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IMF Staff Country Report No. 00/79

Republic of Estonia: Staff Report for the 2000 Article IV Consultation and First Review Under the Stand-By Arrangement

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Republic of Estonia, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 4, 2000** with the officials of Republic of Estonia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 8, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of **June 28, 2000**, updating information on recent economic developments;

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the June 30, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation;

- a statement by the authorities of *Republic of Estonia*.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2000 Article IV Consultation and First Review Under the Stand-By Arrangement

Prepared by the European II and Policy Development and Review Departments

Approved by Gérard Bélanger and G. Russell Kincaid

June 8, 2000

- The discussions were held in Tallinn during April 24-May 4, 2000.
- The mission met with Prime Minister Laar, Minister of Finance Kallas, the Bank of Estonia's outgoing Governor Kraft, who left office on April 28, and thereafter acting Governor Lõhmus, Minister of Economy Pärnoja, Minister of Social Affairs Nestor, and other officials.
- The mission team consisted of Messrs. Keller (head), Hobdari, Schimmelpfennig (EP), Zavoico (all EU2), Abrams (MAE), and Ms. Immers (EU2 staff assistant). Mr. Knöbl, the Fund's senior resident representative, assisted the mission. Mr. Lehmussaari, Executive Director for Estonia, and Mr. Sutt, his assistant, attended the policy meetings. Mr. Fleming (World Bank) participated in FSSA related discussions.
- Estonia accepted the obligations of Article VIII in 1994. Estonia has no restrictions on current or capital account transactions.
- The Stand-By Arrangement, in an amount equivalent to SDR 29.34 million (45 percent of quota), was approved by the Executive Board on March 1, 2000 and will expire on August 31, 2001. At end-March 2000, all performance criteria under the Stand-By Arrangement were met.
- In the attached letter, dated June 7, 2000, the Prime Minister and the Acting Governor of the Bank of Estonia request the completion of the first review by the Board.
- The second program review is expected to be concluded before December 15, 2000.

As background to the upcoming Board discussions, an FSSA report, a paper on "Pension Reform in the Baltics: Issues and Prospects," a paper on "Saving, Investment, and External Adjustment in the Face of Exogenous Shocks in the Baltics," as well as a paper providing statistical information will be forthcoming.

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Estonia: Basic Data

Social and demographic indicators, 1999	
Area	45,227 sq. km.
Population	1.4429 million
Rate of population growth	-0.6 percent per year
Life expectancy at birth 1/	69.9 years
Male	64.4 years
Female	75.4 years
Infant mortality rate (per 1,000 births) 1/	9.3
Hospital beds (per 10,000 inhabitants) 1/	72.5
Physicians (per 10,000 inhabitants) 1/	30.8

	1995	1996	1997	1998	1999
Nominal GDP (in million of EEK)	40,705	52,446	64,324	73,325	75,360
GDP per capita (in US$)	2,455	2,966	3,180	3,593	3,553
Real GDP (percentage change)	4.3	3.9	10.6	4.7	-1.1
Sectoral distribution of GDP					
	(In percent of GDP)				
Agriculture, hunting, forestry, and fishing	7.9	7.5	6.9	6.3	5.7
Mining, manufacturing, and energy	23.1	22.2	21.5	21.2	19.9
Construction and services	69.0	70.3	71.7	72.5	74.4
Trade	(In millions of kroons, unless otherwise specified)				
Total exports of goods	19,428	21,833	31,871	37,786	36,036
(in percent of GDP)	47.7	41.6	49.5	51.5	47.8
Total imports of goods	29,230	37,637	47,526	53,505	48,975
(in percent of GDP)	71.8	71.8	73.9	73.0	65.0
General government					
Total revenue	16,467	20,431	25,485	28,887	29,083
(in percent of GDP)	40.5	39.0	39.6	39.4	38.6
Total expenditure	16,833	21,200	24,339	29,037	32,542
(in percent of GDP)	41.4	40.4	37.8	39.6	43.2
Net lending	-146	-41	264	-77	-81
(in percent of GDP)	-0.4	-0.1	0.4	-0.1	-0.1
Overall surplus / deficit(-)	-512	-811	1,410	-227	-3540
(in percent of GDP)	-1.3	-1.5	2.2	-0.3	-4.7
Money and credit (end-period)					
Net foreign assets	7,629	7,159	5,091	5,114	7,850
Broad money (M3)	10,344	14,154	19,509	20,798	25,918
Domestic credit	5,200	10,434	19,184	23,622	26,050
Claims on general government (net)	-1,820	-1,501	-2,762	-1,469	-668
Other selected indicators					
	(Annual percentage change)				
GDP at current prices	37.5	28.8	22.6	14.0	2.8
Consumer prices	29.0	23.0	11.2	8.1	3.3
Average nominal wage (in EEK)	37.0	25.7	19.7	15.4	10.4

Sources: Estonian authorities; and Fund staff estimates.
1/ Data for 1998

Executive Summary

Following a sharp but short recession, linked in part to earlier events in Russia, real GDP growth has resumed. Despite the economic recovery, unemployment remained high but inflation has fallen to low levels. Exports to western markets continued to grow in 1999 and accelerated sharply in early 2000. Exports to CIS markets contracted in 1999 and have not recovered. Nevertheless, the current account deficit has been sharply reduced in 1999 and it was again fully financed with non-debt-creating flows. External debt and debt service remain low and confidence in the currency board is strong.

There has been a welcome fiscal correction in early 2000, with the budget deficit falling to 1 percent of GDP. Estonia met all performance criteria under its precautionary stand-by arrangement at end-March 2000, and program projections for 2000 remain broadly valid. Economic growth is expected to reach about 4 percent in 2000 and 6 percent in 2001 and beyond. Due to a higher rate of private investment, the current account deficit is projected at about 6-7 percent of GDP in 2000 and beyond, slightly larger than expected earlier. Recent export growth and the influx of foreign investment suggest that competitiveness remains strong. The Bank of Estonia remains firmly committed to maintaining the currency board until the euro becomes Estonia's official currency, and the ECB recently indicated that euro-based currency boards can be acceptable under ERM2.

The withdrawal of the expansionary fiscal impulse provided in 1999 remains appropriate and a balanced budget is targeted for 2001. The authorities aim to achieve this with further tax cuts accompanied by a freeze in nominal expenditures. A major pension reform that would introduce a mandatory fully funded pillar remains under discussion. Substantial technical assistance has been provided by both the World Bank and the Fund, but the debate over transitional costs and financing implications is likely to delay the reform to 2002.

FSAP missions found that financial sector vulnerabilities had been substantially reduced and the financial condition of the banking system appeared considerably stronger. The banking supervision function has also been markedly strengthened and compliance with the Basel Core Principles has improved and is now high. However, concerns remain regarding the quality of nonbank financial supervisions, particularly the Securities Inspectorate, which is seen as ineffective. Monetary and financial policies are transparent. FSAP recommendations have been integrated into the authorities' work program.

Good progress is being made in the implementation of the structural reform agenda, including the privatization of major infrastructure companies. EU accession negotiations are proceeding apace.

I. Introduction

1. During the discussion of the authorities' request of the present SBA (EBS/00/18) on March 1, 2000, Executive Directors welcomed the authorities' intention to phase out during 2000 the discretionary fiscal stimulus provided in 1999 and to achieve overall fiscal balance in 2001. They also noted that the currency board arrangement has served Estonia well and fully supported the authorities' aim to maintain this arrangement. Directors remarked that the recent improvement in the current account deficit had to a considerable extent been due to cyclical factors. They agreed that a modest widening of the current account should not be a cause for concern in view of the relatively low level of debt and debt service. Directors endorsed the authorities' intention to work towards the introduction of unified financial supervision.

II. Recent Economic Developments

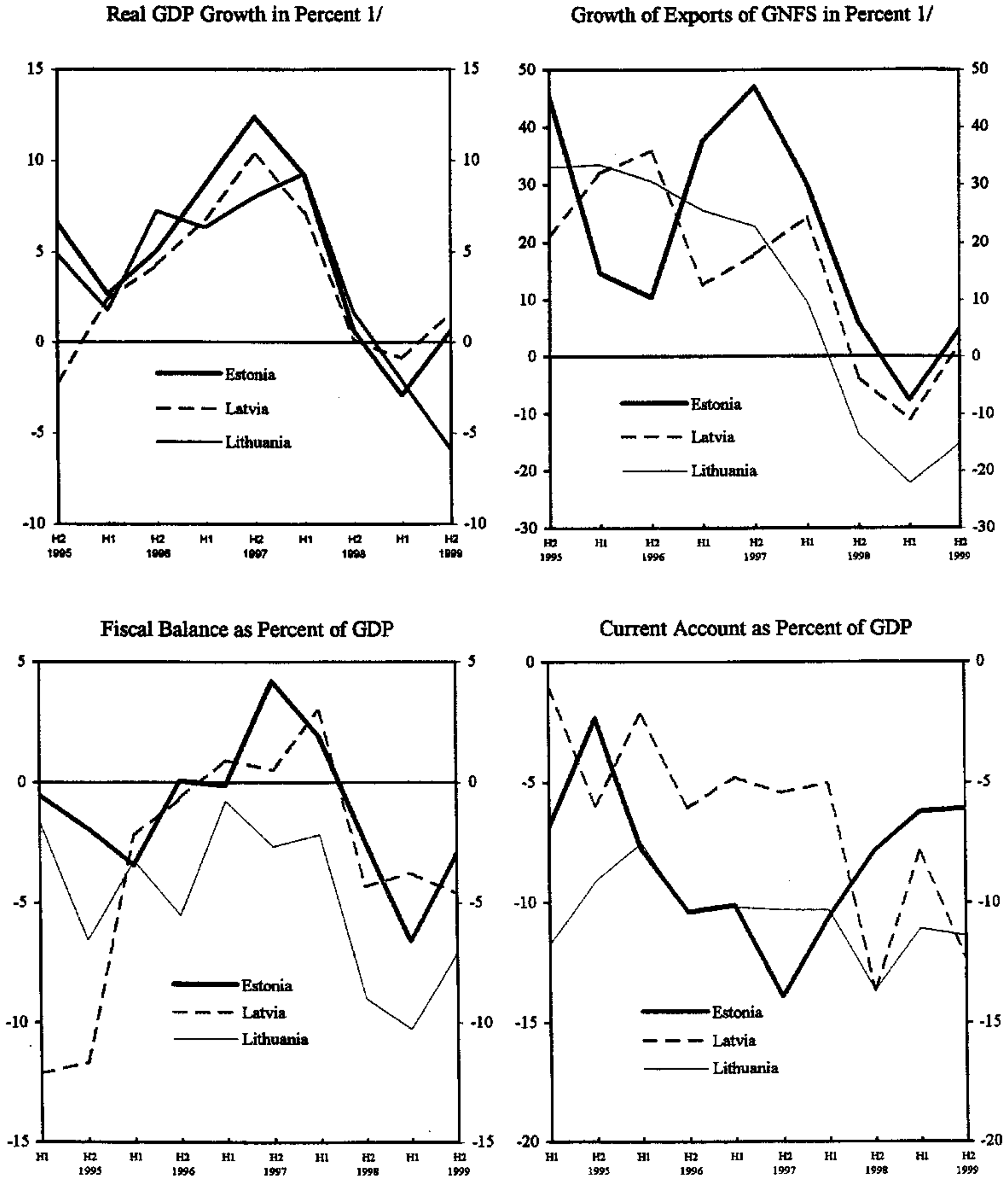
2. **Except for a somewhat wider current account deficit, developments in 1999 were broadly as described in EBS/00/18. Real GDP began to expand again in the last quarter of 1999 and gained strength in the first quarter of 2000 (Figures 1 and 2 and Table 1).** The increase in private demand has offset the tightening of the fiscal stance. Exports to CIS markets contracted sharply in 1999, while exports to western markets continued to grow at an adequate pace. The latter appear to have accelerated sharply in the first quarter of 2000, partly driven by an expansion of the electronics sector. There was a pronounced increase of service exports (oil transshipment and tourism).

3. **Average CPI inflation had fallen to 3.3 percent in 1999, reflecting low inflation rates in the euro area, the impact of the Russia crisis on agricultural prices, and cyclical factors.** The 12-month CPI inflation rate stood at 3.1 percent in April, 2000. Moderate pressure on prices resulted from the economic recovery and several one-time factors such as increases in public transport fares and excises and introduction of tariffs on selected imports, as well as rising energy prices on the world market. Nevertheless, CPI inflation was slightly below program projections. The continuing inflation differential to the euro area largely reflects the relatively fast growth of prices of nontraded goods and services. The producer price index declined for most of 1999, but has increased since end-1999 on account of energy prices.

4. The unemployment rate (ILO definition) reached close to 11 percent at end-1999 and is estimated to have remained at this elevated level over the first quarter of 2000 (Figure 3). Registered unemployment (national definition) rose to about 3.3 percent of the labor force in the first quarter of 2000.[1] So far, the return to growth has not led to a reduction in

[1] The differences between these rates reflect the combination of stringent eligibility requirements and low unemployment benefits.

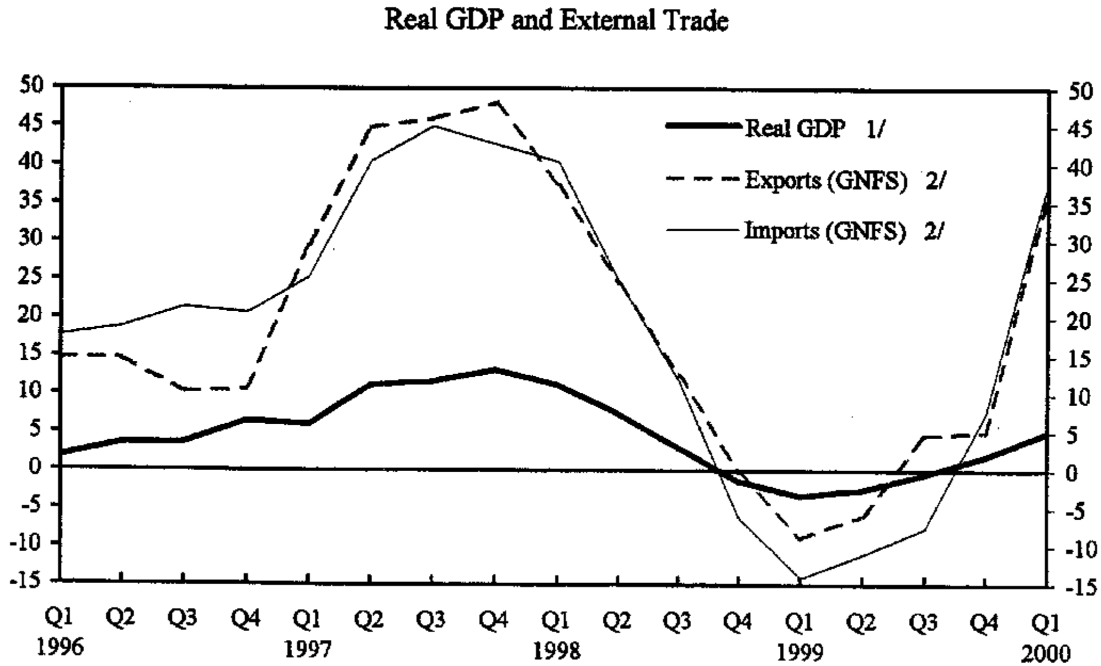
Figure 1. The Baltics: Cross Country Comparisons, 1995-1999



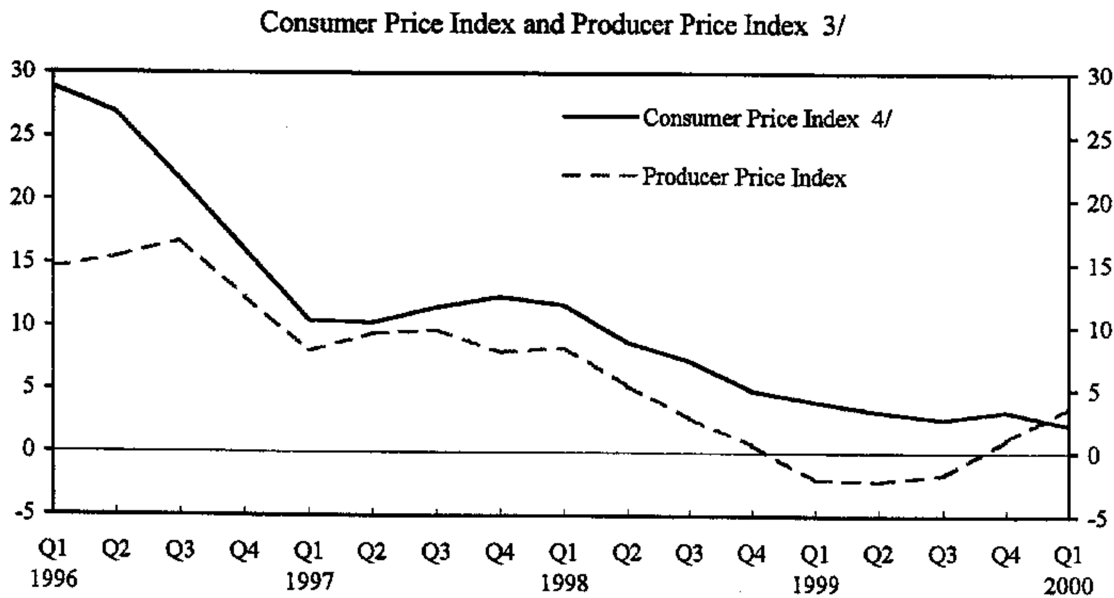
Sources: Country authorities; and Fund staff calculations.
1/ Change from same period in preceding year.

Figure 2. Estonia: Growth of Output and Prices, 1996-2000
(In percent)

Real GDP and External Trade



Consumer Price Index and Producer Price Index 3/



Sources: Bank of Estonia; and Fund staff estimates.

1/ Change over the same quarter of the previous year in constant prices.

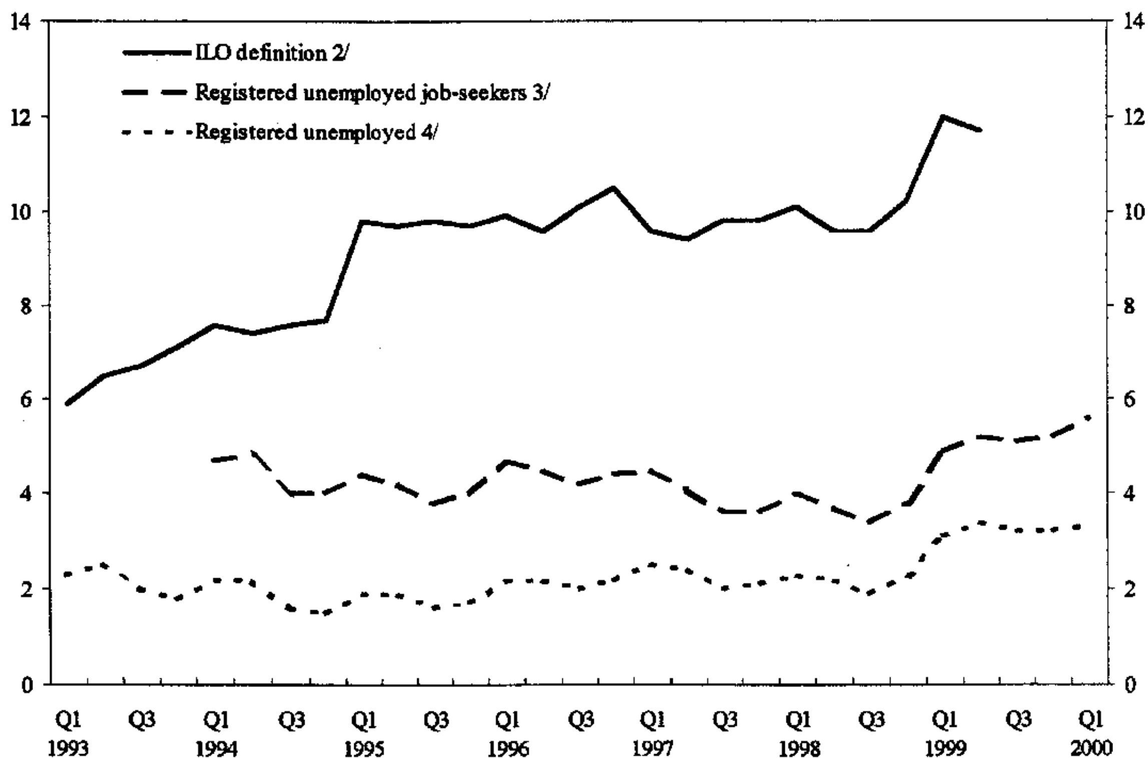
2/ Change over the same quarter of the previous year in current DM prices of goods and nonfactor services.

3/ Change over the same quarter in previous year.

4/ Effective 1998, the CPI weights were adjusted based on 1997 data.

unemployment. There are indications that part of unemployment is becoming structural in nature, owing to skill mismatch; insider-outsider mechanisms or employment protection do not seem to hamper significantly the reallocation of labor and job creation. Public sector wages increased by over 20 percent in real terms during 1999, whereas private sector wages increased on average by only about 2 percent (between 1994 and 1998 public sector and private sector wages had moved fairly parallel). In the sectors that were adversely affected by the contraction of the CIS markets, wages actually declined in nominal terms.

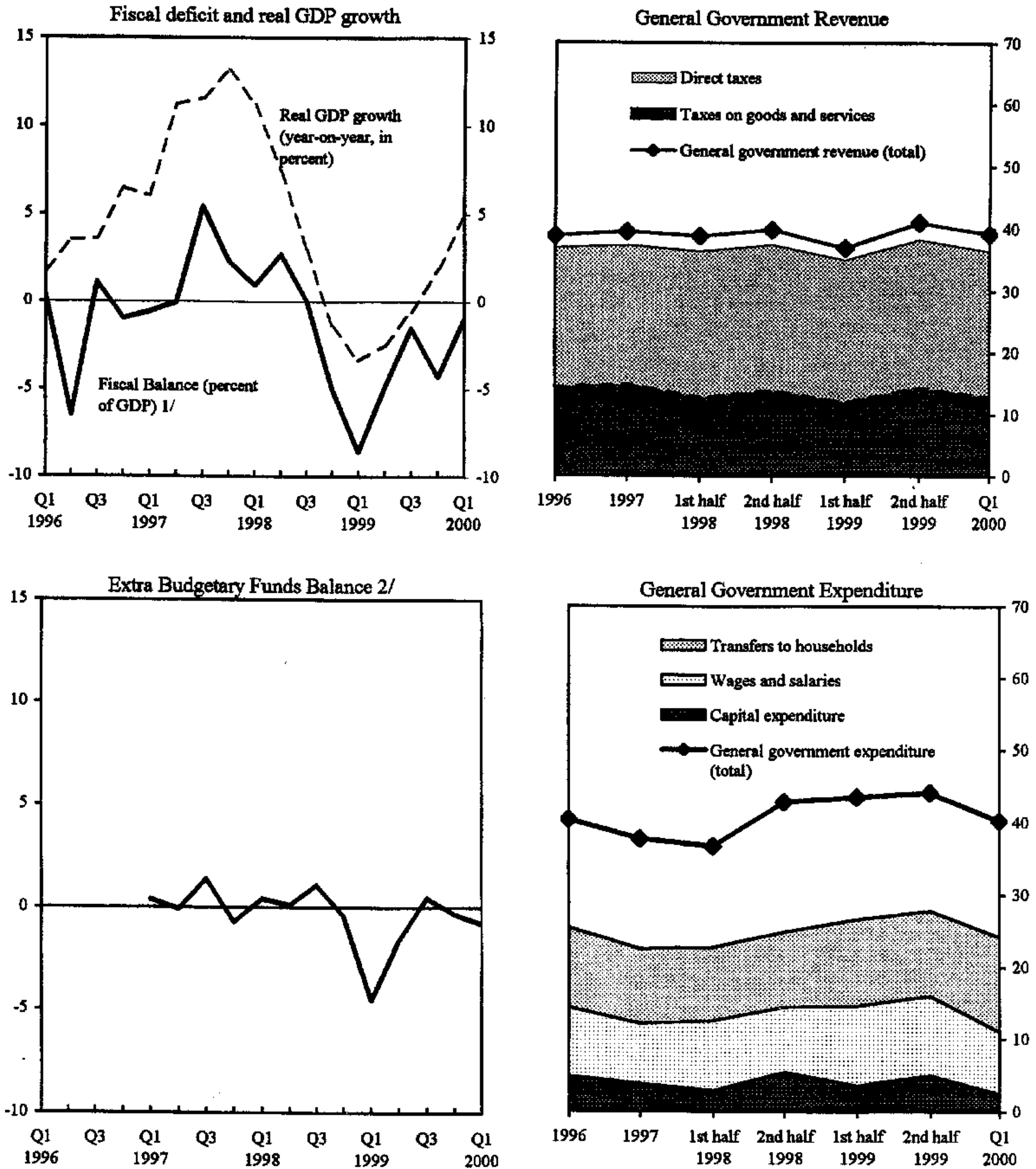
Figure 3. Estonia: Unemployment in Percent of Labor Force, 1993-2000 1/



Source: National authorities; and Fund staff estimates.
1/ The labor force consists of persons aged 15 to retirement age.
2/ Individuals actively seeking employment. Data are based on a labor force survey.
3/ Unemployed job seekers who are registered with the employment office, but are not necessarily eligible for unemployment benefits.
4/ Unemployed job seekers who are registered with the employment office and are eligible for unemployment benefits.

5. **The fiscal deficit decreased sharply in the second half of 1999 (Figure 4 and Tables 2 and 3)**. High public sector wage and pension increases, the contraction of the economy in the first half of 1999, and the impact of one-time factors (EBS/00/18), had contributed to a deficit of 6.6 percent of GDP in the first half of 1999. Discussions between

Figure 4. Estonia: General Government Operations, 1996-2000
(In percent of GDP)



Sources: Estonian Ministry of Finance; and Fund staff calculations.
1/ Includes balances of the state and local governments and extrabudgetary funds.
2/ Includes balances of the Social Insurance and of the Medical Insurance Funds. Available only from 1997 onwards.

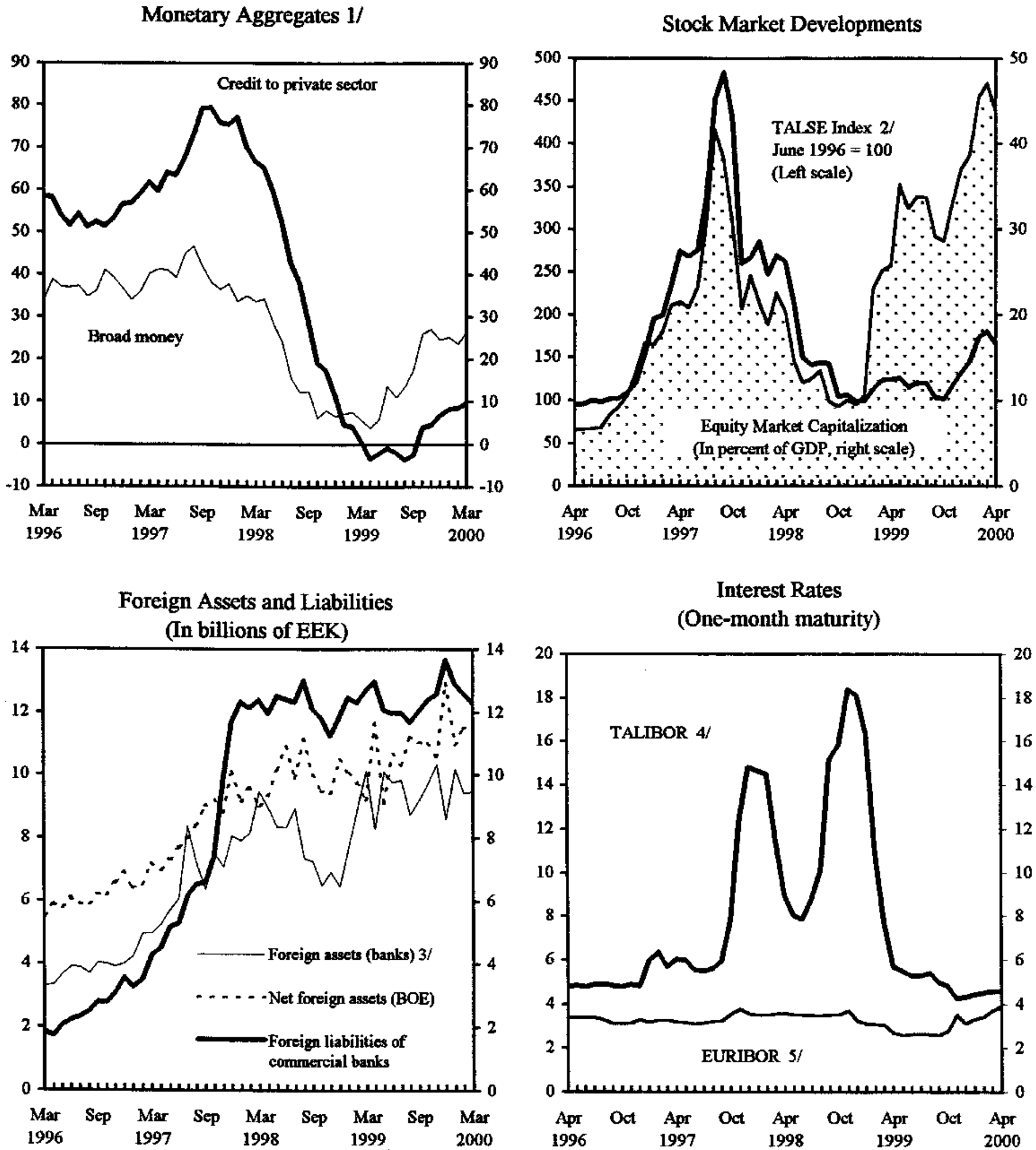
the authorities and the staff led to the passage of a supplementary budget that cut expenditures in the second half of 1999. In addition, the authorities restrained expenditure further by deferring some expenditures (0.6 percent of GDP) to 2000 without incurring expenditure arrears. The fiscal deficit was thus limited to 4.7 percent of GDP for the year as a whole. The deficit was largely financed by the privatization receipts from the sale of 24 percent of Eesti Telecom shares primarily to foreign investors.

6. **Fiscal developments in early 2000 have been broadly in line with the program.** Total general government revenues in the first quarter were 5 percentage points of GDP higher than in the same period in 1999, when revenues were depressed on account of one-time factors. Direct taxes performed well, but, as expected, excise tax collections fell in early 2000. This followed on a spike at the end of 1999 when importers had stockpiled excisable goods prior to sharp increases in excise rates of fuel and tobacco products. Expenditures have been kept in line with program targets in the first quarter of 2000 at 40 percent of GDP. The general government deficit in the first quarter of 2000 amounted to about EEK 167 million (or close to 1 percent of period GDP), compared to the program target of EEK 410 million (2.3 percent of GDP). The small deficit and the net repayment of foreign debt were financed by a drawdown of domestic and external government deposits.

7. **Interest rates have fallen to historic lows and the banking system remains highly liquid.** Lending to the private sector resumed in the second half of 1999 and early 2000 when private sector credit demand began to recover (Figure 5). Lending to leasing companies and mortgage lending to private households have picked up, while the growth of credit to the private enterprise sector has remained relatively modest. Broad money growth, which had stagnated after mid-1998, recovered to about 25 percent year-on-year towards the end of 1999 and the first quarter of 2000. Until the last quarter of 1999, there was little movement in the BoE's accounts. Subsequently, foreign assets and base money registered a sizable increase related to precautionary Y2K preparations by commercial banks. These developments were largely reversed over the first quarter of 2000.

8. **The banking system appears to remain in a strong financial condition (Tables 4 and 5),** with the average capital adequacy ratio at 17 percent of risk-weighted assets at end-March 2000 (compared to a required minimum of 10 percent). Only six banks are now active in Estonia (plus the branch of one foreign bank). The two largest Estonian banks, which together account for about 85 percent of the banking sector assets, are majority owned by foreign banks. International rating agencies have recently further increased the investment grade ratings for these banks, and both banks have successfully refinanced substantial maturing debts on fine multi-year terms in early 2000. The decision to sell the Bank of Estonia's share in Optiva Bank to a Finnish financial conglomerate was announced in late April 2000; details of this sale, which may include very limited guarantees by the BoE, have not yet been finalized. This will increase foreign control of the banking system to about 95 percent. **Stock market prices continued their upward climb in 2000** (with the main index rising by 37 percent in the first quarter); however, even at current levels the stock market index remains well below its mid-1997 peak. Market capitalization increased substantially in 1999, largely because of Eesti Telecom privatization.

Figure 5. Estonia: Monetary and Financial Indicators, 1995-2000



Sources: Bank of Estonia; Statistical Office of Estonia, IFS, and Fund staff estimates.

1/ Growth rates over same month of previous year.

2/ Tallinn Stock Exchange index.

3/ Foreign assets of commercial banks declined at end-1999 as banks shifted resources from deposits abroad to deposits with the Bank of Estonia to enhance domestic liquidity in anticipation of problems related to Y2K.

4/ Tallinn interbank offered rate.

5/ FIBOR from April 1996 to December 1998, and EURIBOR from January 1999.

9. **There have been no significant pressures on the exchange market since early 1999 and confidence in the currency board remains strong,** as evidenced by historically low interest rates and low swap margins on forward markets. The Bank of Estonia's level of NIR (defined as the excess of foreign assets over currency board cover) remained well above the program floor at end-March 2000 (Table 6).[2]

10. **Exports fell by 5 percent in 1999** (Figure 6 and Table 7). This reflected the contraction of CIS markets, while exports to the EU continued to grow at a moderate pace. Service receipts grew by 5 percent in 1999 because of tourism and transit operations. **Imports declined by 9 percent in 1999** despite the fourth quarter surge, largely because of the recession. Based on preliminary data, both exports and imports grew by an estimated 40-45 percent in the first quarter of 2000 relative to the same period of 1999. Growth of both aggregates appeared to be dominated by a sharp expansion of the electronics sector, which is relatively import intensive. In this important export sector, there has been a sharp increase in production and a corresponding increase in inventories of imported components for processing and assembly, which was financed through FDI.

11. **The current account deficit declined to 6.2 percent of GDP** in 1999 (compared to 12.1 percent of GDP in 1997 and 9.2 percent of GDP in 1998). After registering a small surplus in the third quarter of 1999, the current account deteriorated more sharply in the fourth quarter than previously estimated. Developments appear to have been dominated by an import surge in December 1999 related to commodities that were subject to increases in excise taxes (tobacco and fuel) and to tariffs (food products) as of January 2000, as well as a build-up of inventories associated with Y2K preparedness. Despite a relatively wide trade deficit, the BoE's preliminary estimate for the current account deficit in the first quarter of 2000 is 7-8 percent of GDP as growth in services exports appears to have been strong. Even if the outcome would be a somewhat larger current account deficit in the first quarter, this would still be consistent with a deficit of 6-7 percent of GDP for the year, taking into account the strong inventory build-up in the first quarter and the pronounced seasonality of tourism.[3] **Non-debt-creating flows (FDI and net equity investments) comfortably covered** the current account deficit and a very substantial (partly Y2K related) build-up of foreign reserves in the banking system in 1999 and in the first quarter of 2000.

12. **Estonia's net external debt remained unchanged at 33 percent of GDP** at end-1999. Gross external debt rose by 3½ percentage points of GDP in 1999 (to 47 percent of GDP) because of a sharp increase in commercial bank liabilities largely linked to preparations for Y2K. Also, banks exchanged part of their foreign assets for deposits at the

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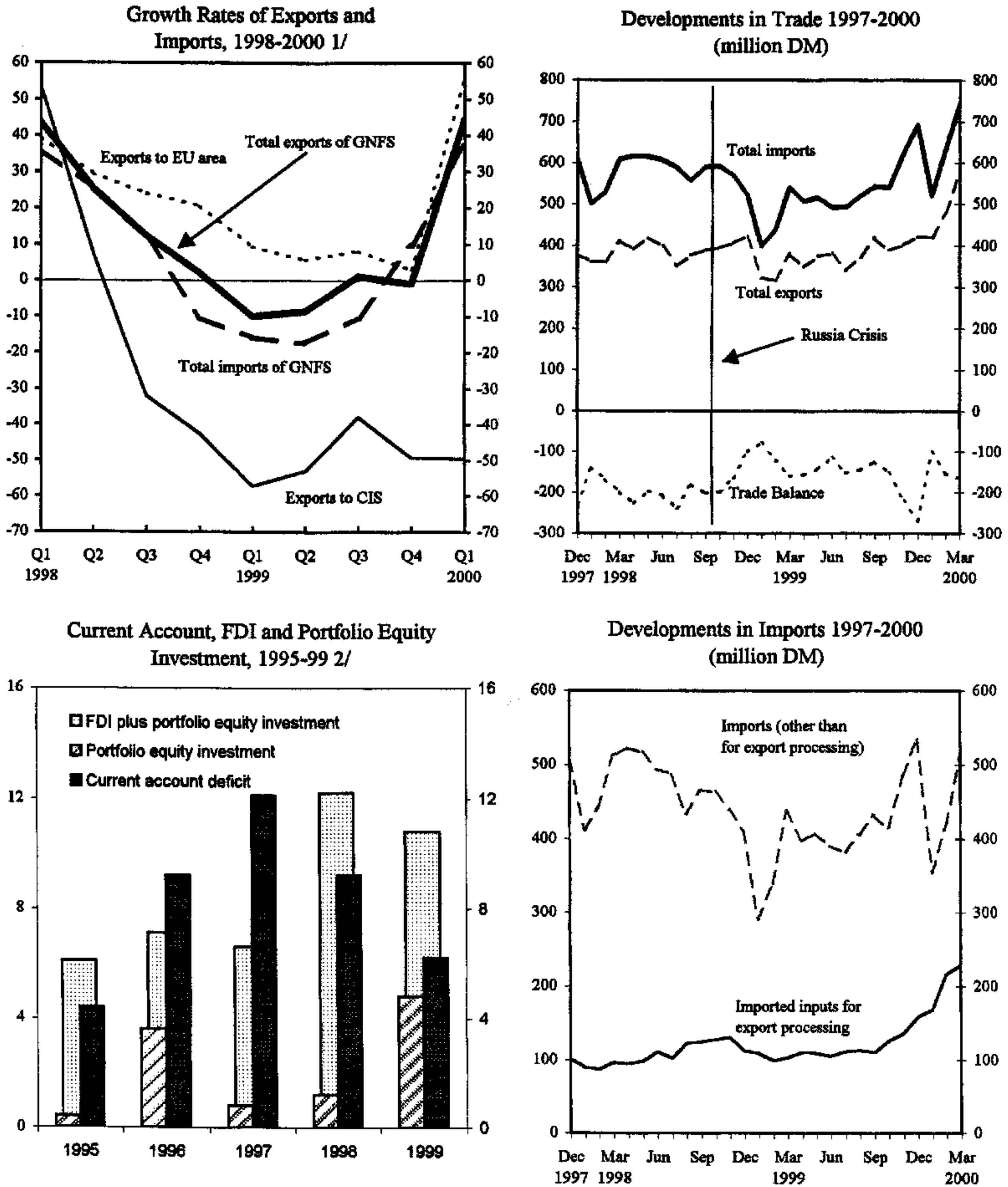
[2] Government deposits held abroad are not included in NIR.

[3] Over the last six years, the current account deficit in the first quarter was on average about 25 percent higher as a percentage of GDP than the annual deficit.

Figure 6. Estonia: External Sector Developments, 1997-2000



Source: Bank of Estonia; and Fund staff estimates.
1/ Percent change over same period in preceding year.
2/ In percent of GDP.

Bank of Estonia before end-1999. As a result, the BoE's gross reserves rose by DM 230 million (2.4 percent of 1999 GDP) in the last quarter of 1999. Since Y2K passed uneventfully, a substantial part of this reserve buildup was reversed in early 2000 as commercial banks reconstituted their foreign asset positions. The consolidated banking system registered an improvement in its net foreign asset position by 3½ percent of GDP in 1999 and a further increase in the first quarter of 2000. Net of deposits held abroad, the external debt of the general government amounted to 2.3 percent of GDP at end-1999. Debt service is estimated at 8 percent of exports of goods and services in 1999.

III. Discussions With the Authorities

A. Prospects for 2001 and Beyond

13. The authorities judge that the projections underlying the program remain broadly valid: they still expect economic growth to reach about 4 percent in 2000 and 6 percent in 2001 and beyond (Table 8). They project CPI inflation in the 3-4 percent range in both years, somewhat above euro-area inflation on account of Balassa-Samuelson effects and the shift from direct to indirect taxation. They recognize the downside risk to their growth projections should higher oil prices or stock market corrections reverse the acceleration of growth in their European export markets. They expect the current account deficit to be about 1 percentage point of GDP wider in 2000 than assumed under the program on account of higher rates of investment, driven by an influx of FDI into the export sector.

14. Against this background, the authorities still aim to withdraw the expansionary fiscal impulse they had provided in 1999, and they see no reason to change the fiscal targets of a deficit of 1¼ percent in 2000 and budget balance in 2001. Specifically, they do not see the expected widening of the current account deficit as requiring a further tightening of the fiscal position because the external debt to GDP ratio is still projected to decline (and they would be content with keeping this ratio at its present moderate level). The mission agreed that the projected widening of the current account deficit and its financing are not a matter of concern at this time, but the staff cautioned against complacency should there be a much sharper increase in the current account deficit in combination with a greater reliance on debt financing.[4] The mission discussed its tentative work on the determinants of the current account (Box 1), which suggests that the current account is negatively correlated with real

[4] In the increasingly important electronics sector, which is very capital intensive and dominated by one foreign-owned firm, machinery is provided directly by the parent company located outside Estonia. The high value components for final processing and assembly in Estonia are also provided by the parent company or the customer, who retain ownership of the components. For example, in March 2000, import of components accounted for about one-third of total imports, but no significant financing flows were entailed. If the temporary import of components were excluded, the import cover of reserves would rise very substantially.

domestic credit creation and the fiscal balance. (The negative correlation between the current account and the fiscal balance reflects the impact of GDP growth on both import demand and tax revenues). With banks liquid and enjoying easy access to foreign financing, the BoE is in a relatively weak position to counteract any excessive widening of the current account deficit, unless it were to resort to temporary capital controls or to raise sizably reserve requirements, which are, however, already very high.

Box 1. Estonia: Current Account Adjustment After the Russian Crisis

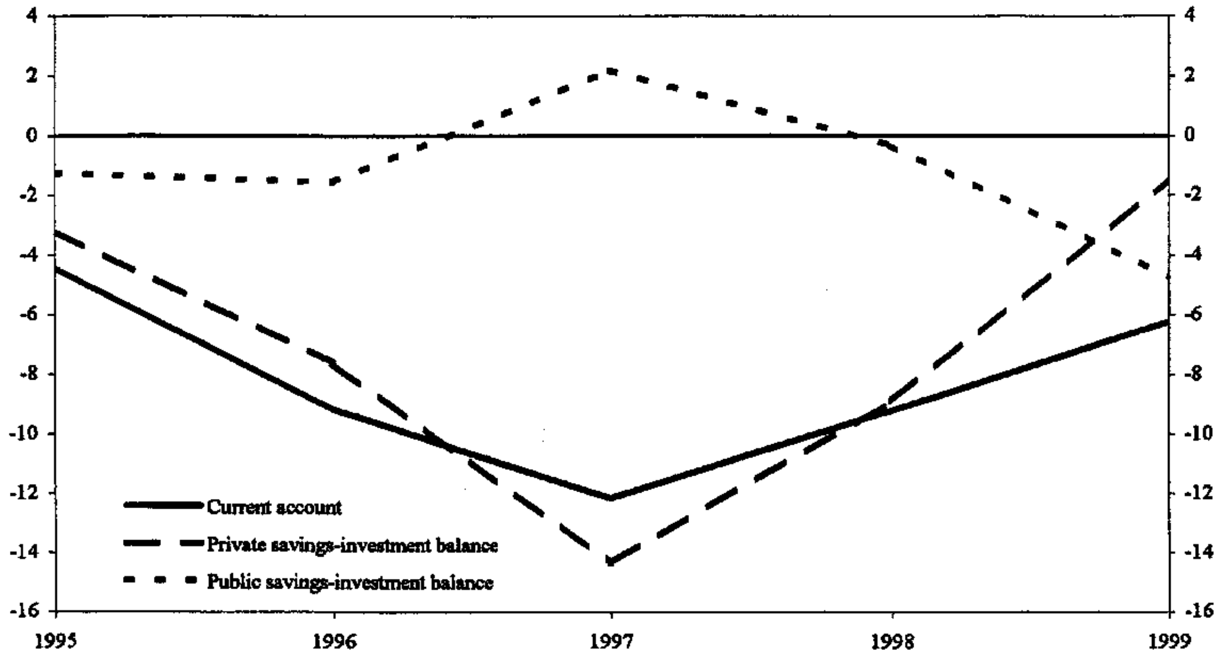
- Estonia's current account deficit widened as the economy entered a phase of strong growth in 1995. The deficit reached 12 percent of GDP in 1997. The current account improved rapidly during the recession following the Asian and Russian crises and the ensuing banking crisis; the current account deficit stood at 6 percent of GDP in 1999 (Figure 7).

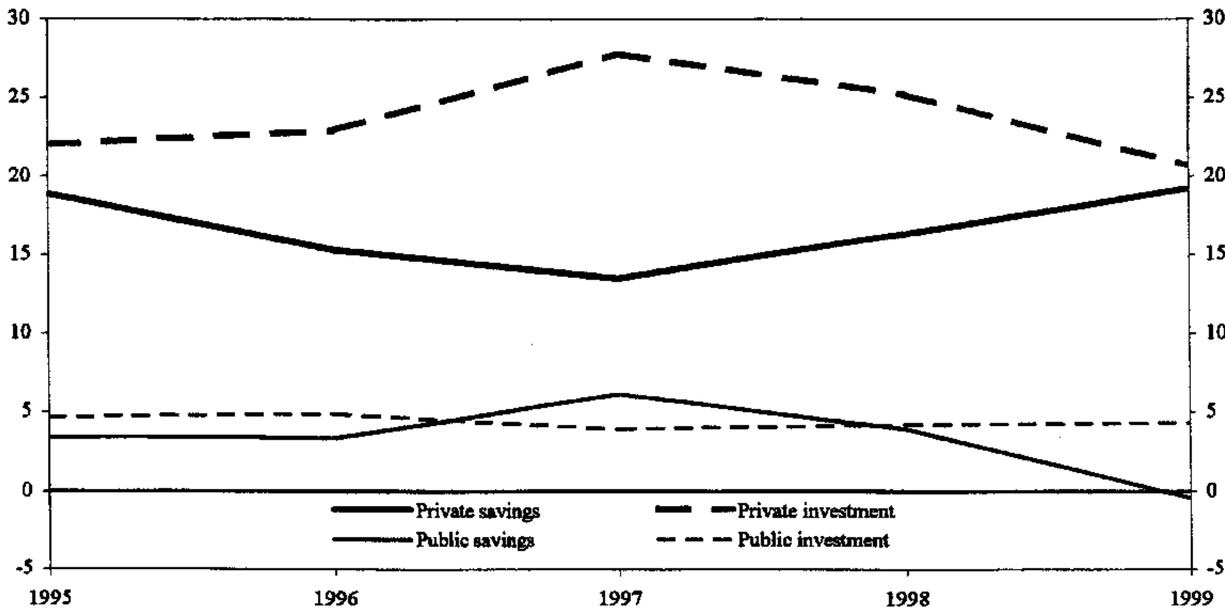
- The driving force of the current account has been the private savings-investment balance. The private savings-investment balance and the cyclically adusted fiscal balance have been negatively correlated over the cycle. Despite the budget surplus in 1997, the current account registered a large deficit in 1997 as the private savings-investment balance fell sharply. The current account subsequently improved strongly even though the budget moved into a large deficit in 1999. The improved private savings-investment balance more than compensated for the weaker fiscal balance.

- The private savings-investment balance can be expected to worsen as the economy enters a renewed growth phase in 2000. A tight fiscal position may help to keep the current account deficit within bounds, although there may be a partial offset from the private savings-investment balance. Controlling the growth of bank credit could contribute, but this option does not exist under a currency board arrangement with no restrictions on capital flows.

- Provided the current account deficit is largely financed by FDI inflows (as was the case in 1998 and 1999) rather than by accumulating external debt, the deficit and the implied resource transfer should be viewed as constituting one aspect of the catching-up process.

Figure 7. Estonia: The Current Account and the Private and Public Savings-Investment Balance, 1995-1999 (In percent of GDP)





Source: National authorities; and Fund staff estimates.

B. The Budget for 2000 and 2001

15. Implementation of the budget for 2000 is proceeding as targeted, and the authorities expect to meet all fiscal program targets. Ministries remain subject to strict monthly expenditure limits and revenues may outperform projections depending on the speed of the recovery. The authorities see no need for a supplementary budget for 2000, nor do they see it as politically feasible. The staff stressed the need to implement the revenue measures scheduled to become effective as of July 1, 2000 as set out in EBS/00/18.

16. The timing of the mission was propitious as the authorities were in the process of deciding on the parameters for the budget for 2001. On current policies, the revenue-to-GDP ratio is realistically projected by the authorities to decline somewhat in 2001 as the full effect of the abolition of the corporate income tax will be felt and as the estimates do not yet make allowance for profit transfers from the BoE. There are also strong political pressures for further cuts in direct taxes by increasing the amounts exempted from the personal income tax and introducing exemptions linked to the number of children. There are also proposals for cuts of some indirect taxes. Preliminary calculations suggest that achieving a balanced budget in 2001 would, under the tax cut scenario, require keeping nominal expenditures approximately unchanged, reducing the expenditure to GDP ratio from a projected 42 percent in 2000 to 39 percent in 2001. These issues are now under debate within the coalition government.

17. The mission cautioned against a decision to cut taxes before the required expenditure cuts are firmly in place. Moreover, should unexpectedly high rates of economic growth result in revenues exceeding projections, excess revenues should be used for moving towards a smaller budget deficit in 2000 and a surplus in 2001. The authorities agreed that, in such circumstances, allowing the automatic stabilizers to have their full effect would help mitigate the risks of an excessive increase in the current account deficit and would also be consistent with their objective of a cyclically balanced budget. (The second review under the program will focus on the details of the budget for 2001.) The authorities noted that the new budget law, which was drafted with assistance from the IMF will be submitted to parliament shortly. The new law should substantially improve overall control over the budgetary process beginning with the budget for 2001.

C. Pension Reform

18. Pension reform continues to be actively debated and the authorities welcomed the technical assistance provided by the Fund and the World Bank. Although no consensus has so far emerged within the governing coalition, pension reform legislation is expected to be submitted to parliament shortly. A quick decision by parliament appears unlikely, and the pension reform is unlikely to have any impact on the budget during the program period. Box 2 describes the state of play. The forthcoming paper on "Pension Reforms in the Baltics: Issues and Prospects" provides additional background.

Box 2. Estonia: Pension System Reform

Estonia inherited from the Soviet Union a traditional, pay-as-you-go (PAYG), defined-benefit pension scheme. Soon after independence in 1991, the PAYG system faced uncertainties on account of an increasing system dependency ratio (i.e., number of pensioners relative to actual contributors in the pension system). This was due to, *inter alia*, a very low retirement age; lax eligibility requirements for early retirements and disability pensions; and weak compliance in the payment of social security contributions. To some extent it also reflected the initial impact of an aging population. Estonia's demographic dependency ratio—i.e., number of people over the pension age relative to labor force—is expected to worsen considerably over the next 20-30 years.

In response to increasing financial pressures on the PAYG, the authorities embarked on a two-pronged reform strategy. First, piecemeal reforms were introduced to the PAYG system. This included a tightening of eligibility requirements for early retirement and disability pensions. In addition, starting from January 1, 1994, the normal retirement ages (60 years for men and 55 years for women) were raised for both men and women with a view to unifying the retirement age for men and women at 63 years by 2016. The retirement age for men will reach that goal in 2001, while that for women will take until 2016. Second, the authorities decided in 1997 to introduce a three-pillar pension system, which will aim at reducing the size of the traditional PAYG (first pillar), and supplementing it with a mandatory, privately-managed, fully-funded second pillar and an optional, tax-advantaged, fully-funded third pillar. Under the reform proposal, the contributions to the second and third pillars would be deposited into individual retirement accounts. These accounts would be the property of the individual, who would decide—subject to regulation—how, and by whom, these accounts would be managed. The pension benefits would be determined by the amount of contributions in these accounts and the returns earned on them.

The legal framework for the first and third pillars was adopted in 1998 through the passage of the Social Tax Act, the State Pension Insurance Act, and the Pension Funds Act. In addition, effective January 1, 1999, individual "notional" accounts were introduced in Estonia with the objective of establishing a link between contributions and benefits of the first pillar. To that end, starting from 2000, an earnings-related component is being introduced for benefits under the first pillar for new retirees (on the basis of contributions to those "notional" accounts); hitherto, first pillar benefits were based exclusively on years of service plus a flat amount independent of earnings or years of service. Individual contributions are recorded in the State Pension Insurance Register, but in contrast to funded schemes, no actual funds are accumulated in these accounts.

The legal framework for the second pillar is expected to be submitted by the government to parliament within the next few months. Although no decision on the specific features of the reform has been made, the proposal that has been considered for some time now has the following main characteristics:

- Redirect 4 percentage points of the current 20 percent payroll tax to the second pillar;
- Make the second pillar compulsory for those younger than 35 years and optional for those older;
- Index the first pillar on the basis of the average increase in the CPI and wage bill. (The authorities favor a link to the wage bill rather than the average wage as social security tax revenues are more closely linked to the former.)

The above proposals are estimated to lead to a deficit in the traditional PAYG system in the order of about 1 to 1½ percent of GDP a year for over 10 years of the transition period. The authorities have indicated that they would aim at a broadly balanced budget over the medium term, including the impact of the pension reform.

19. The authorities are critically debating the advantages and disadvantages of a fully-funded second pillar and its specifications. They are concerned that establishing a meaningful fully-funded second pillar could open up a substantial financing gap in the first pillar. The mission noted that the size of this gap was, in addition to other parameters, very much a function of who would be permitted, or required, to join the second pillar. For example, restricting the eligibility of older workers to join the second pillar would ensure greater flows of social security contributions into the first pillar. The authorities indicated that it may be politically difficult to restrict substantially the eligibility for the second pillar, thereby burdening the budget with larger first pillar financing requirements. If, for example, 4 percentage points[5] of the social security tax (of 20 percent on wages) were redirected towards funding the second pillar, and workers 35 years and younger were required to join, while those over 35 were eligible to join, the resulting gap in the financing of the first pillar would amount to an estimated 1 to 1½ percent of GDP for over 10 years. This gap would decline over time, with the speed of the decline depending on the indexation provisions and retirement age applicable to the first pillar.

20. The authorities do not consider that relying totally, or largely, on debt financing of the reform would constitute a viable option. While the deficit under the first pillar would initially be broadly matched by the accumulation of private savings under the second pillar, debt financing of the first pillar deficit could still create, over time, substantial vulnerabilities for the budget. These vulnerabilities include the need to rely largely on foreign financing to offset expected foreign investments under the second pillar. The authorities are opposed to forcing the second pillar to invest only in government debt instruments or other domestic instruments. In this regard, the mission noted that accumulated proceeds from past privatization and budget surpluses (about 2 percent of GDP) as well as proceeds from future privatizations could be available for the financing of the pension reform. The sale of the last tranche of Eesti Telecom shares alone could bring around 5 percent of GDP, so that a significant portion of a cautious reform could be covered. Some officials, however, stressed that the concept of a cyclically balanced budget and abstaining from budget borrowing provides clear guidance to policy makers. Any deviation from this principle could result in substantial pressures for debt financing for other government outlays, which may prove difficult to resist.

21. The authorities also noted that a fully-funded second pillar by itself would not address the severe problem of the expected increase over the next 20-30 years in the ratio of retirees to workers. In this regard, the mission stressed the need for further increases in the retirement age and the advantage of indexing benefits under the first pillar to the average increase in wages and CPI, rather than wage bill indexation. This would allow some passthrough of productivity gains to retirees but limit the deficit of the first pillar.

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[5] A larger second pillar funded by 6 percentage points of the social security tax (together with a 2 percentage points increase in that tax) is also being debated.

22. Downplaying the objective of developing a domestic capital market, the authorities favor that the bulk of the funds in the second pillar be invested outside Estonia. This would diversify the risk to pensioners by making returns to investments in the second pillar less dependent on the economic and financial situation in Estonia. They would also like to avoid creating a captive pool of savings that would tempt future governments to rely unduly on domestic debt financing. (There is virtually no domestic government debt now and the public sector's external debt is also very small.)

23. The authorities do not anticipate that the eventual introduction of individual investment accounts under the second pension pillar would lead to significant changes in other private savings. Empirical studies for other countries have been inconclusive as to whether other private savings would fall in response to mandatory pension accounts.

D. Banking, Supervisory and FSSA Issues

24. Under the currency board, the authorities do not target a specific rate of growth in bank credit or money supply nor does the BoE possess any effective instruments for controlling these aggregates on an on-going basis. As it stands, major banks are very liquid and well above the required capital-asset ratio so that it would not be easy to rein in the growth of credit and monetary aggregates. Moreover, in the absence of any capital controls, banks can easily replenish their liquidity through external borrowing on fine margins (the two largest banks are both highly rated). The BoE, however, continues to monitor developments closely and is prepared to intervene directly with the management of the largest banks if, in its judgment, the pace of lending were to become inconsistent with prudent banking. The authorities do not wish to consider introducing a "Tobin tax" or capital controls. Such measures are precluded by understandings already reached with the EU in connection with the harmonization of domestic legislation with the *acquis communautaire*, specifically the chapter on the "Free Movement of Capital."

25. **As foreseen in the MEP, the Bank of Estonia has reviewed the operations of its monetary policy framework,** taking account of the longer term objective of harmonization with EU practices. The main conclusion was that the present level of reserve requirements was relatively high at 13 percent of eligible liabilities. However, reserve requirements are seen not so much as a tool for controlling credit expansion, but primarily as instruments to ensure an adequate buffer of bank liquidity for prudential reasons, as, under the currency board, the Bank of Estonia has only limited scope for providing liquidity support to banks. To provide banks with greater flexibility in managing their asset positions and to increase the remuneration on reserves, the BoE will permit banks—effective January 1, 2001—to meet up to 3 percentage points of the reserve requirement with liquid foreign assets (highly rated euro-denominated foreign instruments). The BoE's objective is to phase in the eligibility of foreign assets until up to 50 percent of the reserve requirement can be met with such assets. While the net foreign asset position of the consolidated banking system may not change much as a result of these steps, the BoE's official foreign reserves held as currency board cover would decline pari passu with the decline in (domestic) base money.

The impact on banks' ability to expand credit is judged by the BoE to be small for the reasons explained above. The performance criterion on NIR would not be affected by this change as it applies only to reserves in excess of currency board cover.

26. Discussions with the EU and ECB regarding the modalities for the eventual transition of the Estonian currency board into the eurosystem have intensified. There has also been some public debate in Estonia regarding the possibility of an early introduction of the euro as the national currency, replacing the kroon prior to EU accession. This has been rejected as an option by the Bank of Estonia and the government, partly because the idea has met with strong opposition from the EU. The Bank of Estonia continues to regard the continuation of the currency board arrangement through EU accession and during ERM2 as appropriate.[6] In this context, the authorities noted Estonia's strong progress toward nominal and real convergence with the EU and stated that they would favorably consider an early entry into the eurosystem and ECB, if this could be accomplished in cooperation with the EU and ECB. They did not see euro participation as entailing significant new risks as the scope for exchange rate adjustment was already very limited under the currency board. The authorities consider the current exchange rate appropriate for the foreseeable future.

27. Discussions were also held with the authorities on the main conclusions of the FSAP (Box 3). The authorities said that they found the FSAP very valuable as it represented the first comprehensive review of Estonia's financial system—especially the nonbank sectors—which incorporated major macroeconomic, institutional, and systemic factors. They particularly welcomed the fact that discussions regarding the scope of the assessment had started at an early stage. The authorities agreed with the assessment that financial sector vulnerabilities have been materially reduced, emphasizing that an important factor has been the integration of the largest Estonian banks into the longer term pan-Baltic strategies of their Swedish and Finnish investors. The provision of substantive financial, technical, and managerial support by these investors has also resulted in a significant strengthening of the banking system. At the same time, major improvements have been made in bank supervision, including a concerted effort to bring the regulatory framework and supervisory practices in banking supervision up to global best practices. Supervisors in Estonia were also strengthening their contacts with supervisors in neighboring countries. Notwithstanding the positive assessment, the authorities emphasized the importance of avoiding complacency in the implementation of measures necessary for further strengthening of the supervisory and regulatory environment. They intend to publish the financial sector ROSC.

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[6] The ECB's governing council decided in April 2000 that euro-based currency boards can be acceptable under ERM2, provided a common accord on the central parity against the euro is reached. Under ERM2, countries preparing to enter the eurozone are expected to maintain an exchange rate against the euro within a band around central parity for at least two years.

Box 3. Estonia: Financial Sector Stability Assessment—The Main Conclusions

Estonia volunteered to participate in the pilot Joint Bank-Fund Financial Sector Assessment Program (FSAP). Two FSAP missions, in February and March 2000, assessed financial sector vulnerabilities and the observance and implementation of supervisory standards and best practices. The missions produced an Aide-Memoire and a FSAP report that formed the basis for the forthcoming Financial Sector Stability Assessment (FSSA).

The main conclusion of the FSAP was that financial sector vulnerabilities in Estonia have been markedly reduced, largely reflecting the consolidation and restructuring that has taken place within the banking system over the past several years during which the stronger banks had merged, while weaker banks failed. The banking system also benefited from major capital injections and improved corporate governance provided by strategic commercial bank investors in Estonia's two systemically important banks (which account for over 85 percent of bank assets). Stress testing of the banking system supported these conclusions. While other financial markets and nonbank financial institutions are developing, they have not yet reached a size where problems therein would be likely to pose a systemic threat to the financial sector.

The overall assessment of the observance of operational standards in banking supervision, insurance supervision, and payments system oversight was broadly favorable (although some shortcomings relating mainly to weak enforcement powers and staffing difficulties were identified). Serious problems, however, were found in securities supervision. The assessments of compliance with the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* were generally favorable, particularly in areas of monetary policy, deposit insurance, insurance, banking supervision, and in payments. The summary standards assessments contained in the FSSA will form the financial sector modules of the Report on Observance of Standards and Codes (ROSCs)—which the authorities intend to publish.

With the banking system dominating financial sector operations, the banking supervision function, which currently lies with the Bank of Estonia, is critical. The FSAP missions found that banking supervision had been considerably strengthened over the last two years, although enforcement of new regulations has not yet been fully tested. The BoE was in full compliance with 19 of the 30 Basel Core Principles (CPs), in partial (and often substantial) compliance with ten, and in noncompliance with only one (relating to the lack of legal protections for all supervisory staff). One earlier key shortcoming, the lack of a regulation on loan classification and loan loss provisioning, is already in the process of being addressed, with the draft regulation awaiting the signature of the new governor of the BoE. Priority was placed on ensuring that all supervisory authorities receive adequate legal protections and on concluding MOUs on information sharing with bank supervisors in Sweden and Lithuania, and with other Estonian financial regulators (when feasible).

The FSAP also reviewed the authorities' plans on unifying financial sector supervision. It is hoped that unified supervision will provide a basis for significant improvements in the quality of financial sector supervision, particularly in the securities area. However, in achieving this objective, the FSAP missions emphasized that the banking supervision function must not be compromised with the introduction of the new unified authority (including during the transition process). To that end, the unified authority should be endowed with operational and budgetary independence as well as enforcement powers comparable with those of the Bank of Estonia—ideally, also including adequate licensing and delicensing powers. Steps are also urgently needed to strengthen the Securities Inspectorate prior to the formation of the new agency. Early passage of the new Securities Market Law will also help in this regard. Finally, at its inception the new unified agency must have sufficient staff to fulfill its full range of responsibilities.

28. The Estonian authorities said that many of the FSAP's main recommendations have already been integrated into the work programs at both the BoE and the government. To that end, the BoE has developed an action plan to improve compliance with the Basel Core Principles (which is already high). The working group on the implementation of the new unified supervisory agency is also exploring ways to reconcile possible legal (mainly constitutional) constraints with the accepted need to establish the agency with adequate operational and budgetary independence and with sufficient enforcement powers. The staff agreed that the independence of the new agency was paramount and stressed the importance of providing legal protection to supervisors and endowing the agency with the power to issue and withdraw operating licenses of financial institutions. The authorities recognized the need to take early action to strengthen the Securities Inspectorate so that it would be able to fulfill its responsibilities prior to the establishment of the new unified agency. They accepted the importance of ensuring that the effectiveness of the banking supervision function would not be compromised, even temporarily, as the transition is made to unified financial supervision. The BoE also recognized that increased concentration in the banking system has raised the issue of ensuring that banks do not abuse their dominant positions.

E. Competitiveness and Medium-Term Prospects

29. Competitiveness remains strong as confirmed by the return to double digit export growth. This is only in part due to the weakness of the euro vis-à-vis the U.S. dollar (Box 4 and Figure 8). Moreover, because of the recent reorientation of trade towards the EU (which now accounts for two-thirds of total trade), Estonia has become less vulnerable to an appreciation of the euro vis-à-vis the U.S. dollar. The authorities are pursuing policies strictly consistent with ensuring a well-functioning currency board arrangement.

30. The mission's assessment of Estonia's medium-term prospects remains broadly as described in EBS/00/18, except that the current account deficit is projected to be somewhat larger in 2000 and beyond, reflecting a more rapid pace of investment. However, the deficit is still expected to be largely, or fully covered, by FDI and net equity investments, without even taking account of likely large-scale privatization proceeds.[7] Moreover, these non-debt-creating inflows are likely to be supplemented by substantial transfers from the EU associated with the accession process and membership. As a result, the net external debt ratio is projected to decline from the end-1999 level of 33 percent of GDP, although this is not an objective under the program. International rating agencies continue to assign Estonia an investment grade (S&P BBB+ for long term foreign currency denominated assets), higher than most transition economies. The Bank of Estonia's foreign exchange reserves are in excess of the requirements for full currency board cover by a comfortable margin. Foreign exchange reserves exceeded 3 months of imports at end-1999 and also the level of short-

[7] Privatization proceeds were excluded by the mission from the medium-term projections shown in Table 8 because of the uncertainty attached to their timing and size, and how the proceeds will be used, for example, to cover the cost of pension reform.

Box 4. Estonia: External Competitiveness

- GNFS export growth—in particular export growth to the EU—and continued attractiveness to foreign investors suggests that the kroon remains competitive, notwithstanding the nominal and real effective appreciation of the exchange rate and the increase in relative unit labor costs (Figure 8).

- The sharp appreciation of the real effective exchange rate after mid-1998 reflected mainly a sizable depreciation of the Russian ruble. However, the peg to the weak deutsche mark resulted in competitiveness gains vis-à-vis Latvia, Lithuania, and other countries, and also offset some of the depreciation of the Russian ruble against the U.S. dollar. In 1999, inflation differentials eroded the real depreciation of the Russian ruble.

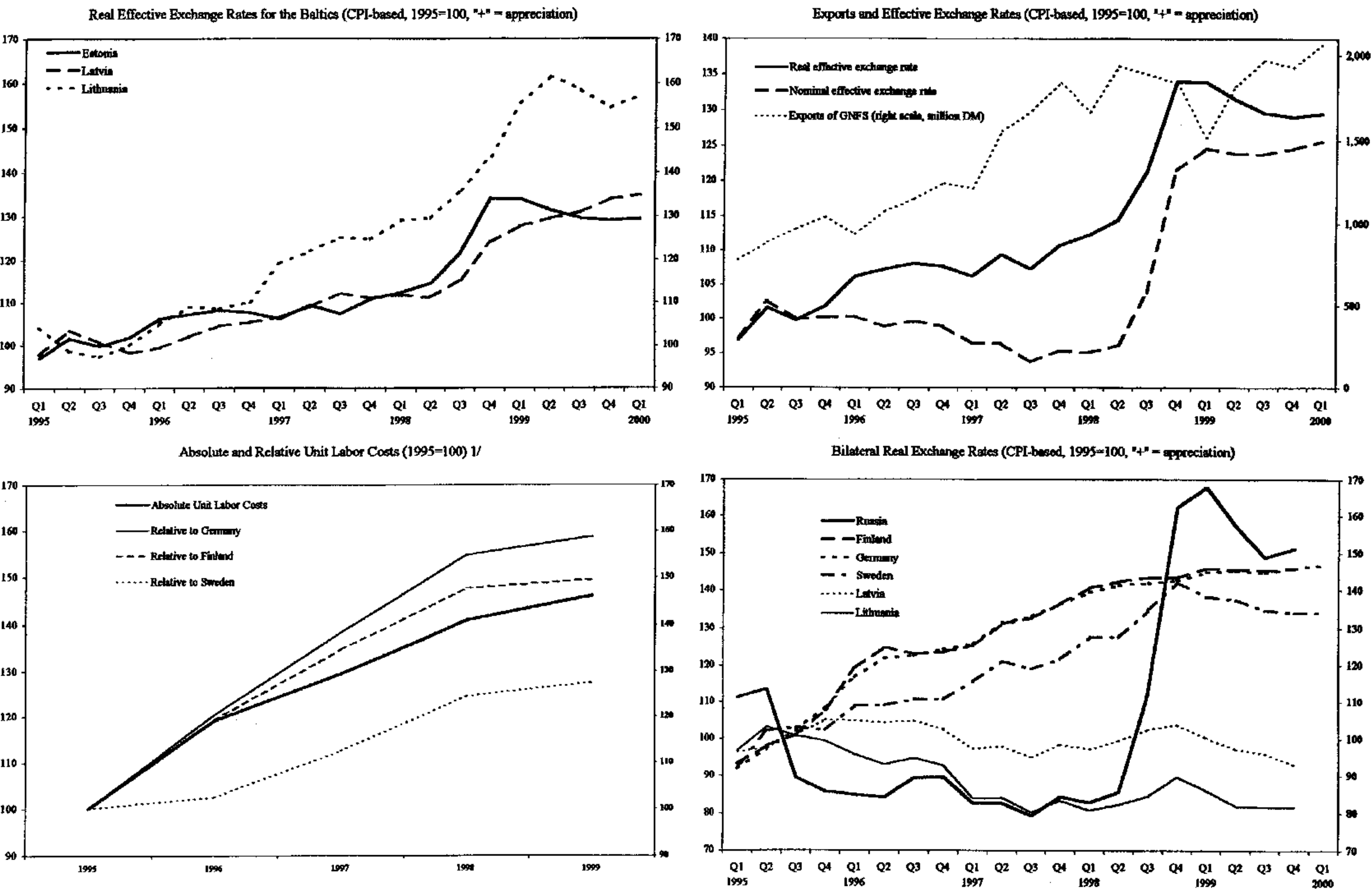
- Exports were severely affected by the Russian crisis, and merchandise exports declined in 1999, while service exports continued to grow. Nonetheless, total exports of goods and services declined marginally by 1 percent in 1999. Exports began to recover in the second half of 1999, driven mostly by exports to the EU. The share of exports to the CIS has fallen from 24 percent in 1995 to only 8 percent in 1999. At the same time, the share of exports to Estonia's main trading partners in the EU has increased to over 60 percent in 1999.

- Nominal unit labor costs have steadily increased since 1995 in absolute terms and relative to EU countries. As in the case of effective exchange rates, nominal unit labor costs were also undervalued. A more detailed discussion of this issue is contained in "The Baltics—Exchange Rate Regimes and External Sustainability," (SM/99/282, 11/29/99). Therefore, the increase itself does not necessarily indicate a lack of competitiveness. The increase in nominal unit labor costs reflects a steady rise in the average nominal and real wage. This increase was mainly driven by expanding, export-oriented industries where productivity is very high; nominal and real wages in some declining industries have fallen during the 1998/99 recession. The wage share in GDP—which is a measure for real unit labor costs (if output and wages are deflated by the same index)—has remained fairly constant since 1997. Foreign direct investment—and investment in general—continues to be very high, and there is no indication that wage growth has lowered Estonia's attractiveness as a location.

term debt (although neither ratio is very relevant in the context of currency boards). External vulnerability is relatively low and is projected to remain so over the medium term.

31. In addition to excluding future privatization related inflows, these balance of payments projections do not include the possible impact of capital inflows and outflows associated with the pension reform, which could be significant. These capital flows will depend on the specifics of the reform and its financing. With substantial privatization proceeds available, the pension reform should not lead to a substantial build up of gross domestic and foreign public sector debt in the coming years (although net debt will be affected).

Figure 8. Estonia: Competitiveness Indicators, 1995-2000



Source: National authorities; and Fund staff estimates and projections.

1/ Unit labor cost are defined as wage multiplied by employment, divided by real GDP.

F. Structural and Social Policies

32. **EU accession discussions are proceeding apace.** At end-April 2000, 12 of 31 "chapters" of the *acquis communautaire* had been provisionally closed and another 13 were under active negotiation. In the authorities' view and consistent with recent EU statements, Estonia, which is in the front rank of countries in line for accession, appears to be proceeding satisfactorily in most areas.[8] However, some of the more difficult chapters, including on environment, are yet to be closed. The authorities said that there was no timetable for further progression towards the EU's trade regime. Thus, no changes are contemplated in the level or coverage of the tariffs first introduced on January 1, 2000. The authorities hope to keep their very open trade regime and low tariff rates until EU accession. On the question of the budgetary costs of EU accession and transfers from the EU over the medium term, the authorities stated that no clear picture has emerged so far. The authorities intend to raise military expenditures from currently 1.4 percent of GDP gradually towards 2 percent of GDP in preparation for joining NATO.

33. **Good progress has been made in the privatization of two major infrastructure companies**—Narva Power Station (NPS) and Eesti Raudtee (the main freight and transit railway line).[9] Discussions with a U.S.-based energy company (NRG) for the sale of a 49 percent stake in NPS have reached their final stages—with only the medium-term trajectory for the price of electricity remaining to be settled. It is expected that electricity prices will need to rise to help finance the ambitious investment program in the Estonian energy sector (including making significant inroads into ameliorating the environmental impact of using oil shale for electricity generation). As Eesti Energia (which remains 100 percent state owned) will be the seller of the NPS stake, the government itself will not directly realize any immediate financial benefit from this transaction. Once the final agreement is concluded (expected by end-2000), a major investment program will get underway. This is expected to lead to FDI inflows on the order of US$100 million annually (or about 2 percent GDP) in the first two years of its operation.[10] Regarding Eesti Raudtee,

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[8] This reflects in part the government's ambitious program of harmonizing legislation and reaching agreement with the EU on key policy issues so as to meet Estonia's internal deadline of full preparedness for EU accession by January 1, 2003.

[9] For an overview of the privatization strategy for NPS and the energy complex, see Box 2 in "Estonia—Request for Stand-by Arrangement," EBS/00/18, February 11, 2000 (page 22).

[10] Given the scale of these flows and the uncertainties regarding their timing, they have not yet been incorporated into Estonia's balance of payments projections. As most inputs required for this investment program will be imported, the current account deficit can be expected to widen *pari passu*. However, as these imports will be financed through non-debt-creating flows in their entirety, the associated increase in the current account deficit will not have any material impact on Estonia's external vulnerability in the short term, although future dividend payments will burden the services account.

the government has decided to sell two thirds of total equity to a strategic investor in a two stage process—managed by the Estonian Privatization Agency (EPA)—that will first involve reaching agreement on a development strategy for the company (including an investment plan to upgrade track and rolling stock). Considerable interest in Eesti Raudtee has been shown by both U.S. and European entities. On the present timetable, it is expected that the sale of Eesti Raudtee will be concluded by end-2000 (consistent with the MEP).

34. **The government has decided to sell off its remaining stake in Eesti Telekom (27 percent of total equity).** At current valuations, the sale of the entire amount would realize about EEK 4 billion (or about 5 percent of GDP). The timing and phasing of this sale are under discussion within the government and will depend on conditions in equity markets and the overall strategy for the development of the telecommunications market in Estonia. Under existing legislation, the entire proceeds from the sale would be invested in the Stabilization Reserve Fund (SRF) held abroad and set aside to help finance the planned pension reform.

35. **The Energy Inspectorate is being strengthened in a phased fashion.** In the first phase, the responsibilities of the Inspectorate are being reviewed to clarify and streamline its duties. This will allow it to focus better on its core mission.

36. **The present high rate of unemployment is, in addition to cyclical factors, the result of the restructuring of the economy in combination with a mismatch of skills both for older workers and labor market entrants**. The authorities do not foresee a significant reduction in unemployment in the near future, as their policy measures will become effective only over the longer run, while the restructuring of the economy continues (Box 5). Displaced workers from shrinking sectors of the economy often do not command the skills required for moving to the expanding parts of the economy. Lack of proficiency in Estonian and lack of regional mobility are often obstacles to finding employment in the emerging service sector. Even the highly flexible wage structure that has allowed for falling nominal wages in shrinking sectors could not avoid the rise of long-term unemployment. Presently, not all displaced workers have access to training programs offered by the employment office. Labor market entrants are also sometimes ill-equipped as the education system has not yet been fully adapted to the requirements of the newly emerging economic structure. Although active labor market policies have often not been very successful in other countries, the mission agreed that, together with the flexible wage structure in Estonia, they could contribute to alleviating structural unemployment.

G. Data and Transparency Issues

37. Estonia continues to participate in the pilot project for the release of Article IV staff reports (the 1999 report is on the Fund's external web site). The authorities have requested publication of the 2000 Article IV staff report, including the ROSCs and other background materials.

Box 5. Estonia: Labor Market Policy

- **Active labor market policy** has three elements:
    - **Training programs** run by the local employment offices and targeted at the local labor market (up to six months, average of three months).
    - **Wage subsidies** to employers who hire 'uncompetitive' unemployed persons.
    - **Subsidies** for unemployed persons who start their own business.
- **Currently, only those who have been unemployed for less than 6 months are eligible for active labor market policy programs.**
- **Long-term unemployed can turn to so-called activating centers** for training and placement assistance. Legislation is pending in parliament to open the regular active labor market policy programs to all unemployed.
- **The education system is currently being reformed**:
    - **Definition of professions** according to the demands of firms and in accordance with European standards.
    - **Introduction of a vocational training system** that combines formal education provided by the state with practical elements provided within firms.
    - **Overhaul of curricula** and **career counseling** of students.
- By the time of **EU accession**, the unemployment benefits system should approach a minimum replacement ratio of 45 percent (currently 12.5 percent on average) and be based on an insurance principle (Social Code of Europe). To this effect, legislation is being considered that would stipulate an unemployment insurance system with an unemployment insurance tax of 1.5 percent (1 percent borne by the employee and 0.5 percent borne by the employer). Unemployment benefits would be paid for 6 months. After that, the unemployed would have to rely on lower state assistance.
- **Employment protection remains moderate in international comparison.** Workers can only be laid-off if the employer names a specific reason (for example, liquidation, bankruptcy, breach of duties, loss of trust, etc.). There is a 2-4 months' notification period. Firms face a mandatory severance payment of 2-4 months' wages.

38. Estonia subscribed to the Fund's Special Data Dissemination Standard on September 30, 1998, and the authorities provide all core data necessary for surveillance on a timely basis. The quality of data remains high.

IV. Staff Appraisal

39. Much has been achieved over the past year. The economic recovery that started in the second half of 1999 has gained momentum, and now seems to be firmly established, supported by strengthened domestic private demand. Despite the recovery and the shift from direct to indirect taxation, inflation has remained low, with the 12-month CPI inflation around some 3 percent early this year. The financial system remains robust. Unemployment, however, remains relatively high with its long-term component presenting a special concern.

40. These overall favorable developments owe much to the policies pursued by the Estonian authorities. Revenues have recovered strongly from their disappointing levels in early 1999 and, together with careful control over government expenditures, brought about a much needed deficit reduction. There are no significant pressures on the exchange market and confidence in the currency board remains strong, as evidenced by the further decline in interest rates to historically low levels.

41. Under a currency board arrangement, fiscal policy remains the only important macroeconomic policy tool. Fiscal policy must now be aimed at ensuring a sustained economic recovery, including, if necessary, by preventing an overheating of the economy and an excessive increase in the external current account deficit. For now, the fiscal program targets for 2000 and 2001 remain appropriate. However, if the external balance were to weaken more than expected, and if this were to lead to a large increase in debt financing, it may become necessary to tighten fiscal policy.

42. It is important to go ahead with the complete implementation of the revenue measures underlying the 2000 budget. The authorities' firm commitment to the program target of a balanced budget for 2001 is laudable, assuming the external balance turns out as expected. While the objective of reducing the size of the public sector is appropriate, the necessary expenditure policies must be in place before proceeding with a reduction in taxation in 2001. The expected increases in expenditures related to preparations for EU and NATO membership may require nominal expenditure reductions in other areas.

43. The currency board arrangement remains a cornerstone of Estonia's economic strategy and the intention to maintain this arrangement in the lead-up to EU membership and under ERM2 is welcome. It will, however, be important to continue to pursue prudent macroeconomic and structural policies (including labor market, educational, and financial sector policies) in support of this arrangement to ensure the continued maintenance of competitiveness and flexibility of labor markets.

44. Broad money growth has recovered, in part because of balance of payments inflows. The Bank of Estonia will need to monitor developments very carefully to detect early on any tendency toward excessive credit growth. With limited monetary instruments under the currency board arrangement, the BoE may need to take recourse to moral suasion. The use of temporary capital controls is precluded by the understandings in place with the EU, while reserve requirements are already at high levels. Nevertheless, resort to higher reserve requirements might become necessary to brake an excessive expansion in domestic credit. Banking supervision must ensure that banks do not unduly relax their internal risk management procedures.

45. Estonia's participation in the pilot Joint Bank-Fund Financial Sector Assessment Program (FSAP) is commendable. Financial sector vulnerabilities have been markedly reduced over the past few years, largely reflecting the consolidation and restructuring that has taken place within the banking system. Banking supervision has been considerably strengthened, though further improvement in meeting Basel Core principles is needed.

Nonbank financial supervision is not fully adequate; however, the insurance and securities sectors are still relatively small. The move to unified supervision of the financial sector is welcome, but care will need to be taken that it will not dilute the effectiveness of banking supervision. For this, it will be crucial to ensure that the new agency has adequate budgetary and operative independence as well as powers to issue and revoke licenses. The sale of Optiva Bank is welcome and fulfills a program undertaking; as a result, all banks will be in private hands. It is also welcome that a new securities market law is expected to be in place by the end of 2000.

46. On pension reform, it is appropriate that all options are now examined before proposals are submitted to parliament. While a second, fully-funded, pillar has certain advantages, it will, by itself, not solve the issues arising from the demographic shift. For this, further reform of the first pillar may be required, including a more ambitious and faster increase in the pension age. Care will also need to be taken that the transition costs of establishing a second pillar are limited so they can be appropriately financed within the budget and do not lead to an excessive increase in domestic and external debt of the public sector, even if largely matched by increases in private assets under the second pillar.

47. Substantial progress has been made on the structural reform agenda. The priority accorded by the government to make further progress towards EU accession is well placed. It is also encouraging that discussions with potential investors are moving forward on the privatization of major state assets.

48. Notwithstanding a high degree of wage flexibility, the restructuring of the economy in combination with a mismatch of skills of displaced workers and labor market entrants alike have resulted in a high level of unemployment. The authorities will need to address the problem of unemployment appropriately as it imposes high social and fiscal costs. Efforts to extend the coverage of active labor market programs—including training—to those who are unemployed for more than 6 months are appropriate, as is the reorientation of the education system to meet the requirements of employers. While experience with active labor market policies in other countries was generally not encouraging, such policies may work in the Estonian context because of their targeted nature. It is laudable that the government has not resorted to measures that would have slowed the transformation of the economy and the exit of failing enterprises.

49. The authorities' intention to again publish the staff report for the Article IV consultation and their initiatives on transparency in general are welcome. The quality of data provided, including on websites, is high and meets the requirement for surveillance and program monitoring.

50. The staff supports the completion of the first program review.

51. It is proposed to keep Estonia on the regular 12-month consultation cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Government of the Republic of Estonia has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for the Republic of Estonia (EBS/00/18, Sup. 2, 6/2/00) and the second paragraph of the letter dated February 11, 2000 from the Prime Minister and the Governor of the Bank of Estonia.

2. The letter dated June 7, 2000 from the Prime Minister and the Acting Governor of the Bank of Estonia shall be attached to the Stand-By Arrangement for the Republic of Estonia, and the letter dated February 11, 2000 from the Prime Minister and the Governor of the Bank of Estonia shall be read as supplemented by the letter dated June 7, 2000 from the Prime Minister and the Acting Governor of the Bank of Estonia.

3. The Fund decides that the first review contemplated in paragraph 3(d) of the Stand-By Arrangement for the Republic of Estonia is completed.

Table 1. Estonia: Selected Macroeconomic Indicators, 1996-2001
(In units as indicated)

	1996	1997	1998	1999		2000		2001	
				EBS/00/18	Act.	*EBS/00/18*	Proj.	*EBS/00/18*	Proj.
National income, prices and wages									
Nominal GDP (kroons, millions)	52,446	64,324	73,325	74,310	75,360	80,036	81,070	87,115	88,473
GDP (US dollars, millions)	4,357	4,637	5,209	5,055	5,136	...	5,159	...	5,813
Real GDP growth (year-on-year in percent) 1/	3.9	10.6	4.7	-1.3	-1.1	4.0	4.0	6.0	6.0
Average CPI (year-on-year change in percent) 2/	23.1	11.2	8.1	3.3	3.3	4.6	3.8	3.0	3.2
12-month CPI (end of period change in percent) 2/	14.8	12.5	4.2	3.9	3.8	4.8	4.3	2.4	2.4
GDP deflator (year-on-year change in percent) 3/	24.0	10.9	8.9	2.9	3.9	3.5	3.4	2.7	2.9
Average monthly wage (end-of-period, US dollars)	291	318	360	347	345	377	368	412	397
Unemployment rate (ILO definition, percent)	10.0	9.7	9.9	...	11.4	...	...	...	...
Saving-investment balances (in percent of GDP)									
Domestic saving	18.6	18.7	20.2	19.1	18.4	22.4	22.4	22.0	22.5
Private	15.3	12.6	16.3	19.5	18.8	19.6	19.6	17.8	18.3
Public	3.3	6.1	3.9	-0.4	-0.4	2.8	2.7	4.2	4.2
Domestic investment	27.8	30.9	29.4	23.2	24.5	27.9	28.9	28.0	29.0
Private	22.9	26.9	25.2	18.9	20.3	23.9	24.9	23.8	24.8
Public	4.9	3.9	4.2	4.3	4.3	4.0	4.0	4.2	4.2
Foreign saving	9.2	12.1	9.2	4.1	6.2	5.5	6.5	6.0	6.5
General government (in percent of GDP) 4/									
Revenue	39.0	39.6	39.4	39.1	38.6	40.6	40.1	39.0	39.4
Expenditure 5/	40.5	37.4	39.7	43.9	43.3	41.9	41.3	39.0	39.4
Fiscal balance	-1.6	2.2	-0.3	-4.8	-4.7	-1.2	-1.2	0.0	0.0
External sector (DM, millions)									
Trade balance	-1,536	-1,957	-1,965	-770	-1,617	-803	-1,883	-928	-2,062
Exports	2,729	3,984	4,723	2,467	4,505	2,576	5,716	2,824	6,191
Imports	-4,265	-5,941	-6,688	-3,237	-6,122	-3,379	-7,599	-3,752	-8,252
Service balance	781	1,029	1,006	555	1,080	498	1,244	533	1,341
Receipts	1,669	2,296	2,601	1,465	2,738	1,463	3,144	1,604	3,405
Payments	-888	-1,267	-1,594	-909	-1,658	-965	-1,900	-1,071	-2,063
Current account	-601	-977	-844	-209	-580	-285	-661	-343	-720
Change in net foreign asset position of commercial banks since previous period (DM, millions, +increase)	-234	-653	-46	75	37	...	...	...	...
Gross international reserves (DM, millions) 6/	995	1,363	1,364	1,573	1,667	1,648	1,598	1,746	1,726
in months of imports	2.8	2.8	2.4	3.2	3.3	3.0	2.5	2.9	2.5
Relative to short-term debt (gross, including trade credits)	1.0	0.9	0.9	1.0	0.9	1.0	0.9	1.2	1.0
Gross external debt/GDP (in percent) 7/	25.5	46.8	43.8	45.1	47.4	39.3	...	34.6	...
Net external debt/GDP (in percent) 8/	17.8	33.1	33.3	30.8	33.3	...	30.2	...	28.7
General government external debt/GDP (in percent) 9/									
Excluding government assets held abroad	5.2	4.3	4.3	...	4.9	...	5.1	...	5.2
Including government assets held abroad 10/	5.2	3.2	2.6	...	2.3	...	2.9	...	3.2
Exchange rate (EEK/US$ - period average) 11/	12.0	13.9	14.1	14.7	14.7	...	...	...	...
Money and credit (year-on-year growth in percent)									
Domestic credit to nongovernment	70	83.9	14.3	6.5	6.5	7.6	10.4	...	...
Base money 6/	21.6	37.7	6.4	27.1	27.1	-1.3	-5.2	...	...
Broad money	36.8	38.0	7.0	24.6	24.6	11.9	13.8	...	...
Base money multiplier (end of period)	2.3	2.3	2.3	2.5	2.5	2.6	2.7	...	...

Sources: Estonian authorities, and Fund staff estimates and projections.

1/ Real GDP growth has been revised up from 4.0 percent to 4.7 percent for 1998 and from -1.4 percent to -1.1 percent for 1999.

2/ Effective 1998, a new CPI index is used that is based on 1997 weights.

3/ The GDP deflator for the fourth quarter of 1999 and thus 1999 as a whole has been revised upward.

4/ Excludes any impact of the planned pension system reform, which is unlikely to come into effect before 2002. Also excludes possible tax cuts and matching expenditure cuts in 2001 currently considered by the government that may amount to 1 percent of GDP.

5/ Includes net lending.

6/ Gross international reserves (and thus base money) at end-1999 were inflated by banks shifting resources from accounts abroad to the Bank of Estonia to enhance domestic liquidity in anticipation of Y2K-related problems. These positions were largely reversed in early 2000.

7/ Includes use of Fund credit and trade credits.

8/ Net of deposits held abroad by the general government and commercial banks.

9/ Includes government-guaranteed debt and Fund credit under the Systemic Transformation Facility (on-lent to commercial banks).

10/ Government assets held abroad include the Stabilization Reserve Fund (SRF).

11/ The Estonian kroon has been pegged to the deutsche mark at EEK 8=DM 1 since June 20, 1992.

Table 2. Estonia: Summary of General Government Operations, 1997-2001
(In millions of EEK)

	1997	1998	1999		2000			2001 (Proj.)	
	Year	Year	Q1	Year	Q1	Year		Year 1/	
	Actual	Actual	Actual	Actual	Prel. Act.	EBS/00/18	Proj.	Current Policy	Tax Cut Scen.
Revenue	25,485	28,887	5,651	29,083	7,014	32,522	32,522	34,829	33,999
Tax revenue	24,076	27,126	5,331	27,383	6,516	30,051	29,957	32,598	31,768
Direct taxes	14,473	17,320	3,576	17,518	4,207	17,749	18,036	19,224	18,753
Corporate profits tax	1,228	1,914	322	1,639	0	275	275	0	0
Personal income tax 2/	5,240	6,233	1,542	6,531	1,835	6,930	7,190	7,801	7,330
Social security tax	4,637	5,303	1,012	5,520	1,430	6,260	6,276	6,789	6,789
Medical insurance tax	3,097	3,573	649	3,518	929	4,069	4,079	4,413	4,413
Land tax	270	297	51	310	13	215	215	221	221
VAT	6,686	6,413	1,157	6,419	1,576	7,719	7,618	8,484	8,486
Excises	2,401	2,789	457	2,685	496	3,512	3,224	3,703	3,342
Other taxes (incl. on intern. trade)	516	606	141	761	236	1,071	1,079	1,186	1,186
Nontax revenue 3/	1,409	1,761	321	1,700	499	2,471	2,565	2,231	2,231
Expenditure 4/	24,339	29,037	7,058	32,542	7,203	33,795	33,795	34,909	34,079
Current expenditure	21,860	25,944	6,568	29,318	6,758	30,568	30,568	...	...
Expenditure on goods and services	14,682	17,740	4,212	19,950	4,227	20,721	20,721	...	...
Wages and salaries 5/	5,308	6,775	1,623	8,149	1,539	8,299	8,299	...	...
Other goods and services	9,356	10,964	2,589	11,801	2,688	12,422	12,422	...	...
Current transfers and subsidies	6,885	7,865	2,269	9,059	2,435	9,462	9,462	...	...
Subsidies	196	311	95	356	95	320	320	...	...
Transfers to households	6,689	7,554	2,174	8,703	2,340	9,142	9,142	...	...
of which: Pensions	4,628	5,200	1,610	6,425	1,606	6,541	6,541	...	...
Interest payments	293	339	87	309	96	385	385	...	...
Capital expenditure	2,479	3,093	490	3,225	445	3,227	3,227	...	...
Financial surplus (+) / deficit (-)	1,146	-150	-1,406	-3,459	-189	-1,272	-1,273	-80	-80
Net lending (-)	264	-77	-30	-81	22	273	273	80	80
Overall surplus (+) / deficit (-)	1,410	-227	-1,436	-3,540	-167	-1,000	-1,000	0	0
Borrowing requirement	-1,410	227	1,436	3,540	167	1,000	1,000	0	0
Domestic financing (net)	-753	669	-156	1,171	14	130	130	...	...
Credit from domestic banks	80	-141	-86	224	-42	...	...	...	...
Change in deposits with domestic banks (-, increase)	-990	1,017	-445	625	110	...	...	...	...
Other domestic financing	157	-207	375	322	-54	...	...	...	...
Change in government deposits held abroad (-, increase)	-700	-524	-1,540	-771	297	181	181	...	...
Foreign financing (net)	43	82	109	117	-144	309	309	...	...
Privatization proceeds 6/	--	--	3,023	3,023	0	380	380	...	...
Memorandum items:									
Primary fiscal balance (+, surplus)	1,703	113	-1,349	-3,231	-71	-615	-615	...	...
Balance in government deposits held abroad	700	1,224	2,764	1,995	1,698	1,814	1,814	...	...
Total general government debt									
Excluding government assets held abroad	4,869	4,714	...	5,509	...	5,709	...	...	...
Including government assets held abroad	4,169	3,490	...	3,514	...	4,384	...	...	...

Sources: Data provided by the Estonian authorities, and Fund staff estimates and projections.

1/ Excludes any impact from the introduction of the pension system's second pillar, as it is no longer expected to become effective in 2001.
2/ Starting from 2000, includes revenue from the taxation of dividends and fringe benefits (the latter was introduced as of January 1, 2000). Prior to 2000, revenue from the taxation of dividends was shown under the corporate profits tax.
3/ For 2000, includes spending agencies own revenue and profit transfer from the BOE. Projections for 2001 do not yet include any BOE profit transfers.
4/ For 2000, includes outlays financed from spending agencies own resources.
5/ Wages and salaries of a number of budgetary institutions are included under "other goods and services".
6/ Used for financing the general government deficit.

Table 3. Estonia: Summary of General Government Operations, 1997-2001
(In percent of GDP)

	1997	1998	1999		2000			2001 (Proj.)	
	Year	Year	Q1	Year	Q1	Year		Year 1/	
	Actual	Actual	Actual	Actual	Prel. Act.	EBS/00/18	Proj.	Current Policy	Tax Cut Scen.
Revenue	39.6	39.4	33.8	38.6	38.9	40.6	40.1	39.4	38.4
Tax revenue	37.4	37.0	31.9	36.3	36.1	37.5	37.0	36.8	35.9
Direct taxes	22.5	23.6	21.4	23.2	23.3	22.2	22.2	21.7	21.2
Corporate profits tax	1.9	2.6	1.9	2.2	0.0	0.3	0.3	0.0	0.0
Personal income tax 2/	8.1	8.5	9.2	8.7	10.2	8.7	8.9	8.8	8.3
Social security tax	7.2	7.2	6.1	7.3	7.9	7.8	7.7	7.7	7.7
Medical insurance tax	4.8	4.9	3.9	4.7	5.2	5.1	5.0	5.0	5.0
Land tax	0.5	0.6	0.3	0.4	0.1	0.3	0.3	0.3	0.3
VAT	10.4	8.7	6.9	8.5	8.7	9.6	9.4	9.6	9.6
Excises	3.7	3.8	2.7	3.6	2.8	4.4	4.0	4.2	3.8
Other taxes (incl. on intern. trade)	0.8	0.8	0.8	1.0	1.3	1.3	1.3	1.3	1.3
Nontax revenue 3/	2.2	2.4	1.9	2.3	2.8	3.1	3.2	2.5	2.5
Expenditure 4/	37.8	39.6	42.3	43.2	40.0	42.2	41.7	39.5	38.5
Current expenditure	34.0	35.4	39.3	38.9	37.5	38.2	37.7	...	...
Expenditure on goods and services	22.8	24.2	25.2	26.5	23.4	25.9	25.6	...	...
Wages and salaries 5/	8.3	9.2	9.7	10.8	8.5	10.4	10.2	...	...
Other goods and services	14.6	15.0	15.5	15.7	14.9	15.5	15.3	...	...
Current transfers and subsidies	10.7	10.7	13.6	12.0	13.5	11.8	11.7	...	...
Subsidies	0.3	0.4	0.6	0.5	0.5	0.4	0.4	...	...
Transfers to households	10.4	10.3	13.0	11.5	13.0	11.4	11.3	...	...
of which: Pensions	7.2	7.1	9.6	8.5	8.9	8.2	8.1	...	...
Interest payments	0.5	0.5	0.5	0.4	0.5	0.5	0.5	...	...
Capital expenditure	3.9	4.2	2.9	4.3	2.5	4.0	4.0	...	...
Financial surplus (+) / deficit (-)	1.8	-0.2	-8.4	-4.6	-1.0	-1.6	-1.6	-0.1	-0.1
Net lending (-)	0.4	-0.1	-0.2	-0.1	0.1	0.3	0.3	0.1	0.1
Overall surplus (+) / deficit (-)	2.2	-0.3	-8.6	-4.7	-0.9	-1.2	-1.2	0.0	0.0
Borrowing requirement	-2.2	0.3	8.6	4.7	0.9	1.2	1.2	0.0	0.0
Domestic financing (net)	-1.2	0.9	-0.9	1.6	0.1	0.2	0.2	...	...
Credit from domestic banks	0.1	-0.2	-0.5	0.3	-0.2	...	...	...	...
Change in deposits with domestic banks (-, increase)	-1.5	1.4	-2.7	0.8	0.6	...	...	...	...
Other domestic financing	0.2	-0.3	2.2	0.4	-0.3	...	...	...	...
Change in government deposits held abroad (-, increase)	-1.1	-0.7	-9.2	-1.0	1.6	0.2	0.2	...	...
Foreign financing (net)	0.1	0.1	0.7	0.2	-0.8	0.4	0.4	...	...
Privatization proceeds 6/	--	--	18.1	4.0	0.0	0.5	0.5	...	...
Memorandum items:									
Primary fiscal balance (+, surplus)	2.6	0.2	-8.1	-4.3	-0.4	-0.8	-0.8	...	...
Balance in government deposits held abroad	1.1	1.7	16.6	2.6	9.4	2.3	2.2	...	...
Total general government debt									
Excluding government assets held abroad	7.6	6.4	...	7.3	...	7.1	...	...	...
Including government assets held abroad	6.5	4.8	...	4.7	...	5.5	...	...	...
GDP (in million of kroons)	64,324	73,325	16,695	75,360	18,028	80,036	81,070	88,473	88,473

Sources: Data provided by the Estonian authorities, and Fund staff estimates and projections.

1/ Excludes any impact from the introduction of the pension system's second pillar, as it is no longer expected to become effective in 2001.
2/ Starting from 2000, includes revenue from the taxation of dividends and fringe benefits (the latter was introduced as of January 1, 2000). Prior to 2000, revenue from the taxation of dividends was shown under the corporate profits tax.
3/ For 2000, includes spending agencies own revenue and profit transfer from the BOE. Projections for 2001 do not yet include any BOE profit transfers.
4/ For 2000, includes outlays financed from spending agencies own resources.
5/ Wages and salaries of a number of budgetary institutions are included under "other goods and services".
6/ Used for financing the general government deficit.

Table 4. Estonia: Banking Survey: 1997-2000
(in millions of EEK)

	1997	1998				1999				2000		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Jan	Feb	Mar
Net foreign assets 1/	**5,091**	**6,114**	**6,843**	**5,126**	**5,114**	**6,619**	**8,470**	**8,205**	**7,850**	**8,211**	**8,363**	**8,756**
Net foreign assets (BOE)	10,104	9,028	10,931	9,986	10,496	9,192	10,677	11,068	12,934	11,039	11,524	11,570
Foreign assets 2/ 3/	10,902	9,788	11,836	10,541	10,909	10,332	11,097	11,471	13,334	11,719	11,906	11,960
Foreign liabilities	-798	-760	-905	-556	-413	-1,140	-420	-403	-400	-680	-383	-391
Net foreign assets (commercial banks)	-5,013	-2,914	-4,088	-4,859	-5,381	-2,573	-2,207	-2,863	-5,084	-2,828	-3,161	-2,814
Foreign assets	8,078	9,469	8,335	7,250	6,481	10,144	9,776	9,186	8,598	10,171	9,434	9,457
Foreign liabilities	-13,090	-12,383	-12,423	-12,109	-11,862	-12,717	-11,983	-12,049	-13,682	-12,999	-12,595	-12,270
Net domestic assets	14,418	14,278	14,303	15,622	15,683	14,907	15,567	16,188	18,041	17,317	17,921	18,463
Domestic credit	19,184	20,754	21,789	22,285	23,622	22,308	22,905	23,624	26,050	25,834	26,440	26,742
Net credit to general government	-2,762	-2,347	-2,552	-2,851	-1,469	-1,999	-1,258	-1,079	-668	-845	-482	-559
Credit to government (banks)	1,087	978	995	856	946	860	1,014	1,049	1,170	1,166	1,121	1,128
Government deposits (banks)	-3,429	-3,256	-3,434	-3,581	-2,412	-2,857	-2,249	-2,125	-1,787	-1,993	-1,591	-1,677
Net credit to government (BOE)	-420	-69	-113	-126	-4	-5	-23	-3	-51	-18	-12	-10
Credit to nongovernment	21,946	23,101	24,341	25,136	25,092	24,307	24,163	24,703	26,717	26,679	26,922	27,302
Credit to nonfinancial public enterprises	320	240	107	107	226	267	256	346	372	329	336	331
Credit to private sector	16,646	18,001	18,634	19,262	18,540	18,097	18,473	18,785	19,821	19,841	19,918	19,868
Households & individuals	4,114	4,148	4,174	4,254	4,181	4,255	4,319	4,829	5,257	5,279	5,312	5,401
Enterprises	12,506	13,825	14,427	14,972	14,319	13,802	14,108	13,908	14,515	14,513	14,557	14,418
Credit to nonbank financial Institutions	4,980	4,860	5,600	5,767	6,326	5,943	5,434	5,573	6,524	6,508	6,668	7,103
Other items (net) 1/	-4,766	-6,476	-7,486	-6,663	-7,939	-7,401	-7,339	-7,436	-8,009	-8,517	-8,520	-8,279
Broad money	**19,509**	**20,392**	**21,146**	**20,749**	**20,798**	**21,525**	**24,036**	**24,393**	**25,918**	**25,539**	**26,290**	**27,226**
of which:												
M1	13,223	13,305	13,808	12,829	12,750	15,271	15,388	15,728	16,910	16,493	17,130	17,082
Currency outside banks	4,588	4,478	4,865	4,568	4,539	4,973	4,902	5,084	5,711	5,380	5,422	5,490
Demand deposits	8,635	8,826	8,943	8,261	8,212	10,298	10,487	10,644	11,198	11,113	11,708	11,593
Time and savings deposits	6,286	7,088	7,338	7,920	8,047	8,561	8,648	8,664	9,008	9,045	9,160	10,144
Memorandum items:												
Base money multiplier	2.29	2.69	2.27	2.53	2.29	2.77	2.59	2.51	2.25	2.65	2.60	2.69
Currency-to-deposit ratio	0.31	0.28	0.30	0.28	0.28	0.26	0.27	0.26	0.33	0.31	0.30	0.29
Bank reserves-to-deposit ratio	0.26	0.20	0.27	0.22	0.28	0.19	0.23	0.24	0.29	0.21	0.22	0.21
Velocity (period average)	3.75	...	...	...	3.57	...	...	...	3.18			
	(percentage change from same period in preceding year)											
Net foreign assets	-29	-18	-16	-38	0	8	24	60	53	56	31	32
Net domestic assets	106	84	60	54	9	4	9	4	15	14	20	24
Credit to the private sector	76	67	52	29	11	1	-1	-2	7	8	9	10
Credit to enterprises	63	62	55	33	15	0	-2	-7	1	2	4	4
Credit to households	129	88	45	16	2	3	3	14	26	28	24	27
Credit to nonbank financial institutions	146	94	60	30	27	22	-3	-3	3	3	10	20
Broad money	38	34	24	12	7	6	14	18	25	25	24	26
Base money	38	19	37	5	6	2	0	18	27	15	21	30

Source: Bank of Estonia and Fund staff estimates

1/ The authorities revised the data on deposit money banks' foreign liabilities in December 1998 by including substantial amounts of bonds issued in foreign liabilities that had hitherto been included in other items (net).
2/ Excludes foreign assets of the Stabilization Reserve Fund
3/ The Bank of Estonia's foreign assets rose sharply in December 1999 as commercial banks shifted funds into their accounts with the Bank of Estonia to enhance domestic liquidity in anticipation of Y2K problems.

Table 5. Estonia: Selected Financial Indicators, 1996-2000

	1996	1997				1998				1999				2000		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Jan	Feb	Mar
	(In percent of total deposits)															
1. Commercial bank reserves	15.6	15.4	14.0	16.9	21.2	16.2	22.3	18.1	24.2	16.4	20.5	21.5	28.1	20.6	21.7	20.8
Cash	5.8	5.1	4.9	3.9	4.6	4.1	4.6	3.8	4.6	3.7	4.8	3.6	4.5	3.9	3.9	3.7
Reserves held at the BoE 1/	9.8	10.3	9.1	13.0	16.6	12.2	17.7	14.2	19.6	12.5	15.6	17.8	23.4	16.5	17.7	17.0
Of which: Required reserves	6.4	6.9	7.7	10.4	11.7	11.0	11.7	13.8	14.3	12.7	11.7	12.1	13.3	13.2	13.1	12.5
2. Average risk-weighted capital adequacy ratio 2/	12.1	12.2	11.0	11.2	13.4	15.2	13.1	12.3	16.9	16.8	16.6	16.7	16.1	15.3	17.3	17.2
3. Non-performing loans 3/	1.3	1.9	1.7	1.1	1.2	1.2	1.1	1.3	1.4	3.2	2.6	2.7	1.7	2.0	2.0	2.2
4. Leverage ratio 4/	8.4	8.1	8.6	8.5	7.3	6.2	6.8	6.2	4.8	5.0	5.1	5.0	5.2	5.2	5.2	5.2
	(In EEK millions)															
5. NFA of commercial banks	214	292	366	-686	-5,013	-2,914	-4,088	-4,859	-5,381	-2,573	-2,207	-2,863	-5,084	-2,828	-3,161	-2,814
6. Net open foreign exchange position of banks 5/	1,111	1,282	2,740	3,019	-1,930	2,082	1,218	548	3,562	5,164	5,740	7,520	7,335	7,899	8,320	9,618
(In percent of total liabilities)	4.8	4.9	9.0	8.4	-4.8	4.9	2.8	1.3	8.7	12.0	13.0	16.9	15.6	16.8	17.7	20.3
of which: net foreign currency assets 6/	958	1,720	3,374	4,572	1,641	5,028	4,985	5,777	6,926	8,742	7,335	8,028	8,672	9,389	10,217	10,650
net forward contracts 7/	154	-438	-634	-1,586	-3,570	-2,946	-3,677	-5,252	-3,364	-3,578	-1,594	-509	-1,337	-1,490	-1,897	-1,032
7. Bank net external obligations maturing within 30 days 8/	979	1,621	1,241	333	731	1,665	1,599	740	255	-743	-914	-758	-652	4,110	2,418	3,615
8. Net international reserves of BoE 9/	1,154	1,190	1,328	1,578	1,658	1,876	1,915	2,035	1,794	1,793	1,750	1,623	1,737	1,726	1,768	1,784
9. Interest spread (in percent per annum) 10/																
Domestic currency	10.3	7.6	5.6	5.6	7.6	4.7	8.6	4.9	8.6	8.2	5.9	7.9	5.5	6.8	3.7	4.0
Foreign currency	8.1	6.7	6.5	5.9	5.7	3.4	7.1	7.9	4.6	9.6	4.5	3.5	6.9	6.8	4.8	3.3
10. Growth of domestic credit to non-government 11/	70.0	75.3	82.3	94.3	83.9	68.4	50.5	27.6	14.3	5.2	-0.7	-1.7	6.5	7.2	9	12.3

Source: Bank of Estonia.

1/ Banks must meet reserve requirements on the basis of average reserve holdings over each reporting period. End of period levels can, therefore, be below the level of required reserves.

2/ The minimum risk-weighted capital adequacy ratio was increased from 8 to 10 percent on October 1, 1997.

3/ In percent of total loans. Non-performing loans are defined as loans overdue from 30-150 days and under current regulations all non-performing loans over 150 days are written off. The ratio rose sharply in early 1999 reflecting the impact of the Russia crisis on the financial condition of enterprises.

4/ Defined as the ratio of total liabilities to total capital; a decline in the ratio indicates improvement.

5/ A (-) sign indicates a short position and includes forward contracts. Switches from positive to negative positions are normally associated with short-lived speculation against the kroon in the form of forward sales (e.g., December 1997 and August 1998). The reversal of these positions has been associated with a sharp improvement in the net open position (e.g., December 1998).

6/ Differs from line 5 as this includes positions held vis-à-vis residents (e.g., foreign currency deposits).

7/ Also includes swaps and off-balance sheet commitments.

8/ Commercial banks only. Commercial banks by mid-May 2000 had successfully refinanced on fine terms through multiyear eurobonds the maturities falling due in early 2000.

9/ Excludes currency board cover and Government deposits held abroad (including the Stabilization Reserve Fund).

10/ Calculated as the difference between short-term (under 1 year) average lending and deposit rates on domestic and foreign currency (DM) loans and deposits.

11/ Percentage change over same month in the preceding year.

Table 6. Estonia: Monetary Authorities: 1997-2000
(in millions of EEK)

	1997	1998				1999				2000		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Jan	Feb	Mar
Net foreign assets	**10,104**	**9,028**	**10,931**	**9,986**	**10,496**	**9,192**	**10,677**	**11,068**	**12,934**	**11,039**	**11,524**	**11,570**
Foreign assets 1/	10,902	9,788	11,836	10,541	10,909	10,332	11,097	11,471	13,334	11,719	11,906	11,960
of which:												
Currency board cover 2/	8,526	7,593	9,298	8,207	9,070	7,780	9,296	9,701	11,526	9,647	10,094	10,133
Foreign liabilities	798	760	905	556	413	1,140	420	403	400	680	383	391
Net domestic assets	**-1,577**	**-1,435**	**-1,633**	**-1,779**	**-1,426**	**-1,412**	**-1,381**	**-1,267**	**-1,408**	**-1,392**	**-1,430**	**-1,437**
Net claims on Government	-352	-2	-113	-126	-4	-3	-23	-3	-24	-7	-5	-3
Claims on financial institutions	23	25	17	17	270	281	279	279	268	268	268	268
Claims on non-financial public enterprises	0	0	0	0	0	0	0	0	0	0	0	0
Claims on private sector	26	27	33	36	40	40	46	48	49	49	49	49
Other	-1,275	-1,486	-1,570	-1,706	-1,731	-1,731	-1,683	-1,592	-1,701	-1,703	-1,741	-1,750
Base money	**8,526**	**7,593**	**9,298**	**8,207**	**9,070**	**7,780**	**9,296**	**9,701**	**11,526**	**9,647**	**10,094**	**10,133**
Currency issue	5,439	5,260	5,773	5,322	5,391	5,233	5,928	5,856	6,649	6,188	6,241	6,297
Deposits of commercial banks	3,035	2,330	3,521	2,855	3,676	2,513	3,333	3,812	4,824	3,405	3,769	3,751
of which: required reserves 3/	2,798	2,944	3,205	3,720	3,653	2,532	3,436	3,557	3,745	3,743	3,806	3,779
Other deposits at BOE	52	3	4	30	-4	4	36	33	54	54	84	85
Memorandum items:												
Gross international reserves (in millions of US$) 1/	**768**	**662**	**819**	**787**	**813**	**660**	**732**	**782**	**856**	**733**	**739**	**730**
Net international reserves (in millions of DM) 4/	207	235	239	254	224	225	217	203	217	215	221	223
Net international reserves (in millions of US$) 4/	116	127	132	152	134	115	115	111	112	108	110	109
Government balances held abroad 5/	700	1,000	1,100	1,226	1,224	2764	2,764	2,499	1,995	...	...	1,698

Source: Bank of Estonia and Fund staff estimates.

1/ Excludes foreign assets of the central government's Stabilization Reserve Fund.

2/ Currency board cover is equivalent to base money (e.g., the sum of currency issue plus the kroon liabilities of the Bank of Estonia in its correspondent accounts).

3/ Requirement to be met on the basis of daily average of deposits over month. Includes liquidity requirement equivalent to 3 percent of the reserve requirement base (imposed since December 1997).

4/ Net of currency board cover (program definition).

5/ Including balances in the Stabilization Reserve Fund (SRF).

Table 7. Estonia: Summary Balance of Payments 1996-2006

(In millions of DM)

	1996	1997	1998	1999		2000		2001	2002	2003	2004	2005	2006
				EBS/00/18 Proj.	Prel.	EBS/00/18 Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current Account	-601	-977	-844	-379	-580	-550	-661	-720	-776	-844	-915	-988	-1,080
Trade Balance	-1,536	-1,957	-1,965	-1,414	-1,617	-1,550	-1,883	-2,062	-2,235	-2,405	-2,568	-2,729	-2,898
Exports	2,729	3,984	4,723	4,534	4,505	4,975	5,716	6,191	6,686	7,167	7,569	7,955	8,352
Imports 1/	-4,265	-5,941	-6,688	-5,948	-6,122	-6,525	-7,599	-8,252	-8,921	-9,572	-10,137	-10,684	-11,250
Services Balance	781	1,029	1,006	1,027	1,080	963	1,244	1,341	1,447	1,548	1,628	1,703	1,781
Receipts	1,669	2,296	2,601	2,699	2,738	2,825	3,144	3,405	3,677	3,942	4,163	4,375	4,594
of which: travel and tourism	729	826	947	999	1,013	...	...	...	...	...	...	...	...
Payments	-888	-1,267	-1,594	-1,672	-1,658	-1,863	-1,900	-2,063	-2,231	-2,393	-2,535	-2,671	-2,813
Income	3	-251	-146	-207	-223	-238	-263	-275	-275	-288	-288	-288	-300
Current Transfers	151	203	260	215	180	275	247	275	288	300	313	325	338
Capital and Financial Account 2/	800	1,369	859	733	889	531	592	848	914	993	1,076	1,162	1,268
Capital Transfers	-1	0	3	2	2	19	19	40	60	80	100	150	150
Financial Account	801	1,369	856	731	887	512	573	808	854	913	976	1,012	1,118
Direct Investment	166	223	999	381	420	600	459	500	500	625	688	750	813
From abroad 1/ 3/	227	462	1,009	504	559	...	...	...	...	...	...	...	...
Outward (by Estonians)	-61	-239	-10	-124	-138	...	...	...	...	...	...	...	...
Net equity investment 3/	239	66	113	495	442	250	188	200	200	200	200	200	200
Loans and other investments 4/	395	1,081	-256	-145	25	-338	-73	108	154	88	89	62	105
of which:													
Banks	263	797	37	-2	11	...	...	...	...	...	...	...	...
Government	40	-79	-103	-54	-60	61	61	...	...	...	...	...	...
Monetary Authorities	-28	-38	-38	22	39	...	...	...	...	...	...	...	...
Errors and Omissions	-45	-46	1	-71	-37	0	0	0	0	0	0	0	0
Overall balance	154	346	16	283	273	-19	-69	128	138	149	161	174	188
Change in official reserves (- increase)	-154	-346	-16	-283	-273	19	69	-128	-138	-149	-161	-174	-188
Memorandum Items:						*(units as indicated)*							
DM/US$ exchange rate (period average)	1.50	1.73	1.76	...	1.83	...	...	...	...	...	...	...	...
Gross International Reserves 5/ 6/ 7/													
(DM millions)	995	1,363	1,364	...	1,667	...	1,598	1,726	1,864	2,013	2,174	2,348	2,536
In months of imports	2.8	2.8	2.4	...	3.3	...	2.5	2.5	2.5	2.5	2.6	2.6	2.7
Relative to (ratio)				...		...							
Short-term debt (gross) 8/ 9/	1.0	0.9	0.9	...	0.9	...	0.9	1.0	1.0	1.1	1.2	1.3	1.3
						(In percent)							
Trade Balance/GDP	-23.4	-24.3	-21.4	-15.2	-17.2	-15.5	-18.6	-18.6	-18.7	-18.5	-18.3	-17.9	-17.6
Current Account/GDP	-9.2	-12.1	-9.2	-4.1	-6.2	-5.5	-6.5	-6.5	-6.5	-6.5	-6.5	-6.5	-6.5
Total external debt/GDP													
Gross 8/	25.5	46.8	43.8	45.1	47.4	39.3	...	...	...	...	...	...	...
Net 10/	17.8	33.1	33.3	30.8	33.3	...	30.2	28.7	27.8	26.3	24.9	23.4	22.3
General government external debt/GDP 11/													
Excluding Govt. assets held abroad	5.2	4.3	4.3	...	4.9	...	5.1	5.2	...	...	...	...	...
Including Govt. assets held abroad	5.2	3.2	2.6	...	2.3	...	2.9	3.2	...	...	...	...	...
Debt Service/Exports of GNFS	5.4	8.1	8.2	7.9	8.1	6.9	7.6	7.1	6.7	6.3	5.9	5.5	5.2

Sources: Bank of Estonia and Fund staff estimates.

1/ The revised projections for 2000 and beyond do not include imports of capital equipment and FDI inflows associated with the privatization of the electricity complex and the railroads. The timing and scale of these inflows, which are expected to be large, remain highly uncertain.

2/ Projections for 2001 and beyond do not take into account the impact on capital flows of the pension reform now under discussion.

3/ The large flows in 1998 were associated with the purchase by Swedish banks of substantial interests in the two largest Estonian banks (Hansapank and Uhispank).

4/ Includes operations in debt securities.

5/ Excludes Government deposits held abroad (including in the SRF).

6/ Changes in gross international reserves may differ from flows implied by overall balance of payments due to valuation changes, etc.

7/ Gross international reserves at end-1999 were inflated by banks shifting resources from accounts abroad to the Bank of Estonia to enhance domestic liquidity in anticipation of Y2K-related problems.

8/ Includes trade credits.

9/ Short term debt is defined on the basis of original maturity.

10/ Net of Government deposits held abroad and foreign assets of commercial banks.

11/ Includes government guaranteed debt.

Table 8. Estonia: Macroeconomic Framework, 1996-2006
(in percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.
Domestic saving	18.6	18.7	20.2	18.4	22.4	22.5	22.5	22.5	22.5	22.5	22.5
Private	15.3	12.6	16.3	18.8	19.6	18.3	18.3	18.3	18.3	18.3	18.3
Public	3.3	6.1	3.9	-0.4	2.7	4.2	4.2	4.2	4.2	4.2	4.2
Investment	27.8	30.9	29.4	24.5	28.9	29.0	29.0	29.0	29.0	29.0	29.0
Private	22.9	26.9	25.2	20.3	24.9	24.8	24.8	24.8	24.8	24.8	24.8
Public	4.9	3.9	4.2	4.3	4.0	4.2	4.2	4.2	4.2	4.2	4.2
Foreign saving	9.2	12.1	9.2	6.2	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Memorandum items:											
Fiscal balance 1/	-1.4	2.2	-0.3	-4.7	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Revenues	39.0	39.6	39.4	38.6	40.1	39.4	39.4	39.4	39.4	39.4	39.4
Expenditures 2/	40.5	37.4	39.7	43.3	41.3	39.4	39.4	39.4	39.4	39.4	39.4
Net non-debt creating capital inflows ("+" inflo	6.2	3.6	12.1	9.2	6.4	6.3	5.8	6.4	6.3	6.2	6.1
Net equity investment	3.6	0.8	1.2	4.7	1.9	1.8	1.7	1.5	1.4	1.3	1.2
Net foreign direct investment	2.5	2.8	10.9	4.5	4.5	4.5	4.2	4.8	4.9	4.9	4.9
GDP real growth (year-on-year in percent) 3/	3.9	10.6	4.7	-1.1	4.0	6.0	6.0	6.0	6.0	6.0	6.0
CPI inflation (average, year-on-year in percent)	23.1	11.2	8.1	3.3	3.8	3.2	2.4	2.4	2.4	2.4	2.4
CPI inflation (end-period, in percent) 4/	14.8	12.5	4.2	3.8	4.3	2.4	2.4	2.4	2.4	2.4	2.4
GDP (millions of kroons) 5/	52,446	64,324	73,325	75,360	81,070	88,473	95,829	103,797	112,427	121,775	131,900

Sources: Estonian authorities, and Fund staff estimates.

1/ Excludes any impact of the planned pension system reform.
2/ Includes net lending.
3/ Real GDP growth has been revised up from 4.0 percent to 4.7 percent for 1998 and from -1.4 percent to -1.1 percent for 1999.
4/ As of 1998, a new CPI index is used that is based on 1997 weights.
5/ The GDP deflator for the fourth quarter of 1999 and thus 1999 as a whole has been revised upward.

Performance Criteria and Benchmarks under the Program, March 31, 2000 1/

	Program target	Outcome
Quantitative Performance Criteria		
	(In millions of EEK)	
I. Limit on cumulative general government deficit	410	167
	(In millions of deutsche mark)	
II. Minimum levels of net international reserves of the Bank of Estonia (January 1 through December 31, 2000)	200	223
	(In millions of U.S. dollars)	
III. Ceilings on external short-, medium-, and long-term debt of general government		
Maturity of 0-2 years	0.0	0.0
Maturity of over 2 years	130.0	0.1
of which: Maturity of more than 2 years but less than 10 years	15.0	0.1
IV. The government will not accumulate any payments arrears during the period of the arrangement		Observed
V. The currency board is fully backed with foreign exchange at all times		Observed
Structural Benchmark		
I. Implement improved loan assessment framework including a uniform minimum loan provisioning system in line with international standards		Draft regulations are awaiting signature of the new Governor of the Bank of Estonia

1/ Definitions of the concepts were set out in the Annex to the Memorandum of Economic Policies, EBS/00/18.

FUND RELATIONS[1]
(As of April 30, 2000)

I. **Membership Status:** Joined May 26, 1992; Article VIII.

II. General Resources Account	SDR Million	Percent of Quota
Quota	65.20	100.0
Fund holdings of currency	81.66	125.3
Reserve position in Fund	0.01	0.0

III. SDR Department	SDR Million	Percent of Allocation
Holdings	0.22	N.A.

IV. Outstanding Purchases and Loans	SDR Million	Percent of Quota
Systemic Transformation	16.47	25.3

V. **Financial Arrangements**[2]

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	3/1/2000	8/31/2001	29.34	0.00
Stand-by	12/17/97	3/16/99	16.10	0.00
Stand-by	7/29/96	8/28/97	13.95	0.00
Stand-by	4/11/95	7/10/96	13.95	0.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2000	2001	2002	2003	2004
Principal	1.9	3.9	3.9	3.9	1.9
Charges/interest	0.6	0.6	0.5	0.3	0.1
Total	2.6	4.5	4.3	4.1	2.0

[1] Updated information relating to members' positions in the Fund can be found on the IMF web site (http://www.imf.org/external/np/tre/tad/index.htm).
[2] Estonia has in the recent past agreed to stand-by arrangements with the stated intention not to draw upon them. These are called "precautionary arrangements" and further information on this type of arrangement can be found on the IMF's web site (http://www.imf.org/external/np/exr/facts/surv.htm).

VII. Exchange Arrangements

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that date, the Bank of Estonia has guaranteed the conversion of kroon bank notes, coins, and reserve deposits of commercial banks at a fixed rate of exchange of EEK 8 per deutsche mark (and EEK 15.6466 per euro). The kroon is fully convertible for all current and capital account transactions.

VIII. Article IV Consultations

The 1999 Article IV consultation was concluded by the Executive Board on June 24, 1999.

IX. Technical Assistance

Appendix II provides information on the Fund's recent technical assistance activities in Estonia.

X. Resident Representative

Mr. Adalbert Knöbl assumed the position of senior resident representative in Estonia and Latvia starting October 1999. He replaced Mr. Dimitri Demekas who had served since January 1, 1997 as resident representative for both Estonia and Latvia.

XI. Legislation Related to the Fund

Eleventh General Review of Quotas:	Passed in April 1999
Fourth Amendment to Articles:	Passed in April 1999

TECHNICAL ASSISTANCE FROM THE FUND, 1996-2000

Department	Subject/Identified Need	Action	Timing	Counterpart 1/
			1996	
MAE	Bank supervision	Expert	Jan.-April (5 visits)	BoE
MAE	Payments system	Expert	July	BoE
MAE	Bank supervision	Expert	August	BoE
MAE	Bank supervision	Expert	November (2 visits)	BoE
MAE	Bank supervision	Expert	December	BoE
STA	General statistics	Resident Advisor 2/	December (1 year)	BoE/MOF/ Stat
			1997	
MAE	Bank supervision	Expert	Jan., Apr. (2 visits)	BoE
MAE/LEG	Bank supervision and legislation	Mission	October	BoE
MAE	Bank supervision	Mission	November	BoE
			1998	
MAE	Bank supervision	Expert	Jan.-July (3 visits)	BoE
MAE	Bank supervision, analysis and research	Mission	March	BoE
MAE	Bank supervision	Short visit	September	BoE
MAE	Bank supervision	Resident Advisor	August (1 year)	BoE
			1999	
MAE	Bank supervision	Mission	July	BoE
STA	Money and banking statistics	Staff visit	October	BoE
FAD	Budget Law	Staff visit	October	MoF
			2000	
MAE/World Bank	FSSA/FSAP	Mission(s)	Feb.-Mar. (2 visits)	BoE/MoF
FAD	Pension Reform	Staff visit	April	MoF/MoSA

Source: International Monetary Fund.

1/ BoE: Bank of Estonia; MoF: Ministry of Finance; MoSA: Ministry of Social Affairs; Stat: Statistical Office of Estonia.

2/ Covering all three Baltic states.

RELATIONS WITH THE WORLD BANK

1. Estonia became a member of the World Bank on June 23, 1992. The World Bank's early involvement in Estonia included work on public expenditure issues (1994), local government financing (1995), and the impact of the transition process on living standards (1996). In June 1997, the Bank completed a Public Expenditure Review Update.

2. In June 1999, the World Bank completed a Country Economic Memorandum entitled "*Estonia: Implementing the EU Accession Agenda.*" The focus was on the areas of overlap between the EU accession agenda and measures to strengthen economic management. The study also examined areas where implementing the accession agenda entailed either a fundamental policy change or high compliance costs, such as adopting the EU's Common Agricultural Policy and complying with EU environmental standards.

3. In February 2000, the World Bank initiated work on a Regional Development Program for the northeastern-most county of Estonia, Ida Virumaa. The work includes the development of an action program designed to: (a) strengthen regional institutions providing labor and education services, as well as other social services; (b) support the development of small and medium enterprises; and (c) mitigate past environmental damages, contributing to sustainable development. The work shall be completed by mid-2000.

4. The Board of Executive Directors approved the first World Bank lending operation in Estonia, a Rehabilitation Loan for US$30 million, in October 1992. In May 1994, loans to support district heating rehabilitation (US$38.4 million) and highway maintenance (US$12 million) were approved. A US$10 million Financial Institutions Development Loan (FIDL) was approved in October 1994, a health project (US$18 million) in January 1995, followed in April 1995 by an environment loan (US$2 million), and an agricultural loan (US$ 16 million) in March 1996. More recently, in March 2000, the Board approved a Transport Sector Project (US$25 million), focusing primarily on road improvements.

ESTONIA—STATISTICAL ANNEX

1. Estonia is a subscriber to the Special Data Dissemination Standard (SDDS). The Bank of Estonia (BoE) publishes a wide variety of data on the key variables for each of the four sectors—monetary, fiscal, real and external—on its website, with periodic updates.

2. However, more detailed data are available to Fund staff for purposes of program monitoring. The following is a summary of both the frequency and the timing of key data as made available to Fund staff:

A. Monetary Statistics

3. All monetary data are issued by the Bank of Estonia (BoE).[1]

- Monthly reporting of BoE balance sheet (base money and NIR) are available on the eighth day following the end of the month.[2]
- Monthly broad money and its components are available from the BoE on the thirteenth banking day from the beginning of the month.[2]
- Monthly interest rate updates on domestic and foreign currency transactions are available on the seventeenth banking day from the beginning of the month.[2]

B. Financial Statistics

4. All financial data are compiled by the Bank of Estonia (BoE) and are reported on a monthly basis:[3]

- Commercial bank reserves data are available on the eleventh banking day from the beginning of the month.[2]
- Commercial bank off-balance sheet data are available on the eighteenth banking day from the beginning of the month.[2]
- Average capital adequacy ratios are available on the thirteenth banking day from the beginning of the month.[2]

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[1] All monetary data are collected with a frequency of 10 days and are available to Fund staff upon request.

[2] Indicates publicly available data on the Bank of Estonia website (http://www.epbe.ee).

[3] Data for individual banks are also available on a quarterly basis.

- Nonperforming loans data are available on the seventeenth banking day from the beginning of the month.[2]

- Leverage ratios are available on the eighteenth banking day from the beginning of the month.

- Liquidity ratios are available on the eighteenth banking day from the beginning of the month.

- NFA of commercial banks is available on the eleventh banking day from the beginning of the month.[2]

- Net open foreign exchange positions are available on the eleventh banking day from the beginning of the month.

- Short-term external debt are available on the eighteenth banking day from the beginning of the month.

C. Balance of Payments Statistics

5. All balance of payments data are also compiled by the Bank of Estonia (BoE):

- Daily exchange rate data are available with a one-working day lag.[4]

- Monthly imports/exports data are available with a two-month lag.

- Quarterly current account data is available with a one-quarter lag.[4]

- Quarterly public and private external debt data is available with a one-quarter lag.[4]

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF).

- Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government has started to report monthly data on a consolidated government basis in January 1999 (http://www.fin.ee).

- Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag.

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[4] Indicates publicly available data on the Bank of Estonia website (http://www.epbe.ee).

E. National Accounts Statistics

- Data on GDP (quarterly, by semester, and annually) are currently being issued by the Statistical Office of Estonia (SOE) with a lag of five months after the end of the quarter. Flash estimates of aggregate GDP are available two months after the end of the quarter.[5]

- Monthly CPI inflation data are available seven days after the end of the accounting period, and are received directly from the SOE. Monthly PPI and Export Price Index data are available four weeks after the end of the accounting period.[5]

- Monthly indicators of output, i.e., retail trade, industrial output, industrial sales, are reported approximately six weeks to two months after the end of the accounting period.[5]

- Monthly wage data (nominal) are produced by the SOE with a two-month lag. Quarterly wage data (nominal and real) are now produced by the SOE with a lag of two months.[5]

[5] Indicates publicly available data on the Statistical Office of Estonia website (http://www.stat.ee).

Estonia: Core Statistical Indicators
(As of May 23, 2000)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt
Date of latest observation	5/11/00	4/30/00	4/30/00	4/30/00	4/30/00	4/30/00	4/00	Q1 1999	Q4 1999	3/00	Q4/99	Q4/99
Date received	5/11/00	5/9/00	5/9/00	5/18/00	5/18/00	4/20/00	5/7/00	5/10/00	3/20/00	4/25/00	5/23/00	3/25/00
Frequency of data	D	M	M	M	M	M	M	M	Q	M	Q	Q
Source of data	N	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	O 1/	O 1/	O 1/	O 1/	O 1/3/	O 1/	C 2/	O 1/	O 1/	C,V 2/4/	C,V 2/	V,O 1/2/
Frequency of reporting	D	M	M	M	M	M	M	M	Q	M	Q	Q
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C

Source: Fund staff.

1/ Via electronic mail or Internet.
2/ Through the resident representative's office.
3/ Broad money computed by staff based on balance sheets received (consolidated commercial banks balance sheet and central bank balance sheet).
4/ General government balance computed by staff based on separate data provided by the Ministry of Finance.

Explanatory Notes
Frequency of data: D-daily, W-weekly, M-monthly, Q-quarterly.
Frequency of reporting: M-monthly, Q-quarterly, V-irregularly in conjunction with staff visits.
Source of data: A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release.
Mode of reporting C-cable or facsimile, V-staff visits, or O-other.
Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

June 7, 2000

Dear Mr. Köhler:

Developments in the Estonian economy have been quite favorable under the program, which is supported by the Fund with a stand-by arrangement, which we intend to treat as precautionary. The economic recovery that started in the second half of last year has gained momentum early this year, and now appears to be broadly based. Both exports and imports have risen rapidly and we believe that developments in the first quarter are consistent with only a slight widening of the current account deficit for 2000 as a whole. We have met all performance criteria in the program underlying the stand-by arrangement with comfortable margins. As expected, tax receipts have rebounded and through vigorous control of government spending we have held the budget deficit well below its program ceiling. Confidence in our currency board also has remained strong and domestic interest rates have declined further to historically low levels. The FSAP exercise found that the banking system appears to be healthy and banking supervision has been strengthened. The government has little domestic or foreign debt and holds significant balances abroad.

We will, however, monitor developments closely and we are committed to act decisively, if warranted. Should faster growth generate an excess of tax revenue over projections, the budget deficit will be reduced below the program limits. We also remain committed to a balanced budget for next year. Moreover, should economic growth exceed current projections, we intend to use any additional revenues to generate a budget surplus in 2001, so as to contain the current account deficit and accumulate resources for the financing of the pension reform. Our structural policies are also progressing as contemplated under the program. Against this background, we are requesting the completion of the first review under the stand-by arrangement.

Sincerely,

/s/

Mart Laar
Prime Minister

/s/

Peter Lõhmus
Acting Governor
Bank of Estonia

Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Statement by the IMF Staff Representative
June 30, 2000

Since EBS/00/101 was issued, the authorities have confirmed that they have submitted the new Basic Budget Law to parliament, thereby fulfilling the structural performance criterion for June 30, 2000. Also, the Bank of Estonia has issued regulations for the improved loan assessment framework, including a uniform minimum loan loss provisioning system in line with international standards (a structural benchmark).

While the VAT exemption on thermal energy was lifted effective July 1, 2000, parliament decided to apply the VAT only at a reduced rate of 5 percent instead of the full rate of 18 percent. This will imply a loss of revenue of about EEK 94 million for 2000 (about 0.1 percent of GDP). The government is committed to submit, if necessary, to parliament in August 2000 a supplementary budget with sufficient expenditure cuts to ensure that the fiscal program targets will be met. The authorities have reaffirmed their intention to use any windfalls in revenues resulting from faster than expected economic growth to further reduce the fiscal deficit in 2000.

New balance of payments data show a downward revision of the 1999 current account deficit from 6.1 percent of GDP to 5.8 percent of GDP and a preliminary estimate of the current account deficit for the first quarter of 2000 of about 8 percent of GDP. This outturn is consistent with a current account deficit of 6.5 percent for 2000 as projected in EBS/00/101. The current account deficit in the first quarter of 2000 was financed entirely by non-debt-creating flows—overwhelmingly in the form of foreign direct investment (including a significant amount of reinvested earnings).

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/49
FOR IMMEDIATE RELEASE
July 11, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Estonia

On June 30, 2000, the Executive Board concluded the Article IV consultation with Estonia.[1]

Background

Since regaining its independence in 1991, Estonia has been a leader among transition economies in its consistent implementation of strong market and stability oriented policies. These include a currency board tying the exchange rate for the kroon to the deutsche mark (and now effectively to the euro), full convertibility for current and capital account transactions, and an active privatization program (which is nearing completion). Since Estonia applied for EU membership in November 1995, the structural reform program has been driven primarily by the government's objective of meeting all EU accession requirements by January 2003. The combination of conservative macroeconomic policies and a vigorous structural reform effort has resulted in substantial progress being made toward creating a flexible, competitive, and market driven economy.

Growth faltered in 1999, due mainly to an earlier decline in the stock markets, difficulties in the banking sector, and a sharp contraction in exports to the Commonwealth of Independent States (CIS) in the wake of the Russia crisis. After high growth in 1997 and 1998, real GDP declined by 1.1 percent in 1999, with much of the contraction concentrated in the first half of the year. This contributed to unemployment rising to over 11 percent and a further reduction in consumer price index (CPI) inflation, to 3.3 percent in 1999. Notwithstanding the drop in exports to the CIS, the current account deficit declined to 6 percent of GDP in 1999 (down from 12 percent of GDP in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

1997 and 9 percent of GDP in 1998), reflecting the impact on import demand of the economic slowdown. Current account deficits in both 1998 and 1999 were financed by non-debt-creating flows—mainly foreign direct investment. GDP growth started to recover in the last quarter of 1999, largely on the strength of an increase in private demand and export growth to western markets (the latter accelerated sharply in early 2000).

After experiencing a budget surplus in 1997 and near balance in 1998, the fiscal position weakened in 1999. This was due to the impact of the recession on revenue collection and high public sector wage and pension increases. The government cut back expenditures in mid-1999, implementing a supplementary budget. This helped limit the fiscal deficit to 4.7 percent of GDP for the year. The deficit in 1999 was financed mainly from privatization receipts from the partial sale of the telecommunications company. The fiscal position improved substantially in the first quarter of 2000 as revenues picked up with the economic recovery and expenditures were restrained. The budget deficit for the first quarter of 2000 is estimated at about 1 percent of GDP. If the 2000 budget is fully implemented, the ratio of general government expenditures to GDP would fall to 42 percent of GDP in 2000. This is consistent with the government's intention to reduce the size of the public sector over the medium term.

The currency board and its fixed peg have continued to provide a transparent and credible framework for financial operations and the formation of economic expectations. Following slow growth in monetary aggregates from mid-1998 through late 1999, broad money growth recovered and expanded at about 25 percent (year-on-year) towards the end of 1999 and early 2000, partly funded by a balance of payments surplus. Lending to the private sector also resumed at the same time—albeit at a more moderate pace (less than 10 percent). Reflecting confidence in the currency board, domestic interest rates fell to historically low levels in mid-1999 and the differential to euro area levels has dropped for short-term rates to below 100 basis points by mid-2000. The banking system appears to be in a strong financial condition, as reflected in a high average capital adequacy ratio and the fact that the two largest Estonian banks, which control about 85 percent of the Estonian bank assets, are both majority owned by Swedish banks. The Bank of Estonia continued to improve banking supervision in 1999, building on the implementation of the revised Law on Credit Institutions that became effective July 1999.

The government's medium-term economic program is reflected in the precautionary stand-by arrangement with the Fund that was approved in March 2000 (for more details see IMF Press Release No. 00/14 and the Memorandum of Economic Policies posted on the IMF's External Website). It provides for the (i) implementation of fiscal policies consistent with limiting the fiscal deficit to 1¼ percent of GDP in 2000 and attain budgetary balance thereafter, (ii) maintenance of the currency board and current exchange rate peg through accession to the EU and joining the eurosystem, (iii) proceeding with the implementation of second generation structural reforms, including pension and health sector reforms, as well as continuing with the privatization of remaining state infrastructure enterprises.

Estonia participated in early 2000 in a joint World Bank-IMF study of its financial sector. In that connection, a report dealing with its observance of standards and codes as they apply to its monetary and financial system will be published in the near future.

Executive Board Assessment

Executive Directors welcomed the further strengthening of Estonia's economic performance in the recent past. The recovery has gained momentum, inflation remains low, and confidence in the currency board remains high as evidenced, inter alia, by the convergence of interest rates toward euro-area levels. Directors emphasized that these favorable developments owed much to the authorities' policies. They stressed the importance of maintaining the fiscal consolidation effort under the currency board arrangement. Directors saw fiscal policy as critical in providing a favorable climate for sustained economic growth, including by regulating demand pressures to prevent overheating and an excessive external current account deficit. Against this background, they welcomed the reduction in the fiscal deficit in early 2000.

Directors agreed that the fiscal targets for 2000 and 2001 remain appropriate. They welcomed the authorities' commitment to take any corrective actions needed to achieve them, and noted the authorities' intention to target a budget surplus next year should the economy perform better than expected. Directors emphasized that, to safeguard the fiscal position, firm expenditure policies must be in place before proceeding with the planned reduction in taxation in 2001, and that recent revenue measures should be fully implemented.

Directors agreed that the currency board arrangement should remain a cornerstone of Estonia's economic strategy in the lead-up to EU membership and under ERM2. They emphasized the importance of appropriate macroeconomic and structural policies, particularly in the labor markets, to support the currency board and maintain external competitiveness.

Directors noted the recent rebound in broad monetary growth, partly caused by balance of payments inflows. They noted the challenge for policymakers that could arise from the possibly destabilizing effects of abrupt swings in the banking system's recourse to foreign borrowing, and in the saving-investment balance of the private sector. The Bank of Estonia will need to monitor developments very carefully to forestall any excessive growth in credit. While reserve requirements are already high, Directors warned that a further increase may become necessary to restrain domestic credit expansion. They also stressed that banking supervision must ensure that banks do not unduly relax their internal risk management procedures.

Directors welcomed Estonia's participation in the pilot Joint Bank-Fund Financial Sector Assessment Program. They noted that financial sector vulnerabilities have been markedly reduced over the past few years, largely reflecting bank consolidation and restructuring (including, importantly, foreign ownership). Banking supervision has also been considerably strengthened. Directors welcomed Estonia's compliance with many of the Basel Core Principles and encouraged the authorities' effort in areas where compliance is not complete. They considered that nonbank financial supervision should be strengthened, and supported the move to unified supervision of the financial sector by a new agency. Directors stressed that this new

agency should have adequate budgetary and operational independence, as well as powers to issue and revoke licenses.

On pension reform, Directors agreed that a second, fully funded, defined contribution pillar has certain advantages, but that it would not, by itself, solve the issues arising from the adverse demographic shift. For this, further reform of the first pillar would be required, including a more ambitious and faster increase in the pension age. Directors stressed that care would need to be taken that the transition costs associated with a second pillar are constrained to avoid budget pressures or an excessive increase in public debt.

Directors commended the substantial achievements with regard to structural reforms and the priority accorded by the government to making further progress toward EU accession. They praised the establishment of a well-functioning market economy, the maintenance of a very open trade and payments system, and the fostering of a conducive environment for foreign direct investment. Directors noted that discussions with potential investors were moving forward concerning the privatization of the few remaining major state assets.

Directors were concerned that, notwithstanding a high degree of wage flexibility, the ongoing restructuring of the economy in combination with mismatched skills has resulted in a high level of unemployment. They recognized that this, in part, resulted from the fact that the authorities had resisted measures that would have slowed the transformation of the economy. Nevertheless, Directors emphasized the importance of addressing—including through targeted active labor policies—the problems related to high unemployment, not least in order to preserve a social climate favorable to the continuation of reforms.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Republic of Estonia: Selected Economic Indicators

	1996	1997	1998	1999
Real Economy	*Changes in percent*			
Real GDP	3.9	10.6	4.7	-1.1
CPI (period average)	23.1	11.2	8.1	3.3
Unemployment rate (in percent) 1/	10.0	9.7	9.9	11.4
Domestic saving (in percent of GDP)	18.6	18.7	20.2	18.4
Domestic investment (in percent of GDP)	27.8	30.9	29.4	24.5
Public Finance	*In percent of GDP*			
General government balance	-1.6	2.2	-0.3	-4.7
General government external debt				
Excluding government assets held abroad	5.2	4.3	4.3	4.9
Including government assets held abroad	5.2	3.2	2.6	2.3
Money and Credit	*Changes in percent*			
Base money	21.6	37.7	6.4	27.1
Broad money	36.8	38.0	7.0	24.6
Domestic credit to nongovernment	70.0	83.9	14.3	6.5
Balance of Payments	*In percent of GDP*			
Trade balance	-23.4	-24.3	-21.4	-17.2
Current account	-9.2	-12.1	-9.2	-5.8
Gross international reserves (in millions of deutsche mark)	995	1,363	1,364	1,667
Exchange Rate				
Exchange rate regime	Currency Board Arrangement			
Present	EEK 8 = DM 1			
Real effective exchange rate (1995=100) 2/	108.4	110.6	123.3	134.8

Sources: Data provided by the Estonian authorities, and Fund staff estimates and projections.

1/ Based on the definition of the International Labor Organization (ILO).
2/ Export-share weighted real exchange rate (CPI-based) against the 15 major trading partners in 1998.

Statement by Olli-Pekka Lehmussaari, Executive Director
for the Republic of Estonia
June 30, 2000

Let me start by thanking the staff on behalf of my Estonian authorities and myself for their dedication and frankness in discussions on the current state of the Estonian economy and the challenges for the period ahead. Their analysis is thorough, the assessment well balanced, and policy advice constructive. My authorities do not have any major disagreement with the staff appraisal. They are of the view that staff gives fair credit to Estonia's commitment to pursue prudent macroeconomic policies, implement structural reforms, and adhere to the best standards of policy transparency.

My authorities also wish to give high marks to the FSAP mission. The authorities found Estonia's participation in the pilot project a most useful experience, both with regard to the general assessment of the financial system, as well to defining the areas of concern. They also see the FSAP/FSSA as a valuable complement to the Fund's surveillance activity.

In addition, we are likewise pleased with the set of background papers discussing the pension reforms as well as saving, investment and external adjustment in the face of exogenous shocks in the Baltics. In the authorities' view, these papers provide a thorough insight into the challenges Estonia and the other Baltic countries are faced with from a medium term perspective. Not least importantly, they also serve, through the cross-country comparisons, the Fund's goal for enhanced regional surveillance.

Notwithstanding the staff's positive assessment, the authorities are well aware of the challenges posed by Estonia's ever growing integration with the global economy and EU accession. Therefore, my Estonian authorities wish to restate their determination to continue with the prudent but ambitious policy course aimed at ensuring long-term sustainable economic growth and being ready for the EU accession by January 1, 2003.

Economic developments and outlook

Recent economic data supports the view that the Estonian economy has firmly returned to the growth path and that the recession was short-lived. Following four quarters of contraction, the economy started to revive in the fourth quarter of 1999, driven primarily by the rebound in domestic demand. Further broadening of the recovery in the beginning of 2000 was largely due to the increasingly favorable external conditions – the positive outlook for the global economy and, in particular, strengthening growth in Europe – and Estonia's healthy competitive position. This allowed export volumes to reach their all-time-high as export growth accelerated sharply and reached 47% over the previous year in the first quarter

of 2000. Although domestic demand was somewhat weaker than expected, exports lifted economic growth to around 5.2% in the first quarter of this year.

The latest data also provides further evidence that the two main concerns Directors highlighted during the 1999 Article IV consultation -- the high current account deficit and the deteriorating fiscal balance – are fading away. Moderate consumption and lower investment spending, partly explainable by a still existing output gap, resulted in higher domestic savings that contained the current account deficit to approximately 8% of the first quarter GDP. Most importantly, the trade and services balance improved markedly and was only 5% of GDP. Dividend payments, which were reinvested, accounted for the rest of the current account deficit, reflecting the continued profitability of the FDI and the attractiveness of Estonia's investment climate. As the government maintained strict expenditure controls and the economy revived, the fiscal position recorded welcomed improvement and the deficit narrowed to around 1% of the first quarter GDP, or within the program ceilings.

Inflation has remained moderate and the 12-month change in consumer price index stood at 2.9% in May 2000. Monetary conditions continue to be supportive for growth. Likewise, the financial sector is well capitalized and liquid to support structural changes in the economy and the new growth cycle. Labor costs in the first quarter grew apparently slower than GDP, thereby compensating in part for last year's excessive wage increases. However, despite the flexibility in the labor market, unemployment has increased somewhat, and stood at nearly 15% in the first quarter.

Against this background, the authorities see the near term outlook for Estonia as favorable. They expect the Estonian economy to expand by 4 to 5% in the year 2000 and by 5 to 6% in 2001, while inflation is expected to remain in the range of 3.8 to 4.5% in 2000 and 4 to 4.5% in 2001. The moderate underlying current account deficit in the first quarter lays a good foundation for keeping the deficit for the year 2000 below 7%. However, the authorities also agree with staff that, as the economic growth gains momentum, investment demand and credit growth are likely to accelerate and current account developments need close monitoring.

Monetary policy in the light of forthcoming EU accession

My Estonian authorities continue to see the currency board arrangement (CBA) as the most suitable monetary framework for a small open economy such as Estonia. Eight years of experience under the CBA have demonstrated that the CBA has brought substantial nominal and real convergence of the Estonian economy with that of the EU. The CBA has also proved its robustness through the entire business cycle and has readied the economy for the new expansion. Therefore, the authorities continue to believe that, by the time of actual transition to the euro, convergence will have advanced further and the Estonian economy will be able to cope with the increasing competitive pressures of the single market.

The authorities are also of the view that the CBA remains the appropriate framework until Estonia's accession to the EMU. They believe that an orderly adoption of the euro after

Estonia has become a full member of the EMU is the best option for the country, as the authorities do not see clear advantages to any alternative strategy. My Estonian authorities are therefore pleased that the ECB has expressed its preliminary position that the accession countries with a sustainable and euro-based CBA might be allowed to participate in the ERM II with a zero fluctuation band, where the CBA serves as a unilateral commitment to augment the discipline within the ERM.

The authorities have launched a comprehensive two-stage review of the operational framework of the monetary policy, aiming at reducing market distortions and achieving full compatibility with the Eurosystem over the medium term. While the CBA remains intact, the reform foresees technical changes in the commercial banks' reserve requirement system. As a most important change in the first stage, banks will be allowed to partially meet the reserve requirement by high quality euro-denominated foreign assets.

The second stage of the reform involves the development of the monetary policy operational framework towards a full convergence with that of the EMU in the medium term. Also, in the second stage, the reserve requirement system will be harmonized with the Eurosystem and intra-day liquidity instruments will be introduced. The second stage will be concluded with Estonia's accession to the EMU, after which, active monetary policy instruments, *inter alia* open market operations, will be introduced.

Fiscal policy in the short and medium term

The authorities continue their course of fiscal consolidation and streamlining public finances. Fiscal performance in the first half of the year 2000 has been broadly consistent with forecasts, and a deficit ceiling of 1.25% of GDP for the year as a whole is well within reach. Should the interim revenue performance turn out to be unsatisfactory, the authorities are committed to submit to the Parliament a negative supplementary budget in August in order to meet the program targets. My authorities are determined to save any windfall gains which may result from a stronger than anticipated economic expansion, bearing in mind the costs of the pension reform and the fact that, under the CBA, fiscal policy is the primary tool for maintaining macroeconomic stability. The government has started the drafting process of the 2001 budget, which aims at achieving a fiscal balance. However, should the economy perform better than underlying projections, the authorities are targeting a surplus for the year to come.

The authorities have also advanced in refining the medium-term framework of fiscal policy. Two issues are central in this respect. First, the government has submitted to the parliament the new draft Budget Law. When passed, the law will enhance fiscal transparency and will bring Estonian budget legislation in line with the EU requirements and with the IMF's code of good practices on fiscal transparency. Second, the government has approved the main principles of the fiscal strategy for the period 2001-2004. The strategy foresees a lowering of the tax burden; an increase in the quality of public expenditures; speeding up European integration, *inter alia* via strengthening the administrative capacity of the public sector; and streamlining public debt management. As a result, by 2004, the tax burden should

decline to 34% of GDP and government expenditures to 34% of GDP; Estonia should be ready to join the European Union by 2003; and the public debt is not expected to increase.

Financial sector issues

My Estonian authorities are in broad agreement with the main conclusions of the FSAP and FSSA reports. This first ever comprehensive assessment of the strengths and vulnerabilities of the Estonian financial sector has supported the authorities in their efforts to set priorities down the road. By now the predominantly foreign financial institutions' owned Estonian financial industry has undergone major consolidation and their corporate governance has significantly improved. Against this background and given the increased integration of the Estonian economy with that of the EU, the staff's conclusion that financial sector vulnerabilities are materially reduced and that the financial supervision is strengthened, save for securities market regulation, did not come as a surprise.

My authorities are particularly satisfied with the input the FSAP exercise produced in preparing for the unification of the presently institutionally separate Banking Supervision, Insurance Inspectorate and Securities Inspectorate. The authorities are convinced that the supervisory reform should result in high and even quality supervision and regulation in all segments of financial markets. However, they also share the view that the introduction of the new unified supervisory authority should not compromise the quality of the banking supervision function, even during the transitional phase. The final decision on the precise modalities of unification, notably on the legal form, will be taken in immediate future.

The authorities agree with the staff that, given the banks' ample capitalization and liquidity, credit developments need a close monitoring. While they also agree that the use of the moral suasion in influencing banks' behavior is one of the policy options, they also see a role for other regulatory measures for this purpose.

Main challenges in the structural arena

My authorities continue to give due consideration to structural issues, which, if not properly addressed, might pose a serious threat to fiscal sustainability, and to the economy's long-term growth potential. Therefore the overhaul of the current pay-as-you-go (PAYG) pension system, health care and education framework, as well as the strengthening of public administration, are on the top of the authorities' reform agenda.

With respect to the pension reform, the authorities have yet to decide the key issues of financing the transition costs and the eligibility criteria for joining the fully funded mandatory pillar. While specifics are still open, the authorities do not see debt financing as a viable option, nor do they envisage any capital controls on the investments of pension funds. In this debate, the authorities value the quality over the speed of the decision. Therefore they expect the implementation of the fully funded mandatory pillar to take place as of 2002.

Regarding the labor market, the authorities are of the view that labor market development and flexibility deserve continuous attention, particularly bearing in mind the upcoming EU accession. Although the labor market has exhibited considerable flexibility, allowing the real and, in certain cases, also the nominal wages to decline, the current framework of wage formation, social guarantees and vocational training are at the heart of the agenda.

My Estonian authorities are also of the view that the current high unemployment level should not be seen as a "hardship" imposed by the CBA. Rather it is a reflection of economic restructuring during the transition phase, and of the business-friendly legal framework that allows lay-offs as a necessary part of economic restructuring. In particular, the recent recession has forced companies to increase their efficiency, as the pre-crisis output levels have been reached with lower employment. Therefore the authorities consider the improvement of vocational training and retraining, as well as the reform of the educational system, while maintaining a business-friendly legal framework, as primary policy tools for reducing the unemployment level and ensuring labor market flexibility, labor mobility and competitiveness. In this connection, they also emphasize that labor market measures will have a considerable time lag before their full effect is seen, and therefore the unemployment is expected to remain elevated in the near-term.

The authorities have also advanced with the privatization agenda. The government has approved the sale of a 49% holding in Estonia's main power generation company to the US energy firm NRG Energy. Privatization of the railway company is proceeding according to schedule, and the Bank of Estonia is closing the sale of its majority holding in Optiva Bank to the Finnish financial conglomerate.

Transparency initiatives

Finally, my Estonian authorities wish to restate their commitment to the highest standards of transparency. To this end, the authorities continue to participate in the pilot project of the publication of Article IV staff reports. They also intend to publish the financial sector ROSC binder. Although understanding the reservations that some countries have regarding the publication of the FSSA report itself, they regret that this is currently not possible on a voluntary basis. The assessment of compliance with the Code of Good Practices in Fiscal Policies is currently underway.