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Country Report No. 01/14

Estonia: Second Review Under the Stand-by Arrangement--Staff Report; News Brief by the Deputy Managing Director; and Statement by Authorities of Estonia

In the context of the second review of the Stand-by Arrangement with Estonia, the following documents have been released and are included in this package:

- the staff report for the second review of the Stand-by Arrangement, prepared by a staff team of the IMF, following discussions that ended on **September 20, 2000,** with the officials of Estonia. **Based on information available at the time of these discussions, the staff report was completed on November 27, 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 News Brief by **Deputy Managing Director Shigemitsu Sugisaki** on the completion of the second review by the IMF Executive Board on a lapse-of-time basis;

- a statement by the authorities of Estonia.

The Letter of Intent sent to the IMF by the authorities of Estonia and the Supplementary Memorandum of Economic Policies have been separately released.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Second Review Under the Stand-By Arrangement

Prepared by European II and Policy Development and Review Departments

Approved by Gérard Bélanger and G. Russell Kincaid

November 27, 2000

- The discussions were held in Tallinn during September 6-20, 2000. The mission team consisted of Messrs. Keller (head), Zavoico, Mongardini, and Schimmelpfennig (EP) (all EU2). Mr. Knöbl, the Fund's senior resident representative, assisted the mission. Mr. Sutt, assistant to the Executive Director for Estonia, attended the policy meetings.

- The mission met with Prime Minister Laar, Minister of Finance Kallas, the Bank of Estonia's (BoE) Governor Kraft, Minister of Economy Pärnoja, Minister of Social Affairs Nestor, and other officials, as well as with representatives of commercial banks and academia.

- Estonia accepted the obligations of Article VIII in 1994 and has no restrictions on current or capital account transactions. The authorities have submitted to the Fund the documents required under the safeguards assessment guidelines, which are now under review by the staff.

- The precautionary Stand-By Arrangement, in the 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. All performance criteria were met at end-June and end-September 2000.

- In the attached letter, dated November 24, 2000, the Prime Minister and the Governor of the Bank of Estonia request completion of the second review by the Board. The authorities intend to publish this staff report together with the attached supplementary memorandum of economic policies (SMEP).

Contents

I. Introduction

1. During the discussions for the first program review and the 2000 Article IV consultations on June 30, 2000, Directors welcomed the further strengthening of Estonia's economic performance and endorsed the fiscal program targets for 2000 and 2001. Directors noted that further reform of the pension system would be required, including a faster increase in the pension age. They supported the move to unified supervision of the financial sector and stressed that the new agency should have adequate budgetary and operational independence, as well as powers to issue and revoke licenses.

II. Recent Economic Developments and Performance Under the Program

2. **Despite a sharp fiscal correction, the economic recovery is gaining momentum** (Figure 1). Driven mainly by strong export growth, real GDP growth reached 6.4 percent in the first half of 2000 over a weak first half in 1999; compared to the first half of 1998, real GDP was only 3.3 percent higher. For the year 2000, growth is likely to exceed the program projections to reach 5½-6 percent. As a result of the large increase in oil prices and the weakness of the euro (to which the kroon is pegged), 12-month CPI inflation reached 4.7 percent in September 2000. Unemployment has begun to decline from its peak in the first quarter of 2000 but remains higher than in 1999 as the rapid reorientation of the economy continues and traditional sectors such as agriculture and fisheries continue to decline.

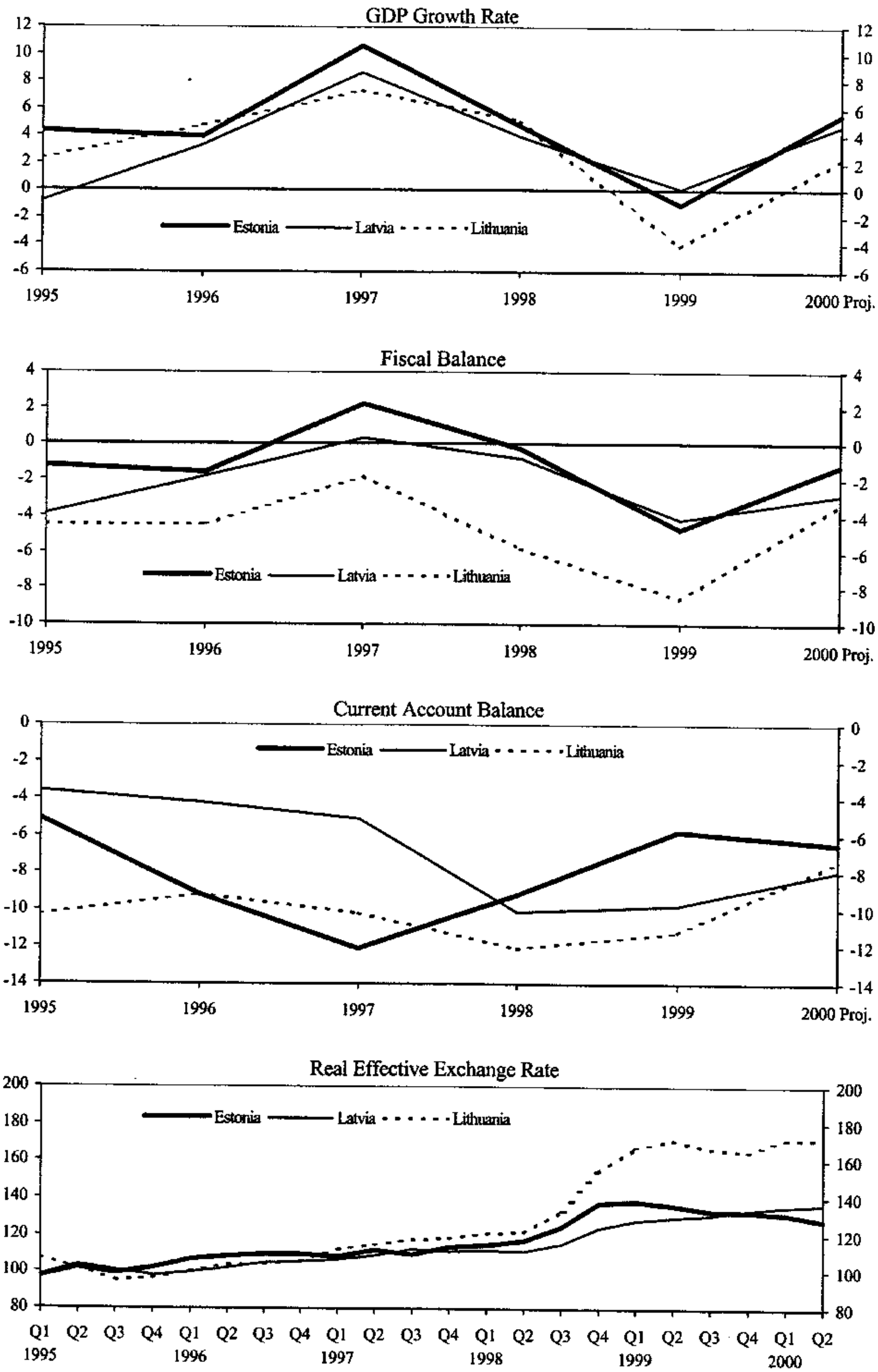
3. **The external position has strengthened more than projected.** Notwithstanding the economic upturn, the current account deficit narrowed in the first half of 2000 to 5½ percent of GDP from 6.2 percent of GDP in the first half of 1999. Spurred by the recovery in the EU and the competitiveness gains from the peg to the euro, the value of exports of GNFS grew by nearly 40 percent in the first half of 2000 (y-o-y). Subcontracting (mainly of electronics and textiles) nearly doubled (Table 1) and there was strong demand for traditional wood and furniture products. Imports of GNFS, excluding those related to subcontracting activity, recovered by 23 percent after a substantial contraction in the first half of 1999. The confidence in the currency board remains high, as demonstrated by falling interest rate spreads (Figure 2). The strengthened external position resulted in the recent increase in Estonia's sovereign ratings by a major rating agency (Fitch IBCA) to BBB+, the second highest amongst EU accession candidates.

Table 1. Estonia: Annual Growth Rate of Export and Import Values in Deutsche Mark, 1998-2000
(in percent)

	1998	1999	2000 H1
Exports of goods, fob	18.6	-4.6	48.5
General merchandise	10.9	-7.2	29.7
Subcontracting (goods for processing)	42.4	1.4	90.3
Imports of goods, fob	12.6	-8.5	39.7
General merchandise	7.6	-12.2	23.5
Subcontracting (goods for processing)	38.4	8.6	99.5

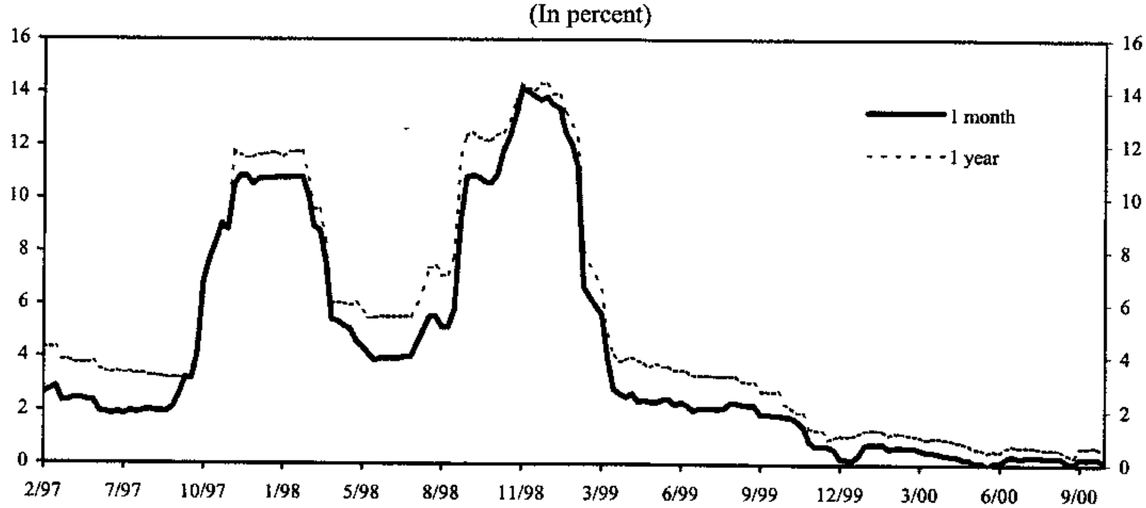
Source: Bank of Estonia

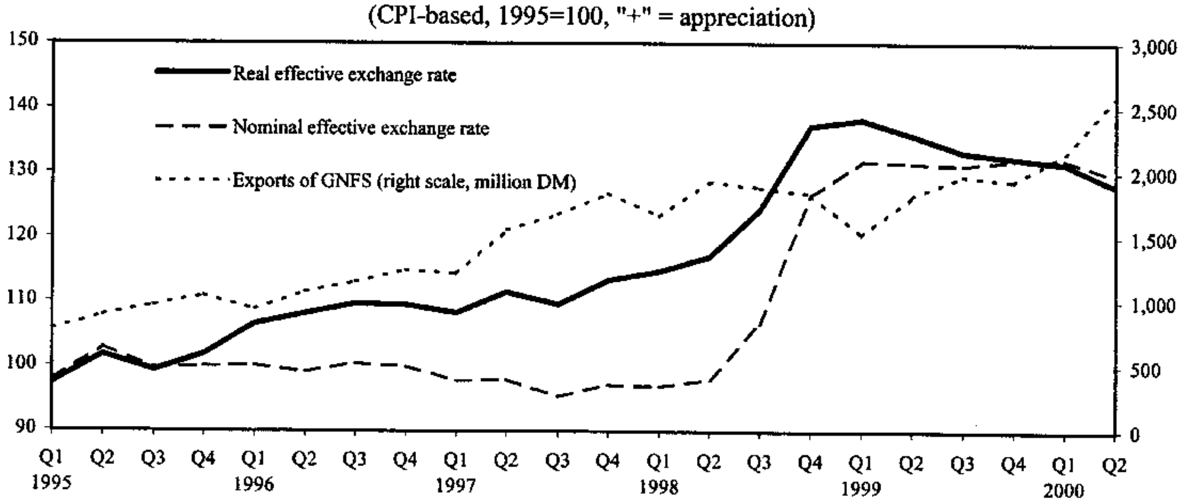
Figure 1. Baltic Countries: Selected Economic Indicators, 1995-2000



Source: Country authorities; and Fund staff estimates.

Figure 2. Estonia: External Sector Financial Indicators, 1995-2000 1/





Sources: National authorities, Bloomberg; and Fund staff estimates and projections.
1/ Difference between EEK and Euro money market rates.

4. **Fueled by a strong balance of payments position, monetary aggregates continue to grow at a relatively fast pace** (Figure 3). At end-September, broad money was 31 percent higher than a year earlier, reflecting the recovery of the economy and a redirection of funds from the stock market (which had crashed in 1997) to the banking system. An estimated 5 percentage points of broad money growth reflected the impact of the 17 percent increase in the U.S. dollar-euro exchange rate on the kroon value of dollar-denominated bank deposits. Credit to the non-government sector recovered after stagnating in mid-1999, with credit to nonbank financial institutions (mainly leasing companies) gaining in importance.[1] The increase in the NFA of the banking system accounted for about one third of the growth of broad money during the first three quarters of 2000. Banks continue to hold very high levels of liquidity. The average capital adequacy ratio was over 14 percent in September 2000, substantially higher than the mandated ratio of 10 percent. **With the sale of Optiva Bank completed, about 97 percent of assets of the banking system are now fully or majority owned by Swedish or Finnish banks.** The recent buyout of the Estonian minority stake in the second largest bank reflects the increased role assumed by strategic foreign investors in the Estonian banking system (and will register as a large influx of FDI in the second half of 2000).

5. **All end-June and end-September performance criteria were met**, including the structural performance criterion on the submission of a new basic budget law to parliament. All structural benchmarks were also observed, with the exception of the benchmark on the new securities market law (Annex, Tables 1 and 2). The latter will be submitted to parliament only at end-December 2000 as more time was needed to ensure its consistency with changing EU requirements and the soon to be established unified financial supervision agency (SMEP, paragraph 13). The benchmark on the submission to parliament of a complete pension reform package by December 1, 2000 is expected to be met only with a few weeks' delay, as forming a broad political consensus within the government coalition and refining the calculations is proving more time consuming than anticipated.

6. **The divestiture of the few remaining public enterprises is proceeding**. The sale of the Narva power station is being finalized, which should lead to substantial new investments in the electricity generation and a marked reduction in pollution (SMEP, paragraph 16). Several bids have also been received for the sale of a two thirds stake in the main railway company. The sale is expected to be completed by March 2001. Negotiations on EU accession are proceeding well, with 15 of the 31 chapters of the *Acquis Communautaire* already provisionally closed.

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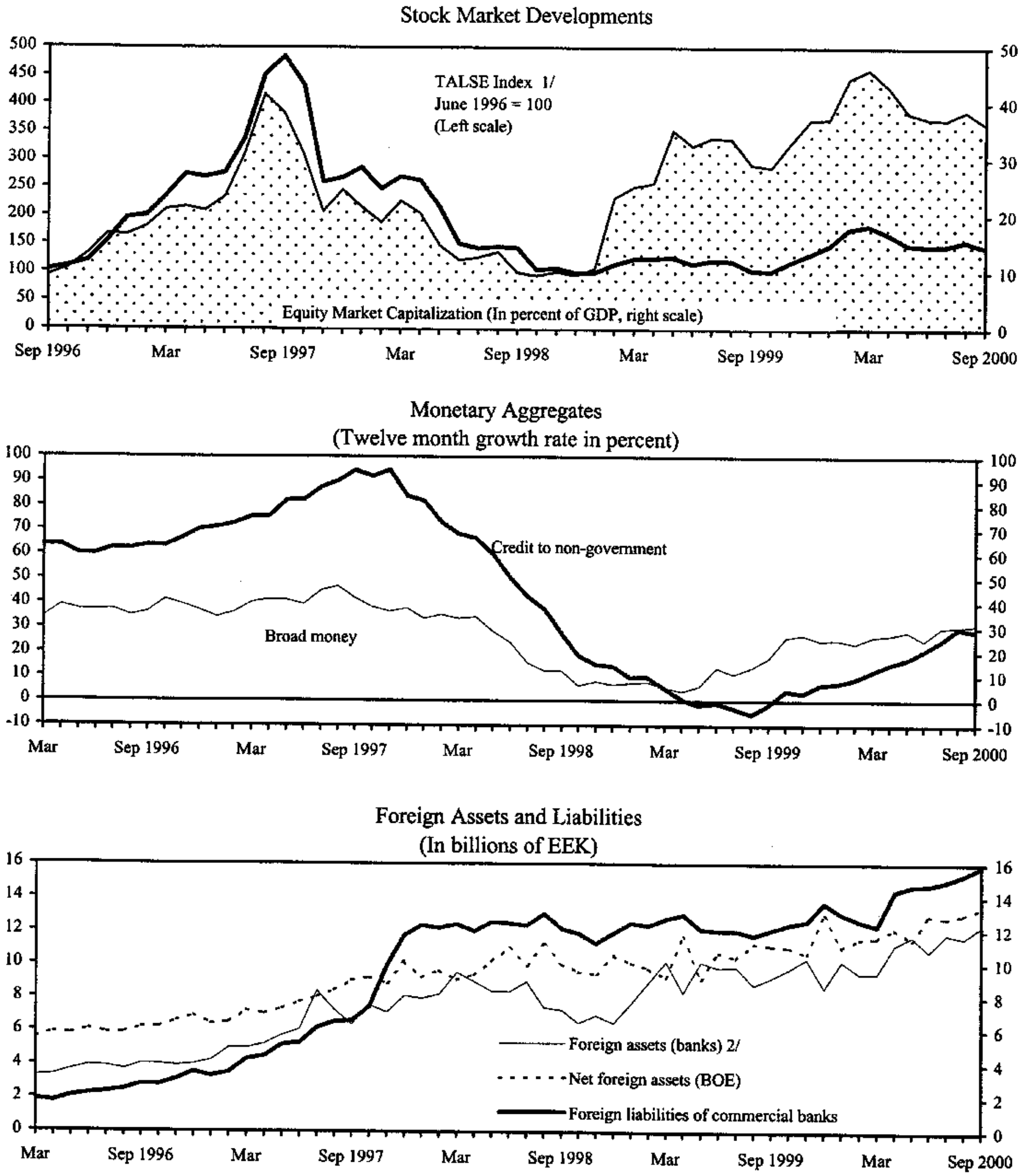
[1] Banks have recently favored extending lease finance via their subsidiaries as it carries lower credit risks than collateralized loans since banks retain ownership of the underlying assets in a lease.

Figure 3. Estonia: Monetary and Financial Indicators, 1995-2000



Sources: Bank of Estonia; Statistical Office of Estonia, IFS, and Fund staff estimates.
1/ Tallinn Stock Exchange index.
2/ 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.

III. Discussions with the Authorities

7. In the attached letter of intent, Prime Minister Laar and Governor Kraft reaffirm the policy commitments expressed in the original memorandum of economic policies (EBS/00/18). The macroeconomic and structural policies specified for the remainder of the program period carry forward the basic thrust of the original program.

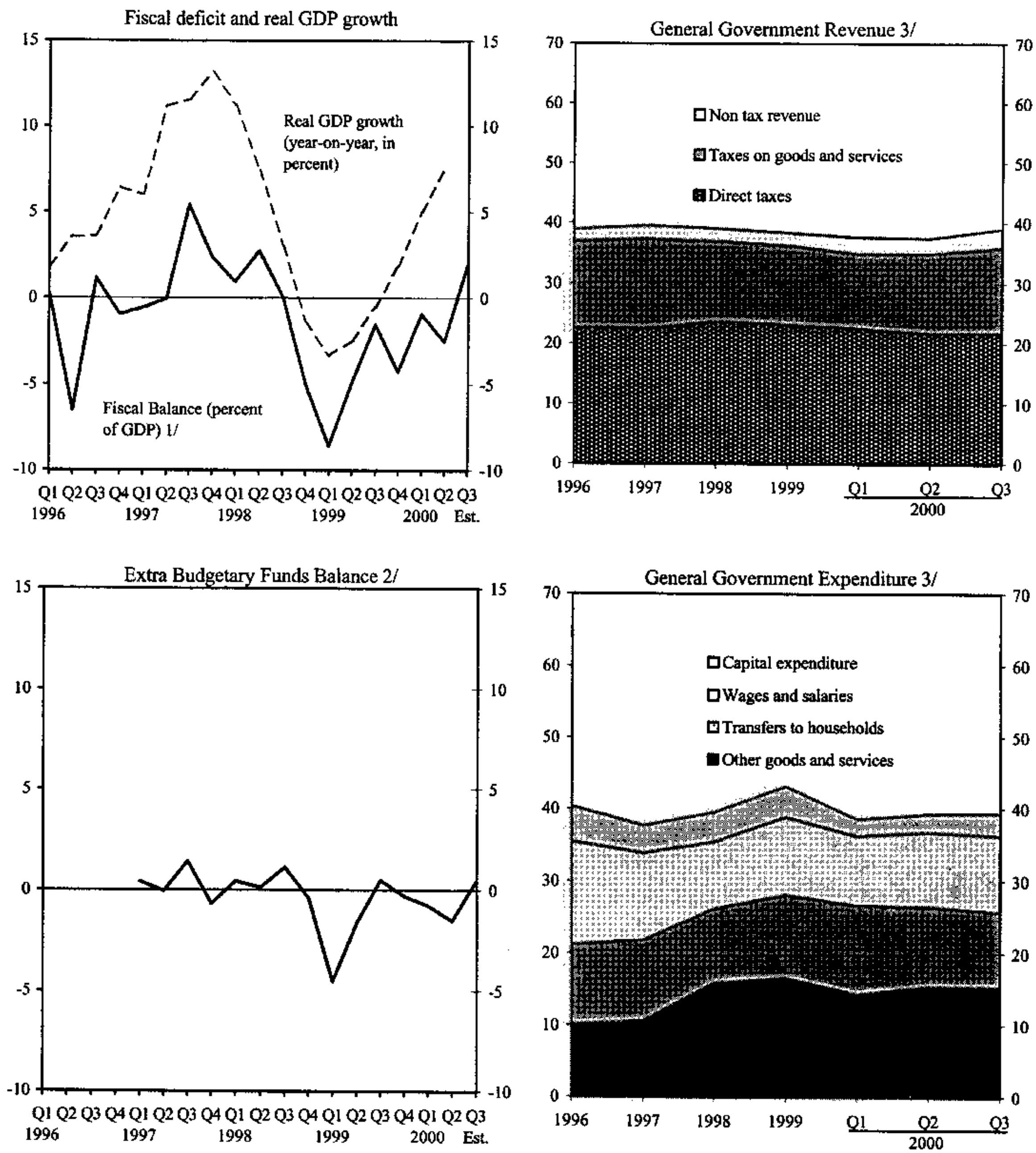
8. **External and domestic prospects remain broadly unchanged.** The authorities have revised upward their growth projections for 2000, but kept unchanged their projections for 2001 and the medium term. The inflation forecasts for 2000 and 2001 have been increased moderately to take account of higher imported inflation on account of energy prices and the weak euro. The medium-term outlook for the trade, current account and the saving-investment balance remain unchanged, as the stronger-than-expected export growth in the first half of the year has been matched by an almost equally large increase in imports. The mission concurred with the authorities that there was no evidence of an overheating economy or balance of payments pressures, and that the budgetary targets for 2000 and 2001 remained appropriate. The authorities stressed that they stand ready to tighten fiscal policy in the event of a substantial weakening of external conditions or an overheating of the domestic economy.

9. **Important challenges remain**. The authorities acknowledge that high oil prices could negatively affect growth in Estonia's export markets and that domestic demand and employment have yet to recover fully. Their objective of reducing the size of government over time within the constraint of a budget which is balanced over the business cycle, remains ambitious as the transitional costs of the pension reform, and of NATO and EU accession, may imply sizable fiscal outlays (although these remain for now difficult to quantify). The appropriate structure of the tax system against the prospect of EU accession is also an important issue. In this regard, Prime Minister Laar and Minister Kallas have requested technical assistance from the Fund to assess the present tax system and the advisability of a further shift toward indirect taxation.

A. Fiscal Policy in 2000 and 2001

10. **The budget outlook for the remainder of 2000 remains broadly in line with the program** (Figure 4). As projected, data for end-September, which only became available after the mission, show a substantial increase in budget revenues in the first nine months of 2000. In nominal terms, revenues increased by 14 percent (y-o-y), while the ratio of revenues to GDP increased to 39.4 percent, despite the phase-out of the corporate profits tax. However, the authorities do not anticipate that the higher-than-expected real growth would lead to a substantial overperformance in tax collections for the year, as the recovery has been mostly driven by the export sector, which is not directly part of the tax base. Stronger than expected

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.
3/ Data shown are on a cumulative basis.

revenues from the VAT and corporate income tax for the year[2] are expected to be offset to some extent by a shortfall in excise revenues and personal income tax. The former reflects a three- and six-month delay, respectively, in the implementation of excise taxes on fuel components and the introduction of alcohol excise warehouses; both measures were originally scheduled for July 2000. While slow wage growth and high unemployment explain part of the relatively poor performance of personal income tax, revenues from the social security and medical insurance taxes, which have a similar tax base as the personal income tax, are nevertheless growing fast. Higher-than-projected land tax revenue (a local tax) is likely to lead to higher expenditures at the local government level.

11. **The authorities have been successful in restraining expenditures.** In the first nine months of 2000, expenditures grew only by 2 percent (y-o-y) in nominal terms, while declining by 2.3 percentage points of GDP. The authorities expect transfers and subsidies, and capital expenditures to remain in line with the program. In particular, the Social Insurance Fund is projected to move toward balance this year after a deficit of close to 1 percent of GDP in 1999. The government also expects to recover EEK 200 million (0.25 percent of GDP) in deposits and guarantees it had lost in a bank failure in 1998.[3]

12. **Meeting the budget deficit target of 1¼ percent of GDP for 2000 will imply a fiscal adjustment by over 3½ percent of GDP**. While the budget deficit in the first half of 2000 was only slightly less than targeted, the budget was in a substantial surplus in the third quarter. For the first nine months, the budget deficit amounted to about ½ percent of period GDP. The authorities are concerned about the seasonal expenditure pressures in the fourth quarter of 2000, when ministries spend their budget allocations and many workers receive an extra month's pay as a year-end bonus. In addition, expenditure pressures from local governments may emerge.[4] The authorities are, nevertheless, confident that the end-year target will be met, and they stand ready to cut central government expenditures if necessary. The mission recommended meeting the fiscal target for the year without counting the expected recovery of bank deposits and guarantees, given the one-off nature of this transaction. Prime Minister Laar stated that he was committed to fiscal overperformance by the amount of the recovered deposits (SMEP, paragraph 8). This would imply aiming at a budget deficit of only 1 percent of GDP for 2000.

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[2] This has occurred in spite of the fact that the VAT on heating fuels was introduced in July at the reduced rate of 5 percent instead of the full rate (18 percent).

[3] This would be shown as negative net lending in the fiscal accounts, but has not yet been reflected in tables 3 and 4.

[4] The city of Tallinn passed a supplementary 2000 budget in June with an additional 0.3 percent of GDP in capital expenditures, which are to be financed by borrowing against future privatization proceeds. So far, no such financing has been arranged.

13. **Consistent with program commitments, the government presented a balanced budget for 2001 to parliament in October** (SMEP, paragraph 9). On the revenue side, the budget anticipates a significant reduction in the ratio of direct taxes to GDP on account of the completed phase-out of the corporate tax on retained profits and a 25 percent increase in the income threshold for the personal income tax. This is in line with the government's long-term objective of lowering overall taxation, while reducing its reliance on direct taxes. Tax revenues will, however, benefit from the full-year impact of the introduction of the excise measures mentioned above and the VAT on heating fuel. The mission concurred that the revenue projections were appropriately cautious. It was agreed that any overperformance in revenue collection should lead to a budget surplus so as to strengthen the balance of payments position.

14. **The restraint on nominal wages and the freeze on pensions have been maintained to complete the correction for the excessive increases awarded in 1999** (SMEP, paragraphs 9 and 10). Teachers' salaries, however, will be increased by 15 percent and a bonus fund has been created within the envelope of the wage bill to reward government employees on the basis of performance. Overall, the wage bill is projected to increase by 4 percent in nominal terms. Starting in 2001, local governments will assume the responsibility for education expenditures; accordingly, the share of the personal income tax transferred to local governments will be increased by 10 percentage points to 66 percent. Notwithstanding the preparation for NATO accession, military expenditures will be contained to 1.8 percent of GDP in 2001, compared with 1.6 percent of GDP in 1999. Capital outlays on transportation and agriculture will increase in line with a near doubling of EU disbursements to ½ percent of GDP. The pension and medical insurance funds are both expected to produce a surplus in 2001. Overall, total government expenditures will remain broadly constant in real terms, while declining sharply relative to GDP.

15. **The organic budget law was submitted to parliament in June 2000 and is expected to be approved by year-end** (SMEP, paragraph 10). The law will increase the transparency of the fiscal accounts by consolidating extra-budgetary funds and foreign-financed capital expenditures in the budgetary process. It will also strengthen the control of the central government on all government entities, including local governments. **The structure of local governments is also being reviewed** with a view to reducing the number of administrative units and improving control over public expenditure. The current structure, with 247 municipalities, leads to excessive administrative costs and unnecessary replications of services. The government expects to complete the review early next year and develop an approach for restructuring by June 2001.

B. Financial and External Sector Issues

16. **The relatively fast growth of the monetary aggregates is being closely scrutinized** (SMEP, paragraph 11). The BoE stated that it had already taken recourse to moral suasion with key commercial banks and was carefully monitoring banks' lending policies and risk management. However, the BoE also pointed out that the relatively high rates of growth in credit and broad money followed on a sharp slowdown in the growth of these aggregates

during the recession in 1999, and that the financial deepening was linked to the stabilization gains made. Over the medium term, the growth of broad money was expected to become more closely aligned with the growth of nominal GDP. In this regard, the recent slowdown in the growth of base money was a welcome sign. The authorities indicated that they stand ready to act decisively should excessive credit growth threaten a weakening of the external accounts. As discussed in EBS/00/101, page 21, the decision to allow commercial banks to meet a portion of the reserve requirements with foreign assets as of January 1, 2001, is not expected to lead to a significant easing of monetary conditions.

17. **The mission sought an explanation as to why banks have strived to remain highly liquid**. The BoE and commercial bank officials suggested that this may to some extent reflect the preparation for expansion into neighboring countries, as part of the Baltic strategy of the banks' corporate parents. Banks also take account of the fact that the BoE is not willing to act as lender of last resort (and could in any case do so only to a limited extent) and that banks' access to capital markets can dry up, as was the case during the Asia crisis in 1997 and the Russia crisis in late 1998. Banks also seek to avoid any need for recourse to their foreign owners in the event of a liquidity squeeze (although banks and rating agencies expect that such liquidity support would be forthcoming in the event of a crisis). Finally, an additional explanatory factor for the rapid growth of both banks' foreign assets and liabilities is the fact that banks hedge their maturity and currency risks by redepositing non-kroon deposits (mainly U.S. dollar-denominated) received with highly rated banking institutions abroad, while borrowing longer term in euros to fund their lending in Estonia.

18. **The authorities continue to remain vigilant against fragility in the financial system** (SMEP, paragraph 14). Specifically, the authorities have already queried whether the high rate of growth of leasing transactions (which has recently played an important role in the expansion of the monetary aggregates) had been associated with a weakening of risk assessment and management by the (bank-owned) leasing companies. Supervisors underscored the need to enforce the same high risk monitoring standards for leasing as for lending operations.

19. **The authorities judge that the external outlook remains favorable.** Prime Minister Laar stressed that the structure of the Estonian economy has changed. Estonia now produces a wide range of goods and has, therefore, become less dependent on imports. Moreover, the fiscal adjustment had made an important contribution to the strengthening of the saving-investment balance. The economic upturn has, therefore, not led to a widening of the current account deficit. The authorities recognized the potential risk to the external balance from a possible slowdown in Estonia's export markets at a time when domestic demand was recovering.

20. **The authorities do not intend to raise tariffs or introduce new ones until Estonia is on the verge of EU accession.** Estonia introduced in January 2000 import tariffs on

agricultural products,[5] primarily to demonstrate the administrative capacity for handling the EU's tariff and trade system. The rest of the trade system continues to be free of any restrictions. On balance, Estonia's trade system remains one of the most liberal.

C. Structural Reforms

21. **Legislation to establish a second pillar of the pension system as of January 2002 will be submitted to parliament in December** (SMEP, paragraph 15). The government's draft proposal calls for the participation to be voluntary for current members of the workforce. However, the mandatory participation for new entrants in the workforce is still under debate. For participants, 4 percentage points of the 20 percent social security tax will go toward the fully funded second pillar, together with an additional contribution of 2 percentage points of their wage income. The latter is likely to increase national savings, but it would make participation in the second pillar somewhat less attractive. This would reduce the deficit in the first pillar and the transitional costs to the government budget.[6] The mission urged the further reform of the first pillar, most notably by increasing the retirement age, in order to maintain the pension system financially viable.[7]

22. **The government and the central bank have reached agreement to create a unified financial supervision agency**. The agency is expected to become operational at end-2001. Consistent with earlier recommendations of the staff, it will have full operational and licensing independence and its work will reflect international best practices in financial supervision. In the meantime, a new securities market law will be submitted to parliament in December to strengthen the supervision of the stock market.

23. **The privatization of the few remaining public enterprises continues as planned** (SMEP, paragraph 17). The majority stake in the main railway company is expected to be sold before March 2001, and the government is currently considering the privatization of a portion of Eesti Energia. Linked to the completion of negotiations for the sale of the Narva power plants to a U.S. company in June 2000, the government has completed the upgrading of the

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[5] These tariffs are below WTO bindings and only affect those countries that do not have a free trade agreement with Estonia. They therefore affect only a small portion of agricultural trade, mostly with Canada, Russia, and the United States.

[6] As some important details have yet to be agreed, it is not possible at this stage to quantify precisely the fiscal impact of the reform on the medium-term fiscal outlook. Earlier calculations suggested a first pillar deficit of 1-1½ percent of GDP per annum for the first 10 years, which may represent an upper bound. Much will depend, of course, on the formula used for indexation of benefits under the first pillar (EBS/00/101).

[7] For a more detailed discussion, see "Pension Reform in the Baltics—Issues and Prospects," (SM/00/117), June 16, 2000.

energy inspectorate. The government plans to strengthen the agency further in the coming months by increasing staffing and seeking EU and World Bank technical assistance.

24. **The government is completing an overhaul of labor market legislation**. The new legislation will include measures to target training programs to the needs of local labor markets, increase regional mobility, and improve the effectiveness of employment offices. A labor force development plan has also been drawn up to tackle the problem of long-term unemployment by providing incentives for retraining or early retirement. There was concern that the EU accession process may lead to a reduction of the flexibility of the labor market, and the mission agreed that labor market issues should figure prominently in the next Article IV discussions.

D. Program Monitoring

25. The remainder of the program period will be monitored through quarterly performance criteria for end-March and end-June 2001, as specified in the attached SMEP (Paragraph 18 and Table 1). The limit on the cumulative government deficit has been set in line with the target of a balanced budget for the year, but takes account of the fact that the first half of the year is normally characterized by weaker revenue performance. The floor on NIR and the debt ceilings will remain unchanged compared to the end-2000 targets, except for the ceiling on the contracting of long-term debt, which has been raised by US$50 million in order to accommodate possible new project loans from multilateral institutions. The high quality and timeliness of data permits effective program monitoring.[8]

IV. Staff Appraisal

26. The fast economic recovery despite a strong fiscal correction testifies to the success of the authorities' determined macroeconomic and structural policies. Confidence in the currency board remains high, external debt, debt service and the current account deficit remain moderate, the banking system has strengthened, and unemployment has started to decline. Preparation for EU accession is well advanced.

27. The authorities are to be commended for adhering to their ambitious fiscal targets for 2000 and 2001. The commitment to overperform vis-à-vis the budgetary targets at end-December 2000 to the extent of recovered deposits from an earlier bank failure is laudable, as is the intention to compensate for any overspending by local authorities. This will ensure the withdrawal of fiscal stimulus at a time when export growth and private sector demand are leading the recovery. The revenue estimates for 2001 are appropriately cautious, and the continuation of the wage and pension freeze is necessary in order to complete the correction of the excessive increases granted in 1999. The budget for 2001 will decisively reduce the share

[8] As the frequency and quality of data has remained unchanged over the last few months, the statistical annex of the Article IV staff report remains valid (cf. EBS/00/101, page 46).

of government in the economy. The authorities are rightly committed to achieving a fiscal surplus next year should revenue growth exceed expectations, so as to protect the balance of payments. The authorities are encouraged to implement the new organic budget law as early as practical.

28. The careful crafting of legislation to establish a second pillar of the pension system is appropriate and the brief delay in submitting this legislation inconsequential. The higher contribution rate required for participants in the second pillar would alleviate a portion of the transitional costs to the budget and could increase national savings. The authorities need now to strengthen the first pillar, including by raising the retirement age, in order to maintain the financial viability of the pension system. The review of the structure of local administration is a welcome step, as it is likely to lead to a more effective control of public expenditures.

29. The continued high confidence in the currency board and the strengthening of the banking system bode well for the stability of the financial system. The authorities need to remain vigilant against a recurrence of excessive credit growth and, if necessary, act decisively. The authorities are to be commended for reaching an agreement on creating a unified financial supervision agency. Non-banking supervision will need to be strengthened further and the authorities will need to ensure that adequate resources are made available to the relevant institutions. In this context, the draft securities market law should be implemented as soon as feasible.

30. Reducing unemployment remains appropriately one of key priorities for the government. The overhaul of the labor market legislation is a welcome step, which aims at reducing both frictional and structural unemployment. However, the authorities need to guard against reforms that may reduce the flexibility of the labor market or increase the non-wage costs to employers.

31. The authorities' intention to publish this staff report together with the SMEP is commendable. Estonia is a subscriber to the SDDS and the quality and frequency of data provided, including on websites, is high and fully meets the requirements for surveillance and program monitoring.

32. Staff recommends completion of the second review.

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 November 24, 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, as supplemented, from the Prime Minister and the Governor of the Bank of Estonia shall be read as supplemented by the letter dated November 24, 2000 from the Prime Minister and the Acting Governor of the Bank of Estonia.

3. Accordingly, the performance criteria for March 31, 2001 and June 30, 2001 as set forth in paragraph 3(a) of the Stand-By Arrangement for the Republic of Estonia shall be provided in Table 1 to the letter dated November 24, 2000.

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

Table 2. Estonia: Selected Macroeconomic Indicators, 1997-2001 1/
(In units as indicated)

	1997	1998	1999	2000 EBS/00/ 101	2000 Proj.	2001 Proj.
National income, prices and wages						
Nominal GDP (kroons, millions)	64,324	73,325	75,360	81,070	82,677	90,629
GDP (US dollars, millions)	4,637	5,209	5,131	5,159	4,951	5,358
Real GDP growth (year-on-year in percent)	10.6	4.7	-1.1	4.0	5.5	6.0
Average CPI (year-on-year change in percent) 2/	11.2	8.1	3.3	3.8	4.0	4.4
12-month CPI (end of period change in percent) 2/	12.5	4.2	3.8	4.3	4.8	3.5
GDP deflator (year-on-year change in percent)	10.9	8.9	3.9	3.4	4.0	3.4
Average monthly wage (end-of-period, US dollars)	318	360	345	368	325	357
Unemployment rate (ILO definition, percent)	9.7	9.9	12.3	...	...	...
Saving-investment balances (in percent of GDP)						
Domestic saving	18.7	20.2	18.8	22.4	21.3	21.2
Private	12.6	16.3	19.2	19.6	18.6	17.7
Public	6.1	3.9	-0.4	2.7	2.7	3.6
Domestic investment	30.9	29.4	24.5	28.9	27.8	27.8
Private	26.9	25.2	20.3	24.9	23.8	24.2
Public	3.9	4.2	4.3	4.0	3.9	3.6
Foreign saving	12.1	9.2	5.8	6.5	6.5	6.5
General government (in percent of GDP) 3/						
Revenue	39.6	39.4	38.6	40.1	39.8	38.3
Expenditure 4/	37.4	39.7	43.3	41.3	41.0	38.3
Fiscal balance	2.2	-0.3	-4.7	-1.2	-1.2	0.0
External sector (DM, millions)						
Trade balance	-1,957	-1,965	-1,617	-1,883	-1,921	-2,288
Exports	3,984	4,723	4,505	5,716	6,486	7,784
Imports	-5,941	-6,688	-6,122	-7,599	-8,407	-10,072
Service balance	1,029	1,006	1,057	1,244	1,270	1,529
Receipts	2,296	2,601	2,744	3,144	3,331	3,997
Payments	-1,267	-1,594	-1,687	-1,900	-2,061	-2,469
Current account	-977	-844	-542	-661	-668	-739
Change in net foreign asset position of commercial banks since previous period (DM, millions, +increase)	-653	-46	37	...	...	...
Gross international reserves (DM, millions) 5/	1,363	1,364	1,667	1,598	1,791	1,935
in months of imports	2.8	2.4	3.3	2.5	2.6	2.3
Relative to short-term debt (gross, including trade credits)	0.9	0.9	0.9	0.9	1.0	1.0
Gross external debt/GDP (in percent) 5/ 6/	46.8	43.8	47.9	...	...	...
Net external debt/GDP (in percent) 7/	33.1	33.3	33.9	30.2	31.7	30.7
General government external debt/GDP (in percent) 8/						
Excluding government assets held abroad	4.3	4.3	4.9	5.1	5.0	5.1
Including government assets held abroad 9/	3.2	2.6	2.3	2.9	2.9	3.1
Exchange rate (EEK/US$ - period average) 10/ 11/	13.9	14.1	14.7	...	17.8	...
Money and credit (year-on-year growth in percent)						
Domestic credit to nongovernment	83.9	14.3	6.5	10.4	...	...
Base money	37.7	6.4	27.1	-5.2	...	...
Broad money	37.8	6.6	24.6	13.8	...	...
Base money multiplier (end of period)	2.3	2.3	2.2	2.7	...	...

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

1/ Projections exclude the impact of the Narva power plant investment program which could start in late 2001.
2/ Effective 1998, a new CPI index is used that is based on 1997 weights.
3/ Excludes any impact of the planned pension system reform, which is unlikely to come into effect before 2002.
4/ Includes net lending.
5/ 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.
6/ Includes use of Fund credit and trade credits.
7/ Net of deposits held abroad by the general government and commercial banks.
8/ Includes government-guaranteed debt and Fund credit under the Systemic Transformation Facility (which was on-lent by the Government to commercial banks).
9/ Government assets held abroad include the Stabilization Reserve Fund (SRF).
10/ The Estonian kroon has been pegged to the deutsche mark at EEK 8=DM 1 since June 20, 1992.
11/ The exchange rate in the 2000 column reflects the rate at end-September 2000.

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

	1997	1998	1999	1999	2000	2000		2001
	Year Actual	Year Actual	Year Actual	Q1-Q3 Actual	Q1-Q3 Prel. Act.	Year EBS/00/101	Year Rev. Proj.	Year Rev. Proj.
Revenue	25,485	28,887	29,083	20,895	23,726	32,522	32,865	34,724
Tax revenue	24,076	27,126	27,383	19,757	21,893	29,957	30,331	32,170
Direct taxes	14,473	17,320	17,518	12,837	13,543	18,035	18,487	19,149
Corporate profits tax	1,228	1,914	1,639	1,358	804	275	804	0
Personal income tax 1/	5,240	6,233	6,531	4,805	4,824	7,190	7,010	7,777
Social security tax	4,637	5,303	5,520	3,917	4,629	6,276	6,276	6,692
Medical insurance tax	3,097	3,573	3,518	2,529	3,009	4,079	4,079	4,350
Land tax	270	297	310	228	277	215	318	330
VAT	6,686	6,413	6,419	4,506	5,664	7,618	7,800	8,450
Excises	2,401	2,789	2,685	1,871	1,916	3,224	2,969	3,431
Other taxes (incl. on intern. trade)	516	606	761	543	770	1,079	1,075	1,140
Nontax revenue 2/	1,409	1,761	1,700	1,138	1,833	2,565	2,534	2,554
Expenditure 3/	24,339	29,037	32,542	23,525	24,071	33,795	34,087	34,979
Current expenditure	21,860	25,944	29,318	21,127	22,269	30,568	30,877	31,549
Expenditure on goods and services	14,682	17,740	19,950	14,141	15,110	20,721	21,065	21,403
Wages and salaries 4/	5,308	6,775	8,149	5,677	6,109	8,299	8,421	8,654
Other goods and services	9,356	10,964	11,801	8,464	9,001	12,422	12,644	12,749
Current transfers and subsidies	6,885	7,865	9,059	6,749	7,007	9,462	9,450	9,766
Subsidies	196	311	356	253	262	320	277	426
Transfers to households	6,689	7,554	8,703	6,496	6,745	9,142	9,173	9,340
of which: Pensions	4,628	5,200	6,425	4,806	4,843	6,541	6,541	6,788
Interest payments	293	339	309	237	152	385	362	380
Capital expenditure	2,479	3,093	3,225	1,342	1,802	3,227	3,210	3,430
Financial surplus (+) / deficit (-)	1,146	-150	-3,459	-2,630	-345	-1,273	-1,222	-255
Net lending (-) 5/	264	-77	-81	-60	74	273	223	255
Overall surplus (+) / deficit (-)	1,410	-227	-3,540	-2,690	-271	-1,000	-999	0
Borrowing requirement	-1,410	227	3,540	2,690	271	1,000	999	0
Domestic financing (net)	-753	669	1,171	817	-348	130	297	-330
Credit from domestic banks	80	-141	224	103	34	...	...	...
Change in deposits with domestic banks (-, increase)	-990	1,017	625	287	-37	...	...	...
Other domestic financing	157	-207	322	427	-345	...	...	...
Change in government deposits held abroad (-, increase)	-700	-524	-771	-1,275	422	181	422	0
Foreign financing (net)	43	82	117	125	197	309	280	330
Privatization proceeds 6/	0	0	3,023	3,023	0	380	0	0
Memorandum items:								
Primary fiscal balance (+, surplus)	1,703	113	-3,231	-2,453	-119	-615	-637	380
Balance in government deposits held abroad	700	1,224	1,995	2,499	1,573	1,814	1,573	1,573
Total general government debt								
Excluding government assets held abroad	4,869	4,714	5,509	...	...	...	5,020	5,475
Including government assets held abroad	4,169	3,490	3,514	...	...	...	3,447	3,902

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

1/ 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.

2/ For 2000, includes spending agencies own revenue.

3/ For 2000, includes outlays financed from spending agencies own resources.

4/ Wages and salaries of a number of budgetary institutions are included under "other goods and services".

5/ For 2000, excludes the recovery of expected deposits from a bank failure in 1998.

6/ Used for financing the general government deficit.

Table 4. Estonia: Summary of General Government Operations, 1997-2001
(In percent of GDP)

	1997 Year Actual	1998 Year Actual	1999 Year Actual	1999 Q1-Q3 Actual	2000 Q1-Q3 Prel. Act.	2000 Year EBS/00/101	2000 Year Rev. Proj.	2001 Year Rev. Proj.
Revenue	39.6	39.4	38.6	37.6	39.4	40.1	39.8	38.3
Tax revenue	37.4	37.0	36.3	35.6	36.4	37.0	36.7	35.5
Direct taxes	22.5	23.6	23.2	23.1	22.5	22.2	22.4	21.1
Corporate profits tax	1.9	2.6	2.2	2.4	1.3	0.3	1.0	0.0
Personal income tax 1/	8.1	8.5	8.7	8.6	8.0	8.9	8.5	8.6
Social security tax	7.2	7.2	7.3	7.1	7.7	7.7	7.6	7.4
Medical insurance tax	4.8	4.9	4.7	4.6	5.0	5.0	4.9	4.8
Land tax	0.5	0.6	0.4	0.4	0.5	0.3	0.4	0.4
VAT	10.4	8.7	8.5	8.1	9.4	9.4	9.4	9.3
Excises	3.7	3.8	3.6	3.4	3.2	4.0	3.6	3.8
Other taxes (incl. on intern. trade)	0.8	0.8	1.0	1.0	1.3	1.3	1.3	1.3
Nontax revenue 2/	2.2	2.4	2.3	2.0	3.0	3.2	3.1	2.8
Expenditure 3/	37.8	39.6	43.2	42.3	40.0	41.7	41.2	38.6
Current expenditure	34.0	35.4	38.9	38.0	37.0	37.7	37.3	34.8
Expenditure on goods and services	22.8	24.2	26.5	25.5	25.1	25.6	25.5	23.6
Wages and salaries 4/	8.3	9.2	10.8	10.2	10.1	10.2	10.2	9.5
Other goods and services	14.6	15.0	15.7	15.2	14.9	15.3	15.3	14.1
Current transfers and subsidies	10.7	10.7	12.0	12.1	11.6	11.7	11.4	10.8
Subsidies	0.3	0.4	0.5	0.5	0.4	0.4	0.3	0.5
Transfers to households	10.4	10.3	11.5	11.7	11.2	11.3	11.1	10.3
of which: Pensions	7.2	7.1	8.5	8.7	8.0	8.1	7.9	7.5
Interest payments	0.5	0.5	0.4	0.4	0.3	0.5	0.4	0.4
Capital expenditure	3.9	4.2	4.3	2.4	3.0	4.0	3.9	3.8
Financial surplus (+) / deficit (-)	1.8	-0.2	-4.6	-4.7	-0.6	-1.6	-1.5	-0.3
Net lending (-) 5/	0.4	-0.1	-0.1	-0.1	0.1	0.3	0.3	0.3
Overall surplus (+) / deficit (-)	2.2	-0.3	-4.7	-4.8	-0.4	-1.2	-1.2	0.0
Borrowing requirement	-2.2	0.3	4.7	4.8	0.4	1.2	1.2	0.0
Domestic financing (net)	-1.2	0.9	1.6	1.5	-0.6	0.2	0.4	-0.4
Credit from domestic banks	0.1	-0.2	0.3	0.2	0.1	...	...	...
Change in deposits with domestic banks (-, increase)	-1.5	1.4	0.8	0.5	-0.1	...	...	...
Other domestic financing	0.2	-0.3	0.4	0.8	-0.6	...	...	...
Change in government deposits held abroad (-, increase)	-1.1	-0.7	-1.0	-2.3	0.7	0.2	0.5	0.0
Foreign financing (net)	0.1	0.1	0.2	0.2	0.3	0.4	0.3	0.4
Privatization proceeds 6/	0.0	0.0	4.0	5.4	0.0	0.5	0.0	0.0
Memorandum items:								
Primary fiscal balance (+, surplus)	2.6	0.2	-4.3	-4.4	-0.2	-0.8	-0.8	0.4
Balance in government deposits held abroad	1.1	1.7	2.6	4.5	2.6	2.2	1.9	1.7
Total general government debt								
Excluding government assets held abroad	7.6	6.4	7.3	...	...	...	6.1	6.6
Including government assets held abroad	6.5	4.8	4.7	...	...	...	4.2	4.7
GDP (in million of kroons)	64,324	73,325	75,360	55,555	60,227	81,070	82,677	90,629

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

1/ 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.

2/ For 2000, includes spending agencies own revenue.

3/ For 2000, includes outlays financed from spending agencies own resources.

4/ Wages and salaries of a number of budgetary institutions are included under "other goods and services".

5/ For 2000, excludes the recovery of expected deposits from a bank failure in 1998.

6/ Used for financing the general government deficit.

Table 5. Estonia Banking Survey and Monetary Authorities: 1997-2000
(In millions of EEK)

	1997	1998	1999				2000		
	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Banking Survey									
Net foreign assets 1/	5,091	5,114	6,619	8,470	8,205	7,850	8,755	8,970	9,853
Net foreign assets (BOE)	10,104	10,496	9,192	10,677	11,068	12,934	11,569	12,906	13,388
Foreign assets 2/ 3/	10,902	10,909	10,332	11,097	11,471	13,334	11,960	13,294	13,752
Foreign liabilities	-798	-413	-1,140	-420	-403	-400	-392	-387	-364
Net foreign assets (commercial banks)	-5,013	-5,381	-2,573	-2,207	-2,863	-5,084	-2,814	-3,937	-3,535
Foreign assets	8,078	6,481	10,144	9,776	9,186	8,598	9,457	10,786	12,300
Foreign liabilities	-13,090	-11,862	-12,717	-11,983	-12,049	-13,682	-12,270	-14,723	-15,835
Net domestic assets	14,418	15,683	14,907	15,567	16,188	18,041	18,464	21,036	22,160
Domestic credit	19,184	23,622	22,308	22,905	23,624	26,050	26,742	28,920	31,087
Net credit to general government	-2,762	-1,469	-1,999	-1,258	-1,079	-668	-559	-258	-710
Credit to nongovernment	21,946	25,092	24,307	24,163	24,703	26,717	27,302	29,178	31,798
Credit to nonfinancial public enterprises	320	226	267	256	346	372	331	337	373
Credit to private sector	16,646	18,540	18,097	18,473	18,785	19,821	19,868	20,441	21,660
Credit to nonbank financial Institutions	4,980	6,326	5,943	5,434	5,573	6,524	7,103	8,399	9,765
Other items (net) 1/	-4,766	-7,939	-7,401	-7,339	-7,436	-8,009	-8,278	-7,884	-8,927
Broad money	19,509	20,798	21,525	24,036	24,393	25,918	27,226	30,012	32,021
of which:									
M1	13,223	12,750	15,271	15,388	15,728	16,910	17,082	18,854	19,866
Currency outside banks	4,588	4,539	4,973	4,902	5,084	5,711	5,490	5,861	6,133
Demand deposits	8,635	8,212	10,298	10,487	10,644	11,198	11,593	12,994	13,734
Time and savings deposits	6,286	8,047	8,561	8,648	8,664	9,008	10,144	11,158	12,154
Monetary Authorities									
Net foreign assets	10,104	10,496	9,192	10,677	11,068	12,934	11,569	12,906	13,388
Foreign assets 4/	10,902	10,909	10,332	11,097	11,471	13,334	11,960	13,294	13,752
of which: currency board cover 5/	8,526	9,070	7,780	9,296	9,701	11,526	10,133	11,475	11,586
Foreign liabilities	798	413	1,140	420	403	400	392	387	364
Net domestic assets	-1,577	-1,425	-1,412	-1,381	-1,267	-1,408	-1,436	-1,432	-1,802
Net claims on Government	-352	-4	-3	-23	-3	-24	-3	-4	-4
Claims on financial institutions	23	270	281	279	279	268	268	156	11
Claims on private sector	26	40	40	46	48	49	49	51	50
Other	-1,275	-1,731	-1,731	-1,683	-1,592	-1,701	-1,749	-1,635	-1,860
Base money	8,526	9,070	7,780	9,296	9,701	11,526	10,133	11,475	11,586
Currency issue	5,439	5,391	5,233	5,928	5,856	6,649	6,297	6,764	6,967
Deposits of commercial banks	3,035	3,676	2,513	3,333	3,812	4,824	3,751	4,618	4,495
of which: required reserves 6/	2,798	3,653	2,532	3,436	3,557	3,745	3,779	4,286	4,298
Other deposits at BOE	52	4	4	36	33	54	85	93	124
Memorandum items:									
Base money multiplier	2.29	2.29	2.77	2.59	2.51	2.25	2.69	2.62	2.76
Currency-to-deposit ratio	0.31	0.28	0.26	0.27	0.26	0.29	0.25	0.28	0.27
Bank reserves-to-deposit ratio	0.26	0.28	0.19	0.23	0.24	0.29	0.21	0.23	0.21
Velocity (period average)	3.75	3.57	...	...	...	3.18	...	...	...
Net international reserves (in millions of DM) 7/	207	224	225	217	203	217	223	217	256
Government balances held abroad (in millions of EEK) 8/	700	1,224	2764	2,764	2,499	1,995	1,698	1,573	1,574
			(percentage change from same period in preceding year)						
Net foreign assets of banking system	-28.9	0.5	8.2	23.8	60.0	53.5	32.3	5.9	20.1
Net domestic assets of banking system	106.1	8.8	4.4	8.8	3.6	15.0	23.9	35.1	36.9
Credit to non-government of banking system	83.9	14.3	5.2	-0.7	-1.7	6.5	12.3	20.8	28.7
Broad money	37.8	6.6	5.6	13.7	17.6	24.6	26.5	24.9	31.3
Base money	37.7	6.4	2.5	0.0	18.2	27.1	30.2	23.4	19.4

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

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. This was reversed in the first quarter of 2000.

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

5/ 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).

6/ Requirement to be met on the basis of daily average of deposits over month. Up to June 2000, it includes a liquidity requirement equivalent to 3 percent of the reserve requirement base (imposed since December 1997). After June 2000, the liquidity requirement was incorporated into the reserve requirement.

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

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

Table 6. Estonia: Summary Balance of Payments 1997-2001

(In millions of DM)

	1997	1998	1999		2000			2001
			H1	Year	H1 Prel.	Year EBS/00/101	Year Proj.	Year Proj.
Current Account	-977	-844	-283	-542	-274	-661	-668	-739
Trade Balance	-1,957	-1,965	-687	-1,617	-771	-1,883	-1,921	-2,288
Exports	3,984	4,723	2,137	4,505	3,174	5,716	6,486	7,784
of which: goods for processing	990	1,410	665	1,430	1,265	...	...	...
Imports 1/	-5,941	-6,688	-2,824	-6,122	-3,945	-7,599	-8,407	-10,072
of which: goods for processing	-880	-1,218	-604	-1,322	-1,206	...	...	...
Services Balance	1,029	1,006	428	1,057	564	1,244	1,270	1,529
Receipts	2,296	2,601	1,203	2,744	1,475	3,144	3,331	3,997
of which: travel and tourism	826	947	419	1,013	483	...	...	...
Payments	-1,267	-1,594	-775	-1,687	-911	1,900	-2,061	-2,469
Income	-251	-146	-113	-188	-188	-263	-263	-275
Current Transfers	203	260	89	207	121	247	246	296
Capital and Financial Account 2/	1,369	859	286	843	201	592	724	882
Capital Transfers	0	3	1	2	16	19	35	40
Financial Account	1,369	856	284	841	184	573	689	842
Direct Investment	223	999	345	401	81	459	531	525
From abroad 1/ 3/	462	1,009	374	556	292	...	...	...
Outward (by Estonians)	-239	-10	-28	-155	-211	...	...	...
Net equity investment 3/	66	113	461	435	36	188	86	125
Loans and other investments 4/	1,081	-256	-522	5	67	-73	72	192
of which:								
Banks	797	37	-317	11	-25	...	...	...
Government	-79	-103	-154	-60	29	61	24	...
Monetary Authorities	-38	-38	-20	35	-10	...	...	...
Errors and Omissions	-46	1	-39	-28	79	0	79	0
Overall balance	346	16	-36	273	6	-69	135	143
Change in official reserves (- increase)	-346	-16	36	-273	-6	69	-135	-143
Memorandum Items:								
DM/US$ exchange rate (period average)	1.73	1.76	...	1.84	2.04	...	...	...
Gross International Reserves 5/ 6/ 7/								
(DM millions)	1,363	1,364	1,387	1,667	1,662	1,598	1,791	1,935
In months of imports	2.8	2.4	2.7	3.3	2.8	2.5	2.6	2.3
Relative to (ratio)								
Short-term debt (gross) 8/ 9/	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0
Trade Balance/GDP	-24.3	-21.4	-15.1	-17.2	-15.5	-18.6	-18.6	-20.2
Current Account/GDP	-12.1	-9.2	-6.2	-5.8	-5.5	-6.5	-6.5	-6.5
Total external debt/GDP								
Gross 8/	46.8	43.8	46.5	47.9	46.6	...	...	...
Net 10/	33.1	33.3	29.4	33.9	33.3	...	...	...
General government external debt/GDP 11/								
Excluding Govt. assets held abroad	4.3	4.3	4.9	4.9	5.4	5.1	5.0	5.1
Including Govt. assets held abroad	3.2	2.6	1.2	2.3	3.6	2.9	2.8	3.1
Debt Service/Exports of GNFS	8.1	8.2	9.5	8.9	7.2	7.6	7.0	5.7

Sources: Bank of Estonia, and Fund staff estimates and projections.

1/ The revised projections for 2001 and beyond do not include imports of capital equipment and FDI inflows associated with the privatization of the electricity comp and the railroads. Preliminary estimates suggest that if these projects proceed on a relatively ambitious timetable, the current account deficit could widen by as mu as 1 percent and 2 percent of GDP in 2001 and 2002, respectively. Outer years would be less affected.

2/ Projections for 2001 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 1. Estonia: Quantitative Performance Criteria under the Program, September 30, 2000 1/

	March 31, 2000		June 30, 2000		September 30, 2000	
	Program	Outcome	Program	Outcome	Program	Outcome
			(In millions of EEK)			
I. Limit on cumulative general government deficit	410	167	700	695	750	270.5
			(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	200	217	218 2/	255.5
			(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	0.0	0.0	0.0	0.0
Maturity of over 2 years	130.0	0.1	200.0	22.4	250.0	29.2
of which: Maturity of more than 2 years but less than 10 years	15.0	0.1	20.0	0.1	30.0	6.9
IV. The government will not accumulate any payments arrears during the period of the arrangement		Observed		Observed		Observed
V. The currency board is fully backed with foreign exchange at all times		Observed		Observed		Observed

1/ Definitions of the concepts were set out in the Annex to the Memorandum of Economic Policies (EBS/00/18).
2/ The targets for net international reserves at end-September 2000 was adjusted for the net proceeds of the sale of Optivabank, as specified in EBS/00/18.

Table 2. Estonia: Structural Performance Criterion and Benchmarks, September 30, 2000

Measures	Due date	Status
Structural Performance Criterion		
Submit new Basic Budget Law (including improved oversight and control over extrabudgetary funds, local governments, and agencies).	June 30, 2000	Done
Structural Benchmarks		
1. Implement improved loan assessment framework, including a uniform minimum loan provisioning system in line with international standards.	March 31, 2000	Done
2. Initiate assessment of compliance with good practice codes for fiscal and monetary policy.	June 30, 2000	Done
3. Submit to parliament a new Securities Market Law in line with FSAP/FSSA recommendations.	June 30, 2000	Delayed to end-2000.
4. Decide on organizational and legal principles for unified financial supervision agency	June 30, 2000	Done
5. Complete upgrading of Energy Inspectorate	June 30, 2000	Done
6. Submit to parliament complete pension reform package, including proposed eligibility criteria and benefits for second tier of pension system, consistent with World Bank/IMF recommendations.	December 1, 2000	Likely to be delayed to end-2000.

FUND RELATIONS[1]

(As of September 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	80.70	123.8
Reserve position in Fund	0.01	0.0

III. **SDR Department**	**SDR Million**	**Percent of Allocation**
Holdings	0.01	N.A.

IV. **Outstanding Purchases and Loans**	**SDR Million**	**Percent of Quota**
Systemic Transformation	15.50	23.8

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

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	1.0	3.9	3.9	3.9	1.9
Charges/interest	0.2	0.7	0.5	0.3	0.1
Total	1.2	4.6	4.4	4.2	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 30, 2000.

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.

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, 1999-2000

Department	Subject/Identified Need	Action	Timing	Counterpart 1/
			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.*" In February 2000, the World Bank initiated work on a Regional Development Program for the northeastern-most county of Estonia, Ida Virumaa. The work included 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 was completed in mid-2000.

3. 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.

4. Bank borrowing has been limited in recent years and is likely to remain small.

Estonia: Core Statistical Indicators

(As of November 10, 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	11/9/00	10/31/00	10/31/00	10/31/00	10/31/00	10/00	10/00	9/00	Q2/00	9/00	Q2/00	Q2/00
Date received	11/9/00	11/7/00	11/7/00	11/7/00	11/7/00	11/8/00	11/7/00	11/6/00	9/18/00	10/21/00	10/27/00	9/25/00
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 2/	O 2/	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.

November 24, 2000

Dear Mr. Köhler,

The attached Supplementary Memorandum of Economic Policies reaffirms the policy commitments described in our letter of intent dated February 11, 2000 and provides an update of our policy for the remainder of 2000 and the first half of 2001. We have fully met all end-June and end-September performance criteria underlying the program supported by the Fund with a stand-by arrangement, which we continue to treat as precautionary. We are encouraged by the fast recovery of the Estonian economy from the recession after the Russia crisis, the better-than-expected current account developments, the strong confidence in our currency board, and the strengthening of our financial system. We expect to meet the original program targets for end-2000, and we have submitted a balanced budget for 2001 to parliament. We are proceeding with the reform of the pension system and the strengthening of financial sector supervision. We are making strong progress in meeting the conditions for early EU accession.

We believe that the policies described in the attached memorandum are adequate to achieve the objectives of our economic program. We will however, continue to monitor developments closely and are committed to act decisively, if warranted. In particular, should economic growth exceed current projections, we intend to use any additional revenues to generate a budget surplus in 2001, so as to protect the balance of payments position. We are herewith requesting the completion of the second review under the stand-by arrangement.

Sincerely,

/s/

Mart Laar
Prime Minister

/s/

Vahur Kraft
Governor
Bank of Estonia

Attachment

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

November 24, 2000

REPUBLIC OF ESTONIA

Supplementary Memorandum of Economic Policies

I. Introduction

1. The economic recovery from the effects of the Russia crisis gained momentum in the first half of 2000, despite a sharp fiscal correction. The recovery was importantly supported by rapid growth of our export markets, but also by our prudent policies and further structural reforms, as outlined in our policy memorandum earlier this year. These policies aimed at laying the basis for rapid economic recovery through maintaining macroeconomic stability and increasing the efficiency and competitiveness of the Estonian economy. In order to achieve sustainable fast economic growth and prepare the economy for accession to the European Union (EU), we intend to continue these policies through 2001 and beyond, and strengthen them where appropriate.

2. The strong growth in our key export markets in Finland, Sweden, and other EU countries and deployment of new investments in the electronics sector and other exporting industries, has led to a rapid increase in exports of goods and services by 39 percent in the first half of 2000. Together with a recovery of private domestic demand, this resulted in an increase in real GDP by almost 6½ percent in the first half of 2000 over the same period in 1999. However, 1999 had been characterized by a recession, and output in the first half of 2000 was only about 3¼ percent higher than in the first half of 1998. The twelve-month inflation rate rose from 3.8 percent in December 1999 to 4.7 percent in September 2000, largely reflecting the weakness of the euro and the sharp increase in international energy prices, as well as the feed-through to transportation fees, and the extension of VAT of 5 percent to thermal energy in June 2000. Unemployment has started to fall recently with the rapid economic recovery, but remains above the level in 1999. The external current account deficit in the first half of this year was 5.4 percent of GDP, which is lower than in the same period of 1999, when it had amounted to 6¼ percent of GDP. The debt service ratio has declined from already moderate levels because of strong non-debt creating inflows financing much of the current account deficit and the increase in net foreign assets of the banking system.

3. The tightening of fiscal policy that had begun in the second half of 1999 was continued in the first half of 2000, with a general government deficit of about 1.7 percent of GDP, compared with 6.6 percent of GDP in the same period in the previous year. VAT has performed better than projected, but excise tax collection was initially weak. So far, overall revenue and expenditure performance has been broadly in line with expectations, as the unexpectedly fast growth of exports (which are not taxed) has not yet resulted in revenues exceeding projections.

4. Representing a catch-up after the slow growth in the monetary aggregates in 1998 and much of 1999, broad money grew at about 25 percent (year-on-year) in the first half of this year, and by 31 percent in the third quarter. Interest rates are near historic lows. While there has been a slight upward tendency recently, this was less than in euro interest rates. The commercial banking sector remains in a strong financial position, and the Bank of Estonia has sold its equity stake in Optivapank in July 2000.

5. As regards structural reforms, we submitted to parliament a new budget law that will make expenditure control more effective. While, after passage in parliament, the new law will apply only to the budgets from 2002 onwards, we have already framed the budget proposal for 2001 in accordance with the new law. The Bank of Estonia and the government also agreed in June 2000 to establish a unified financial supervision agency and to provide strong safeguards to ensure its budgetary and operational independence. Finally, a principal agreement on the partial privatization of the electricity complex was reached in August 2000.

II. POLICY PROGRAM THROUGH 2001

Macroeconomic Framework

6. While Estonia's economy has improved substantially over the past year, we will remain vigilant to ensure that this improvement will be sustained. To this end, the currency board arrangement will remain the cornerstone of our stabilization policies, supported by strong fiscal policies to protect our external position.

7. We now expect real GDP to rise by 5½-6 percent in 2000 (rather than by 4 percent previously expected), and at a similar rate in 2001. Economic growth will continue to be export-led, even though export growth is likely to slow down somewhat from its very brisk pace in early 2000. We expect that investment will become the second engine of growth. Barring further unforeseen external price increases, the rate of average consumer price inflation is expected to remain between 4 and 5 percent in 2000 and 2001. With strong economic growth, the rate of unemployment should continue to decline somewhat from its present high level of 13.2 percent. However, this is likely to be a gradual process as the rapid transformation of the economy will continue to lead to closures of labor intensive enterprises. Finally, with continued strong export growth, the external current account deficit is projected to remain in the range of 6-7 percent of GDP in 2001, despite the upward push on imports from strengthening domestic demand.

Fiscal Policy

8. As already noted, the economic recovery has been led by a rapid increase in exports, which are not taxed. Therefore, while the recovery has been stronger than expected, this has not yet led to higher revenues, nor to a weaker external position. Thus, the budget outlook for the remainder of 2000 is broadly in line with earlier expectations, and the budget also remains appropriate from a macro-economic point of view. Revenues are likely to meet budget targets, with higher direct taxes and VAT compensating for relative weakness in excise tax collection.

The deficit of the central government is expected to be somewhat below earlier expectations, while, with the economic recovery and the freezing of pensions, the Social Insurance Fund will move towards balance after a deficit of close to 1 percent of GDP in 1999. However, the municipalities may be running a higher deficit than planned. In particular, the City of Tallinn has passed a supplementary budget (0.3 percent of GDP), the full implementation of which could threaten achievement of our fiscal target this year. We are, therefore, trying to persuade the municipalities to refrain from undermining our fiscal policy. In any case, we will stand ready to cut back expenditure of the central government to compensate for any overspending at the local level, to ensure that our fiscal targets are met. For this purpose, we are already holding back spending until the overall fiscal position becomes clearer toward the end of the year. Moreover, while we expect to recover some of the deposits lost in a bank failure in 1998, we do not intend to rely on these funds for meeting the budget target in consideration of the one-off nature of these receipts.

9. We have submitted a balanced budget for 2001 to parliament. On the revenue side, the ratio of direct taxes to GDP will fall on account of the completion of the phase-out of the corporate profits tax and the introduction of higher exemptions for personal income tax. This is expected to be only slightly offset by higher excise tax collection—as a result of the introduction of excises on fuel components as from September 1, 2000, the introduction of alcohol excise warehouses from January 1, 2001, and improvements in tax administration. Moreover, non-tax revenue will also be smaller, as there will be no repeat of the bank deposit recovery. On the expenditure side, the budget is based on a continuation of the general freeze of nominal pensions and government wages, following the sharp increase in 1999, with the important exception of salaries of teachers and cultural workers. The budget also includes the transfer of education spending and their financing from the central government to the local authorities, but this will not affect the consolidated budget. The continued freeze of pensions, together with the effects of the economic recovery, is expected to move the central government budget (including the Medical Insurance and the Social Insurance Funds) into a slight surplus, covering the expected deficit of the municipalities. Should revenues exceed projections, we intend to generate a fiscal surplus next year, so as to protect our external current account, and prepare for the pension reform starting in 2002. Consistent with the target of fiscal balance for 2001 as a whole, but allowing for seasonal movements, we have set general government deficit targets for March and June 2001 to cover the remainder of the program period (Table 1).

10. The government has made considerable progress in rationalizing and streamlining the operations of the central government and the extrabudgetary funds, including through the introduction of a comprehensive Treasury system in 1998 and the submission to parliament of a new basic budget law in June 2000. The government intends to continue the process of administrative reform through the early review of the structure of local government finance. At present, there are 247 separate municipalities, each with its own budget and financial administration. It has long been recognized that this system is expensive, unwieldy, and inhibits effective control over public spending. Accordingly, the government intends to propose by mid-2001 an approach to the restructuring of the system of local governments with a view to reducing substantially the number of independent administrative units.

Monetary Arrangements and Financial Market Supervision

11. As already noted, the currency board arrangement will remain the cornerstone of our economic policies. Within the currency board requirements, we continue to streamline our operational framework to reduce the distorting effect of the high reserve requirement and to bring it in line with that of the Eurosystem central banks. Following the review envisaged in our original MEP, as of July 1, 2000, we have combined the reserve and liquidity requirements into one uniform reserve requirement at 13 percent of the reserve base. This change had a marginally tightening impact on banks' balance sheets by increasing the level of mandatory intra-day minimum reserves. Moreover, as of January 2001, banks will be allowed to invest up to 25 percent of their required reserves into highly rated foreign money market instruments. We have also ceased the issuance of Bank of Estonia CDs as of April 20, 2000, as recommended by Fund staff. As described in our earlier policy memorandum, we are carefully monitoring credit and monetary developments. We have already taken recourse to moral suasion with key commercial banks and we are scrutinizing their lending plans, credit policy, and risk strategies for the coming year. In addition, we would consider, if necessary, a combination of monetary and financial policy measures to limit credit growth.

12. The Bank of Estonia has completed in June 2000 an assessment of compliance with good practice codes for monetary policy as part of the Financial Sector Assessment Program (FSAP). The FSAP concluded that vulnerabilities in the financial sector had been substantially reduced.

13. The government and the Bank of Estonia agreed in June 2000 on the basic structure of the agency that would unify supervision over the banking, insurance, and securities industries (the Financial Supervision Agency or FSA). It is expected that enabling legislation would be submitted to parliament by March 31, 2001, which would allow the FSA to commence operations on January 1, 2002. It is already agreed that the FSA would have full operational and licensing independence (consistent with the principles set out in the FSAP). In addition, the legislation will also reflect international best practices in financial supervision, including full protections from legal actions associated with the discharge of its core responsibilities.

14. We recognize that the banking sector plays a key role in ensuring macroeconomic stability and the stability of the currency board, and will therefore ensure that there will be no compromise in the standards of commercial banking supervision during the transition to the FSA and thereafter. We are also mindful of the shortcomings in financial supervision that were identified in the FSAP, in particular in the case of the Securities Inspectorate. Accordingly, and to ensure a smooth transition to the new supervisory environment, we will (i) submit the new Securities Market Law to parliament before end-December 2000; and (ii) proceed with the enhancement of the standards of supervision in the Insurance and Securities Inspectorates; this may entail the commitment of additional managerial resources as well as considerable assistance (twinning, training, IT systems) from the EU, especially in the case of the Securities Inspectorate.

Other Structural Policies

15. We now expect that the pension reform proposal to establish a fully funded voluntary second pillar will be submitted to parliament towards the end of December 2000, rather than December 1. This brief delay is needed to reach a broader political consensus and refine the calculations. Under the government's proposal, 4 percentage points of the 20 percent payroll tax will be redirected from the first to the second pillar for workers who choose to participate, plus a further 2 percentage points to be contributed by the participant. Participants would not be able to opt out of the second pillar after they join. The question whether participation in the second pillar should become mandatory for new entrants in the labor force is still under discussion. The reform is expected to be implemented from January 1, 2002. While much will depend on the actual participation of employees in the system, preliminary estimates suggest that the emerging deficit in the first pillar could initially amount to about 1 percent GDP. We will also continue with the reform of the first pillar of the pension system, including by introducing indexation to prices and the wage bill. This will ensure the system's financial integrity over the medium term by removing decisions on discretionary pension increases from the political sphere.

16. The sale of a minority stake in Narva Power Station to a foreign investor is expected to be completed by mid-2001. This will signal the beginning of a major investment program into Estonia's energy sector and should lead to substantial improvements in the productivity of the electricity generation and oil shale mining industries. It will also bring with it a sharp reduction in the harmful environmental impact associated with the production of electricity. A special fund is being created by Narva Power Station to address the social consequences of the restructuring. At the same time, the power purchase agreement associated with this deal implies that Eesti Energia, buying a substantial amount of the Narva Power Station's output of electricity, maintains a dominant position in this sector. This dominance is enhanced through its simultaneous control over the Estonia's transmission system and most of its distribution network. To ensure that Eesti Energia does not abuse its market power and that independent producers enjoy reasonable access to the transmission and distribution networks (as guaranteed under the 1998 Energy Act), the government has already upgraded the functioning of the Energy Inspectorate, including by narrowing the focus of its work. The government will continue this process by further enhancing staffing and seeking EU assistance in improving the technical capacities of this agency. Our intention is to proceed with the privatization of the energy complex after the completion of the sale of the stake in Narva Power Station.

17. The government is also at the final stage of the privatization of a two-thirds stake in Eesti Raudtee—the major freight and transit line. The tender process has identified a number of prospective buyers, and it is expected that a final selection will be made by the end of this year. The government recognizes the importance of ensuring that the strategic investor in Eesti Raudtee has the experience and the financial capacity to undertake the task of upgrading and streamlining the railway, which plays such a crucial role in the export of transit services.

III. Performance Monitoring

18. Progress in the implementation of the program will continue to be monitored through quarterly performance criteria, which have now been set through the end of the program through June 2001, and are presented in the attached table. The definitions remain those of the Letter of Intent dated February 11, 2000, except for the definitions of the performance criteria on the debt ceilings at end-March and end-June 2001, which have been revised to bring them in line with the IMF Executive Board decision of August 24, 2000.

Table 1. Estonia: Quantitative Performance Criteria under the Program, 2000-01 1/

	December 31, 2000 Program	March 31, 2001 Program	June 30, 2001 Program
		(In millions of EEK)	
I. Limit on cumulative general government deficit	1000	1150	1250
		(In millions of deutsche mark)	
II. Minimum levels of net international reserves of the Bank of Estonia (January 1 through December 31, 2000) 2/	200	200	200
		(In millions of U.S. dollars)	
III. Ceilings on new external short-, medium-, and long-term debt of general government 3/			
Maturity of 0-2 years	0.0	0.0	0.0
Maturity of over 2 years	250.0	300.0	300.0
of which: Maturity of more than 2 years but less than 10 years	30.0	30.0	30.0
IV. The government will not accumulate any payments arrears during the period of the arrangement			
V. The currency board is fully backed with foreign exchange at all times			

1/ Definitions of the concepts were set out in the Annex to the Memorandum of Economic Policies (EBS/00/18), except for the definitions of the performance criteria on the debt ceilings at end-March and end-June 2001, which have been modified in accordance with the IMF Executive Board decision dated August 24, 2000 (see footnote 3).

2/ The targets for net international reserves will be adjusted for the net proceeds of the sale of Optivabank, as specified in EBS/00/18.

3/ The performance criteria on the debt ceilings for end-March and end-June 2001 apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (August 24, 2000) but also to commitments contracted and guaranteed for which value has not been received. Because of difficulties in ensuring effective monitoring of leasing and import financing by local entities, such transactions by local governments are not included under the external debt limits.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

EDITORIAL DIVISION
ROOM IS 7-1200 0493

News Brief No. 00/115
FOR IMMEDIATE RELEASE
December 13, 2000

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

IMF Completes Second Estonia Review

The Executive Board of the International Monetary Fund (IMF) today completed the second, and last, review of Estonia's performance under a 18-month, SDR 29.34 million (about US$37.8 million) stand-by arrangement. This opens the way for release of a further SDR 4.2 million (about US$5.5 million) from the arrangement, which the authorities, however, are not expected to request as they have treated stand-by arrangements as precautionary for a number of years already.

In commenting on the Executive Board's decision to complete the review of Estonia's economic program, Shigemitsu Sugisaki, Deputy Managing Director, stated:

"The Estonian authorities are to be commended for the successful implementation of their macroeconomic and structural policies. Despite the sizable fiscal correction this year, the economy is recovering faster than expected, led by strong export growth and the increase in private sector demand. For the first nine months of 2000, the budget showed a deficit of only ½ percent of GDP, entailing a reduction by over 4 percentage points of GDP compared to 1999. Confidence in the currency board is high, the current account deficit remains moderate, the banking system has strengthened, and the unemployment rate has started to decline albeit from high levels. The privatization program of the few remaining public enterprises continues as planned. Preparation for EU accession is well advanced.

"The submission to parliament of a balanced budget for 2001 is a welcome step, as is the commitment to protect the balance of payments by aiming for a fiscal surplus next year, should economic activity turn out to be stronger than expected. The authorities also need to remain vigilant against a recurrence of excessive credit growth. The strengthening of financial supervision, particularly through the speedy implementation of the new securities market law and the unified financial supervision agency is, rightly, accorded high priority. The careful crafting of a voluntary fully funded second pillar of the pension system is appropriate. Further reforms of the first pillar, including a further increase in retirement age, will also be required in order to ensure the financial viability of the pension system," Mr. Sugisaki said.

Statement by Olli-Pekka Lehmussaari, Executive Director
For the Republic of Estonia
December 13, 2000

Let me start by thanking the staff on behalf of my Estonian authorities and myself for a frank discussion, a balanced diagnosis of the state of the Estonian economy, as well as for constructive policy advice. My authorities are in agreement with all the main conclusions of the staff appraisal, and they are of the view that staff fairly reflects Estonia's progress in program implementation and economic policy management.

While the Estonian economy has performed strongly and all policy targets are within reach, and some of them are likely to be exceeded, the authorities wish to restate that they will remain mindful of the challenges posed by the less certain global outlook. Also, they will closely monitor that the strengthening domestic demand does not translate to the overheating of the economy. Therefore, my Estonian authorities wish to yet again reaffirm their earnest commitment to prudent economic policy.

Economic developments and outlook

The nearly six months which have passed since the completion of the 2000 Article IV discussion and the first program review in June have bolstered the evidence of strong economic growth. The latest information that has become available confirms the continuation of a solid expansion. Based on preliminary data, the third quarter GDP grew by 6.9 percent, value-added is increasing in all major industries, and exports are keeping up their rapid pace as the investments in new technologies are deployed. Growing exports also signal that the Estonian economy is maintaining its competitive edge. Domestic demand is increasing alike and, while still subdued, investments are expected to pick up as the output gap narrows and economic restructuring carries on. Also, unemployment has continued to decline.

Most importantly, the fiscal performance has showed continuous improvement and, as of end-November, the general government accounts were close to balance on a yearly basis, for the first time in nearly two years. While the revenues have grown broadly in line with the projections, the recorded over performance vis-à-vis the deficit targets largely originates from efficient expenditure restraint.

Despite the robust real activity and credit expansion, the current account has remained in check. The deficit in the trade and services balance is expected to improve to around 4.5 percent from 5.9 percent in 1999. However, the overall current account deficit for the year 2000 is likely to exceed 6 percent, as the improved profitability of enterprises is expected to turn the investment income balance significantly negative. At the same time, the authorities anticipate that reinvested earnings will finance about half of this deficit. Over the medium term, the authorities see the current account deficit likely to widen somewhat as investment demand recovers and credit growth fuels consumption. They expect, however, that a hefty share of this deficit will continue to be financed by the

FDI inflows, as Estonia remains an attractive investment location, and the reminder, to a large extent, by other long-term capital flows. As a result, debt and debt service ratios are expected to remain low.

Following the disposal of the authorities' last shareholding in the banking industry last June, the Estonian financial sector is now fully integrated with European markets, as all major banks and insurance companies are strategically owned by foreign banking or insurance institutions.

Estonia is also advancing well on the EU accession track, and the authorities remain committed to meet the accession requirements by 2003 in order to be ready to join the EU at the earliest opportunity.

On balance, the authorities are of the view that external and domestic prospects remain generally favorable. While there is no evidence of the economy overheating, they remain alert to the signs of build up of domestic or external imbalances and stand ready to react preemptively, if needed.

Policy agenda

The authorities continue to see the currency board arrangement (CBA) as the cornerstone of pre-accession economic policies in joining the EU and eventually the EMU. The CBA keeps the economy firmly on the convergence path and forces the economic agents to rely on productivity growth as an underlying force to maintain competitiveness. Indeed, the European Commission's recent progress report on Estonia also indicates that the Estonian economy can withstand the competitive pressures in the single market in the near term.

The authorities continue their course of fiscal consolidation. The budget for 2001, which aims for balance at the general government level, is based on conservative revenue assumptions and implies a negative fiscal impulse on the order of 1.2 percent of GDP, consistent with the economy's cyclical position. Like in earlier statements, the authorities are committed to save surpluses should the actual revenues over perform the underlying projections; inter alia, because the fiscal policy is the primary tool for maintaining macroeconomic stability and bearing in mind the costs associated with the pension reform.

As a part of the comprehensive public sector reform launched in 1998, the authorities are now discussing the modalities of the administrative reform of local governments, which should yield to a rationalization of local government finances and to a substantial reduction in the number of municipalities, presently standing at 247.

The authorities have also advanced further with implementing a major overhaul of the existing pension system. The Parliament has passed legislation indexing the pensions in the first pillar to the average of the CPI inflation and the growth in social security contributions. The authorities are finalizing draft legislation establishing the second fully funded pillar as of 2002, and are continuing efforts to build up a broad social consensus on the question whether the otherwise voluntary second pillar should be mandatory for new entrants in the workforce. They expect to reach this consensus and enact all necessary legislation related to the second pillar before July 2001. The authorities are also continuing to refine the assessment of transitional costs of the reform and to specify the financing structure.

In reforming the oversight of financial markets, the authorities have finalized the draft legislation on the creation of a unified financial supervisory agency, and it will be submitted to Parliament shortly.

Recent months have likewise shown marked progress in divesting the last major companies that remained on the privatization list. Following the agreement to privatize the power generation company to the US energy firm NRG Energy, the authorities are now in the final stage for picking up a strategic investor to acquire 66 percent of the equity of Eesti Raudtee, a major freight and transit company.

Finally, my Estonian authorities, in demonstrating their commitment to adhere to the highest standards of transparency, have requested the publication of the staff report for the Second Review Under the Stand-By Arrangement.