# FACTORS INFLUENCING THE FINANCIAL SYSTEM STABILITY ORIENTED POLICIES OF A SMALL COUNTRY SOON TO BECOME AN EU MEMBER – ESTONIAN EXPERIENCE[1]

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## Introduction

The efficiency of financial system is particularly important for Central and Eastern European countries where modern financial systems have been built up almost from scratch over the last decade. In line with the EU enlargement process the integration of Central and Eastern European countries' financial systems to the EMU has increasingly become a priority. The integration and flexibility of financial systems play an essential role in promoting full convergence and supporting economic stability within the monetary policy framework of the EMU. On the day a country accedes to the common currency area, its financial sector monetary policy transmission channels have to be very similar to those of the present Member States. This would ensure effective and full transmission of monetary policy signals of the European Central Bank (ECB).

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Now I would like turn to the factors influencing financial sector policies of a small country like Estonia, soon to become an EU member. This is the point of view of the country where banking sector forms more than 80% of the whole financial sector.

## The Role of a Central Bank in Ensuring Financial Stability

**Directly or indirectly, the ultimate goal of most central banks is price stability.** Regardless of the exact monetary policy regime under which price stability is targeted,

[1] The article is based on the speech the Governor of Eesti Pank Vahur Kraft made in the European Money and Finance Forum (SUERF) colloquium held on 12–14 June 2003 in Tallinn.

financial systems always have a crucial role in this process. On the one hand, stable and well-functioning financial systems themselves promote price stability via effective resource allocation. On the other hand, monetary policy can be successfully implemented only through an effective and well-functioning financial system.

Monetary transmission cannot be efficient if a weak financial system distorts interest rate signals by increasing margins or if financial markets have ceased to function because some of the participants do not trust others. This causality can also run in the opposite direction. Over the past decade we have, time and again, witnessed weak financial systems causing currency crises in many countries resulting in capital flight, devaluation of currency and economic recession. The threat is particularly relevant to fixed exchange rate systems where financial sector assets and liabilities usually have currency mismatch. Besides, central banks are interested in financial stability, as it is often a central bank who has to take the leading role in crisis resolution by providing emergency assistance and working out restructuring plans.

## Key Responsibilities in Maintaining Financial Stability

The direct responsibilities of a central bank in maintaining financial stability, apart from supervisory functions, can be divided into three large areas.

Firstly, central banks are responsible for the **monitoring and analysis of financial system developments** and have to take note of any early signs of possible financial difficulties. Central banks are well positioned for that task due to their close relations with market participants and analytical skills that enable them to analyse macro-prudential indicators and perform regular stress testing.

Secondly, central banks are by definition involved in **designing and building up financial system safety nets.** The so-called traditional central banks are directly responsible for short-term liquidity support to prevent the problems of one institution from developing into a systemic crisis. Even if the ability to provide liquidity assistance is limited, as it is in the case of the currency board system, central banks still play, or are obliged to play a key role in crisis resolution.

Thirdly, central banks are often responsible for the **regulation of the banking system**. That is also the case with Eesti Pank, even after the recent launching of the Financial Supervision Authority and restructuring of the supervisory function. From the central bank's point of view, banking regulation policy goes somewhat beyond the traditional micro-prudential approach that is the basis for the Basel capital accords. For a central bank the crucial question is to what extent does banking policy depend on the general macroeconomic conditions – should business cycles be considered when changing regulation or should it be guided solely by concerns on the micro level?

## *Monitoring and Analysis*

**The successful fulfilment of the central bank's financial stability maintaining function highly depends on the quality of information and analysis available.** A thorough understanding of the functioning of modern complex financial systems is a prerequisite for developing an adequate framework for financial intermediation. Availability of timely and high quality information on changes in the general operating environment, especially risk exposures and potential contagion channels, would enable a central bank to implement timely and effective counteractive measures to support the stability and sustainability of the system.

In analysing vulnerability of the system, ideally, several analytical tools, including **early warning systems and macro-prudential analysis** should be used. Early warning systems typically try to estimate the impact of external factors on domestic financial systems, ie how sensitive the banking sector is to decline in exports, worsening market sentiment or sudden changes in the exchange or interest rates. Macro-prudential analysis undertakes to broaden that approach to a variety of economic indicators, using stress-testing models. Several international organisations, such as Bank for International Settlements (BIS), ECB and International Monetary Fund (IMF), focus precisely on the development of macro-prudential analysis.

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There are several prerequisites for the development of a reliable and robust early warning system, and even more so for the development of a meaningful macro-prudential approach. Reliable data for reasonably long time series, as well as high-quality analysis are a necessity. Of these prerequisites, long time series of data are in relatively scarce supply in the EU accession countries with only ten years of independent banking history. However, the foundations are in place.

It should also be mentioned that creating an early warning system in a small country like Estonia with highly concentrated banking sector is very different from the practice in large countries. When there are only seven individual banks to supervise, one could argue that close individual monitoring of each bank might be more cost-effective than creating a sophisticated aggregated system. Indeed, in a country where banking sector includes hundreds of individual institutions, the situation is probably quite different. Nevertheless, it is necessary to have both individual monitoring and early warning systems in either case.

**For Estonia, some harsh lessons from late-1990s have underlined the need for as good as possible understanding of the key vulnerabilities in the financial system.** This need has become even more pressing now, when Estonian banks have become an integral part of major Nordic financial groups. While this development has somewhat lessened our concern for immediate liquidity and capital of the banks, the new structure of the financial system is yet to be tested during an economic downturn. Cross-border supervision has been and will be an important priority for Estonian supervisors. Currently, the Estonian Financial Supervision Authority has cooperation agreements with the respective authorities of the Baltic countries, Finland, Sweden, Germany and Denmark. We attach continuously high importance to the development of bilateral cooperation with financial supervision authorities of the countries having agencies or branches in Estonia.

**Eesti Pank has a well-developed and sophisticated monitoring system**, making it possible to observe the developments on the level of the whole banking system, a group of banks or an individual bank on a monthly or daily basis – whatever is necessary. The system has been successfully tested over the last year. Eesti Pank has also dedicated significant resources to improve analytical skills. Against this background, we plan to pay considerable attention to the further upgrading of our financial system analysis, and we are also looking forward to cooperation with experts of European institutions as well as international organisations.

## Safety Net

**Estonian financial system safety net has been developed in compliance with EU practices.** Thus, European Union membership will not bring any sweeping changes in this sphere. It must be noted, however, that this is one of the few financial sector related issues where Estonia has asked for a transition period for full adoption of the EU directive. Namely, the level of funds to be reimbursed by the deposit guarantee scheme is presently somewhat lower than required in the EU.

I would like to stress the importance of a **dialogue with market participants.** Constructive discussions with bank managers serve two purposes. Commercial bank executives know and understand both market situation and prevailing trends in real economy. Thus, these regular discussions are a welcome complement to the economic analysis produced by central bank experts. Moreover, regular contacts provide a unique channel for moral suasion, for explaining the concerns of the central bank. Obviously, these contacts are easy to arrange in a small country like Estonia. We have made use of that advantage and established a dialogue with our financial sector on financial as well as general economic issues, both on a regular and *ad hoc* basis.

Another essential element for crisis prevention **is pre-emptive involvement of the private sector in crisis resolution.** While the so-called soft policy principles support crisis prevention by providing a relatively stable and transparent environment, the flexibility of the system still ultimately depends on the actions of market participants themselves. The task of the authorities is to provide an adequate regulatory framework and efficient supervision of the implementation of the regulations.

There is another interesting, albeit still debated issue: **to what extent should supervision rely on banks' internal risk control models and ratings?** This subject has lately been under international spotlight in connection with the development of the New Basel Capital Accord. Estonian banking supervisors have taken a relatively forward-looking approach in that respect by increasingly relying on the risk-based approach of supervision. At the same time, considering the rapidly developing economy and currency board arrangement, we believe that our banking system should have robust liquidity buffers and sufficient capital to withstand asset price fluctuations. Therefore, we have set a relatively high reserve requirement (13 per cent of the banks' liabilities), half of which the banks can hold in high-quality foreign assets.

Finally, I would like to stress that an essential element of our safety net – Guarantee Fund – is functioning well and has already proved its usefulness in practice. In addition to the deposit guarantee scheme, the Fund also provides investor and pension protection through sectoral funds.

## Regulation

Eesti Pank is responsible for regulating the banking system in Estonia. Without going into precise details of Estonian banking regulation I would like to point out that one advantage of a transition economy is the possibility to draw the legislation from scratch. This has much facilitated reaching the compliance with good practices and the full adoption of the EU acquis.

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It is important to note, however, that the adoption of the aquis does not only mean issuing new legislation but also ensuring compliance with the regulations. Estonia was one of the first countries to join the pilot project under the IMF and World Bank Financial System Assessment Program (FSAP) in 1999–2000. The assessment involved implementation of monitoring standards in the banking, insurance and securities market and requirements set for payment and settlement systems. The FSAP also assessed transparency and openness of monetary and financial sector policy.

Another serious question for us as a central bank is **to what extent should regulatory measures be taken into account in a broader financial policy context.** There are arguments for designing regulations with a view to business cycles, especially as it seems that modern financial systems are much more procyclical than before. In such a case, pre-emptive measures could prevent the devastating effects of asset price volatility and loan losses once the economy starts to cool down.

This approach has a particular appeal under the currency board system, since active use of monetary measures is excluded and reserve requirements are essentially the only available monetary tool. Under these circumstances it is vital that the measures implemented would ensure the application of prudential ratios. It should be underlined that in a heavily bank-dominated financial system, banking regulations might affect domestic demand more directly than anywhere else. For example, in 1997, in the outset of the Asian crisis, just before the peak of the cycle, Eesti Pank raised capital adequacy ratio with the view to promoting greater resilience against cyclical risks.

However, macro-prudential policy approach also has its problems. It is obvious that as financial markets mature and financial instruments become more complex, the tightening of banking regulations will intensify capital flows outside the banking system. Capital flows will be channelled to less regulated areas, which may bring along new risks of potentially systemic nature. Another problem is that it is not possible to determine the exact stage of a business cycle. Therefore, devices able to dynamically react on cyclical factors would be very useful. We know, of course, that we are not the only ones to think about these issues – the topic is on the agenda in several present EU Member States.

## Adequate Framework is a Moving Target

As mentioned earlier, the majority of work for the implementation of the acquis communautaire has been completed in Estonia and our financial sector follows internationally accepted standards and good practices. Moreover, regarding the fast development of Estonian economy, we have sometimes found it necessary to tighten our regulations even more than required by international institutions. At the same time, it is clear that **while talking about adequate regulatory framework we are talking about a moving target.**

Within the European Union the realisation of the Financial Services Action Plan should lead to a complete integration of European financial markets by 2005 and securities markets by 2003. Creating a more fully integrated European financial market would certainly mean some changes in the regulatory environment the outcome of which should be a more flexible framework and better cooperation between regulators and supervisors. One must keep in mind, however, that effective supervision is, evidently, an important priority from the point of view of the European Monetary Union.

As regards broader international standards, Basel2 framework is a good example of the sustainable development of prudential ratios to meet constantly changing complex challenges. Comparing the financial system of 1988 to the present day it is clearly apparent that regulatory reforms are necessary. We can only welcome the active international debates, which have accompanied the process. The process of developing the New Basel Accord has, in itself, served the goal of financial stability by bringing various important issues in international spotlight, such as the potential procyclical effect of different regulatory approaches, and initiating extensive research in this area.

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I would like to stress the word ***awareness*** in relation to the modern approach to financial stability. **One of the aims of the New Basel Accord is to make banks monitor and assess their risks more closely and to increase market discipline through enhanced disclosure by banks.** It is of utmost importance that a bank's risk assessment considers the specifics of the risks of that particular institution. Naturally, a more detailed approach means more complicated calculations and requires more intensive exchange of information between the banks and the supervisory institutions to guarantee sufficient evaluation of all the risks.

Capital adequacy calculation principles have been recently fine-tuned in Estonia, like in many other acceding as well as EU member countries. It is very clear that these adjustments shall not be the last ones. The fast development of international financial system demands continuous regulatory adjustments both from international institutions and individual countries.

And that leads us, once again, to the **crucial importance of the analysis and research preceding regulatory decisions in a rapidly changing and increasingly complex environment.**

## Conclusion

Several papers presented in the SUERF colloquium analysed and emphasised the importance of the link between the banking sector and the real sector. An efficient banking sector accelerates economic growth. Financial deepening and increase of financial sector efficiency have been simultaneous in most Central and Eastern European countries. However, there are also risks that should not be ignored. For instance, from a certain level indebtedness becomes a threat to the sustainability of a country's economic development. This is evident not only in theory but also on a historical basis, and highlights, in turn, the importance of financial regulation and supervision.

In the context of globalisation, financial regulation is not a domestic matter any more, as financial markets become more and more integrated both by sectors and states. Integrated markets need a more unified regulatory framework. The unification of the regulatory framework is one of the major challenges the current and future European Union members have to face.

In a country's balance of payments, which of the following items will be recorded as a debit entry? Domestic bank balances owned by foreigners are reduced. The role of international _____ is to direct one nation's savings into another nation's investments.Â  A statement of the stocks of a country's foreign assets and foreign liabilities at a point in time represents the country's. International investment position. During the 20th century and into the 21st, the U.S. net international investment position has DOI link for Factors inï¬‚uencing the ï¬nancial system stability-oriented policies of a small country soon to become an EU Member. Factors inï¬‚uencing the ï¬nancial system stability-oriented policies of a small country soon to become an EU Member book. The Estonian experience. Factors inï¬‚uencing the ï¬nancial system stability-oriented policies of a small country soon to become an EU Member. DOI link for Factors inï¬‚uencing the ï¬nancial system stability-oriented policies of a small country soon to become an EU Member. Factors inï¬‚uencing the ï¬nancial system stability-oriented policies of a small country soon to become an EU Member book. The Estonian experience. ByVahur Kraft. Member states could create web portals that will allow foreign travelers to ask for recognition of a vaccine passport from a non-EU state, as well as request a green certificate once it comes into use. Also on rt.com Vaccine passports? EU to reopen to American tourists this summer, but travelers must have proof of â€˜APPROVEDâ€™ jabs, Brussels says.Â  The proposed travel policy comes a week after European Commission President Ursula von der Leyen signaled that some form of vaccination certificate would soon be necessary for travelers coming from the US. 4.12 The committee regards population growth policy as an important issue, but one outside the terms of reference of this inquiry. 4.13 The relationship between the overall number of skilled migrant workers and the number with particular skills in the construction industry is discussed in more detail in chapter 5 (paragraphs 5.60â€“5.64). High rents. 4.14 The increase in rents in recent years has increased the desire of many renters to buy a home instead of renting. However, having to pay higher rents has reduced the ability of these households to save a deposit. The net impact on the effective demand for house purchases is therefore ambiguous. Lower interest rates.