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LEGAL WORKING PAPER SERIES

NO 5 / JULY 2007

**LEGAL AND
INSTITUTIONAL ASPECTS
OF THE CURRENCY
CHANGEOVER FOLLOWING
THE RESTORATION OF
THE INDEPENDENCE OF
THE BALTIC STATES**

by Kristīne Drēviņa,
Kęstutis Laurinavičius
and Andres Tupits



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ISSN 1830-2688 (print)

ISSN 1830-2696 (online)

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Abstract

In the monetary reforms that took place in the Baltic States in the 1990s, two approaches were taken for breaking away from the rouble zone: one of them constituted a rapid changeover (Estonia), and the other one was relatively smoother, being made in two stages and involving the use of interim currencies (Latvia and Lithuania). Part 1 of this paper sets out the general considerations common to the currency changeover in the Baltic States, while part 2 examines the two abovementioned approaches in detail, first focusing on the Estonian experience and second on that of Latvia and Lithuania. The paper concludes with a summary.

Introduction

The three Baltic States – Estonia, Latvia and Lithuania – joined the European Union on 1 May 2004. Each of them has participated in Economic and Monetary Union (EMU) from the date of accession as a Member State with a derogation within the meaning of Article 122 of the Treaty establishing the European Community¹. Two of them – Estonia and Lithuania – joined the exchange rate mechanism (ERM II) with effect from 28 June 2004. Latvia joined with effect from 29 April 2005. While initially all three were expected to adopt the euro as soon as possible², the target dates for euro adoption have been altered because of the difficulties in fulfilling the convergence criteria³. With this in mind, it is useful to study the experiences of these three Member States with respect to the changeover from the USSR rouble to their national currencies.

During the early months of 1992, the USSR rouble⁴ zone suffered from a simultaneous excess supply of rouble deposits and a shortage of cash roubles. This forced the Baltic States to depart from the rouble zone entirely. In these States the changeover legislation was prepared by drafters who had little time available and little experience of the issues involved. Unlike the changeovers in other new Member States, such as the Czech Republic, Poland, Slovenia and Slovakia, which also took place at the beginning of the 1990s⁵, the changeover in the Baltic States produced two different legal strategies for breaking away from the rouble.

The breakaway from the rouble zone took place while the Maastricht Treaty, and in particular the creation of EMU, was being debated. At one time consideration was even given to using the European Currency Unit (ecu) as an anchor currency for one of the Baltic States⁶. However, the Baltic States had neither the time nor the finance available for their currency changeovers comparable to that used for the euro changeover from 1999 to 2002. Thus, there were no extensive information campaigns, the relevant

¹ Article 4 of the Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33).

² Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee, the Committee of the Regions and the European Central Bank – First report on the practical preparations for the future enlargement of the euro area, COM(2004) 748 final of 10.11.2004, http://www.europa.eu.int/comm/economy_finance/publications/euro_related/eurorelated_communication2004_748_en.htm.

³ Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee, the Committee of the Regions and the European Central Bank – Fourth report on the practical preparations for the future enlargement of the euro area, COM(2006) 671 final of 10.11.2006., http://ec.europa.eu/economy_finance/publications/euro_related/2006/com2006_671final_en.pdf.

⁴ On 20 December 1991 the State Bank of the USSR was disbanded and all its assets, liabilities and property were transferred to the Central Bank of the Russian Socialist Federated Soviet Republic, which several months later was renamed the Central Bank of the Russian Federation (Bank of Russia). However, USSR rouble banknotes remained in circulation until, on 26 July 1993, the Central Bank of Russia withdrew from circulation all USSR roubles issued between 1961-1992 and the Russian 5 000 and 10 000 rouble notes issued in 1992.

⁵ See COM(2004) 748 final, pp 26-27.

⁶ Cf. Adalbert Knöbl, Andres Sutt and Basil Zavoico. ‘The Estonian Currency Board: Its Introduction and Role in the Early Success of Estonia’s Transition to a Market Economy’, *IMF Working Paper* WP/02/96, p. 14.

legislation was drafted on an ad hoc basis and in some cases the changeover itself was carried out in haste.

This paper consists of a general part, in which some common issues concerning the introduction of the national currencies are described, followed by individual country chapters in which each of the changeovers is explained in more detail. The paper concludes with a summary.

1. General part

The regulation of its currency falls within the jurisdiction of a sovereign state. This principle arises from the ‘state theory of money’, which assumes that a state has a monopoly over the issue of its currency⁷. The Baltic currencies are not entirely new – they had existed before World War II when the Baltic States were independent.

In the USSR, the central bank (the USSR State Bank) played a key role in collecting money from state-owned companies and channelling it from its local branches to its headquarters in Moscow, where it was redistributed according to the State plan and channelled back to the branches. The Soviet central banking system did not have independent national central banks. All other banking institutions were state-owned and had their specific roles in the planned economy.

The perestroika-influenced banking reforms of 1987-89 changed this and provided a brief legislative framework for the setting up of commercial and cooperative banks outside the planned economy. The USSR State Bank started to issue commercial banking licences⁸.

In the second half of the 1980s, the USSR rouble started to lose its purchasing power and became unstable – in the autumn of 1989 there were twice as many rouble notes in circulation as there were goods to spend them on⁹. In order to combat inflation, regional and municipal authorities introduced various measures, ranging from imposing prohibitions on selling certain goods to people from other regions to issuing rationing coupons for certain products. Moreover, on 22 January 1991, the USSR authorities suspended the acceptance of 50 and 100 rouble banknotes of the 1961 series, with effect from 23 January 1991. This caused difficulties for the Baltic States where the rouble was used as legal tender. Only limited quantities of the banknotes were exchangeable within short deadlines¹⁰.

⁷ F.A. Mann, *The Legal Aspect of Money*, 2005, p. 14.

⁸ On 26 September 1988, the USSR State Bank issued commercial banking licence No 1 to Tartu Kommertspank (Estonia) and licence No 2 to Riga Innovation-Commercial Bank (Latvia). Licence No 10, for the first Lithuanian commercial bank, was issued on 14 December 1988. Cf. V. Zirnask, *Fifteen Years of New Estonian Banking*, 2002, p. 15.

⁹ Ibid. p. 25.

¹⁰ Cf. Resolution of Lithuania's Government of 23 January 1991 No 33 on 50 and 100 rouble banknotes of 1961 issued by the USSR State Bank. Lietuvos aidas, 24.1.1991, No 17; supplemented by the Resolution of 8 February 1991 No 58 (unpublished).

In this context, as an experiment, a suggestion was made to introduce a convertible rouble in those regions of the USSR which wished to acquire the status of a special economic zone¹¹. However, in the Baltic States the idea of introducing national currencies gradually began to take hold, as an expression of their aspirations for independence¹². There were five reasons for the introduction of national currencies in countries that were formerly part of the rouble zone¹³:

- 1) A national currency allows a more independent economic policy to be pursued, while underlining the responsibility of national decision-makers for the development of their own economies.
- 2) There was no reason to think of the rouble zone as an optimal currency area; the resource endowments, probable exogenous shocks, institutions and policy goals of the former Soviet republics varied hugely. Different currencies were, therefore, a more natural arrangement than the continuance of the rouble zone.
- 3) The rapid depreciation of the rouble had made it necessary for these countries to protect themselves from the rouble crisis.
- 4) Particularly during the early months of 1992, the rouble zone suffered from a simultaneous excess of rouble deposits and a shortage of cash roubles; supplementary currencies for carrying out transactions were duly introduced in several of the former Soviet republics. It was therefore likely that regional or enterprise-based forms of currency would have appeared in the Baltic States without the introduction of national currencies.
- 5) Having a national currency also introduces the possibility of generating government revenue in the form of seigniorage.

Debates on the future monetary reform were going on both inside and outside the Baltic States. Arnis Vilks suggested four models for such reform:

- 1) The laissez-faire model, where the market is allowed to choose the most suitable currency from among various currencies circulating simultaneously;
- 2) The introduction of national currencies with floating exchange rates;

¹¹ Kalev Kukk, 'Five years in the Monetary Development of the Baltic States: Differences and Similarities', in *Eesti Pank Bulletin* No 5, 1997, p. 30.

¹² Ibid. p. 30.

¹³ Cf. Seija Lainela and Pekka Sutela, *The Baltic Economies in Transition*, Bank of Finland, 1994, p. 36.

- 3) The introduction of national currencies with fixed exchange rates, supported by central bank currency interventions; and
- 4) A Baltic Monetary Union¹⁴.

However, in the months immediately following the restoration of independence, none of the Baltic States was ready to introduce its own national currency.

New currencies were introduced in the Baltic States during the summer and autumn of 1992. Despite the International Monetary Fund's (IMF) advice not to rush into leaving the rouble zone, the Baltic States were eager to do so as soon as possible¹⁵. Two approaches were taken: one constituted a rapid changeover (with the introduction of the kroon in Estonia), and the other took longer and involved using interim currencies (Latvia and Lithuania). These interim currencies were later replaced by the Latvian lats and the Lithuanian litas.

The Estonian kroon was pegged to the German mark under the currency board system on 20 June 1992, and the exchange rate was set at one German mark to eight krooni. Lithuania switched from the USSR rouble to the Lithuanian talonas on 1 October 1992, and Latvia introduced the Latvian rublis on 7 May 1992. The exchange rate for both was one to one against the USSR rouble. Then, from 5 March to 18 October 1993, all Latvian rublis banknotes were gradually exchanged into Latvian lats at the rate of 200 rublis to 1 lats¹⁶. In Lithuania the transition from the talonas to the litas took place from 25 June to 20 July 1993, at an exchange rate of 100 talonas to 1 litas.

Both Estonia and Lithuania use a currency board arrangement as the basis for their exchange rate management regimes. A currency board is, by definition, a special type of fixed exchange rate arrangement that is based on a strong and explicit legislative commitment to a fixed exchange rate, together with the requirement that the domestic currency should only be issued against foreign exchange reserves¹⁷. The foreign exchange reserves for the Estonian kroon were mainly made up of the pre-war gold deposits returned to Estonia by Western banks shortly before the monetary reform – a total of 11.3 tonnes of gold was received in 1992-93 either in gold or in the form of monetary compensation¹⁸. Before the return of the gold, Eesti Pank did not have any foreign reserve assets and the collateral for the Estonian kroon was Estonia's state-owned forests. In January 1992 Eesti Pank's balance sheet showed

¹⁴ Cf. Arnis Vilks, 'Zur Frage der Währungsordnung in den baltischen Staaten' in *Die Wirtschaft der baltischen Staaten im Umbruch*, 1992 pp 47-54.

¹⁵ Cf. Knöbl, Sutt and Zavoico, op. cit. p. 8.

¹⁶ Thus, the two-stage monetary reform of Latvia appeared to repeat the 1920s reform when the Latvian lats replaced the Latvian rouble in 1922.

¹⁷ Urmas Sepp, Raoul Lättemäe and Martti Randveer, 'The History and Sustainability of the CBA in Estonia', in *Alternative Monetary Regimes in Entry to EMU*, Eesti Pank, 2002, p. 328

¹⁸ Kukk, op.cit. p. 35.

150 thousand cubic metres of timber ready for felling. These assets were formally removed from its balance sheet only in June 1997¹⁹.

Latvia had returned to it seven tonnes of gold which had been frozen in 1940, and Lithuania had six tonnes of gold returned to it²⁰.

Although the monetary reforms in the Baltic States were not carried out in a coordinated manner, and on some occasions were characterised as being competitive, there were also some linkages between them. Thus, for example, the Latvian authorities stressed that the main reason for carrying-out monetary reform so quickly was that Latvia had experienced a large inflow of roubles following the currency reform in Estonia²¹.

¹⁹ Cf. Knöbl, Sutt and Zavoico, op. cit. p. 6.

²⁰ Kukk, op. cit. p. 35.

²¹ Adalbert Knöbl and Richard DHaas, 'IMF and the Baltics: A Decade of Cooperation', *IMF Working Paper* WP/03/241, p. 10.

2. Currency reform in the Baltic States – two approaches

2.1 The rapid changeover – the case of Estonia

2.1.1 The institutional structure of the Estonian banking system

In order to launch monetary reform in Estonia, the banking system had to be built up from scratch. Eesti Pank is an old central bank but with a relatively short operational history. It was established as the central bank of Estonia on 24 February 1919, a year after the declaration of independence.

In June 1940, after the annexation of Estonia by the USSR, Eesti Pank was nationalised and all of its assets were supposed to have been transferred to the USSR. In fact, the foreign reserves deposited in the United Kingdom, with the Bank of International Settlements (BIS) and with the Federal Reserve System of the USA were retained, and the USSR only succeeded in acquiring the assets that had been deposited in Sweden. Eesti Pank ceased to exist and a local branch of the USSR State Bank used its premises in Tallinn.

On 15 December 1989 the Supreme Soviet of the Soviet Socialist Republic of Estonia passed a resolution re-establishing Eesti Pank and declared its succession to the central bank established in 1919. Since Estonia was still using roubles issued by the USSR State Bank, Eesti Pank initially lacked any practical authority. At this stage greater emphasis was placed on resolving political constraints and on logistical issues (e.g. banknote printing) than on addressing the broader issues of the preferred foreign exchange regime and the supporting macroeconomic policies²².

The re-established central bank started to operate on 1 January 1990 and co-existed with the Estonian Republic Office of the USSR State Bank until the latter's merger with Eesti Pank on 1 January 1992, after Estonia had regained its independence on 20 August 1991. Until the merger took place, the USSR State Bank was responsible for, *inter alia*, ensuring sufficient banknote issue in Estonia, serving as fiscal agent for the Government, providing a clearing service for bank transfers within Estonia and between Estonia and the other Soviet republics, and exercising a rudimentary degree of banking supervision²³. Meanwhile, until the beginning of 1992, Eesti Pank was engaged mainly in developing Estonian banking legislation and licensing Estonian commercial banks²⁴. Banking supervision and regulation was complicated by the fact that banks registered in Moscow were subject to central scrutiny (by the USSR State Bank), while

²² Knöbl, Sutt and Zavoico, op. cit. pp. 4-5.

²³ A.H. Karell, 'Banking and monetary reform in the Republic of Estonia', in *The Monetary Reform in Estonia 1992*, Bank of Estonia, 1992, p. 32.

²⁴ Ibid. p. 32.

banks registered in Tallinn were subject to local scrutiny²⁵. Eesti Pank only gained full control over local credit institutions after the monetary reform. All banking licences and foreign exchange licences were declared null and void as from 1 July 1992 by the Monetary Reform Committee Decree No 29 of 17 June 1992. The Monetary Reform Committee authorised Eesti Pank to establish new conditions for the grant of banking licences and foreign exchange licences.

Banking activities were regulated by the Law on banking of 28 December 1989²⁶. This Law established the governing bodies of Eesti Pank, regulated commercial banking activities and the relationship between the Government and the central bank. It created the legal framework for a banking system which was independent of the Soviet central authorities and which would help support the transition to a market economy. Under this Law, Eesti Pank was given the task of supervising the establishment of new banks through a system of licences, as well as licensing banks permitted to engage in foreign exchange operations.

By the spring of 1992, the first steps had been taken to create an autonomous monetary system, with the following aims²⁷:

- 1) To move away from and subsequently break away from the monetary system of the former USSR,
- 2) To liberalise the monetary and banking system,
- 3) To move towards a sensible organisation of the monetary system and to avoid anarchy,
- 4) To make the general public aware of the independent and guiding role of Eesti Pank in Estonian society, and
- 5) To gain experience and make the necessary preparations for carrying out monetary reform.

Eesti Pank's membership of the BIS was restored on 15 June 1992²⁸, preceded by Estonia becoming a member of the IMF on 25 May 1992. Estonia joined the World Bank on 23 June 1992.

A referendum on 28 June 1992 approved the Estonian Constitution²⁹, which entered into force on 29 July 1992. Article 111 of the Constitution provides that Eesti Pank has the sole right to issue Estonian currency and that it must regulate the currency in circulation and ensure the stability of the national

²⁵ Ibid. p. 33. The licences issued by the USSR State Bank were declared null and void as from 1 January 1992 by the decision of the Board of Eesti Pank of 29 November 1991. Cf. Märt Karmo, 'Foreign currency regulation in Estonia in 1991-1994' (in Estonian) at http://www.eestipank.info/pub/et/dokumendid/seeriad/bulletaan/bylletaan97/_4/artikkel5/index.html?objId=211048.

²⁶ Eesti NSV pangaseadus, ÜNVT 1989, 41, 647.

²⁷ Cf. Karmo, op. cit.

²⁸ Eesti Pank was one of the founding shareholders of the BIS in 1932.

²⁹ Eesti Vabariigi põhiseadus, RT 1992, 26, 349.



currency. Article 112 provides that Eesti Pank must operate pursuant to its governing law and must report to Parliament.

On the basis of Article 112, Parliament adopted the Law on Eesti Pank on 18 May 1993³⁰. The Law on Eesti Pank is a constitutional law, i.e. it is expressly mentioned in Article 104 of the Constitution as a law which may be passed and amended only by an absolute majority of the members of Parliament. In the hierarchy of Estonian laws, constitutional laws rank next after the Constitution.

2.1.2 Legislative framework for the changeover

Discussions on the introduction of a national currency in Estonia started in 1987 when a group of four high-ranking government officials and scholars published an Estonian economic independence programme, which included references to a national currency³¹.

Public debate on whether to introduce a national currency, and if so in what form³², carried on until 27 March 1991 when the Supreme Soviet of the Republic of Estonia set up the Monetary Reform Committee. The Committee had three members: the Prime Minister, the Governor of Eesti Pank (both ex officio), and one expert appointed by the Supreme Soviet. It was accountable to the Supreme Soviet. The still-functioning Tallinn branch of the USSR State Bank was nevertheless not represented and played virtually no role in the discussions on monetary reform³³. It is noteworthy that the local authorities freely admitted that they had no idea which policies were needed initially and that they lacked an overall view of the economy and its macro linkages³⁴. Therefore, cooperation with foreign experts³⁵ was vital for the success of the monetary reform.

The Monetary Reform Committee's main task was to prepare, implement and complete the monetary reform³⁶. It had exclusive powers to decide upon all issues regarding the reform. Its decisions were occasionally published in the State Gazette, quite often communicated to the general public through the

³⁰ Eesti Panga seadus, RT I 1993, 28, 498.

³¹ Lainela and Sutela, op. cit. p. 40.

³² The general public suggested numerous scenarios for the introduction of the national currencies that varied greatly in their practical application. The proposals included restoring the 1940 currency, or adopting the currency of some foreign country (e.g. Finnish markka). Although these ideas were of little use in carrying out the actual monetary reform in 1992, they did put an end to the public debate about choosing the 'right' way to carry out monetary reform, so that by the time the reform took place it was carried out under the guidance of Eesti Pank without much outside discussion. Cf. Kukk, op. cit. pp 31-32.

³³ Several years later, the inability to cooperate with the USSR State Bank's Tallinn Branch was seen as one of the failures of the first Governor of Eesti Pank, Mr. Rein Otsason. Vt. Eesti rahareform 1992: nelja mehe ettepanekust oma rahani, 1997, lk. 67.

³⁴ Knöbl and Haas, op. cit. p. 23.

³⁵ The USSR State Bank was not considered 'foreign'. Based on a gentlemen's agreement, since the beginning of 1992, the third member of the Monetary Reform Committee had to have a foreign background. Mr. Rudolf Jalakas had extensive banking experience in Sweden, and he was assisted by and later replaced by Mr. Ardo Hansson, who holds a PhD in Economics from Harvard University.

³⁶ To ensure that the work could be completed, the term of office was set to end on 29 June 1995.

media³⁷, and were legally binding. The mandate of the Monetary Reform Committee expired on 29 June 1995. It was assisted by its bureau and regional sub-units, and the number of people working for it was close to 16 500.

The Polish experience of 1990-91 showed that the almost overnight establishment of convertibility was feasible and could contribute to stabilisation by providing a nominal anchor. The Estonian case was heavily influenced by the Polish example³⁸. Also, the monetary reforms in Slovenia, in late 1991, and in Argentina, in the same year, may have influenced the Estonian reform³⁹. However, the initial discussions also included plans to implement monetary reform by using an interim currency⁴⁰. In late 1991 Eesti Pank decided that the preferred route would be to move directly to an independent currency, arguing that vouchers would not help solve the problem of inflation⁴¹. One of the last attempts⁴² to introduce an interim currency was made in May 1992, when Prime Minister Vahi suggested using already-printed one kroon notes as coupons as substitutes for 500 or 1 000 rouble notes, thereby overcoming the rouble cash shortage⁴³.

In late 1991, Estonia initiated negotiations with Sweden (16 September 1991), the BIS (15 October 1991) and the UK (7 November 1991) in order to recover the gold deposits from 1940. The return of this gold played a significant role in carrying-out the reforms. On 27 January 1992 an agreement was concluded with the UK, soon followed by another with the BIS (15 June 1992) and, after the monetary reform, on 8 July 1992, Sweden also provided compensation for its part of the gold⁴⁴.

On 17 June 1992 the Monetary Reform Committee issued Decree No 30, which became the backbone of the monetary reform. On 19 June 1992 Eesti Pank proclaimed that, as from 04.00 on 20 June, the sole legal tender in Estonia would be the Estonian kroon, with an exchange rate against the German mark set at eight krooni to one German mark⁴⁵. The Estonian authorities went ahead with the introduction of the

³⁷ The publication of its decisions in Riigi Teataja was at the Monetary Policy Committee's discretion. Shortages of paper were common and in order to avoid any delays, the decisions of the Monetary Committee were communicated to the general public by television and radio.

³⁸ Lainela and Sutela, op. cit. p. 37.

³⁹ Eesti rahareform 1992: nelja mehe ettepanekust oma rahani, 1997, p. 102.

⁴⁰ Estonia managed to avoid introducing a parallel currency and instead, dealt with the cash shortage through the use of bank cheques and non-cash transactions, and by delaying the payment of wages, pensions and social benefits. Cf. Kukk, op. cit. p. 34.

⁴¹ Knöbl, Sutt and Zavoico, op. cit. p. 6.

⁴² The first attempt was made by the Tartu City authorities, which for a short period issued its own 'city money' between 23 March and 20 April 1992 in order to overcome cash shortages.

⁴³ Knöbl, Sutt and Zavoico, op. cit. p. 15.

⁴⁴ The chronology is available in Estonian at Eesti rahareform 1992: nelja mehe ettepanekust oma rahani, 1997.

⁴⁵ Initially pegging to the European Currency Unit (ECU) was considered. However, as this would not have been as transparent as a link to a well-known currency, the choice was made to peg the Estonian kroon to the German mark (DEM). There was a deliberate rounding up to the nearest whole DEM multiple from the prevailing market rate to build-in a modest cushion of competitiveness. Cf. Knöbl, Sutt and Zavoico, op. cit. p. 14.

Estonian kroon in June 1992, even though the IMF had initially advised Estonia to wait until a Stand-by Arrangement with the IMF was in place; however, when the Estonian authorities insisted on the early introduction of the kroon, they and the IMF agreed to cooperate closely in the run-up to the monetary reform⁴⁶.

In order to avoid any large speculative inflows of USSR roubles, a special monetary reform register had been set up in May 1992 by the Monetary Reform Committee for permanent and temporary residents. Between 20 and 22 June each person on the register was entitled to exchange up to 1 500 roubles at an exchange rate of 10 roubles to 1 kroon. Cash in excess of 1 500 roubles could be exchanged for krooni at the rate of 50 roubles to 1 kroon until 1 July. Rouble deposits of private persons and companies registered in Estonia were converted into krooni at an exchange rate of 10 roubles to 1 kroon. Coins were not exchanged.

1 557 808 natural persons were listed in the monetary reform register, of whom 1 410 951 verified their data and were then entitled to exchange their roubles. However, the actual number of people who exchanged their money was 1 096 706, and the average sum of money exchanged was 136.41 krooni⁴⁷. The enthusiasm of the general public was so overwhelming that the Monetary Reform Committee noted in its report that during the days of the changeover from 20 to 22 June 1992 no crimes were reported⁴⁸.

2.1.3 Continuity of contracts and currency regulation

Continuity of contracts was very briefly dealt with in the changeover legislation. The rule established by the Monetary Reform Committee was that all debts caused by the shortage of cash roubles had to be paid, taking account of the established exchange rate⁴⁹. Also, Article 1.4 of Decree No 30 stipulated that the monetary obligations and claims in force at the time of monetary reform would remain valid and would be redenominated in Estonian krooni; the period for the settlement of existing obligations was extended until 28 June 1992. It was further stipulated in Article 4.1 that USSR rouble current accounts and deposits were to be redenominated in krooni at the official exchange rate. The debt obligations of the USSR were not redenominated in krooni⁵⁰.

⁴⁶ Knöbl and Haas, *op. cit.* p. 7.

⁴⁷ Eesti rahareformi komitee aruanne, Tallinnas, 29. juunil 1995.a., lk. 18. The number of people who actually exchanged their roubles, as well as the average amount of money exchanged illustrates the overall shortage of cash roubles. Many people spent their roubles in shopping sprees several days before the changeover. For example in Jõgeva, a small town of 7000 inhabitants, 500 copies of encyclopaedias were bought. Similar examples can be found at Eesti rahareform 1992: nelja mehe ettepanekust oma rahani, 1997, lk. 128-129.

⁴⁸ Eesti rahareformi komitee aruanne, Tallinnas, 29. juunil 1995.a., lk. 18.

⁴⁹ Decree No 25 of the Monetary Reform Committee of 28 May 1992.

⁵⁰ Decree No 32 of the Monetary Reform Committee of 17 June 1992.

On 20 May 1992 Parliament adopted the Law on currency⁵¹, the Law on foreign currency⁵² and the Law on security for Estonian krooni⁵³, all of which were to take effect on the launch of the monetary reform.

Article 1 of the Law on currency defines the monetary unit of Estonia as the Estonian kroon, which is divided into 100 senti. Article 3 stipulates that the sole legal tender in Estonia is the Estonian kroon. Article 3, in conjunction with the Law on foreign currency (since repealed), prohibited the use of any other currency in daily business between legal and natural persons resident in Estonia.

Other provisions of the Law on currency regulated the obligation to accept payments in krooni, the exchangeability of the kroon and criminal liability for forgery.

The Law on foreign currency supported the operation of the Law on currency. Article 3(1) of the Law on foreign currency provided that foreign currency may only be used in foreign (cross-border) transactions. Article 4 stipulated that payments in foreign currency could only be made through credit institutions licensed by Eesti Pank.

The aim of the Law on foreign currency was to prohibit the circulation of parallel currencies in Estonia and limit the use of foreign currencies to foreign transactions. On the one hand the Law on currency promoted the use of the kroon, while on the other hand the Law on foreign currency restricted the use of other currencies. At the time of the launch of monetary reform, the USSR rouble circulated in Estonia alongside the US dollar, the German mark and the Finnish markka.

However, the Law on foreign currency was relatively liberal, since there were no restrictions on:

- making investments outside Estonia,
- borrowing in foreign currencies (the loans had to be registered with Eesti Pank),
- making investments in Estonia, for transactions concerning both exports and imports,
- exchanging foreign currencies,
- exporting or importing foreign currencies (the sum of money had to be declared to the customs authorities), and
- having a foreign currency account abroad (but for natural persons only).

Payments in foreign currencies received by resident legal or natural persons in Estonia were to be converted into krooni by the credit institution where the payee had their account. In the Law on foreign currency there were separate articles for natural and legal persons – Articles 5 and 6 respectively – but the provisions were the same for both. Resident legal persons had to repatriate money from abroad, as

⁵¹ Eesti Vabariigi rahaseadus, RT 1992, 21, 299; I 2002, 63, 387.

⁵² Eesti Vabariigi välisvaluutaseadus, RT 1992, 21, 298.

⁵³ Eesti Vabariigi seadus Eesti krooni tagamise kohta, RT 1992, 21, 300.

stipulated by Article 7(2). The opening of an account in a foreign currency was restricted to legal persons who had to obtain a permit from Eesti Pank in order to open an account. As stipulated in Article 7(4) of the Law on foreign currency, accounts in foreign currencies were only to be used for cross-border foreign transactions.

Article 8 of the Law on foreign currency regulated loans in foreign currencies. Foreign loans were to be registered with Eesti Pank⁵⁴. However, the registration requirement was not a restriction on the free movement of capital. Article 9(1) of the Law on foreign currency provided that there were no restrictions on the withdrawal of foreign capital invested in Estonia, or dividends. The use of non-convertible currencies – roubles – was made dependant upon an agreement with the relevant foreign authorities as stipulated in Article 11. As there was no such agreement, the use of roubles was restricted to currency exchange at borders and in airports by natural persons, and subject to a limit of 8 000 krooni per person⁵⁵.

However, the need for restrictions on the use of foreign currencies rapidly diminished⁵⁶ and the Law on foreign currency was repealed as from 7 April 1994. All restrictions on the use of foreign currencies were abandoned within two years of the monetary reform. In order to combat money laundering, there remains a duty to report to the customs authorities on foreign currency imported to or exported from Estonia.

The Law on the replacement of the currency unit in laws and other normative instruments⁵⁷, which was adopted on 18 June 1992, stated in very general terms that references to the ‘rouble’ should be understood as references to the ‘kroon’, taking the exchange rate into account. Given the lack of financial markets, there was apparently no need for more detailed regulation. Since the exchange rate was 10 USSR roubles to 1 kroon, no provision for rounding was considered necessary.

Estonia’s departure from the rouble zone meant that the relationship with the former USSR had to be established on a new basis. Therefore, payment and settlement agreements were negotiated with former Soviet republics. On 20 June 1992 an agreement was concluded between Estonia and the Russian Federation which regulated the mutual obligations arising from the monetary reform in Estonia. The agreement included, *inter alia*:

- 1) The settlement of pre-monetary reform accounts between Estonia and the Russian Federation, as well as the rules for future settlements,
- 2) The rules regarding the exchange of money for Russian military personnel⁵⁸, and

⁵⁴ Although resident legal persons considered this a formality, foreign creditors were keen to demand registration by their Estonian borrowers. Cf. Karmo, *op.cit.*

⁵⁵ Eesti Pank Decree of 24 November 1992.

⁵⁶ On 26 January 1993 the Law amending the Law on foreign currency entered into force, enabling resident legal persons to open bank accounts in foreign currencies in Estonian banks and use that money for foreign trade.

⁵⁷ Seadus rahaühiku muutmise kohta seadustes ja muudes normatiivaktides. RT 1992, 30, 380.

⁵⁸ The armed forces of the Russian Federation left Estonia as late as 30 August 1994.

- 3) The unspecified obligation to hand over the cash roubles collected during the monetary reform in Estonia within a month of completion of the reform.

Payment and settlement agreements were also concluded with: Moldova⁵⁹, Latvia⁶⁰, Belarus⁶¹, Lithuania⁶², Uzbekistan⁶³, Kazakhstan⁶⁴, Azerbaijan⁶⁵ and Tajikistan⁶⁶. These agreements sought to maintain a role for the rouble in financing trade with the former Soviet republics, without committing the authorities to a fixed rouble-kroon exchange rate.

2.1.4 The monetary system of Estonia

The Law on security for the Estonian kroon is basically a very short description of a currency board arrangement.

Article 1 stipulates that issues of the Estonian kroon must be fully backed by the gold and convertible foreign exchange reserves of Eesti Pank. Article 4 provides that Eesti Pank has the right to change the volume of Estonian krooni in circulation only following a change in its gold and foreign exchange reserves. The relevant legislation was drafted in early May 1992, with technical advice from the IMF⁶⁷.

In 1999, the euro replaced the German mark as the anchor currency. The Estonian kroon joined ERM II on 28 June 2004. The central exchange rate was set at EUR 1 to EEK 15.6466.

⁵⁹ On 8 September 1992.

⁶⁰ On 9 September 1992.

⁶¹ On 17 September 1992.

⁶² On 25 September 1992.

⁶³ On 25 November 1992.

⁶⁴ On 3 December 1992.

⁶⁵ On 15 December 1992.

⁶⁶ On 24 December 1992.

⁶⁷ Knöbl, Sutt and Zavoico, *op. cit.* p. 13.

2.2 Changeover using an interim currency – the case of Latvia

2.2.1 Institutional set-up

Latvia's independence was proclaimed on 18 November 1918. On 7 September 1922, following the armed struggle to establish independence, the Constitutional Assembly adopted the law founding Latvijas Banka in order to ensure the implementation of monetary policy. The right to issue the national currency was vested in Latvijas Banka. Latvijas Banka was established on 1 November 1922 and the national currency was issued on the next day: this consisted of provisional banknotes denominated as 10 Latvian lati which were actually overprinted 500 rouble notes⁶⁸.

After the occupation of Latvia by the Soviet army on 17 June 1940 and its annexation by the USSR, Latvijas Banka was wound up on 10 October 1940. The Latvian Republic branch of the USSR State Bank was set up in its place.

On 2 March 1990 (i.e. two months before the declaration of independence on 4 May 1990), the Supreme Council of the Soviet Socialist Republic of Latvia adopted the Law on banks and the Resolution on Latvijas Banka, thereby establishing Latvijas Banka as the central bank of the Soviet Socialist Republic of Latvia. Latvijas Banka was virtually a fully-fledged national central bank, the centre for issuing money, the bank of last resort for commercial banks, managing cash operations for the State budget, and regulating the economy by means of monetary policy instruments. However, Latvijas Banka did not actually become the central issuing bank for Latvia for another year and five months, as the Latvian Republic Office of the State Bank of the USSR retained this function.

The work to prepare for the restoration of the national currency started on 31 July 1990 with the passing of the Resolution on the programme to create the monetary system of the Republic of Latvia, by the Supreme Council of the Republic of Latvia⁶⁹. The Board of Governors of Latvijas Banka was asked to establish a commission to take charge of monetary reform⁷⁰. The Resolution required the submission to the Supreme Council of a programme for the establishment of a monetary system by 15 December 1990⁷¹. Such a programme was indeed submitted by the deadline⁷².

⁶⁸ See Latvijas Banka's website: <http://www.bank.lv>; 'History of the Bank of Latvia'.

⁶⁹ Ziņotājs 34, 23.8.1990.

⁷⁰ See Article 1 of the Resolution on the programme to create the monetary system of the Republic of Latvia, Ziņotājs 34, 23.8.1990

⁷¹ Article 4 of the Resolution.

⁷² See the document entitled Monetary System of the Republic of Latvia of 5 December 1990, at the Government's website, under the State Chancellery's policy papers section, <http://ppd.mk.gov.lv/ui/DocumentContent.aspx?ID=1638>.

On 3 September 1991, the Supreme Council passed the Resolution on the reorganisation of banks in the territory of the Republic of Latvia⁷³. In accordance with Article 1 of this Resolution, Latvijas Banka took over the Latvian Republic Office of the USSR State Bank and other State credit institutions and became a central bank with the right to issue the national currency. The legal basis for the adoption of this resolution was the Resolution of the Supreme Council on the economic basis for the sovereignty of Latvia⁷⁴ adopted on 24 August 1991 (i.e. three days after the re-establishment of independence following the coup-d'état in Moscow). Einars Repše, Chairman of the Banking and Finance Subcommittee of the Economic Committee of the Republic of Latvia Supreme Council, was appointed Governor of Latvijas Banka.

On 26 November 1991 the Law on the Monetary Reform Committee of the Republic of Latvia⁷⁵ was passed and the Committee appointed. Article 2 provided that the Committee should consist of three members: the Chairman of the Council of Ministers of Latvia (Chairman of the Committee), the Governor of Latvijas Banka, and the Chairman of the Economic Committee of the Supreme Council of the Republic of Latvia. Article 3 authorised the Monetary Reform Committee to elaborate, implement and complete the monetary reform. The Committee reported directly to the Supreme Council.

On 4 March 1992, the Supreme Council adopted the Law on succession to the rights of Latvijas Banka, founded in 1922⁷⁶, which provided that Latvijas Banka was entitled to succeed to deposits made by Latvijas Banka before 1940, and any other property acquired by Latvijas Banka before 1940, and the gold and other assets which were owned by the Ministry of Finance before 1940 and located abroad⁷⁷. The status of Latvijas Banka as a national central bank with the right to issue the national currency was finally recognised by the adoption of the Law on Latvijas Banka of 19 May 1992⁷⁸. This Law ensured the independence of the national central bank from the Government.

2.2.2 Legislative framework

The earliest public reference to the need to create an independent monetary system in Latvia can be found in the Law on the economic autonomy of the Soviet Socialist Republic of Latvia (the Latvian SSR)⁷⁹ adopted by the Supreme Council on 27 July 1989. Article 11 of this Law stipulated that ‘The Latvian SSR

⁷³ Ziņotājs 35, 12.9.1991.

⁷⁴ Ibid.

⁷⁵ Ziņotājs 49, 19.12.1991.

⁷⁶ Ziņotājs 13, 2.4.1992.

⁷⁷ Article 2.

⁷⁸ Ziņotājs 22, 4.6.1992.

⁷⁹ Ziņotājs 32, 10.8.1989

has control over banking and the circulation of money, including the introduction of the national currency and the determination of its exchange rate against other currencies, including the rouble as the common currency of the USSR'. The next steps in preparing for monetary reform were the Resolution of the Supreme Council on the programme to create the monetary system of the Republic of Latvia, referred to above, and the elaboration of the programme. With regard to the specific steps for monetary reform, the programme provided for transition to the use of the lats as the national currency unit, with an exchange rate of one to one against the rouble. The programme recognised that the amount of cash that could be exchanged, as well as the period during which such exchange could be made, should be restricted. It also provided for a one-month dual circulation period for the lats and the rouble, though the rouble could only be used during this period for buying items of primary necessity. However, most of these measures were not implemented or were only implemented in modified form.

The programme listed several justifications for the monetary reform:

- The political and economic independence of Latvia would be impossible if banknotes issued by the central bank of another state were used for transactions within the Latvian economy,
- The proper functioning of the internal market and external trade relations would not be possible without a stable means of payment and reliable settlements,
- The growing inflation in the area of the USSR rouble, and
- The restriction of the outflow of goods from Latvia.

The programme identified the following five aims of the monetary reform:

- To issue banknotes with a high and stable purchasing power,
- To ensure the privatisation of State property by developing private initiative and introducing a free market economy,
- To develop and protect Latvian goods, the labour force and capital markets and to promote external trade,
- To stabilise and raise the standard of living, and
- To ensure the convertibility of the currency of Latvia.

Among other measures the programme provided for the adoption of a Law on currency. However, such a law was never adopted. Currently Article 34 of the Law on Latvijas Banka establishes the status of the national currency. It provides that the national monetary unit of Latvia is the lats, which comprises 100 santimi, and that the lats is the only legal tender in Latvia.

The monetary reform was carried out on the basis of the resolutions of the Monetary Reform Committee established by the abovementioned Law on the Monetary Reform Committee of the Republic of Latvia.

Article 6 of this Law established that resolutions adopted by the Committee were legally binding within the territory of Latvia, thus giving these resolutions the power of law. The same Article provided for the procedure for the adoption of resolutions by the Committee: a resolution was to be adopted if all three members of the Committee voted in favour of it. Although the Committee reported directly to the Supreme Council, the Law did not provide for any mechanism allowing the Supreme Council to overrule its resolutions.

In practice this programme for establishing the monetary system was not followed. The monetary reform implemented by the Monetary Reform Committee included a transitional period using an interim currency.

On 4 May 1992, the Monetary Reform Committee passed a resolution introducing the Latvian rublis as the interim currency. The resolution provided that the rublis would be put into circulation on 7 May 1992 with the following denominations: 1, 5, 20, 50, 200 and 500 rublis banknotes. The resolution also established the exchange rate between the USSR rouble and the rublis at one to one. Latvijas Banka was empowered to issue the rublis and to establish its exchange rate against other currencies. It provided for the dual circulation of the USSR rouble and the Latvian rublis, establishing that both were legal tender, without setting any closing date for the dual circulation period. The immediate reason for the introduction of Latvia's own currency was the constant large-scale shortage of rouble notes⁸⁰. This shortage was felt throughout the entire rouble zone, especially in early 1992⁸¹. As from May 1992 wages and other payments from the State budget were only made in rublis⁸². The position of the rublis gradually strengthened during the summer⁸³.

Resolution No 2 of the Monetary Reform Committee, establishing the rublis as the only legal tender in Latvia⁸⁴, was adopted on 6 July 1992. This resolution provided for the end of the dual circulation period by establishing that: (i) as from 13 July 1992 the retail sector could only provide change to customers in rublis; (ii) until 20 July 1992 both the rouble and the rublis had to be accepted by the public sector, the retail sector and consumers; and (iii) as from 20 July 1992 banks could only accept rublis and only pay out rublis from accounts which had previously been denominated in roubles⁸⁵. The end of the rouble as

⁸⁰ Article 1 of the Resolution No 1 of the Monetary Reform Committee on circulation of Latvian rublis. This resolution is published only on the website of Latvijas Banka, http://www.bank.lv/images/img_lb/about/latvian/images/2.jpg.

⁸¹ Lainela and Sutela, *op. cit.* p. 53.

⁸² Article 6 of the Resolution No 1 of the Monetary Reform Committee on circulation of Latvian rublis.

⁸³ Lainela and Sutela, *op. cit.* p. 53.

⁸⁴ AP MP 34, 7.7.1992.

⁸⁵ Articles 2 and 3 of the Resolution 2 of the Monetary Reform Committee establishing Latvian rublis as the only legal tender in the Republic of Latvia, AP MP 34, 7.7.1992

the legal tender of Latvia was further reinforced by the provisions of the Resolution establishing that, as from 20 July 1992, the rouble would be considered a foreign currency and that from the same date all prices had to be displayed in rublis⁸⁶.

In view of growing inflation and due to the fact that no sub-units of the Latvian rublis were ever produced and circulated, further provisions were adopted establishing one Latvian rublis as the lowest denomination means of payment and providing that sub-units of the rouble (kopecks) only had legal tender status until 20 July 1992⁸⁷.

With regard to the second step of the currency changeover, some commentators have suggested that the original plan was to introduce the lats in 1992⁸⁸, but the resolutions of the Monetary Reform Committee do not confirm this. The Committee's Resolution No 4, adopted on 31 August 1992, shows the intention for the monetary reform to take place in two stages, and for the rublis only to be an interim currency⁸⁹. The most important provision of this Resolution was that which provided for the gradual introduction of the lats, coupled with exchanging all rublis in circulation at a uniform exchange rate. Interestingly, this particular Resolution was never published.

After a relatively quiet period, the Committee adopted Resolution No 5 on the issuance of five lats banknotes⁹⁰ on 12 February 1993. This confirmed the gradual continuation of the reform and established the exchange rate between the lats and the rublis at 1 to 200. Interestingly, these provisions only applied to cash transactions. In mid-March coins of 2 lati, 1 lats and 50 santimi were put into circulation⁹¹.

Resolution No 7 of the Committee on transition to lats⁹² of 27 May 1993 was the most important, since it provided the general framework for the changeover from the interim currency to the lats. 28 June 1993 was established as the date from which the retail sector had to display prices only in lati and from which the display of prices in foreign currencies (e.g. the USSR rouble) was prohibited. The Resolution also provided for the conversion of accounts denominated in rublis into accounts denominated in lati, and all balance sheets of organisations and companies had to be expressed in lati as from 28 June 1993. It further provided for rather robust rounding rules. It established that when converted to the lats, all amounts contained in legal instruments adopted by the Supreme Council and the Government, including the prices

⁸⁶ Ibid. at Articles 5 and 6.

⁸⁷ Resolution No 3 of the Monetary Reform Committee on establishing the rouble as the minimal payment amount; AP MP 34, 7.7.1992.

⁸⁸ Lainela and Sutela, *op. cit.* p. 54.

⁸⁹ Resolution No 4 of the Monetary Reform Committee on guarantees related to the transition to the national currency unit the lats'. This resolution has not been published until now.

⁹⁰ AP MP 11, 12.3.1993.

⁹¹ Resolution No 6 of the Monetary Reform Committee on the putting into circulation of fifty santimi, one lats and two lati coins, AP MP 14, 2.4.1993.

⁹² AP MP 20, 4.6.1003.

of goods and services, and the tariffs for determining wages, had to be expressed in lati, santimi and decimal amounts of santimi, only rounding the final amounts to natural numbers. The wording of this provision does not seem to cover transactions between parties which are based on a contractual relationship as opposed to prices established by law.

On 27 May 1993 the Monetary Reform Committee adopted Resolution No 8⁹³ establishing that all taxes and duties payable to the State and to local authorities had to be paid in lati. The Resolution also provided for the possibility of discharging such obligations in foreign currencies (i.e. roubles), but only with the authorisation of the Government.

The monetary reform was formally concluded by two resolutions of Latvijas Banka. On 14 September 1993 it adopted a Resolution on the total withdrawal of rublis from public circulation⁹⁴. The withdrawal date was 18 October 1993. More specifically, this Resolution contained several prohibitions and obligations addressed to the retail sector, such as the prohibition on accepting rublis as legal tender and on giving change in rublis. The Resolution also contained an obligation addressed to credit institutions – to ensure that all rublis banknotes of all denominations could be exchanged for lati without any restrictions on the amounts exchanged. The Resolution contained a statement that Latvijas Banka would continue the unlimited exchange of Latvian rublis banknotes for lati banknotes and coins after 18 October 1993 until the complete withdrawal of rublis banknotes, without indicating an expiry date. On 25 May 1994 Latvijas Banka adopted Resolution No 44⁹⁵ stating that the exchange of rublis banknotes would end on 1 July 1994.

2.2.3 Continuity of contracts

As previously explained, there is no specific law on currency in Latvia. Furthermore, the Law on Latvijas Banka, which establishes the status of the lats, does not contain any provisions establishing continuity between the lats and the interim currency, the rublis, nor between the rublis and the USSR rouble. Therefore the Monetary Reform Committee's resolutions are the only legal source from which norms on the continuity of contracts can be derived.

With regard to the transition from the USSR rouble to the Latvian rublis, the Committee's Resolution No 1 provided for the automatic conversion of savings in USSR roubles to savings in rublis. Resolution No 2 provided that from 20 July 1992 all natural and legal persons had an obligation to accept the rublis as legal tender.

⁹³ AP MP 20, 4.6.1993.

⁹⁴ Annex No 13 to daily newspaper 'Diena', 22.9.1993.

⁹⁵ Vēstnesis (Official Gazette) No 64, 31.5.1994.

With regard to the transition from the interim currency to the lats, Resolution No 5 provided that after 28 June 1993 all credit institutions had to convert all accounts by expressing amounts in lati at the exchange rate of 200 rublis to 1 lats and, after the conversion, to denominate the accounts as lats accounts. The Resolution further specified that, when executing documents originating from before 28 June 1993 containing monetary obligations expressed in rublis, the amounts should be converted to lati. The Resolution also contained rounding rules establishing that, when converted to lati, all amounts referred to in legal instruments adopted by the Government, including the prices of goods and services, and the tariffs for determining wages, have to be expressed in lati, santimi and decimal amounts of santimi, only rounding the final amounts to whole numbers.

2.2.4 The monetary system

Initially the lats was allowed to float freely, but due to the small size of the money market the floating exchange rate was very vulnerable to any kind of speculation⁹⁶. The monetary reform was completed on 12 February 1994 when the lats was informally and through the intervention of the central bank pegged to the IMF's SDR currency unit with a narrow fluctuation band of +/- 1 % around parity of SDR 1 to LVL 0.7997⁹⁷. At this time the SDR contained five currencies in the following proportions: USD 39 %, DEM 21 %, JPY 18 %, GBP 11 % and FRF 11 %. Thus, Latvia chose a different policy from its neighbouring countries Estonia and Lithuania, where the national currencies were anchored against one strong foreign currency (the German mark and the US dollar respectively). This regime was chosen to provide a nominal anchor which would facilitate business planning and bring down inflation and it was fairly successful in achieving these objectives⁹⁸. There were no exchange restrictions on current account transactions, since Latvia accepted the obligations of Article VIII of the IMF Articles of Agreement from June 1993.

A fixed exchange rate strategy, secured by the central bank's interventions, was chosen as it was seen as one of the most effective instruments for reducing inflation, stabilising the macroeconomic environment and strengthening the public's confidence in the national economic policy during the initial phase of the transitional economic reforms. Latvijas Banka's foreign exchange reserves backed every lats in circulation (the monetary base), therefore it was capable of maintaining a stable lats exchange rate even in the event of external disorders⁹⁹.

⁹⁶ Kuk, op. cit. p. 36.

⁹⁷ See Kārlis Bauze 'Piesaiste SDR – veiksmīgs lata kursa stabilitātes nodrošinājums', *Averss un reverss* (Quarterly publication of Latvijas Banka), 1996 1, and Kuk, op. cit. p. 35.

⁹⁸ Agenda 2000 – Commission Opinion on Latvia's Application for Membership of the European Union, 15 July 1997 DOC/97/14, page 25. To be found at http://ec.europa.eu/enlargement/archives/pdf/dwn/opinions/latvia/la-op_en.pdf

⁹⁹ See Latvijas Banka's website chapter, Monetary Policy of Latvijas Banka.

Since 1 January 2005 the lats has been pegged to the euro. Latvia joined ERM II on 29 April 2005 at the already established lats exchange rate against the euro, i.e. EUR 1 to LVL 0.702804. Although the permissible standard exchange rate fluctuation within ERM II is +/- 15 %, Latvia has unilaterally undertaken to guarantee an exchange rate fluctuation within +/- 1 %, preserving the fluctuation band which is familiar to the financial market and has existed since the lats was pegged to the SDR in 1994. That same fluctuation band was retained when the lats was re-pegged to the euro on 1 January 2005.

2.3 Changeover using an interim currency – the case of Lithuania

2.3.1 Lithuania's independence and the establishment of Lietuvos bankas

After the declaration of independence on 16 February 1918, Lithuania introduced its own currency, the litas. On 9 August 1922 Parliament adopted the Law on the monetary unit. The introduction of the litas was entrusted to Lietuvos bankas, established by a separate Law adopted on 11 August 1922.

Following the occupation of Lithuania by the Soviet army and its annexation in 1940, the litas was withdrawn from circulation in 1941 and replaced by the USSR rouble. Lietuvos bankas lost its independence and was subsequently turned into a local branch of the USSR State Bank¹⁰⁰.

On 11 March 1990, Lithuania's democratically elected Parliament declared the restoration of Lithuania's independence. Lithuania's Supreme Council had already adopted, on 18 May 1989, the Law on the fundamentals of independence which provided for the possibility of introducing a separate monetary and banking system in Lithuania. On 13 February 1990 the Supreme Council passed the Law on Lietuvos bankas¹⁰¹ in accordance with which Lietuvos bankas was established on 1 March 1990. It was established as an institution reporting directly to the Supreme Council. Government decrees were only binding on Lietuvos bankas to the extent provided by law (Article 3 of the Law on Lietuvos bankas).

Although Lietuvos bankas was re-established, it was not provided with capital or premises, and it only started its activities in September 1990. On 2 October 1990, Parliament decided to take over the property of the USSR banks operating in Lithuania and to transfer some of their property to Lietuvos bankas¹⁰². In September 1992, the commercial functions of Lietuvos bankas were acquired by the newly-established State Commercial Bank of Lithuania¹⁰³, thus leaving to Lietuvos bankas only the core activities of central banking. Upon the recognition of Lithuania as an independent state, France and the UK returned Lithuania's gold reserves, and Sweden provided compensation for the gold reserves that had been expropriated¹⁰⁴.

¹⁰⁰ V. Terleckas. Slaptieji dokumentai dėl lito ir kredito sistemos likvidavimo. *Monetary studies* (1998) 2, p. 38.

¹⁰¹ Official Gazette, 1990, No 7-172.

¹⁰² Law on the ownership of USSR banks operating in Lithuania, Official Gazette, 1990, No 29-697; Resolution of Parliament of 2 October 1990 No I-630 on the implementation of the Law on the ownership of USSR banks operating in Lithuania, Official Gazette, 1990, No 29-698.

¹⁰³ Resolution of the Government of 8 September 1992 No 655 on the establishment of the State Commercial Bank, Official Gazette, 1992, No 29-885.

¹⁰⁴ Sudarytoja R. Kropienė, *Lietuvos bankas: 1990 – 1992*, 1993, pp. 16-18, 38.

A referendum on 25 October 1992 approved the Constitution¹⁰⁵. Article 125 of the Constitution provides that Lithuania's central bank shall be Lietuvos bankas, which is owned by the State. Lietuvos bankas enjoys the exclusive right to issue banknotes.

2.3.2 Preparations for the issuance of the national currency

Preparations for the introduction of the national currency began in 1988, when a working group of academics and banking experts was formed. The group prepared the draft laws which were to form the basis for the independent monetary and banking system of Lithuania¹⁰⁶. On 5 November 1991 Parliament adopted the Law on the issuance of money¹⁰⁷, which provided that the national monetary unit of Lithuania is the litas, with 100 subunits called a centas ('centai' in the plural). The Law also stated that after the issuance of the national currency the litas and the centas would be the only legal tender in Lithuania. Other currencies would be used in accordance with the law. At the same time a special committee, the Litās Committee, was established to take charge of the changeover. The Litās Committee ex officio consisted of the Speaker of Parliament¹⁰⁸, the Prime Minister and the Chairman of the Board of Lietuvos bankas.

The Litās Committee's mandate was: (i) to establish the issuance date for the litas; (ii) to establish the date by which USSR roubles were to be withdrawn from circulation; and (iii) to set the rate at which roubles were to be exchanged for the litas, as well as other necessary conditions. The resolutions of the Committee were legally binding (Article 3 of the Law on the issuance of money). Under Article 4 of the Law, the Committee could be dissolved by a resolution of Parliament.

During the preparations for the new currency, three possibilities were discussed for the printing of banknotes: (i) printing them abroad; (ii) printing them in Lithuania; or (iii) establishing a common printing works for Estonia, Latvia and Lithuania. In the end Lietuvos bankas decided to print the banknotes abroad, claiming that the establishment of a printing works in one of the Baltic States would have been too costly. Shortly after that, Lithuania decided to revive its mint. In late 1991, the first newly-printed litas banknotes were received at Lietuvos bankas. Technically, Lietuvos bankas was ready to circulate the new currency¹⁰⁹. However, doubts were raised over the quality of the banknotes¹¹⁰.

¹⁰⁵ T. Birmontienė, E. Jarašiūnas et al. *Lietuvos konstitucinė teisė*, 2002, p. 169.

¹⁰⁶ Kropienė, op. cit. p. 40.

¹⁰⁷ Official Gazette, 1991, No 33-896.

¹⁰⁸ Lithuania's Constitution introduced the Office of the President of the Republic of Lithuania. In 1993, the Law on the issuance of money was amended in order to provide for the President to chair the Litās Committee, Law amending the Law on the issuance of money, Official Gazette, 1993, No 12-297.

¹⁰⁹ Lietuvos bankas: 1990 – 1995, 1995, pp. 31-33.

The use of a foreign currency in Lithuania during 1990-92 raised various obvious difficulties. The country needed its own money, but the economic situation at the time was rather difficult. Therefore, special coupons were issued and these were used together with USSR roubles for buying certain goods¹¹¹. The coupons had none of the features of an independent currency. Non-cash payments were all made in roubles¹¹².

In 1992, the rouble was finally replaced by an interim currency, the talonas. It was introduced on 16 September 1992 and was exchangeable with the rouble at the rate of one to one. The Litas Committee also mandated Lietuvos bankas and the Government to establish the conditions for the withdrawal of roubles from circulation. In response to this mandate, on 23 September 1992 Lietuvos bankas and the Government adopted a Resolution on the withdrawal of the rouble¹¹³.

Pursuant to this Resolution, roubles could be accepted as a means of payment until 30 September 1992. After this date, payments could only be made in talonas, with certain exceptions. Thus, until 30 September 1992 it was still possible to make payments in roubles or to deposit them in banks. However, deposits with the banks could only be withdrawn in roubles up to this date.

As from 30 September 1992, all rouble funds in accounts were redenominated in talonas. During the transitional period, i.e. from 16 September 1992 to 30 September 1992, salaries, pensions and allowances were paid in talonas or, if the payee chose, in roubles. All other payments had to be made in roubles. State-owned banks were obliged, and other banks were recommended, to extend their working hours during the transition period and, if needed, to open offices on 26-27 September 1992. After 30 September the rouble was no longer legal tender.

2.3.3 Issuance of the litas

On 30 October 1992 the Litas Committee decided that the new currency, the litas, would be introduced in Lithuania upon the fulfilment of the following conditions: (i) interbank payments between the former USSR republics had to be fully restored; (ii) the inflation rate had to be stabilised; and (iii) the balance of payments had to be adjusted. The Litas Committee also proposed that all talonas would be exchanged to litai at the same rate.

¹¹⁰ M. Vinkus, *Lito užkulisiai: Kęstučio Lyniko vaidmuo atkurto lito istorijoje*, 2004, pp. 68-70.

¹¹¹ Resolution of the Government of 17 July 1991 No 285 on the introduction of coupons for acquiring goods, Official Gazette, 1991, No 23-626.

¹¹² Lietuvos bankas: 1990 – 1995, 1995, p. 34.

¹¹³ Resolution of the Government and Lietuvos bankas's Board of 23 September 1992 No 695 on the withdrawal of roubles from circulation in Lithuania, Official Gazette, 1992, No 29-902.

Finally, after inflation in Lithuania had been reduced to a normal level and the value of the talonas stopped declining against the US dollar¹¹⁴, the Litas Committee decided, on 14 June 1993, to put the litas into circulation with effect from 25 June 1993. The Government and Lietuvos bankas were mandated to establish the conditions for the withdrawal of the Lithuanian talonas from circulation. The talonas was exchanged for the litas at a rate of 100 to 1, given the high number of notes in circulation and rather high prices. A transitional period from 25 June to 20 July 1993 was established during which both talonas and litas banknotes and litas coins (and coins denominated in the litas subunit, the centas) were in circulation. On 20 July 1993 the talonas ceased to be legal tender in Lithuania. As from 1 August 1993, the Litas Committee prohibited payments in currencies other than the litas.

Following the introduction of the litas, all organisations were obliged to redenominate their balances, salaries, allowances and income and to change prices into the litas with effect from 25 June 1993¹¹⁵. Banks were obliged to change the balances in accounts into the litas at the established exchange rate. As from 25 June 1993, all accounting had to be expressed in the litas. Salaries, pensions and allowances were all paid in litai. There was no requirement to display prices in two currencies during the dual circulation period.

On 16 June 1993, Lietuvos bankas's Board and the Government adopted Resolution No 461 on the withdrawal of the Lithuanian talonas from circulation in Lithuania¹¹⁶. In accordance with this Resolution, natural persons were allowed to use the talonas for making payments during the dual circulation period, as well as to deposit them in banks. After 25 June 1993, deposits could only be withdrawn from banks in litai. Organisations were allowed to pay talonas into banks until 21 July 1993. It was also recommended that legal entities should provide their employees with the possibility of exchanging talonas into litai through the centralised collection and distribution of banknotes. It was suggested that banks should organise additional personnel for the collection and exchange of talonas and prolong their working hours.

The Resolution also required retailers to give change in litai; if litai were not available the talonas could be used until 5 July 1993. Banks were obliged to exchange talonas into litai without charge. After 20 July

¹¹⁴ During late 1992 and early 1993 the monthly inflation rate was approximately 20-30%. The talonas was devalued against the US dollar from 250 talonas to 1 USD in October 1992 to 550 talonas to 1 USD in May 1993. Lietuvos bankas applied certain regulatory measures (e.g. introduced minimum reserve requirements for deposits in foreign currencies and increased minimum reserve requirements for deposits in the national currency), which resulted in the appreciation of the talonas up to 440 talonas to 1 USD in June 1993. The inflation rate was reduced to 6 % in June 1993. See P. Hedfors, 'Lietuvos pinigų sistemos pagrindų kūrimas 1990-1993', in *Monetary Studies* (1997) 2, p. 56.

¹¹⁵ The Ministry of Social Security issued a resolution clarifying the rounding rules for salaries and allowances. Resolution of 24 June 1993 No 07-1468 on salaries, hourly compensation rates and other payments in national money, Official Gazette, 1993, No 26-619.

¹¹⁶ Official Gazette, 1993, No 25-587.

1993 talonas were no longer accepted, except for justified cases of incapacity, such as absence due to foreign travel or hospitalisation (and in any case no longer than until 1 February 1994).

Legal acts in which the title of a currency was named were not amended individually. A law adopted by Parliament on 6 October 1992 (the Law on the change and use of the title and values of the monetary units of the Republic of Lithuania in laws and other regulatory enactments)¹¹⁷ provided that in all legal acts references to the rouble should be construed as references to the talonas, and upon the introduction of the litas, all references to the talonas should be construed as references to the litas, taking into account the rate of exchange established by the Litas Committee. Another law adopted by Lietuvos bankas's Board and the Government laid down the obligation to express all prices only in litai as from 1 August 1993¹¹⁸.

On 1 July 1993, Parliament adopted the Law on money¹¹⁹, which replicated the provisions of the Law on the issuance of money, and provided that Lithuania's monetary unit is the litas, with 100 subunits called centas ('centai' in the plural). The Law also provided that Lietuvos bankas should establish the values of banknotes and coins as well as their design, and should have the exclusive right to issue the litas. The Law on money further stated that the litas is the only legal tender in Lithuania and that, upon its introduction, all financial transactions, debt instruments, contracts, payments and settlements must be made using that currency. The latter provision was subsequently removed¹²⁰ with the aim, as was stated in the preparatory documents, of achieving consistency between the Law on money and the proposed amendments to the Law on foreign currency in the Republic of Lithuania, described below. By 20 July 1993, the changeover had been completed.

On 7 July 1993 Parliament adopted the Law on foreign currency in the Republic of Lithuania¹²¹. The Law provided that foreign currency could only be used for payments to natural or legal persons established or residing abroad. The Law entered into force on 1 August 1993, and has subsequently been amended. For instance, it was amended in 2002 to provide that foreign currency may be used for non-cash payments, if the parties so agree. The parties could also agree to use the euro for both cash and non-cash payments¹²². The courts regard this provision as an indication that, provided the parties consent, the litas is not the sole legal tender in Lithuania¹²³.

¹¹⁷ Official Gazette, 1992, No 30-917.

¹¹⁸ Resolution of the Government and Lietuvos bankas's Board of 30 July 1993 No 585 on prohibition on trade in foreign currencies in the internal market of the Republic of Lithuania, Official Gazette, 1993, No 34-790.

¹¹⁹ Official Gazette, 1993, No 27-623

¹²⁰ Law amending Article 3 and repealing Article 5 of the Law on money, Official Gazette, 2002, No 105-4688.

¹²¹ Official Gazette, 1993, No 28-640.

¹²² Law amending the Law on foreign currency in the Republic of Lithuania, Official Gazette, 2002, No 105-4687.

¹²³ Opinion of the Lithuanian Supreme Court's Division of Civil Cases of 4 March 2004.

2.3.4 Continuity of contracts

According to the Law on money, on the introduction of the litas, contracts in which debt obligations were expressed in talonas had to be performed using litas. Moreover, it is generally accepted that a monetary obligation can always be performed – if one currency is withdrawn from circulation, the obligation can be performed in another¹²⁴. The doctrines of frustration and of changed circumstances should not apply in these cases, provided there is no unforeseen and fundamental change in circumstances, such as a significant change in the value of a currency¹²⁵. The Lithuanian Supreme Court appears to support the idea that it is always possible to perform monetary obligations¹²⁶.

Article 6.36(4) of the Lithuanian Civil Code, adopted on 18 July 2000¹²⁷, provides that if a monetary obligation is expressed in a currency which is not legal tender, the debtor must pay in a currency which is legal tender in accordance with the rate effective at the time of the payment in the place where the obligation is to be performed. In the view of V Mikelėnas, this provision could also apply to the currency changeover scenario¹²⁸. Also, according to Article 1.57 of the Civil Code, the currency used for payment must be determined by the law of the state in which the payment has to be made, unless the parties have specified the currency for payment; in all other matters the law of the state issuing the currency applies to the currency.

Interestingly, the Lithuanian courts were confronted with some cases in which they had to apply the principles of restitution and in which the monetary obligations had to be recalculated, taking into account the fact that the currency in which the obligations were expressed (e.g. the USSR rouble) had been replaced by another currency. A formal recalculation, merely based on the conversion rates adopted by competent authorities, may not always be equitable since the real value of money may have changed over the years due to inflation¹²⁹. Similarly, the courts have considered the amount of monetary obligations, recalculated to take into account the changed value of money where a debtor has failed to repay in time¹³⁰.

¹²⁴ V. Mikelėnas *Prievolių teisė. Pirmoji dalis*, Vilnius, 2002, pp. 182, 184; V. Mikelėnas. *Lietuvos Respublikos civilinio kodekso komentaras. Šeštoji knyga. Prievolių teisė. Pirmas tomas*, 2003, p. 168.

¹²⁵ On the position in English law, see C. Proctor, *International Payment Obligations - a Legal Perspective*, 1997, pp. 316-317. On German law, see G. Maier-Reimer, 'Continuity of Contracts: German Perspectives', *Yearbook of International Financial and Economic Law* 1998, pp. 317-322. For a comparative analysis of, Austrian, English, French, German, Japanese, Swiss and US laws, see O. Sandrock, 'The Euro and Its Impact on Private Law Contracts', *National and International. Yearbook of International Financial and Economic Law* 1998, pp. 238-256.

¹²⁶ Decision of the Supreme Court of Lithuania of 19 May 2003 in the civil case No 3-3K-612/2003.

¹²⁷ Official Gazette, 2000, No 74-2262.

¹²⁸ Mikelėnas, 2002 op. cit. pp. 182, 184; Mikelėnas, 2003 op. cit. p. 65.

¹²⁹ See, for instance, Mikelėnas, 2002 op. cit. pp. 181-182; Decision of the Supreme Court of Lithuania of 30 May 2001 in the civil case No 3-3K-575/2001.

¹³⁰ See, for instance, Decision of the Supreme Court of Lithuania of 23 January 2002 in the civil case No 3K-3-151/2002.

2.3.5 The exchange rate regime in Lithuania following the changeover

On 21 October 1993, on the basis of Article 75 of the Constitution, Parliament passed a vote of no-confidence in Chairman of the Board of Lietuvos bankas, R Visokavičius¹³¹. Concerns were raised about the exchange rate regime and the stance of Lietuvos bankas vis-à-vis monetary policy¹³².

On 17 March 1994 Parliament adopted the Law on the credibility of the Lithuanian litas¹³³. The Law ensured the full backing of the litas by the country's foreign reserves. A currency board regime was effectively put in place. As argued by some experts, the Lithuanian currency board arrangement was somewhat unorthodox, reflecting a difficult compromise between the Government's desire to stabilise the exchange rate by limiting central bank functions and Lietuvos bankas's aim of retaining conventional central bank operations¹³⁴. Article 2(4) of the Law provided that Lietuvos bankas may only change the amount of litas in circulation when corresponding changes are made to the amount of gold and foreign exchange reserves. The Government was entrusted with the power to establish, in consultation with Lietuvos bankas, the rate of the litas against the base currency. The Law was amended shortly afterwards however, to provide that Lietuvos bankas may establish the rate of the litas against the base currency in agreement with the Government¹³⁵. On 30 March 1994 the Government pegged the value of the litas to the US dollar¹³⁶. Since 4 January 1999 Lietuvos bankas has been responsible for announcing the average interbank interest rates VILIBID and VILIBOR¹³⁷.

Although the need for the currency board arrangement was questioned by some analysts, Lietuvos bankas argued in favour of it and decided, on 28 June 2001, that the litas would be re-pegged to the euro with

¹³¹ Resolution of Parliament of 21 October 1993 No I-287 on the dismissal of R. Visokavičius from the office of Chairman of the Board of Lietuvos bankas, Official Gazette, 1993, No 56-1085.

¹³² Transcript of Parliament's meeting of 21 October 1993.

¹³³ Official Gazette, 1994, No 24-378.

¹³⁴ P. Alonso-Gamo, S. Fabrizio, V. Kramarenko and Q. Wang, 'Lithuania: History and Future of the Currency Board Arrangement', *IMF Working Paper*, WP/02/127 August 2002, p. 5.

¹³⁵ Law amending Article 3 of the Law on credibility of the litas, Official Gazette, 1994, No 59-1157.

¹³⁶ Resolution of the Government of 30 March 1994 No 213 on the base currency and the official litas exchange rate, Official Gazette, 1994, No 25-416.

¹³⁷ Resolution of Lietuvos bankas's Board of 10 December 1998 No 211 on calculation and promulgation of average interbank interest rates (VILIBID and VILIBOR), Official Gazette, 1998, No 112-3121.

effect from 2 February 2002¹³⁸. The market rate of the euro against the US dollar on 1 February 2002 was taken as the basis for the new official rate (EUR 1 to LTL 3.4528)¹³⁹.

With effect from 28 June 2004, Lithuania joined ERM II with its currency board arrangement in place, as a unilateral commitment. The litas was included in ERM II with the central rate of EUR 1 to LTL 3.45280¹⁴⁰. Preparations are under way to adapt Lithuania's legislative framework for the introduction of the euro as soon as Lithuania's derogation is abrogated.

¹³⁸ Resolution of Lietuvos bankas's Board of 28 June 2001 No 112 on the establishment of the base currency and the official litas exchange rate, Official Gazette, 2001, No 57-2073.

¹³⁹ In accordance with the Resolution of Lietuvos bankas's Board of 28 June 2001 No 113 on the establishment of the official Lithuanian litas exchange rate (Official Gazette, 2001, No 57-2074), the European Central Bank's (ECB) EUR/USD reference rate of 1 February 2002 was the basis for the calculation of the new official exchange rate. See also Resolution of Lietuvos bankas's Board of 1 February 2002 No 15 on the base currency and the official the Lithuanian litas exchange rate, Official Gazette, 2002, No 12-453.

¹⁴⁰ Lithuanian litas included in the Exchange Rate Mechanism II (ERM II), ECB press release of 27 June 2004.

Summary

In the monetary reforms of the Baltic States two approaches were taken for breaking away from the rouble zone: one of them constituted a rapid changeover (Estonia), and the other one was relatively smoother, being made in two stages and involving the use of interim currencies (Latvia and Lithuania).

Although the preparations for the introduction of the national currencies started as early as the late 1980s, the changeovers could only take place after the Baltic States had regained their independence. The breakaway from the rouble zone was initially not recommended by foreign advisers and, as a response to the rouble cash shortages, was ultimately carried out within a relatively short time-frame, compared to the euro changeover in 1999-2002.

Of all the possible scenarios, Estonia chose a rapid changeover while Latvia and Lithuania took somewhat longer paths that involved the use of interim currencies. Monetary Reform Committees were established in each Baltic State: these consisted of the prime minister (chair), the central bank governor, and one member appointed by the national parliament. In Estonia, the person appointed by parliament was always someone with a Western background, while in Latvia and Lithuania it was a member of parliament (in Latvia, the Chairman of the Economic Committee, and in Lithuania, the Speaker of the Parliament).

The changeover legislation in the Baltic States had to be drafted within a limited period by drafters who had limited experience of the topics they had to deal with. Given that the financial markets were rudimentary, the changeover legislation concentrated mostly on the introduction of cash and, apart from addressing social concerns, only briefly touched on the continuity of contracts. The Estonian and Lithuanian laws also initially prohibited the use of foreign currencies in domestic trade, but these prohibitions were phased out as confidence grew.

Full control over local credit institutions and the financial system in general was only gained after the monetary reforms had been completed.

Latvia chose a monetary system – nominally anchored on the SDRs of the IMF – different from its neighbouring countries, Estonia and Lithuania, where the national currencies were pegged to one foreign currency (the German mark¹⁴¹ and the US dollar respectively¹⁴²). The Estonian kroon and the Lithuanian litas joined ERM II on 28 June 2004, and the Latvian lats joined ERM II on 29 April 2005.

¹⁴¹ As from 1 January 1999 the anchor currency was the euro.

¹⁴² As from 2 February 2002 litas was re-pegged to the euro.

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ISSN 1830268-8



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