debt	EEK m	Q4 2008	298,227.2	1.3	11.0	
o/w government	EEK m	Q4 2008	7,269.2	-6.9	110.6	
EEK/USD average quarterly exchange rate	EEK	Q1 2009	12.004	0.9	14.8	EP

* Preliminary estimation of the GDP growth has been calculated according to the new methodology. Whereas, Statistics Estonia previously calculated the GDP growth at the constant prices of fixed year 2000, since 2008 the growth is calculated by chain-linking method in which the year preceding the accounting period is applied as a base year.
** Instead of changes comparing to previous periods, absolute figures for the periods are shown by this indicator.
*** Net borrowing is not included here.

Source:
SA - Statistical Office of Estonia
ARK - Motor Vehicle Registration Centre
EP - Eesti Pank /Bank of Estonia
TTA - Labour Market Board
RM - Ministry of Finance
EKI - Estonian Institute of Economic Research