English summaries

RISTO MURTO: *How to Live with Deposit Insurance*

There is broad agreement in the literature that deposit insurance

in banking and thrift-industries entails the moral hazard problem.

In its simplest form, the moral hazard argument states that if no one charges a bank a higher price for accepting more risk, optimizing banks will exploit the risk-return trade-off by assuming as much risk as possible. Under flat-rate deposit insurance, no one charges a risk premium – neither depositors nor insurer. However, deposit insurance is by no means the only reason for the banking crisis.

I discuss three major ways to reduce the moral hazard problem, as suggested in the literature. First, several authors have suggested the use of market discipline to restrict banks' risk taking. According to this view, investors should monitor banks' activities and require higher premiums for their investments whenever a bank engage in riskier activities. This, however, requires that investors have sufficient information on banks' loan portfolios and that they be exposed to default risk. These conditions are not necessarily fulfiled.

Second, the alternative to deposit insurance provided by the government is the mutual-guarantee system. Under a mutual-guarantee arrangement the solvent banks cover the obligations of an insured bank that has failed. In these circumstances banks should monitor each other. The situation is complicated, however, if banks assume that the government is still providing the ultimate deposit guarantee. In Finland monitoring is further complicated by the fact that there is a very limited number of bank groups.

Finally, the insurer can charge risk-based deposit insurance premiums. Option pricing models are used extensively in the literature to determine the fair price for deposit insurance. In practice, however, there are a number of technical difficulties in implementing these models.

SEIJA LAINELA and PEKKA SUTELA: *Monetary Reforms in Baltic States*

This paper offers an overview of the currency reforms in Baltic countries. Aftr surveying the arguments for introducing national currencies, the differing solutions applied in the three countries are analyzed. Estonia opted for a modified currency board, while Latvia has pursued institutionally liberal but in the stabilization sense stringent policies. Lithuania has followed Latvia in adopting a piecemeal reform strategy. Both approaches have their pros and cons which are discussed. Still, the conlusion is that escaping from the rouble zone has not only been possible and desirable, there are also more than one way of doing it.

PENTTI PIKKARAINEN: *Intermediate Targets, Indicators and Stance of Monetary Policy*

Irrespective of the exchange rate regime, the objective of monetary policy is the attainment of stable monetary conditions, an intrinsic part of which is a low and stable inflation. In February 1993 the Bank of Finland announced an inflation target according to which the aim is to stabilize the "underlying" inflation at the level of two per cent by 1995.

Central banks make use of various intermediate targets in endeavouring to attain the ultimate objective. Under a fixed exchange rate regime the exchange rate itself is an intermediate target of monetary policy. Under a floating exchange rate regime the definition of intermediate targets is more difficult. Accordingly, many central banks do not publish intermediate targets but instead use (internally) various monetary policy indicators, such as monetary aggregates, credit expansion, interest rates and exchange rates, for this purpose. In addition central banks monitor extensively developments in the real economy as well as in prices and wages. This is also the policy that has been applied by the Bank of Finland during the time the markka has been floating.