

Republic of Estonia: 2001 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by Authorities of the Republic of Estonia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with the Republic of Estonia, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 25, 2001**, with the officials of the **Republic of Estonia** on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 5, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **June 22, 2001** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its June 27, 2001 discussion** of the staff report that concluded the Article IV consultation.
- A statement by the authorities of Estonia.

The document(s) listed below have been or will be separately released.

- Labor Markets in Hard-Peg Accession Countries: The Baltics and Bulgaria
- Report on Observance of Standards and Codes—Fiscal Transparency Module
- Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation
with the Republic of Estonia

Approved by Gérard Bélanger and Liam P. Ebrill

June 5, 2001

- The discussions were held in Tallinn during April 11-25, 2001
- 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, as well as with representatives of commercial banks, industry, the European Union, and academia.
- The mission team consisted of Messrs. Keller (head), Burgess, Moers (EP), Mongardini, and Ms. Boyd (administrative assistant) (all EU2). Mr. Knöbl, the Fund's senior resident representative, assisted the mission. Mr. Törnqvist, Alternate Executive Director for Estonia, attended the policy meetings.
- Estonia accepted the obligations of Article VIII in 1994. Estonia has no restrictions on current or capital account transactions.
- The Stand-By Arrangement, in an amount equivalent to SDR 29.34 million (45 percent of quota), was approved by the Executive Board on March 1, 2000 and will expire on August 31, 2001. The second (and final) review was approved by the Executive Board on December 13, 2000. At end-March 2001, all performance criteria were again met. The authorities have treated this and earlier Stand-By Arrangements as precautionary. They have indicated that they do not intend to request a new Fund arrangement after the current one expires.
- The safeguards assessment completed in December 2000 concluded that the Bank of Estonia's external audit mechanism meets internationally accepted standards.

As background to the upcoming Board discussions, a fiscal transparency ROSC, a paper on "Labor Markets in Hard-Peg Accession Countries: The Baltics and Bulgaria," a paper on "Pension Reform in the Baltics" (IMF Occasional Paper No. 200), as well as a paper providing statistical information (SM/01/162, 6/6/01) have been, or will be, issued.

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Estonia: Basic Data

Social and demographic indicators, 2000

Area	45,227 sq. km.
Population	1.4392 million
Rate of population growth	-0.4 percent per year
Life expectancy at birth 1/	70.7 years
Male	65.4 years
Female	76.1 years
Infant mortality rate (per 1,000 births) 1/	9.5
Hospital beds (per 10,000 inhabitants) 1/	71.9
Physicians (per 10,000 inhabitants) 1/	30.8

	1996	1997	1998	1999	2000
Nominal GDP (in million of EEK)	52,446	64,324	73,325	75,297	84,382
GDP per capita (in US\$)	2,856	3,069	3,761	3,347	3,486
Real GDP (percentage change)	3.9	10.6	4.7	-1.1	6.4
Sectoral distribution of GDP	(In percent of GDP)				
Agriculture, hunting, forestry, and fishing	7.5	6.9	6.3	5.7	5.2
Mining, manufacturing, and energy	22.2	21.5	21.3	19.9	21.2
Construction and services	70.4	71.6	72.4	74.5	73.6
Trade	(In millions of kroons, unless otherwise specified)				
Total exports of goods	21,833	31,871	37,786	36,036	56,013
(in percent of GDP)	41.6	49.5	51.5	47.9	66.4
Total imports of goods	37,637	47,526	53,505	48,975	69,510
(in percent of GDP)	71.8	73.9	73.0	65.0	82.4
General government	(In millions of kroons, unless otherwise specified)				
Total revenue	20,431	25,485	28,887	29,083	32,696
(in percent of GDP)	39.0	39.6	39.4	38.6	38.7
Total expenditure	21,200	24,339	29,037	32,542	33,400
(in percent of GDP)	40.4	37.8	39.6	43.2	39.6
Net lending	-41	264	-77	-81	406
(in percent of GDP)	-0.1	0.4	-0.1	-0.1	0.5
Overall surplus / deficit(-)	-811	1,410	-227	-3,540	-298
(in percent of GDP)	-1.5	2.2	-0.3	-4.7	-0.4
Money and credit (end-period)	(In millions of kroons, unless otherwise specified)				
Net foreign assets	6,720	5,083	5,112	8,022	9,098
Broad money (M3)	14,853	20,466	21,328	26,390	33,162
Domestic credit	11,664	20,797	24,223	26,542	33,758
Claims on general government (net)	-913	-1,716	-930	-197	-1,078
Other selected indicators	(Annual percentage change)				
GDP at current prices	28.8	22.6	14.0	2.7	12.1
Average CPI	23.1	11.2	8.1	3.3	4.0
Average nominal wage (in EEK)	25.7	19.7	12.5	10.4	9.8

Sources: Estonian authorities; and Fund staff estimates.

1/ Data for 1999.

EXECUTIVE SUMMARY

Led by strong export growth and subsequently by a recovery of private consumption, the economy grew by 6½ percent in 2000, after a short recession in the wake of the Russia crisis. The government implemented an impressive fiscal adjustment, with the budget deficit declining from 4½ percent of GDP in 1999 to less than ½ percent of GDP in 2000. Inflation rose moderately, largely reflecting higher import prices. Unemployment has started to decline, albeit from high levels. The current account widened somewhat in 2000, reflecting unusually high returns on FDI, but was again financed by non-debt creating flows. External debt and debt service remain low and confidence in the currency board is strong.

The discussions focused on the appropriate stance of macroeconomic policy, fiscal and other issues related to EU accession, labor market issues, and the completion of the structural reform agenda. Growth in 2001 is expected to moderate in line with a projected slowdown in external demand. The current account is likely to widen marginally as private demand is forecast to pick up. A balanced budget remains appropriate for 2001, but the automatic stabilizers should be permitted to operate in both directions. The relatively rapid credit expansion remains primarily a prudential concern. A sharp downturn in the world economy would, however, represent a significant risk to the near term outlook.

The government aims at keeping the budget in balance over the medium-term and at increasing the efficiency and transparency of government operations through administrative reforms. A reasonable amount of NATO and EU-accession related spending can be absorbed within the envelope of a balanced budget, provided that economic growth remains robust. EU accession negotiations are well advanced.

Solid progress was made in the implementation of structural reforms, including the privatization of the few remaining enterprises. Pension reform legislation was submitted to parliament. Most of the recommendations of the FSAP/FSSA have been implemented, including the creation of the unified financial supervisory agency. The government has also embarked on the rationalization of the structure of local governments and the hospital system.

The program supported under the current Stand-By Arrangement (SBA) has been fully implemented and all performance criteria have been met so far. The authorities do not intend to request a new arrangement from the Fund, after the current one expires in August 2001. This completes a series of four precautionary arrangements over the last seven years. The authorities have expressed interest in maintaining close collaboration with the staff. In this regard, the recent missions on tax policy, the fiscal transparency ROSC, and the data quality ROSC, were seen as useful. The authorities again agreed to publish the Article IV staff report, as well as the ROSCs.

I. INTRODUCTION

1. During the discussions for the 2000 Article IV consultations on June 30, 2000, Directors welcomed the continued 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. They supported the move to unified supervision of the financial sector and stressed that the new agency should have adequate budgetary and operational independence.

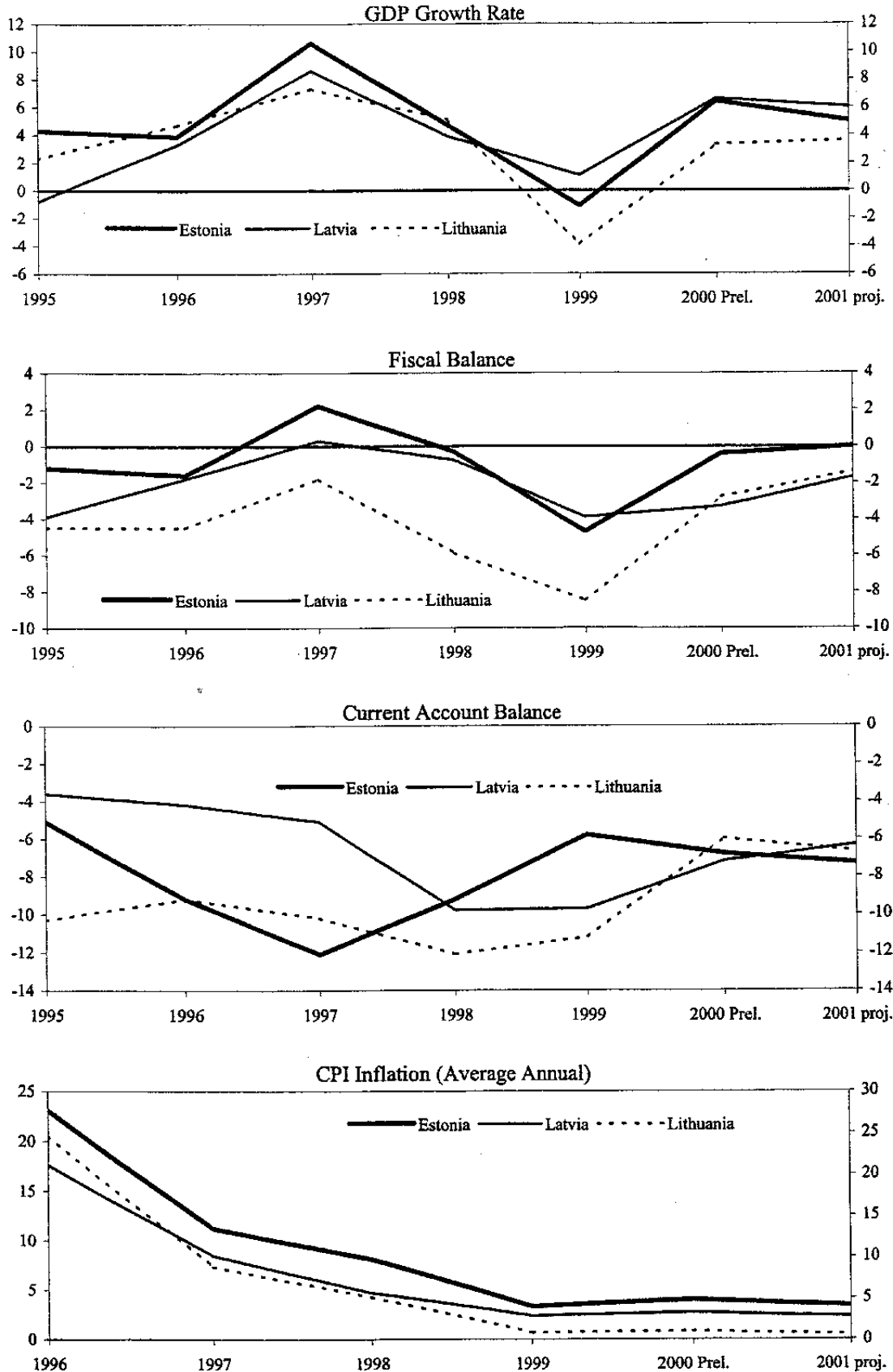
II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE STAND-BY ARRANGEMENT

2. **Recovery from the economic downturn in the wake of the Russia crisis began in the second half of 1999 and gathered momentum in 2000 (Figure 1 and Table 1).** Notwithstanding fiscal restraint, real GDP growth reached 6½ percent in 2000, substantially higher than the 4 percent growth originally expected under the program. The recovery was driven by the rapid growth of exports in response to strong external demand, especially in the electronics sector. In the second half of 2000, the economic upswing was also supported by a robust expansion in private consumption, when consumer confidence was buoyed by a fall in unemployment and other favorable economic news. Moreover, banks increased their credit and leasing operations to households. Private investment, which had contracted during the recession in 1999, also increased in 2000 and there was a strong improvement in corporate profitability. Gross National Income (GNI) grew by 3.8 percent in 2000, significantly less than GDP, as foreign-owned firms increased their contribution to Estonian output. Industrial sales rose by 9 percent in real terms, led by sectors such as machinery and communication equipment. Indications are that economic growth slowed somewhat towards the end of 2000 and in the first quarter of 2001. The unemployment rate has fallen from a peak of 14.8 percent in the first quarter of 2000 to 13.9 percent in the fourth quarter of 2000.¹

3. **Inflation rose moderately in 2000.** Consumer prices grew by an average 4.0 percent in 2000, compared with 3.3 percent in 1999. The average rise in prices was in line with program projections, although the rate of inflation accelerated in the second half of 2000. The 12-month CPI inflation rate stood at 6.4 percent in April 2001, with the weakness of the euro and the increase in oil prices accounting for about one half. In addition, the resumption of food exports to Russia and import supply problems related to BSE and foot and mouth diseases were reflected in pronounced increases in domestic food prices. Wages were on average 9.8 percent higher in 2000 than in 1999.

¹ On an ILO basis. Registered unemployment remained far lower at 6.8 percent in March 2001 due to strict eligibility rules and the relatively low level of benefits. However, it has risen over the last year in response to amendments to the unemployment law, which extended the duration of unemployment benefits from 180 to 270 days and eased the registration rules.

Figure 1. Baltic Countries: Selected Economic Indicators, 1995-2001

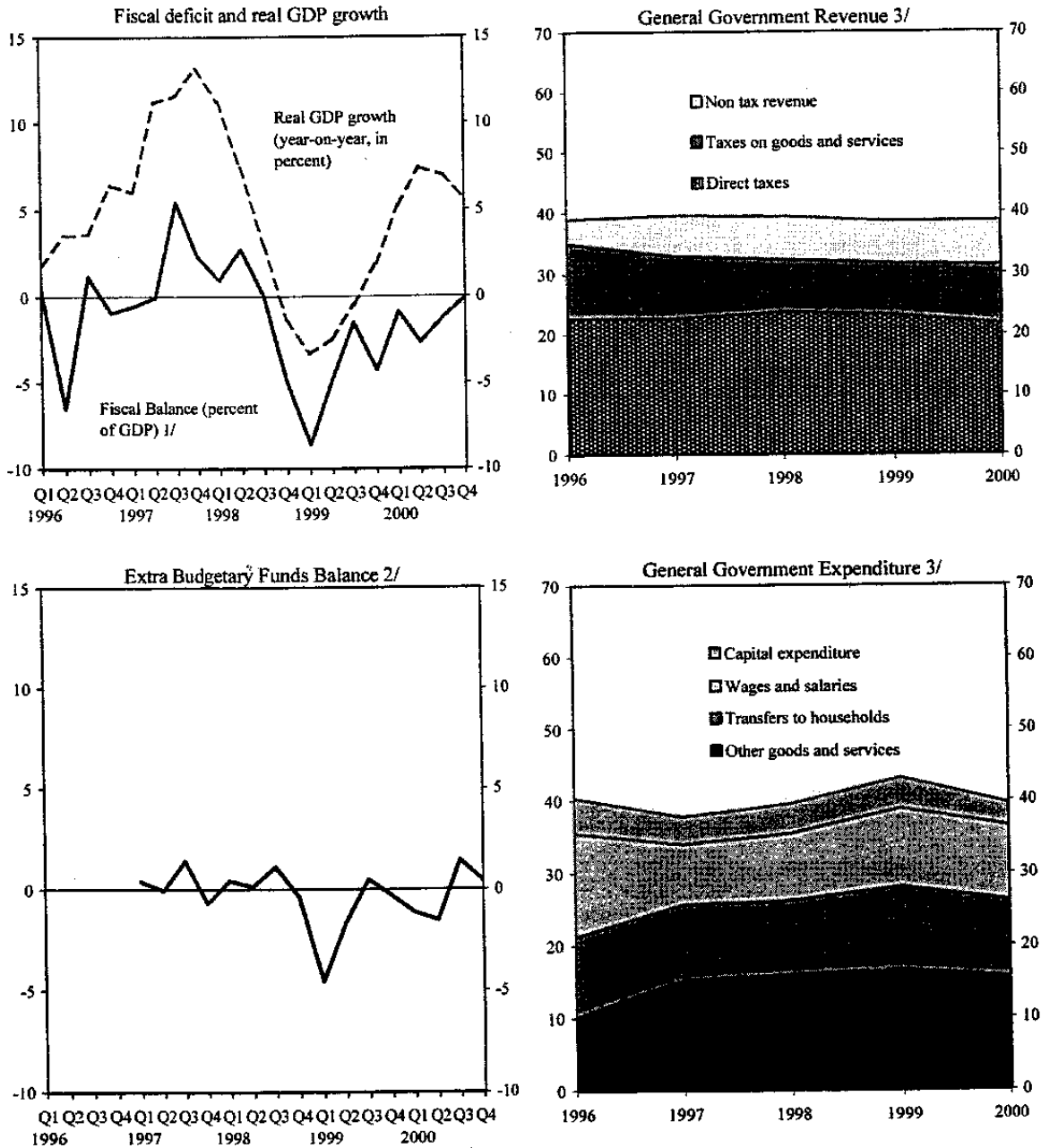


Source: Country authorities; and Fund staff estimates.

4. **The government successfully implemented an impressive fiscal adjustment in 2000 (Figure 2, and Tables 2 and 3).** Revenues were slightly below budget projections, despite the faster than expected growth of the economy. Revenue collection, especially of VAT, improved during the second half of the year as the sources of economic growth shifted from exports, which are not part of the tax base, towards private consumption. Excise revenues benefited from the introduction, albeit delayed, of duties on fuel components and alcohol excise warehouses. As a result, revenues remained broadly unchanged as a share of GDP (38.7 percent) despite the abolition of the tax on retained corporate profits and a 60 percent increase in the personal income tax threshold (which remains well below the minimum wage level).
5. **Strict implementation of the tight budget resulted in a substantial reduction in the size of the public sector from 43.2 percent of GDP in 1999 to 39.6 percent in 2000.** The restraint on nominal wages and the freeze on pensions were maintained throughout 2000 (following large real increases in 1999). As expected, there was a sizeable shortfall from budgeted amounts in capital spending. Overall, public spending increased by only 2.6 percent in nominal terms in 2000, resulting in a real reduction in expenditures. This reversed the trend of a rising share of government in GDP.
6. **Reflecting in part the cyclical upturn of the economy, the budget deficit fell from 4.7 percent of GDP in 1999 to 0.4 percent of GDP in 2000—well below the program target of 1.2 percent of GDP.** There was a recovery of government deposits and other claims from the wind-up of bankruptcy procedures of failed commercial banks; this is shown as negative net lending in the fiscal accounts. Excluding this one-off recovery, the budget deficit would have amounted to 0.7 percent of GDP. Thus, the authorities more than fully met the commitment expressed in the last supplementary letter of intent (EBS/00/237) to meet the budget targets without counting the recovered deposits. There was a drawdown of external government deposits to finance the small overall budget deficit, the net repayment of external debt, and a build-up of domestic bank balances.
7. **The growth of monetary and credit aggregates recovered in the second half of 1999 and remained relatively high in 2000 and early 2001 (Figure 3 and Table 4).** In the first half of 2000, the growth of broad money was partly driven by the accumulation of NFA. In the second half of the year, however, the expansion of domestic credit dominated, reflecting, in particular, a sharp increase in leasing activity.² The latter was concentrated on the real estate, industrial machinery, and automobile sectors. In real estate-related transactions

² The figures for domestic credit to nonbank financial institutions in the monetary survey (Table 5) also include financing for leasing operations carried out via banks' own leasing companies in other Baltic states. In 2000, the BoE estimates that about half of the increase in this credit category went to institutions outside of Estonia. Excluding this outflow, the growth of credit to the non-government sector would have been less than 20 percent.

Figure 2. Estonia: General Government Operations, 1996-2000
(In percent of GDP)



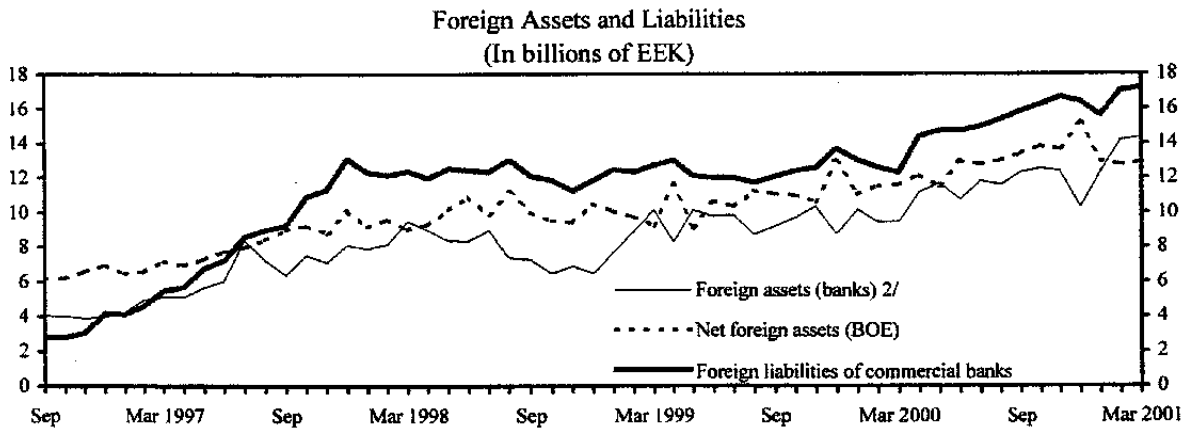
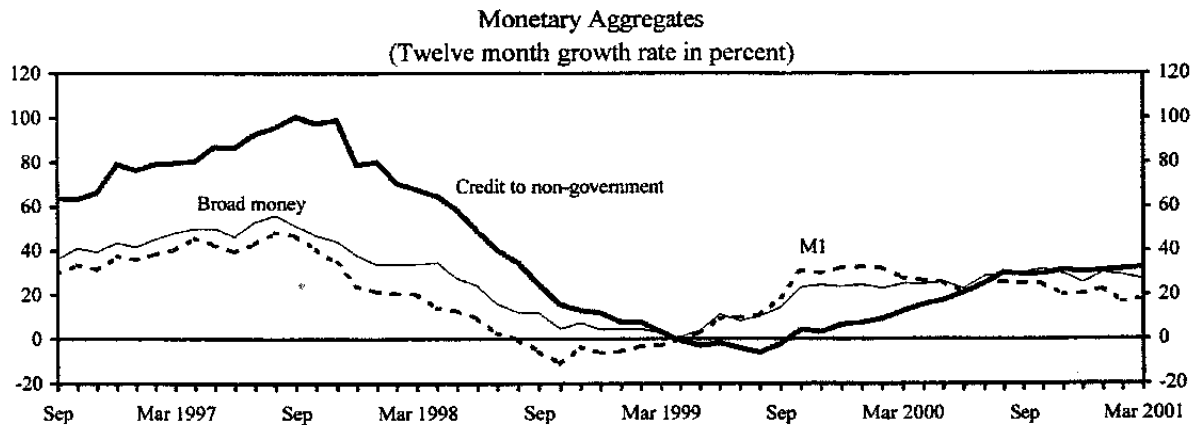
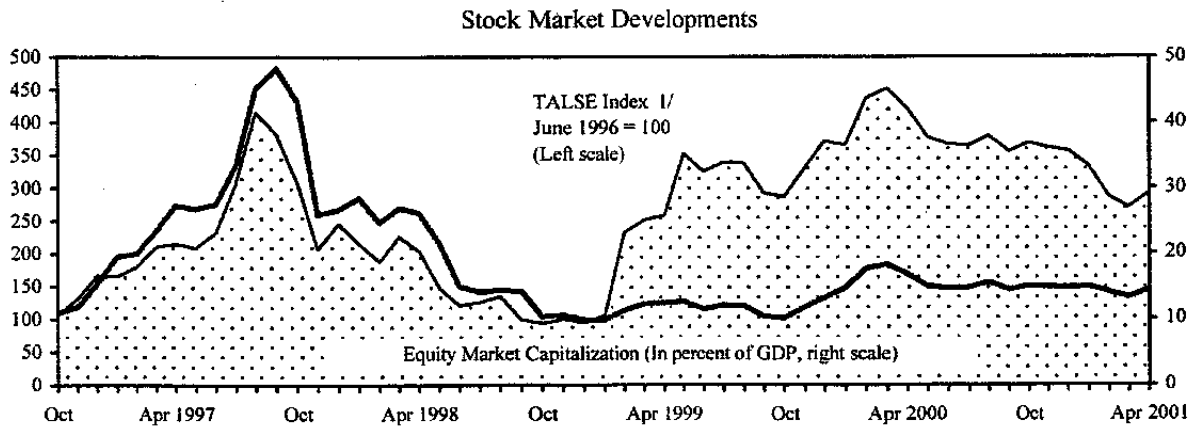
Sources: Estonian Ministry of Finance; and Fund staff calculations.

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.

Figure 3. Estonia: Monetary and Financial Indicators, 1996-2001



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.

leasing is increasingly replacing mortgage-based lending. During the first quarter of 2001, the increase in NFA of the banking system accounted for over 40 percent of broad money expansion. At end-March 2001, the 12-month growth rates for credit to the non-government sector and for broad money (M2) remained high at about 32 percent and 27 percent, respectively. The growth rate for M1 declined, however, to around 18 percent.

8. **The banking system remains in a strong financial position (Table 5).** The average capital adequacy ratio remains well above the required 10 percent threshold. Banks remain highly liquid. Non-performing loans are near historic lows. Following the sale of the Bank of Estonia's share in Optiva Bank in June 2000 and the buyout at end-2000 of the Estonian minority stake in the second largest bank, the banking system is now entirely in private hands and virtually all foreign-owned.

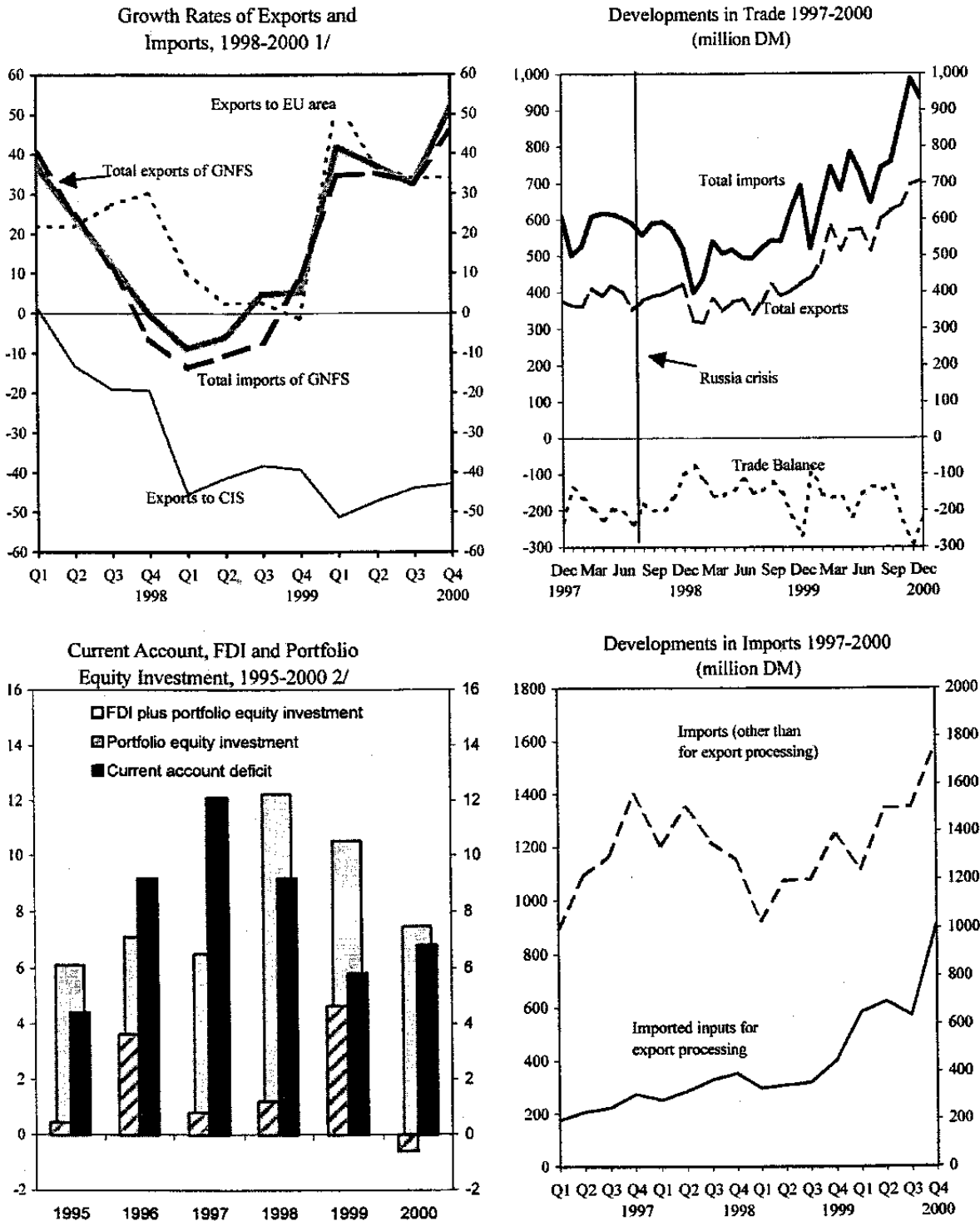
9. **The external balance in goods and non-factor services (GNFS) improved substantially in 2000.** Exports and imports of GNFS grew by 40 and 36 percent, respectively, reflecting in part the near doubling of trade flows associated with sub-contracting activity (Figure 4 and Table 6)³. All export sectors registered double digit growth rates; electronics and textiles, as well as more traditional sectors such as wood and furniture, fared particularly well. Exports of food products also started to recover for the first time since the Russia crisis. The GNFS deficit fell to 4.3 percent of GDP in 2000, continuing a declining trend since 1996-97, when it was 2½ times as high. Preliminary estimates for the first quarter of 2001 suggest a moderation of both export and import growth.

10. **The current account deficit in 2000—at 6.8 percent of GDP—turned out broadly as projected.** The greater-than-forecast improvement in the GNFS balance was more than offset by unexpectedly high returns on FDI (Figure 5). With the economic recovery, profits accruing to foreign investors are estimated to have doubled to 4 percent of GDP in 2000. However, more than half of these profits were reinvested in Estonia, contributing to strong FDI inflows, which exceeded the current account deficit.⁴ At the same time, there were large investments by Estonians abroad, mainly in Latvia and Lithuania. In the second half of 2000, commercial banks borrowed abroad and increased their deposits with the BoE. As a result, the overall balance of payments turned strongly positive, after a flat first half. Net external debt remains low. The debt service ratio is estimated to have declined to below 7 percent of exports of GNFS (Table 7).

³Estonia has established itself as a major outsourcing center for foreign (mainly Finnish and Swedish) companies. Initially, these companies shifted their assembly functions to Estonia. More recently, some have started to transfer the production of inputs and research facilities as well.

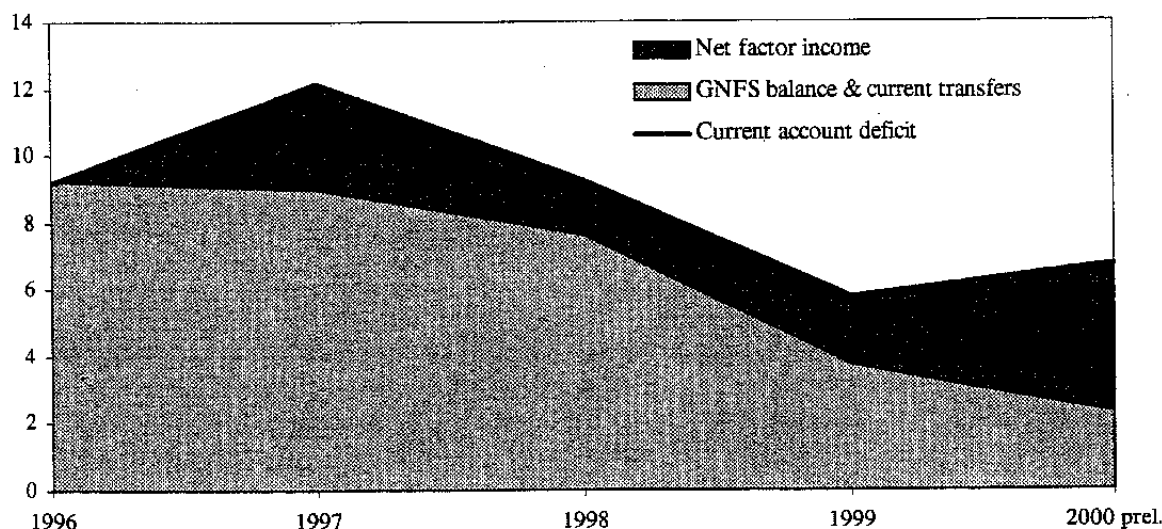
⁴ The large increase in reinvested earnings may reflect in part an accounting strategy by foreign companies to shift earnings from 1999 to 2000 to take advantage of the elimination of the corporate income tax on retained earnings. Capital gains and dividends are, however, taxed.

Figure 4. Estonia: External Sector Developments, 1995-2000



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

Figure 5. Estonia: The Composition of the Current Account Deficit, 1996-2000
(In percent of GDP)



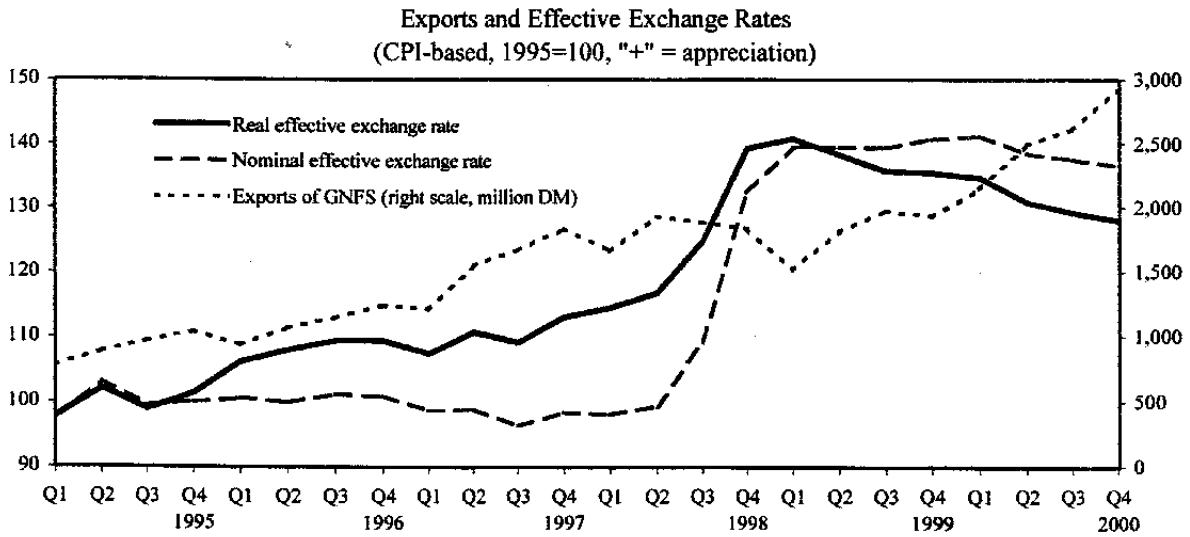
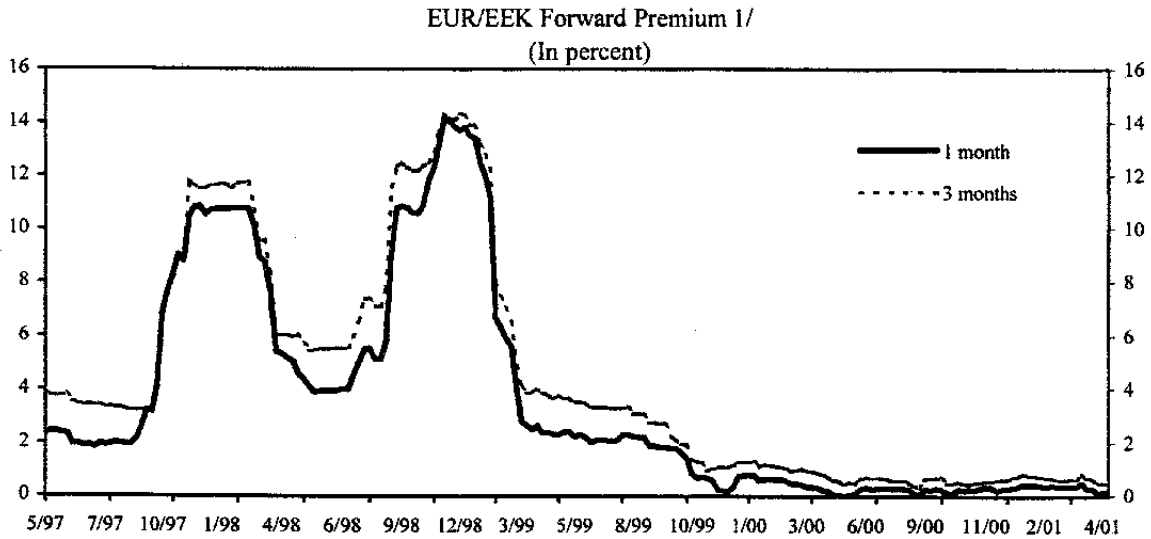
11. **There have been no significant pressures on the exchange market since early 1999, and confidence in the currency board remains strong (Figure 6).** The Bank of Estonia's NIR (defined as the excess of foreign assets over currency board cover) increased rapidly in the second half of 2000 and the first three months of 2001 and remained well above the program floor.⁵ The real effective exchange rate has declined markedly in the last two years as have dollar wages because of the weakness of the euro vis-à-vis the U.S. dollar. Estonia ranked highest amongst transition economies in a recent competitiveness survey and ahead of many advanced economies.⁶

12. **EU accession discussions continue to proceed at a fast pace.** Of the two economic criteria for accession, the EU Commission's periodic report issued in late 2000 concluded that (i) Estonia is already a functioning market economy, and (ii) should be able to cope with the competitive pressures and market forces within the EU in the near term provided that it stays

⁵ Government deposits held abroad are not included in NIR. Standard measures of external vulnerability related to official reserves are not particularly meaningful for Estonia as, under the currency board, the bulk of official reserves is earmarked to back the monetary base. Also, more than half of short-term debt reflects the foreign liabilities by Swedish-owned Estonian banks. Nearly two-thirds of these liabilities are matched by banks' own foreign assets and the parent companies can be expected to act as lender of last resort, if necessary.

⁶ International Institute of Management Development, "World Competitiveness Yearbook", April 2001 (<http://www.imd.ch/wcy/>).

Figure 6. Estonia: External Sector Financial Indicators, 1995-2001



Sources: National authorities, Bloomberg; and Fund staff estimates.

1/ Difference between EEK and Euro money market rates.

with its present reform path. At end-April 2001, 18 of the 31 chapters of the *acquis communautaire* had already been provisionally closed, and another 11 chapters were under active negotiation. In most instances, Estonia has not asked for any transitional arrangements.

13. **Estonia continues to be at the forefront of the transition process.** According to the 2000 EBRD transition report, Estonia has already reached standards and performance typical of advanced economies in small-scale privatizations, and trade and foreign exchange systems, and is near those standards for large-scale privatizations and the banking system. With the implementation of the unified financial supervisory agency, progress towards improved supervision of non-bank financial institutions can be expected.

14. **At end-December 2000 and end-March 2001, all quantitative performance criteria under the program were again met by large margins (Annex I).** The delayed structural benchmark measures have now also been implemented (Annex II). The new securities market law was submitted to parliament in April 2001. The pension reform legislation was submitted to parliament in two stages: the first part, establishing new indexation rules for pensions under the first pillar, was submitted in September 2000 ahead of schedule; the second part, establishing the fully-funded second pillar, was submitted in April 2001.

III. DISCUSSION WITH THE AUTHORITIES

15. **The discussions focused on the appropriate stance of macroeconomic policy, fiscal and other issues related to EU accession, labor market issues, and the completion of the structural reform agenda.** The discussions took place against the background of a robust rebound in economic activity in 2000 but an uncertain external outlook. GDP growth is expected to moderate somewhat in 2001, reflecting a likely slowdown in the growth of foreign demand. In the absence of further import price shocks, the inflation rate is expected to decline substantially in the second half of 2001.

16. **The main risk to the near-term outlook is a substantial slowdown in Estonia's main export markets.** A possible hard landing of the U.S. economy could result in slower growth in Europe and a significant appreciation of the euro. The resulting slowdown in exports could reduce Estonia's growth substantially. Moreover, the fiscal position could turn into a sizable deficit and the current account deficit could widen significantly (Box 1). The latter would, however, not be an inevitable outcome as much would depend on the extent of the slowdown in private sector demand. In this regard, it was noted that despite the loss of important export markets, the sharp real appreciation of the kroon, and the emergence of a pronounced fiscal deficit after the Russia crisis in 1998, the current account deficit narrowed substantially.

17. **The underlying trend in the goods and non-factor services account has been encouraging.** Also, FDI inflows have, on average, exceeded the current account deficit during the last three years, and NFA of the banking system has nearly doubled since end-1997. Together with fast growth and a sterling record on fiscal performance and structural reforms,

Box 1. Estonia: Potential Impact of a "Hard Landing"

The staff's baseline medium-term scenario is predicated on the continuation of a broadly favorable external environment. It assumes only a modest appreciation of the euro and a growth rate of about 2.5 percent in the economies of the EU, which account for more than 75 percent of Estonia's trade flows (Table). Under these conditions, Estonia's growth rate is expected to be around 5 percent in 2001 and to average 5.5 percent over the medium term, sustained by continued large investment flows. GDP inflation is forecast to moderate to 3.6 percent in 2001 and to about 3 percent over the medium term. Domestic savings would rise moderately in 2002, mainly on account of the pension reform, thus reducing the need for foreign savings.

The possibility of a "hard landing" of the U.S. economy poses a substantial downside risk to this scenario. The May 2001 WEO exercise estimated that a hard landing in the U.S. would lead to a marked appreciation of the euro, a further decline in equity prices, and a slowdown in world growth. A MULTIMOD simulation indicates that a 1 percentage point decline in U.S. growth would roughly translate into a 0.7 percentage point decline in EU growth on account of these factors. Under these conditions, Estonia's export growth would be negatively affected and real GDP growth would be reduced by about 2 percentage points compared with the baseline scenario. Nominal growth would decline even more, as the euro appreciation would reduce inflation. This, in turn, would further reduce the growth in government revenues and, *pari passu*, lead to a deterioration in the fiscal balance, as it would be politically difficult to reduce nominal expenditures in the budget law during the year. The corresponding deterioration in public savings could lead to a marked widening of the current account deficit, although private investment and savings behavior could dominate the results.

Table. Estonia: Macroeconomic Scenarios, 2000-2002
(In percent of GDP; unless otherwise indicated)

	Baseline Scenario			"Hard Landing" Scenario	
	2000	2001	2002	2001	2002
WEO assumptions 1/					
EU real GDP growth rate	3.4	2.4	2.8	1.3	1.6
USD/Euro exchange rate	0.92	0.93	0.93	1.11	1.13
Estonian Macroeconomic indicators					
Real GDP growth rate	6.4	5.0	5.5	3.0	3.3
GDP deflator	5.3	3.6	2.7	2.9	0.7
Domestic savings	17.3	17.3	18.1	16.1	15.5
Private	14.4	14.0	15.0	13.8	14.8
Public	2.9	3.3	3.1	2.3	0.7
Domestic investment	24.1	24.6	24.9	24.3	24.6
Private	20.8	21.3	21.1	20.9	20.5
Public	3.2	3.3	3.8	3.4	4.1
Current account balance	-6.8	-7.3	-6.8	-8.1	-9.1
Fiscal balance	-0.4	0.0	-0.7	-1.0	-3.4
<i>Memorandum items:</i>					
Exports of GNFS (in millions of DM)	10,176	11,468	12,102	10,705	9,724
Imports of GNFS (in millions of DM)	-10,628	-12,098	-12,733	-11,405	-10,571
Government revenues (in millions of EEK)	32,696	35,263	37,884	34,333	35,405
Government expenditures (in millions of EEK)	32,994	35,263	38,561	35,263	38,561

Source: Staff estimates and projections.

1/ World Economic Outlook, May 2001, Chapter 1 and Appendix II.

this has reduced the external vulnerabilities one would otherwise associate with relatively large current account imbalances. In addition, profits earned by foreign investors in 2000—the reason for the somewhat wider deficit—may have been atypically high because of changes in tax legislation.

18. **Taking account of recent cyclical and balance of payments developments, the current stance of macroeconomic policies remains broadly appropriate.** Policies would need to be reassessed in the event of substantial departures from the assumptions regarding the external environment.

A. Fiscal Policy

19. **Parliament approved in December 2000 a balanced budget for 2001,** along the lines set out in EBS/00/237. In early 2001, however, parliament postponed by four years the budgeted increase in the VAT rate on heating fuel, and a 3 percent increase in pensions for the year was approved, with a combined net cost to the budget of only around 0.2 percent of GDP as the number of projected pensioners was lowered. A substantial shortfall in investment expenditures from budgeted amounts is again expected. At the local government level, the City of Tallinn passed its budget for 2001 with a deficit of 0.4 percent of GDP, but may still reduce its spending plans under pressure from the central government. In the first quarter of 2001, the budget of the general government registered a small surplus. An approximately balanced budget continues to be seen by the authorities and the staff as appropriate and also as the most likely outcome for 2001 as a whole. At the same time, however, there was also agreement that the automatic stabilizers should be allowed to work in both directions as the external debt position is favorable.

20. **An important focus of the discussions were the parameters of the budget for 2002.** The government's macroeconomic assumptions for the 2002 budget (5.7-6 percent real growth, 3-3.4 percent inflation) are broadly in line with staff projections. The government also decided to aim at a balanced budget for 2002, excluding the transitional cost of the pension reform, now estimated in the range of ½ to 1 percent of GDP (Appendix D). This is in line with the original commitments under the program (EBS/00/18, page 57). The mission stressed the importance of cautious revenue projections for the 2002 budget. It was also agreed that the appropriate budgetary stance would need to be reassessed periodically in light of cyclical and balance of payments developments.

21. **An FAD tax policy mission in March 2001 concluded that the tax structure is largely in line with international norms (Box 2).⁷** Harmonization of Estonia's tax system with EU requirements would in itself result in a further modest shift towards indirect taxation. The scope for a more significant shift toward indirect taxation appears limited.

⁷ A summary of the tax system is available on the website of the Ministry of Finance at http://www.fin.ee/english/tax/summary/summary_of_the_tax_system.html.

Box 2. Estonia: Tax Policy

Unlike many other transition economies, Estonia has been able to maintain relatively high revenues, at a little under 40 percent of GDP, for most of the 1990s. Together with fast economic growth, this has allowed the government to increase pensions and civil service salaries rapidly and maintain an adequate level of essential government services without the need for substantial government borrowing. Most elements of Estonia's tax system are broadly consistent with international norms. As in many countries, the share of direct taxes within total tax revenues has fallen modestly in recent years and the authorities have, from time to time, contemplated a further shift towards indirect taxation. The corporate profits tax is the one tax somewhat at variance with international norms. This tax has been reduced to a tax on distributed profits (dividends and other profit distributions, fringe benefits, charitable donations, and non-business related expenses). With revenues from taxes on other investment income limited,¹ Estonia imposes taxes primarily on consumption and labor income. A further meaningful shift towards indirect taxation would therefore necessarily entail a reduction in personal income or payroll taxes.

A shift towards VAT or excises could improve economic efficiency by reducing distortions to savings and investment decisions. There may also be a case for reducing personal income and payroll taxes to facilitate employment growth: the combined level of these taxes is relatively high in Estonia (although not out of line compared to the level of similar taxes in other accession candidates and a number of EU countries). The scope for a substantial shift from payroll taxes or personal income taxes to VAT would, in any event, appear to be limited as the standard rate of VAT, at 18 percent, is already relatively high and only a little below the EU average of 19.3 percent. There is also relatively little progressivity within the tax system: a switch from direct to indirect taxation would, therefore, raise a number of potentially significant equity considerations.

The Government should, however, avoid further increases in the taxation of labor income. Over time, as budgetary resources permit, it would also be desirable to reduce personal income taxation through further increases in the tax threshold, which remains significantly below the minimum wage. The authorities' priorities in the near-term are to further improve tax administration, and to align the tax system with EU requirements as part of the process of accession. The latter will require specific action in at least three areas – excises, VAT, and customs duties. Excises on tobacco and petroleum products must be raised substantially in order to meet minimum EU rates. Only small changes are needed to Estonia's VAT system, which applies a standard rate to most goods and services, and already meets most EU requirements. Estonia must also adopt the common external tariff, which is higher than the customs duties now levied. Estonia will also be subject to, and already complies with, the EU's Code of Conduct for Business Taxation which guards against harmful tax competition.

Table: Estonia and Selected Countries: Tax Structure
(in percent of GDP)

	Total	Income taxes:			Property			Other
		Personal	Corporate	Payroll Taxes	Taxes	VAT	Excises	Indirect Taxes
Estonia 1/	35.8	7.8	1.0	12.3	0.4	9.7	3.3	1.2
CEEC Accession 2/	33.3	4.8	3.1	11.5	0.1	8.0	2.7	2.8
European Union 3/	41.3	10.8	3.5	11.9	1.9	7.3	4.4	0.4

Sources: IMF Government Finance Statistics; OECD Revenue Statistics; Estonian authorities and staff estimates.

1/ 2000.

2/ Unweighted average for Bulgaria, Hungary, Poland, Romania, Slovak Republic, Slovenia. Figures 1995-98, except Romania 1995-97.

3/ Unweighted average for EU15, 1998.

¹ While capital gains are taxed, interest earned on bank deposits is exempt from taxation.

22. **The mission discussed the balance of payments and fiscal projections underlying the draft Pre-accession Economic Program (PEP).**⁸ The medium-term fiscal strategy is designed to (i) balance the budget over the medium-term, and (ii) increase the efficiency and transparency of government operations through administrative reforms. The public finances will be subject to pressure in a number of areas over the coming years from public investments to improve environmental conditions and enhance transport infrastructure—expenditures that Estonia would need to undertake even without EU accession considerations—and, to a lesser extent, from plans to increase defense expenditure from currently 1.8 percent to 2 percent of GDP to prepare for NATO accession. The PEP also presents broad estimates of the costs for health and education reform, which could be substantial. Much will, however, depend on the phasing of such outlays. Significant pre-accession grants from the EU are expected. Also, the harmonization of the tax system with EU requirements will strengthen revenues, especially from excises. Moreover, the transitional cost of pension reforms is projected to recede over the medium-term. An additional sources of savings would be a reduction in the costs of public administration (paragraph 38).

23. **The mission broadly agreed with the authorities' medium-term strategy and the objective of a balanced budget over the economic cycle.** With no further changes in the tax system contemplated, the staff's projections underlying the medium-term scenario are based on approximately unchanged ratios of revenues and expenditures to GDP. In real terms, however, expenditures would grow (in line with GDP) at about 5½ percent per annum. Within this expanding expenditure envelope, increased outlays related to preparation for EU and NATO membership of around 2 percent of GDP per annum could be accommodated without compression of other expenditure categories in real terms.

B. Monetary and Financial Sector Issues

24. **The BoE still interprets the relatively fast growth of monetary and credit aggregates largely as a recovery from the 1999 recession.** The BoE and commercial banks pointed out that much of the domestic credit expansion was to Estonian leasing companies, which were rapidly expanding their activities in Latvia and Lithuania. The measured increase in domestic credit was therefore misleading. Also, the growth of the banking system's NFA,

⁸ Starting this year, the EU Commission requires each accession country to prepare a PEP once a year. The PEP consists of a discussion of recent macroeconomic developments, a medium-term framework, and detailed five-year fiscal projections and policy description. On the basis of the PEP, the Commission will form a judgment on the appropriateness of the authorities' envisaged policies. The PEP is seen as a precursor to the notification procedures of EU member countries under the EMU Convergence Pact. Estonia submitted its first PEP in May 2001, which is available at http://www.fin.ee/majandus/estonia_pre_accession_economic_programme.pdf. There are no substantial differences between the fiscal projections in the PEP for 2002, and beyond, and the mission's projections.

which reflected in large part the influx of foreign direct investment, was an important explanatory factor for broad money expansion.

25. **The authorities are closely monitoring developments.** During recent discussions with commercial banks, the BoE had noted its primarily prudential concerns, which the staff shares, regarding the fast growth of leasing operations. The BoE is also prepared to raise prudential requirements, including the capital adequacy ratio, if credit growth were to accelerate. For now, however, developments are seen as reflecting a desirable financial deepening and a return to more normal conditions. The reductions in banks' holding of excess reserves with the BoE and banks' capital asset ratios were welcome as this will improve the profitability of the banking system. The mission cautioned against complacency in interpreting the developments of the financial aggregates and argued that the present rate of credit growth may already be excessive. The fast expansion of leasing operations, in particular, suggested that banks may not be applying the same prudential standards to leasing as to other forms of lending.⁹ Banks may also overestimate the protection entailed in retaining ownership of the underlying asset.

26. **As of January 1, 2001, commercial banks are permitted to meet 3 percentage points of the 13 percent reserve requirement by holding high quality euro-denominated foreign instruments.** As expected, this led in the first quarter of 2001 to a decline in base money and a shift of net foreign assets from the BoE to commercial banks. The mission argued that a further step in the same direction, slated for July 2001, should be delayed if there were no clear signs of a slowdown in bank lending.¹⁰ The BoE was hesitant to contemplate such a delay, as this step had already been announced. Moreover, the BoE aims at reducing reserve requirements to EU levels over the medium term.

27. **The planned merger of two Swedish banks will have large repercussions on Estonia's banking system.** Swedbank, the majority owner of Estonia's largest bank (Hansapank), and Skandinaviska Enskilda Banken (SEB), the owner of Estonia's second largest bank (Ühispank), have recently announced plans to merge. The merger could lead to the new Swedish bank group controlling 89 percent of total assets of the Estonian banking system (as well as important shares of the Latvian and Lithuanian banking systems). The group would also have a dominant position in the leasing and insurance markets. Concerned about the systemic and competition issues, the BoE has announced that it will insist on the sale

⁹ There does not appear to be a regulatory bias in favor of leasing operations. Moreover, representatives of commercial banks stated that the same prudential standards are applied to bank lending and leasing operations by their subsidiaries as internal risk management is carried out on a consolidated basis.

¹⁰ As commercial banks are already holding substantial amounts of such instruments, this would further ease their liquidity position.

of either Hansapank or Ühispank to third parties if the Swedish bank merger proceeds as expected.

28. **Solid progress was made in implementing the recommendations of the 2000 FSAP report (Box 3).** The establishment of the Unified Financial Supervisory Agency, which was approved in May 2000, will be helpful in addressing the remaining institutional weaknesses in non-bank financial sector supervision. The agency will have operational and budgetary independence. Following the Finnish model, it will receive administrative support from the BoE. The authorities intend to ensure that the transition to the new agency will not weaken the effectiveness of bank supervision.

C. External Sector Outlook for 2001 and Medium-Term Prospects

29. **The trade balance is expected to weaken in 2001.** Exports of GNFS are likely to slow, in part because of the expected decline in the demand for mobile phones (one of Estonia's main exports). Imports are expected to outpace exports on account of a projected 8 percent real growth in private consumption. The recorded return on FDI is forecast to moderate in 2001 as profits in 2000 may have been inflated because of changes in the tax law. Against this background, the projections for 2001 are for a current account deficit of about 7 percent of GDP.

30. **Non-debt creating inflows are likely to dominate again the financial account in 2001 and finance the bulk of the current account deficit.** Reinvested profits together with fresh inflows related in part to the restructuring of the Narva Power Plants and the privatization of the main railway company are expected. The reduced reserve requirements are likely to lead to a small decline in the NIR of the BoE. NFA of the consolidated banking system is, however, expected to increase again.

31. **The outlook for the medium-term is intertwined with the progress toward EU accession.** FDI inflows, driven by Estonia's favorable EU accession prospects, are likely to sustain real GDP growth at an average rate of 5½ percent over the medium term (Table 8). The medium-term fiscal projections take account of estimates for the fiscal costs of EU-related structural reform measures. The staff projects that EU accession related outlays of about 2 percent of GDP per annum could be absorbed over the medium term while maintaining a balanced budget policy, provided growth remains reasonably strong and expected EU pre-accession grants are disbursed. Domestic savings are cautiously forecast to increase moderately as pension reforms generate higher private savings. As a result, the current account

Box 3. Estonia: Implementation of the FSAP Recommendations

Estonia participated in the pilot Joint Bank–Fund Financial Sector Assessment Program (FSAP) in 2000.¹ The main conclusions, as presented in the 2000 Article IV staff report, were that financial sector vulnerabilities in Estonia had been markedly reduced, reflecting the consolidation of the banking system, the foreign takeover of the largest banks, and strengthened banking supervision. The assessment of the observance of operational standards in banking and insurance supervision, and payment system oversight was broadly favorable. The BoE was found to be in full compliance with 19 of the 30 Basel Core Principles (CPs), in partial, often substantial, compliance with 10, and in noncompliance with only one. The assessment of compliance with the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* was also generally favorable. While serious weaknesses were found in the supervision of the securities market, this market remains relatively small.

The authorities have made solid progress in implementing the recommendations that originated from the FSAP exercise. Legislation has been submitted to parliament to provide legal protection to the supervisory agency and its staff, addressing the only area of noncompliance with Basle Core Principles. The BoE has also strengthened the rules governing reporting requirements of credit institutions, loan classification and loan loss provisioning, addressing weaknesses in the management of country and transfer risk as well. Full supervisory access to bank staff will require an amendment to the commercial bank law that will be introduced in the second half of 2001. The BoE is already cooperating closely with the supervisory authorities in countries where the corporate parents of the major Estonian banks are located.

The 2000 Insurance Activities Act addressed the few weaknesses identified in the area of insurance supervision. The law strengthened licensing and control requirements; restricted the use of financial derivatives exclusively to manage risk, and forbade insurance companies from writing put-options. Moreover, a Ministry of Finance (MoF) decree in August 2000 updated the methods for calculating capital adequacy and solvency ratios, and the reporting procedures of insurance companies.

In the area of securities market supervision, the MoF issued new rules for licensing securities market participants and pension funds in July 2000. The new securities market law, which was submitted to parliament in April 2001, establishes the rights of the securities inspectorate to obtain information from market participants, perform on-site inspections, and enforce its rulings. However, institutional weaknesses in the securities inspectorate will only be more fully addressed with the establishment of a unified financial supervision agency (FSA). The law, which was passed by parliament in May 2001, calls for the FSA to unify the banking, insurance, and securities supervision as of end-2001. The agency will have operational and budgetary independence, licensing and delicensing powers, and will be mainly financed by contributions from market participants.

¹ The FSAP report formed the basis of the Financial Sector Stability Assessment (FSSA) that was distributed to the Board in conjunction with the 2000 Article IV staff report. The report on the Observance of Standards and Codes (ROSC) was published on the Fund's website at <http://www.imf.org/external/np/rosce/est/index.htm>.

deficit should stabilize at about 6½ percent of GDP.¹¹ However, as amply demonstrated in recent years, the savings-investment behavior of the private sector remains hard to predict.

32. **The authorities are aware of the need to sustain their reform agenda to maintain the high level of investors' confidence in the Estonian economy.** At the same time, however, stronger-than-expected capital inflows could pose severe policy challenges in the period leading up to EU accession and entry into the Euro area. Aside from running budget surpluses, the authorities would only have limited instruments for maintaining macroeconomic stability, short of introducing capital controls or floating the exchange rate. The authorities categorically ruled out such measures.

33. **The trade system remains fully liberal,** with the exception of import tariffs on selected agricultural products,¹² which were imposed in January 2000 primarily to demonstrate the administrative capacity for handling the EU's tariff and trade system. As a result, Estonia's index of overall trade restrictiveness continues to be 1, the most liberal level.

D. Structural Policies

34. **Unemployment has proven more persistent than expected (Appendix II).** Estonia has very liberal labor market policies, suggesting that unemployment is not the result of an overly-regulated labor market. Instead, as indicated by the growing share of long-term unemployed and the geographical concentration of unemployment, the main determinants of unemployment seem to be a skill mismatch and limited geographic mobility. Workers laid off from traditional sectors find it difficult to meet the requirements of the new services and high-tech sectors. With population and labor force growth stagnant, or negative, Estonia's growth over the medium-term will depend in part on the successful integration of the long-term unemployed into the work force. The authorities are emphasizing active labor market policies and plan a reorientation of the educational system towards labor market needs. They intend to guard against adopting more rigid labor policies as labor market flexibility remains crucial under a currency board.

35. **To strengthen the social safety net, the government has proposed a new unemployment insurance scheme.** The proposal, currently before parliament, calls for workers and employers to pay 1 percent and 0.5 percent, respectively, of wage income into an unemployment insurance fund administered by the Ministry of Finance. While supporting the

¹¹ The authorities project larger current account deficits than the mission for 2002 and 2003, because of a higher estimate for investments related to the modernization of the Narva power plants.

¹² 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.

aim of this legislation, the mission stressed that the scheme, together with the additional 2 percent contribution of wage income to the second pillar of the pension system, would substantially increase payroll taxation that is already relatively high. The authorities agreed that a reduction in the rate of labor taxation would be an important medium-term objective provided it could be financed by economies in other areas. However, such savings may only be realized over time.

36. **The new organic budget law was revised and resubmitted to parliament.** The law is expected to increase the transparency of the fiscal accounts by consolidating extra-budgetary funds and foreign-financed capital expenditures in the budget process. It will also strengthen the control of the central government over other government entities, including local government. The authorities expect the law to be passed by end-June, so as to be fully effective starting with the 2002 budget. The main elements of the law were already respected in the formulation of the 2001 budget.

37. **The Report on the Observance of Standards and Codes (ROSC) on fiscal transparency concluded that Estonia meets most of the relevant standards and codes (Appendix III).** Passage of the State Budget Law will further clarify the definition of general government and ensure full coverage of extrabudgetary activities. Additional improvements would arise, inter alia, from a more detailed fiscal analysis in the budget and the establishment of a fully-articulated debt management framework.

38. **The government is embarking on the rationalization of the structure of local governments.** The number of municipalities is to be reduced to below 100 by 2005, from the current 247. This should lead to improved control over public expenditure and substantial gains in efficiency. **The privatization of the few remaining public enterprises continues.** Negotiations for the sale of a two-thirds stake in the main railway company (Eesti Raudtee) were completed in April 2001. The sale of the Narva power plants is expected to be finalized in the second half of 2001. In connection with the sale, the government has agreed on a schedule for electricity price increases for the next ten years to finance environmental and other improvements. The sale of Eesti Energia, the main distributor of electric energy, will need to await a decision on the regulatory environment after EU accession. The government has also decided to retain ownership of the port of Tallinn and a small stake in Eesti Telecom.

39. **An overhaul of Estonia's hospital system was launched in 2001.** Estonia inherited an excessive number of hospital facilities from the Soviet Union. The reform proposal calls for a reduction in the number of health care institutions and a more rational use of medical funds.

IV. OTHER ISSUES

40. **The authorities will not seek a new arrangement after the current stand-by arrangement expires in August 2001.** They expressed interest, however, in maintaining close collaboration with staff, including on issues related to budget preparation and EU accession.

41. **The quality of data remains high.** Estonia subscribed to the Fund's Special Data Dissemination Standard on September 30, 1998 and the authorities provide all core data necessary for surveillance on a timely basis. A recent mission to prepare a data module for the Report on the Observance of Standards and Codes concluded that the authorities follow an open dissemination policy, and make freely available a wide variety of data and metadata through official publications, press releases, and on the internet. The authorities are making good progress towards meeting the demanding statistical requirements of EU membership. Some unresolved issues remain with respect to interagency coordination and incomplete coverage of fiscal and monetary data.

V. STAFF APPRAISAL

42. **The economic recovery gained momentum in 2000.** It was driven by a rapid growth of exports, and, in the second half of the year, also by private consumption. Inflation rose somewhat, primarily because of the weakness of the euro and the increase in oil prices. The external current account deficit widened a little, as profits accruing to foreign investors rose sharply. Importantly, the economic recovery has also led to a decline in unemployment from its peak in early 2000.

43. **Appropriate economic policies have contributed substantially to these favorable developments.** Most noteworthy was the impressive fiscal adjustment, with the general government deficit declining from over 4½ percent of GDP in 1999 to less than ½ percent of GDP in 2000. This stance of budgetary policy was fully appropriate in the prevailing cyclical and balance of payments situation, and also consistent with Estonia's medium-term strategy. It is commendable that all the quantitative performance criteria under the program were met with large margins.

44. **Confidence in the currency board remains strong.** The quick recovery from recession and the strong external position underscore the appropriateness of the current exchange rate peg and the currency board mechanism. The authorities' intention to maintain these arrangements until the introduction of the euro is a reasonable strategy. The maintenance of liberal exchange and trade systems is welcome.

45. **While a sharp slowdown in the world economy could cast a shadow on the near term outlook, the medium-term prospects of the Estonian economy remain favorable.** Real GDP growth is expected to moderate somewhat in 2001, but to remain robust over the medium term. Inflation is expected to slow as the effects of higher import prices taper off. The slowdown in export growth could contribute to a moderate and temporary widening of the external current account deficit in the near term. With continued robust economic growth, unemployment should continue to decline, albeit moderately as structural factors will continue to inhibit employment growth.

46. **Fiscal policy remains the primary macroeconomic policy instrument available under the currency board arrangement.** The target of a balanced budget for 2001 remains appropriate. However, it would also seem appropriate to permit the automatic stabilizers to operate in both directions.

47. **The government's target of a broadly balanced budget for 2002 and the medium term is also fitting.** With EU support and continued growth of the economy, the government should still be able to finance reasonable amounts of EU-accession related expenditures without tax increases or cutting other outlays in real terms. This may require substantial transition periods in key areas such as transport and the environment.

48. **Money and credit aggregates have risen briskly throughout 2000 and in the first quarter of 2001.** The BoE should stand ready to rein in the growth of bank credit mainly for prudential reasons. The BoE's decision not to allow a merger of the two largest banks, or for those banks to be controlled by a single foreign investor, is appropriate for systemic and competition reasons.

49. **Substantial progress was made on structural reforms.** The new organic budget law is welcome and the government will now need to focus on passing the law through parliament so that it can apply to the 2002 budget. The government's intention to rationalize the structure of local governments, which should improve control over public expenditure and reduce administrative costs, is also appropriate.

50. **Estonia has very liberal labor market policies.** A skills mismatch and limited geographical mobility appear to be the main reasons for persistently high unemployment. Active labor market policies may help in the near term, while a reorientation of the educational system could help in the longer run. Labor market flexibility remains crucial under a currency board. While the objectives of the new unemployment insurance scheme are laudable, this legislation and the pension reform will increase non-wage costs. The government should consider cutting social security taxes, or increasing the threshold for the personal income tax, when the budgetary situation permits.

51. **Estonia continues to be at the forefront of transparency of public policy making.** Staff welcomes the intention to again publish the Article IV report, as well as the Reports on the Observance of Standards and Codes (ROSC) on fiscal transparency and data quality.

52. Staff recommends that Estonia remain on a standard 12-month consultation cycle.

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

	1997	1998	1999	2000		2001
				Prog. 1/	Prel. Est.	Rev. Proj.
National income, prices and wages						
Nominal GDP (kroons, millions)	64,324	73,325	75,297	82,677	84,382	91,780
GDP (US dollars, millions)	4,637	5,209	5,130	4,951	4,973	5,440
Real GDP growth (year-on-year in percent)	10.6	4.7	-1.1	5.5	6.4	5.0
Real GNI growth (year-on-year in percent)	7.1	6.4	-1.5	...	3.8	...
Average CPI (year-on-year change in percent)	11.2	8.1	3.3	4.0	4.0	5.0
12-month CPI (end of period change in percent)	12.5	4.2	3.8	4.8	5.0	3.3
GDP deflator (year-on-year change in percent)	10.9	8.9	3.9	4.0	5.3	3.6
Average monthly wage (end-of-period, US dollars)	318	360	345	325	341	364
Unemployment rate (ILO definition, percent)	9.7	9.9	12.3	...	13.7	...
Saving-investment balances (in percent of GDP)						
Domestic saving	18.7	20.2	18.9	21.3	17.3	17.3
Private	12.6	16.3	19.3	18.6	14.4	14.0
Public	6.1	3.9	-0.4	2.7	2.9	3.3
Domestic investment	30.9	29.4	24.7	27.8	24.1	24.6
Private	26.9	25.2	20.4	23.8	20.8	21.3
Public	3.9	4.2	4.3	3.9	3.2	3.3
Foreign saving	12.1	9.2	5.8	6.5	6.8	7.3
General government (in percent of GDP)						
Revenue	39.6	39.4	38.6	39.8	38.7	38.1
Expenditure	37.4	39.7	43.3	41.0	39.1	38.1
Fiscal balance 2/	2.2	-0.3	-4.7	-1.2	-0.4	0.0
External sector (DM, millions)						
Trade balance	-1,957	-1,965	-1,617	-1,921	-1,687	-1,999
Exports	3,984	4,723	4,505	6,486	7,002	7,891
Imports	-5,941	-6,688	-6,122	-8,407	-8,689	-9,890
Service balance	1,029	1,006	1,057	1,270	1,235	1,370
Receipts	2,296	2,601	2,744	3,331	3,174	3,578
Payments	-1,267	-1,594	-1,687	-2,061	-1,940	-2,208
Current account	-977	-844	-542	-668	-714	-834
Change in net foreign asset position of commercial banks (DM, millions)						
	-653	-44	59	...	-145	...
Gross international reserves (DM, millions) 3/						
in months of imports (excluding imports of goods for processing)	1,363	1,364	1,667	1,791	1,942	1,916
Relative to short-term debt (gross, including trade credits)	3.2	3.0	4.2	...	3.9	...
	0.9	0.9	0.9	1.0	0.8	...
Gross external debt/GDP (in percent) 4/ 5/						
Net external debt/GDP (in percent) 6/	57.1	53.5	59.4	...	60.5	...
General government external debt/GDP (in percent) 7/	16.3	15.0	15.4	...	17.2	...
Excluding government assets held abroad	4.3	4.3	4.9	5.0	4.1	4.1
Including government assets held abroad 8/	3.2	2.6	2.3	2.8	2.3	2.5
Exchange rate (EEK/US\$ - period average) 9/						
	13.9	14.1	14.7	...	17.0	...
Money and credit (year-on-year growth in percent)						
Domestic credit to nongovernment	79.0	11.7	6.3	...	30.3	...
Base money	37.7	6.4	27.1	...	14.6	...
Broad money	37.8	4.2	23.7	...	25.7	...
Base money multiplier (end of period)	2.4	2.4	2.3	...	2.5	...

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

1/ Staff report for the second review under the stand-by arrangement (EBS/00/237).

2/ Includes net lending.

3/ 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. Lower reserve requirements introduced in 2001 are expected to lead to a moderate decline in international reserves under the mechanics of the currency board.

4/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.

5/ Based on a wider definition of gross external debt than previously reported. Were it not for the change in definition of external debt, the gross debt to GDP ratio would have declined in 2000.

6/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.

7/ Includes government-guaranteed debt and Fund credit under the Systemic Transformation Facility (which was on-lent by the Government to commercial banks).

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

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

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

	1997	1998	1999	2000		2001	
	Year Actual	Year Actual	Year Actual	Year EBS/00/237	Year Pref Act	Year Budget	Year Baseline
Revenue	25,485	28,887	29,083	32,865	32,696	35,295	35,263
Tax revenue	24,076	27,126	27,383	30,331	30,208	32,458	32,496
Direct taxes	14,473	17,320	17,518	18,487	18,214	19,451	19,378
Corporate profits tax 1/	1,228	1,914	1,639	804	855	570	543
Personal income tax	5,240	6,233	6,531	7,010	6,594	7,277	7,088
Social security tax	4,637	5,303	5,520	6,276	6,297	6,833	6,919
Medical insurance tax	3,097	3,573	3,518	4,079	4,093	4,441	4,498
Land tax	270	297	310	318	375	330	330
VAT 2/	6,686	6,413	6,419	7,800	8,153	8,450	8,692
Excises	2,401	2,789	2,685	2,969	2,819	3,431	3,301
Other taxes (incl. on intern. trade)	516	606	761	1,075	1,022	1,126	1,126
Nontax revenue 3/	1,409	1,761	1,700	2,534	2,488	2,837	2,767
Expenditure 4/	24,339	29,037	32,542	34,087	33,400	35,550	35,518
Current expenditure	21,860	25,944	29,318	30,877	30,664	31,993	32,507
Expenditure on goods and services 5/	14,682	17,740	19,950	21,065	20,775	21,542	21,912
Wages and salaries 6/	5,308	6,775	8,149	8,421	8,604	8,967	8,967
Other goods and services	9,356	10,964	11,801	12,644	12,171	12,575	12,945
Current transfers and subsidies	6,885	7,865	9,059	9,450	9,594	10,071	10,215
Subsidies	196	311	356	277	682	840	840
Transfers to households	6,689	7,554	8,703	9,173	8,913	9,231	9,375
of which: Pensions	4,628	5,200	6,425	6,541	6,445	6,788	6,898
Interest payments	293	339	309	362	295	380	380
Capital expenditure	2,479	3,093	3,225	3,210	2,736	3,557	3,011
Financial surplus (+) / deficit (-)	1,146	-150	-3,459	-1,222	-704	-255	-255
Net lending (-) 7/	264	-77	-81	223	406	255	255
Overall surplus (+) / deficit (-)	1,410	-227	-3,540	-999	-298	0	0
Borrowing requirement	-1,410	227	3,540	999	298	0	0
Domestic financing (net)	-753	669	1,171	297	71	-319	-319
Credit from domestic banks	80	-141	224	...	96	...	...
Change in deposits with domestic banks (-, increase)	-990	1,017	625	...	-997	...	...
Other domestic financing	157	-207	322	...	972	...	...
Change in government deposits held abroad (-, increase)	-700	-524	-771	422	548	...	...
Foreign financing (net)	43	82	117	280	-321	319	319
Privatization proceeds 8/	...	...	3,023	0	0	...	...
<i>Memorandum items:</i>							
Primary fiscal balance (+, surplus)	1,703	113	-3,231	-637	-4	380	380
Balance in government deposits held abroad	700	1,224	1,995	1,573	1,447	...	...
Total general government debt							
Excluding government assets held abroad	4,869	4,714	5,503	...	5,278	...	...
Including government assets held abroad	4,169	3,490	3,508	...	3,831	...	...
National defense expenditure	733	821	1,048	...	1,350	...	1,652

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

1/ Starting from 2000, Estonia introduced a new corporate income tax in which profits retained within an Estonian company are not taxed. Profits are instead taxed at the point of distribution (whether in the form of dividends, fringe benefits, or certain other payments) outside the Estonian corporate sector. Figures for 2000 include some tax receipts on 1999 profits.

2/ Baseline projection for 2001 includes EEK 100 million shortfall in VAT receipts due to postponement of increase in VAT rate on heating oil.

3/ From 2000, includes spending agencies own revenue.

4/ From 2000, includes outlays financed from spending agencies own resources.

5/ For 2001, includes higher budgetary spending by the City of Tallinn

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

7/ Net lending includes EEK 303 million recovery of deposits from Maapank and EVEA bank.

Overall deficit excluding deposit recovery was EEK 601 million.

8/ Used for financing the general government deficit.

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

	1997	1998	1999	2000		2001	
	Year Actual	Year Actual	Year Actual	Year EBS/00/237	Year Prel Act	Year Budget	Year Baseline
Revenue	39.6	39.4	38.6	39.8	38.7	38.4	38.4
Tax revenue	37.4	37.0	36.4	36.7	35.8	35.3	35.4
Direct taxes	22.5	23.6	23.3	22.4	21.6	21.2	21.1
Corporate profits tax 1/	1.9	2.6	2.2	1.0	1.0	0.6	0.6
Personal income tax	8.1	8.5	8.7	8.5	7.8	7.9	7.7
Social security tax	7.2	7.2	7.3	7.6	7.5	7.4	7.5
Medical insurance tax	4.8	4.9	4.7	4.9	4.9	4.8	4.9
Land tax	0.5	0.6	0.4	0.4	0.4	0.4	0.4
VAT 2/	10.4	8.7	8.5	9.4	9.7	9.2	9.5
Excises	3.7	3.8	3.6	3.6	3.3	3.7	3.6
Other taxes (incl. on intern. trade)	0.8	0.8	1.0	1.3	1.2	1.2	1.2
Nontax revenue 3/	2.2	2.4	2.3	3.1	2.9	3.1	3.0
Expenditure 4/	37.8	39.6	43.2	41.2	39.6	38.7	38.7
Current expenditure	34.0	35.4	38.9	37.3	36.3	34.8	35.4
Expenditure on goods and services 5/	22.8	24.2	26.5	25.5	24.6	23.4	23.9
Wages and salaries 6/	8.3	9.2	10.8	10.2	10.2	9.8	9.8
Other goods and services	14.6	15.0	15.7	15.3	14.4	13.7	14.1
Current transfers and subsidies	10.7	10.7	12.0	11.4	11.4	11.0	11.1
Subsidies	0.3	0.4	0.5	0.3	0.8	0.9	0.9
Transfers to households	10.4	10.3	11.6	11.1	10.6	10.0	10.2
of which: Pensions	7.2	7.1	8.5	7.9	7.6	7.4	7.5
Interest payments	0.5	0.5	0.4	0.4	0.3	0.4	0.4
Capital expenditure	3.9	4.2	4.3	3.9	3.2	3.9	3.3
Financial surplus (+) / deficit (-)	1.8	-0.2	-4.6	-1.5	-0.8	-0.3	-0.3
Net lending (-) 7/	0.4	-0.1	-0.1	0.3	0.5	0.3	0.3
Overall surplus (+) / deficit (-)	2.2	-0.3	-4.7	-1.2	-0.4	0.0	0.0
Borrowing requirement	-2.2	0.3	4.7	1.2	0.4	0.0	0.0
Domestic financing (net)	-1.2	0.9	1.6	0.4	0.1	-0.4	-0.4
Credit from domestic banks	0.1	-0.2	0.3	...	0.1	...	...
Change in deposits with domestic banks (-, increase)	-1.5	1.4	0.8	...	-1.2	...	...
Other domestic financing	0.2	-0.3	0.4	...	1.2	...	...
Change in government deposits held abroad (-, increase)	-1.1	-0.7	-1.0	0.5	0.6	...	...
Foreign financing (net)	0.1	0.1	0.2	0.3	-0.4	0.4	0.4
Privatization proceeds 8/	...	...	4.0	0.0	0.0	...	...
<i>Memorandum items:</i>							
Primary fiscal balance (+, surplus)	2.6	0.2	-4.3	-0.8	0.0	0.4	0.4
Balance in government deposits held abroad	1.1	1.7	2.6	1.9	1.7	...	...
Total general government debt							
Excluding government assets held abroad	7.6	6.4	7.3	...	6.3	...	...
Including government assets held abroad	6.5	4.8	4.7	...	4.5	...	...
National defense expenditure	1.1	1.1	1.4	...	1.6	...	1.8
GDP (in million of kroons)	64,324	73,325	75,297	82,677	84,382	91,870	91,780

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

1/ Starting from 2000, Estonia introduced a new corporate income tax in which profits retained within an Estonian company are not taxed. Profits are instead taxed at the point of distribution (whether in the form of dividends, fringe benefits, or certain other payments) outside the Estonian corporate sector. Figures for 2000 include some tax receipts on 1999 profits.

2/ Baseline projection for 2001 includes EEK 100 million shortfall in VAT receipts due to postponement of increase in VAT rate on heating oil.

3/ From 2000, includes spending agencies own revenue.

4/ From 2000, includes outlays financed from spending agencies own resources.

5/ For 2001, includes higher budgetary spending by the City of Tallinn

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

7/ Net lending includes EEK 303 million recovery of deposits from Maapank and EVEA bank.

Overall deficit excluding deposit recovery was 0.7 percent of GDP.

8/ Used for financing the general government deficit.

Table 4. Estonia Banking Survey and Monetary Authorities: 1997-2001 1/
(in millions of EEK, unless otherwise indicated)

	1997	1998	1999	2000	2001 Mar.
Banking Survey					
Net foreign assets	5,083	5,112	8,022	9,098	9,939
Net foreign assets (BOE)	10,096	10,493	12,932	15,167	12,852
Foreign assets 2/ 3/	10,901	10,909	13,334	15,540	13,161
Foreign liabilities	-805	-415	-402	-373	-309
Net foreign assets (commercial banks)	-5,013	-5,381	-4,910	-6,068	-2,913
Foreign assets	8,078	6,481	8,772	10,359	14,299
Foreign liabilities	-13,090	-11,862	-13,682	-16,427	-17,213
Net domestic assets	15,383	16,216	18,368	24,064	25,163
Domestic credit	20,797	24,223	26,542	33,758	35,321
Net credit to general government	-1,716	-930	-197	-1,078	-951
Credit to government (banks)	1,108	955	1,172	1,268	1,243
Government deposits (banks)	-2,473	-1,882	-1,345	-2,343	-2,188
Net credit to government (BOE)	4	3	3	3	3
Government deposits (BOE)	-355	-6	-27	-7	-8
Credit to nongovernment	22,512	25,153	26,739	34,837	36,271
Credit to nonfinancial public enterprises	329	226	372	263	233
Credit to private sector	16,953	18,590	19,877	22,203	22,583
Credit to enterprises	12,812	14,369	14,571	15,376	15,564
Credit to households	4,141	4,221	5,306	6,827	7,019
Credit to nonbank financial institutions	5,231	6,337	6,489	12,370	13,455
Other items (net)	-5,414	-8,007	-8,174	-9,695	-10,157
Broad money	20,466	21,328	26,390	33,162	35,102
M1	13,998	13,120	17,336	20,869	20,623
Currency outside banks	4,588	4,539	5,711	6,201	6,101
Demand deposits	9,410	8,581	11,624	14,668	14,522
Time and savings deposits	6,468	8,208	9,054	12,293	14,479
Monetary Authorities					
Net foreign assets	10,096	10,493	12,932	15,167	12,852
Foreign assets 2/ 3/	10,901	10,909	13,334	15,540	13,161
of which: currency board cover 4/	8,527	9,070	11,526	13,207	10,536
Foreign liabilities	-805	-415	-402	-373	-309
Net domestic assets	-1,569	-1,423	-1,406	-1,960	-2,316
Net claims on Government	-351	-3	-24	-4	-5
Claims on financial institutions	186	281	268	10	11
Claims on private sector	44	57	66	70	70
Other	-1,448	-1,758	-1,716	-2,035	-2,391
Base money	8,527	9,070	11,526	13,207	10,536
Currency issue	5,439	5,391	6,649	7,277	6,916
Deposits of commercial banks	3,035	3,676	4,824	5,718	3,363
of which: required reserves 5/	2,000	2,675	2,734	4,634	4,966
Other deposits at BOE	53	4	54	211	257
Memorandum items:					
Base money multiplier	2.40	2.35	2.29	2.51	3.33
Currency-to-deposit ratio	0.29	0.27	0.28	0.23	0.21
Bank reserves-to-deposit ratio	0.25	0.27	0.28	0.25	0.15
Velocity (period average)	3.54	3.39	3.15	2.80	...
Gross international reserves (in millions of US\$) 2/	759	813	851	992	705
Net international reserves (in millions of DM) 6/	207	224	217	271	311
Government balances held abroad 7/	700	1,224	1,995	1,447	...
(percentage change from same period in preceding year)					
Net foreign assets of banking system	-24.4	0.6	56.9	13.4	13.5
Net domestic assets of banking system	89.2	5.4	13.3	31.0	33.3
Credit of banking system to non-government	79.0	11.7	6.3	30.3	32.5
Credit to the private sector	67.3	9.7	6.9	11.7	13.2
Credit to nonbank financial institutions	144.5	21.1	2.4	90.6	89.4
Broad money	37.8	4.2	23.7	25.7	27.0
M1	24.0	-6.3	32.1	20.4	18.2
Base money	37.7	6.4	27.1	14.6	4.0

Source: Bank of Estonia and Fund staff estimates

1/ The monetary authorities' accounts and the monetary survey have been revised, following the recommendations of the 1999 STA mission on money and banking statistics. The main changes affect the monthly revaluation of the monetary authorities' gold, the coverage of government entities and depository institutions, and the inclusion of financial derivatives in the balance sheet of commercial banks.

2/ Excludes foreign assets of the central government's 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.

4/ 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).

5/ Requirement to be met on the basis of daily average of deposits over month. Up to June 2000, it includes liquidity requirement equivalent to 3 percent of the reserve requirement base (imposed since December 1997). After June 2000, the liquidity requirement was incorporated in the reserve requirement. Starting in January 2001, 3 percentage points of the 13 percent reserve requirement can be met with high quality euro-denominated foreign instruments.

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

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

Table 5. Estonia: Selected Financial Indicators, 1997-2000

	1997	1998	1999	2000
Banking sector reserves	21.2	24.2	28.1	23.2
Cash	4.6	4.6	4.5	3.7
Reserves held at the BoE 1/ of which: Required reserves	16.6	19.6	23.4	19.6
of which: Required reserves	11.7	14.3	13.3	15.9
Average risk-weighted capital adequacy ratio 2/	13.5	17.0	16.1	13.2
Non-performing loans (in percent of total loans) 3/	1.2	1.4	1.7	1.0
Leverage ratio 4/	7.1	4.8	5.2	6.6
NFA of commercial banks	-5,013	-5,381	-4,910	-6,068
Net open foreign exchange position of banks 5/ In percent of total assets	-1,930	3,562	7,335	7,985
of which: net foreign currency assets 6/ net forward contracts 7/	-5	9	16	14
of which: net foreign currency assets 6/ net forward contracts 7/	1,640	6,926	8,672	9,751
of which: net forward contracts 7/	-3,570	-3,363	246	538
Banking sector's net external obligations maturing within 30 days 8/	731	255	-651	2,102
Net international reserves of BoE 9/	1,658	1,786	1,737	2,165
Interest spread (in percent per annum) 10/ Domestic currency short-term	7.6	8.6	5.5	3.2
Foreign currency (DEM) short term	5.7	4.6	6.9	5.7
Domestic credit to non-government (annual growth, in percent)	79.0	11.7	6.3	30.3

Source: Bank of Estonia.

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

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

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

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

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

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

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

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

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

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

Table 6. Estonia: Summary Balance of Payments 1997-2006
(in millions of DM)

	1997	1998	1999	2000		2001	2002	2003	2004	2005	2006
				Prog.	Prel.							Staff Projections
Current Account	-977	-844	-542	-668	-714	-834	-843	-879	-948	-1,021	-1,108
Trade Balance	-1,957	-1,965	-1,617	-1,921	-1,687	-1,999	-2,082	-2,218	-2,384	-2,555	-2,752
Exports	3,984	4,723	4,505	6,486	7,002	7,891	8,327	8,891	9,471	10,071	10,709
Of which: goods for processing	990	1,410	1,430	...	2,967	...	...	...	...	...	...
Imports	-5,941	-6,688	-6,122	-8,407	-8,689	-9,890	-10,409	-11,109	-11,855	-12,626	-13,461
Of which: goods for processing	-880	-1,218	-1,322	...	-2,688	...	...	...	...	...	...
Services Balance	1,029	1,006	1,057	1,270	1,235	1,370	1,452	1,551	1,648	1,747	1,850
Receipts	2,296	2,601	2,744	3,331	3,174	3,578	3,775	4,031	4,294	4,566	4,855
of which: travel and tourism	826	947	1,013	...	1,073	...	...	...	...	...	...
Payments	-1,267	-1,594	-1,687	-2,061	-1,940	-2,208	-2,324	-2,480	-2,646	-2,819	-3,005
Income	-251	-146	-188	-263	-467	-500	-513	-525	-538	-550	-563
Current Transfers	203	260	207	246	205	296	300	313	325	338	356
Capital and Financial Account 1/	1,369	859	843	724	953	807	978	1,051	1,157	1,280	1,358
Capital Transfers	0	3	2	35	35	40	60	80	100	150	150
Financial Account	1,369	856	841	689	918	767	918	971	1,057	1,130	1,208
Direct Investment	223	999	401	531	518	500	563	588	613	638	663
From abroad	462	1,009	556	...	851	...	...	...	...	...	...
Outward (by Estonians)	-239	-10	-155	...	-333	...	...	...	...	...	...
Net equity investment	66	113	435	86	-62	75	125	125	125	125	125
Loans and other investments 2/	1,081	-256	5	72	463	192	231	259	319	368	420
Of which:											
Banks	797	37	11	...	307	...	...	...	...	...	...
Government	-79	-103	-60	24	24	...	...	...	...	...	...
Monetary Authorities	-38	-38	35	...	-15	...	...	...	...	...	...
Errors and Omissions	-46	1	-28	79	45	0	0	0	0	0	0
Overall balance 3/	346	16	273	135	284	-26	135	172	208	260	249
<i>Memorandum Items:</i>											
DM/US\$ exchange rate (period average)	1.73	1.76	1.83	...	2.12	...	...	...	...	...	...
Gross International Reserves (DM millions) 4/ 5/ 6/	1,363	1,364	1,667	1,791	1,942	1,916	2,051	2,222	2,431	2,690	2,939
In months of imports (excluding imports of goods for processing)	3.2	3.0	4.2	...	3.9	...	...	...	...	...	...
Relative to gross short-term debt (ratio) 7/ 8/	0.9	0.9	0.9	1.0	0.8	...	...	...	...	...	...
Trade Balance/GDP (in percent)	-24.3	-21.4	-17.2	-18.6	-16.0	-17.4	-16.8	-16.5	-16.3	-16.2	-16.1
Goods and Non-factor Services balance/GDP (in percent)	-11.5	-10.5	-6.0	...	-4.3	-5.5	-5.1	-5.0	-5.0	-5.1	-5.3
Current Account/GDP (in percent)	-12.1	-9.2	-5.8	-6.5	-6.8	-7.3	-6.8	-6.5	-6.5	-6.5	-6.5
Total external debt/GDP (in percent) 9/											
Gross 10/	57.1	53.5	59.4	...	60.5	...	...	...	...	...	...
Net 11/	16.3	15.0	15.4	...	17.2	17.9	17.1	16.3	15.8	15.2	15.1
General government external debt/GDP (in percent) 12/											
Excluding Govt. assets held abroad	4.3	4.3	4.9	5.0	4.1	...	...	...	...	...	...
Including Govt. assets held abroad	3.2	2.6	2.3	2.8	2.3	...	...	...	...	...	...
Debt Service/Exports of GNFS (in percent)	8.1	8.2	7.4	7.0	6.8	...	...	...	...	...	...

Sources: Bank of Estonia and Fund staff estimates.

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

2/ Includes operations in debt securities.

3/ The overall balance in 2001 is expected to turn negative as a result of the changes in the reserve requirements of commercial banks.

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

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

6/ 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.

7/ Includes trade credits.

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

9/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.

10/ Based on a wider definition of gross external debt than previously reported. Were it not for the change in definition of external debt, the gross debt to GDP ratio would have declined in 2000.

11/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.

12/ Includes government guaranteed debt.

Table 7. Estonia: Indicators of External Vulnerability, 1997-2001
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	
					Latest	Date
Financial indicators						
Public sector debt 1/	7.6	6.4	7.3	6.3	...	...
Broad money (percent change, 12-month basis)	37.8	4.2	23.7	25.7	27.0	3/31/01
M1 (percentage change, 12-month basis)	24.0	-6.3	32.1	20.4	18.2	3/31/01
Private sector credit (percent change, 12 month basis)	79.0	11.7	6.3	30.3	32.5	3/31/01
External Indicators						
Exports (percent change, 12-month basis in DM)	42.8	16.6	-1.0	40.4	...	...
Imports (percent change, 12-month basis in DM)	39.9	14.9	-5.7	36.1	...	...
Current account balance	-12.1	-9.2	-5.8	-6.8	...	...
Capital and financial account balance	17.0	9.4	9.0	9.0	...	...
<i>of which:</i> Inward portfolio investment (debt securities etc.)	9.3	0.1	2.7	1.5	...	...
Other investment (loans, trade credits etc.)	13.4	-2.8	0.0	4.4	...	...
Inward foreign direct investment	5.7	11.0	5.9	8.1	...	...
in the form of debt or loans	3.8	2.5	2.8	4.4	...	...
Gross official reserves (in DM millions) 2/	1,363	1,364	1,667	1,942	1,757	3/31/01
NFA of the consolidated banking system (in DM millions)	635	639	1,003	1,137	1,242	3/31/01
Central Bank short-term foreign liabilities (in DM millions)	0.5	0.1	0.3	6.2	0.3	3/31/01
Short term foreign assets of the financial sector (in DM millions) 3/	737	605	825	971	...	...
Short term foreign liabilities of the financial sector (in DM millions)	1,677	949	1,338	1,699	...	...
Foreign currency exposure of the financial sector (in DM millions)	-241	445	917	998	1,454	3/31/01
Official reserves in months of imports (excluding imports of goods for processing)	3.2	3.0	4.2	3.9	...	...
Broad money to reserves	1.9	1.9	2.1	2.0	2.9	3/31/01
Total short term external debt to reserves 4/	0.9	0.9	0.9	0.8	...	...
Total external debt 5/ 6/	57.1	53.5	59.4	60.5	...	...
<i>of which:</i> Public sector debt 1/	4.3	4.3	4.9	4.1	...	...
Net external debt 7/	16.3	15.0	15.4	17.2	...	...
Debt service to exports of GNFS	8.1	8.2	7.4	6.8	...	...
External interest payments to exports of GNFS	1.7	2.5	2.2	1.9	...	...
External amortization payments to exports of GNFS	6.4	5.7	5.2	5.0	...	...
Exchange rate (per US\$, period average)	13.9	14.1	14.7	17.0	18.0	Apr 2001
REER appreciation (-) (12 month basis)	3.3	23.2	-2.8	-5.5	-1.6	Mar 2001
Financial Market Indicators						
Stock market index 8/	265.4	90.7	125.5	138.2	144.4	5/22/01
Foreign currency debt rating 9/	BBB+	BBB+	BBB+	BBB+	BBB+	5/22/01
Spread of benchmark bonds (basis points, end of period) 10/	10.5	13.5	0.7	0.4	0.1	4/27/01

Source: National authorities, Bloomberg, Standard & Poor's, and staff estimates.

1/ Excluding government assets held abroad.

2/ The decline in the first quarter of 2001 reflects the shift of NFA from the central bank to commercial banks following the change in reserve requirements on January 1, 2001.

3/ Excluding reserve assets of the Bank of Estonia.

4/ By original maturity.

5/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.

6/ Based on a wider definition of gross external debt than previously reported. Were it not for the change in definition of external debt, the gross debt to GDP ratio would have declined in 2000.

7/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.

8/ Tallinn stock exchange index (TALSE).

9/ Standard & Poor's long-term foreign exchange sovereign rating.

10/ One-month spread between Tallinn interbank borrowing rate (TALSE) and the corresponding EURIBOR rate.

Table 8. Estonia: Macroeconomic Framework, 1997-2006
(in percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Domestic saving	18.7	20.2	18.8	17.3	17.3	18.1	18.4	18.6	18.8	19.1
Private 1/	12.6	16.3	19.2	14.4	14.0	15.0	15.0	15.0	15.0	15.0
Public	6.1	3.9	-0.4	2.9	3.3	3.1	3.4	3.6	3.8	4.1
Investment	30.9	29.4	24.5	24.1	24.6	24.9	24.9	25.1	25.3	25.6
Private	26.9	25.2	20.3	20.8	21.3	21.1	21.0	21.1	21.3	21.5
Public	3.9	4.2	4.3	3.2	3.3	3.8	3.9	4.0	4.0	4.1
Foreign saving	12.1	9.2	5.8	6.8	7.3	6.8	6.5	6.5	6.5	6.5
<i>Memorandum items:</i>										
Fiscal balance 2/	2.2	-0.3	-4.7	-0.4	0.0	-0.7	-0.5	-0.4	-0.2	0.0
Revenues	39.6	39.4	38.6	38.7	38.4	38.1	38.2	38.3	38.5	38.6
Expenditures 3/	37.8	39.6	43.2	39.1	38.4	38.8	38.7	38.7	38.7	38.6
Net non-debt creating capital inflows	3.6	12.1	8.9	4.3	5.0	5.5	5.3	5.1	4.8	4.6
Net equity investment	0.8	1.2	4.6	-0.6	0.7	1.0	0.9	0.9	0.8	0.7
Net foreign direct investment	2.8	10.9	4.3	4.9	4.4	4.5	4.4	4.2	4.0	3.9
GDP real growth (year-on-year in percent)	10.6	4.7	-1.1	6.4	5.0	5.5	5.5	5.5	5.5	5.5
CPI inflation (average, year-on-year in percent)	11.2	8.1	3.3	4.0	5.0	2.8	3.5	3.5	3.5	3.5
CPI inflation (end-period, in percent)	12.5	4.2	3.8	5.0	3.3	3.5	3.5	3.5	3.5	3.5
GDP (millions of kroons)	64,324	73,325	75,297	84,382	91,780	99,442	107,744	116,739	126,485	137,044

Sources: Estonian authorities, and Fund staff estimates.

1/ The increase in private savings from 2002 onward reflects the estimated impact of the pension reform.

2/ Includes the impact of the pension reform.

3/ Includes net lending.

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

	March 31, 2000		June 30, 2000		September 30, 2000		December 31, 2000		March 31, 2001		June 30, 2001
	Program Outcome		Program Outcome		Program Outcome		Program Outcome		Program Outcome		Program Outcome
	(In millions of EEK)										
I. Limit on general government deficit (cumulative from January 1, 2000)	410	167	700	695	750	271	1000	298 3/	1100	238	1250
	(In millions of deutsche mark)										
II. Minimum levels of net international reserves of the Bank of Estonia (January 1, 2000 through June 30, 2001) 2/	200	223	200	217	218	256	213	267	213	311	200
	(In millions of U.S. dollars)										
III. Ceilings on external short-, medium-, and long-term debt of general government 4/											
Maturity of 0-2 years	0.0	0.0	0.0	0.0	0.0	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	250.0	53.5	300.0	53.5	300.0
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	30.0	11.7	30.0	11.7	30.0
IV. The government will not accumulate any payments arrears during the period of the arrangement	Observed		Observed		Observed		Observed		Observed		
V. The currency board is fully backed with foreign exchange at all times	Observed		Observed		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 and end-December 2000, and end-March 2001, were adjusted for the net proceeds of the sale of Optiva bank, as specified in EBS/00/18.

3/ This includes EEK304 million in deposits recovered from failed commercial banks in December 2000. Excluding this one-off recovery, the deficit would have been EEK601.6 million. The authorities' commitment expressed in EBS/00/237 (page 32) to overperform by the amount of the recovered deposits has been fully met.

4/ 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.

Table 2. Estonia: Structural Performance Criterion and Benchmarks, April 30, 2001

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	Done
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	Done

PENSION SYSTEM REFORM

Estonia inherited a traditional, pay-as-you-go (PAYG), defined-benefit pension scheme from the Soviet Union. Soon after independence in 1991, the PAYG system faced financial pressures, reflecting a low retirement age, lax eligibility requirements, weak compliance in the payment of social security contributions, and the initial impact of an aging population. Estonia's demographic dependency ratio—i.e., number of people over the pension age relative to labor force—is expected to worsen considerably after 2010, leaving a window of opportunity for reform.

In response, the government adopted a two-pronged reform strategy. First, reforms of the PAYG system were introduced to reduce its size and enhance its efficiency. Steps included: (i) tightening eligibility requirements for early retirement and disability pensions; (ii) raising the different retirement ages gradually to 63 years, which will be reached for men in 2001 and for women in 2016; (iii) introducing an earnings-related component for benefits of new retirees, so as to establish a link between contributions and benefits; and (iv) indexing pensions under the PAYG system to the average of CPI inflation and the growth in social security contributions as of 2002. The indexation formula ensures that the pension system's capacity to pay is taken into account.

Second, a comprehensive reform was launched in 1997 based on a three-pillar pension system model. The reform aims at supplementing the PAYG system (first pillar) with a privately-managed, fully-funded second pillar and an optional, tax-advantaged, fully-funded third pillar. Contributions to the second and third pillars would be deposited into individual retirement accounts. These accounts would be the property of the individual, who would decide—subject to regulation—how, and by whom, these accounts would be managed. The pension benefits would be determined by the amount of contributions in these accounts and the returns earned on them. The third pillar was established in August 1998, while the second pillar is expected to be in place by January 2002.

After intense political debate, the government introduced legislation in February 2001 to establish the second pillar. Participation would be mandatory for new entrants into the labor force and voluntary, but irreversible, for existing workers. The second pillar would be funded through the redirection of 4 percentage points of the current 20 percent payroll tax from the first pillar, together with an additional contribution by participants of 2 percentage points of wage income. Transitional shortfalls of an estimated $\frac{1}{2}$ to 1 percent of GDP in the first pillar are projected.¹ The indexation formula is likely to ensure that these shortfalls diminish over time and turn into surpluses over the medium term.

¹ For a more detailed discussion of the projections, see "Pension Reform in the Baltics: Issues and Prospects," IMF Occasional Paper No. 200 (2000). The current estimates are somewhat lower than the staff projections presented in the last Article IV staff report, as the government's proposal at that time called for participation to be mandatory for workers under 35 years of age.

The authorities do not regard the pension reform as a tool for promoting a domestic capital market and do not intend to regulate the portfolios of the investment funds except for prudential reasons. Specifically, funds would be free (and expected) to invest in foreign securities so as to diversify the risk to pensioners by making investment returns less dependent on the domestic economic and financial situation in Estonia.

LABOR MARKET DEVELOPMENTS AND PROSPECTS

Estonia inherited a rigid labor market from the Soviet Union, characterized by job security, hidden unemployment, and the predominance of the state sector.¹ The transition process was expected to result in a rapid rise in unemployment, as the privatization and restructuring of the state sector lead to significant labor shedding. Over time, however, unemployment was expected to decline again, as job creation in the private sector overtook job destruction in the state sector.

The experience of the Estonian labor market followed this pattern to some extent, but unemployment proved more persistent than expected. The unemployment rate mirrored the output decline closely, but with a lag, increasing from virtually zero in 1990 to 10 percent in 1996 (measured according to International Labor Office (ILO) standards). The slow improvement thereafter was interrupted by the Russia crisis in 1998. Unemployment peaked at 14.8 percent in the first quarter of 2000, before declining to 13.9 percent in the fourth quarter of 2000. Employment dropped by about a quarter (falling by more than a half in the state sector), primarily in the initial years of transition. At the same time, labor market participation also decreased, as the population declined, working was no longer compulsory, and individuals were discouraged in their attempts to find a job. The composition of employment shifted markedly from manufacturing to services.

The labor market in Estonia generally performed better than in comparable countries. In particular, in comparison to the other Baltic countries and Bulgaria (the other EU accession countries with pegged exchange rates), Estonia has had the lowest unemployment rate in every transition year for which comparable data is available. Estonia also established some of the most liberal labor market policies. There are few constraints on the ability of firms to hire and fire employees, unions have relatively minor roles, and minimum wages are fairly low (currently at about 30 percent of average gross wages). The unemployment allowance is very parsimonious (currently paid at a flat rate of about 10 percent of average gross wages). However, some disincentives for job search may still arise from local housing and heating benefits, high transport and moving costs, and informal employment. Estonia experienced relatively sharp real wage declines early on in transition, which helped the restructuring process. Nevertheless, the level of unemployment continues to remain high. The growing share of long-term unemployed suggests an increasing skill mismatch. There is the risk that long-term unemployed will lose their employment skills. The geographical concentration of unemployment also points to limited labor mobility, with the unemployment rate in two eastern regions exceeding 20 percent, double the rate of the capital.

Looking ahead, EU accession will have important implications for the Estonian labor market. While the EU internal market requires harmonization of a set of fundamental labor rights and

¹ For a full analysis of labor markets in the Baltics and Bulgaria, see "Labor Markets in Hard-Peg Accession Countries: The Baltics and Bulgaria," forthcoming.

working conditions, Estonia will need to resist pressures to move toward more rigid labor market policies. Excessive labor costs could harm the development of small- and medium-sized enterprises and inflate the informal economy. The extent to which reforms continue to generate growth, as well as the degree to which the economic gains are broadly shared among the population, will depend in part on the functioning of the labor market.

FISCAL TRANSPARENCY ROSC

The preliminary conclusions of the ROSC module on fiscal transparency were discussed with the authorities during the Article IV consultation.¹ Estonia has established a sound and transparent fiscal management system that meets many of the basic requirements of the Fund's Code of Good Practices on Fiscal Transparency: (i) roles and responsibilities within the public sector are, for the most part, clearly defined, and general government activity can generally be distinguished from the rest of the economy; (ii) the annual budget process is open. A traditional focus on financial compliance has now been complemented by a medium-term framework, covering the coming budget year plus a further three years. Fiscal targets are clearly specified in the government's fiscal strategy. More detailed medium-term macroeconomic and fiscal planning has been undertaken as part of the requirements for EU accession; (iii) a large amount of fiscal data covering central and general government operations and central government debt, as well as information including the budget strategy documents, economic forecasts, tax payer rights and compliance information, are readily and publicly available. Estonia is also advanced in its efforts to adopt accrual accounting.

Further efforts to enhance fiscal transparency are underway and should move Estonia substantially toward full compliance with the Code. The passage of a revised State Budget Law in 2001 will clarify the definition of general government, ensure full coverage of all budget and extrabudgetary activities, and improve budget classification. Fiscal transparency would best be further enhanced through efforts to: (i) improve the budget documentation by including more analysis of economic and fiscal risks to the budget, tax expenditures, and fiscal sustainability; (ii) define both the debt and asset management policies underlying the state budget, including through the development of a debt management framework that follows the Fund/Bank Debt Management Guidelines; (iii) improve the quality of fiscal reporting, especially with regard to the government's balance sheet; (iv) develop more detailed expenditure estimates beyond the coming budget year as a basis for more effective budget planning.

¹ For a more detailed discussion, see "Report on the Observance of Standards and Codes (ROSC), Fiscal Transparency Module," forthcoming.

FUND RELATIONS¹
(As of March 31, 2001)

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	78.76	120.8
Reserve position in Fund	0.01	0.0

III. SDR Department	SDR Million	Percent of Allocation
Holdings	0.00	N.A.

IV. Outstanding Purchases and Loans	SDR Million	Percent of Quota
Systemic Transformation	13.56	20.8

V. **Financial Arrangements²**

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	12/17/1997	3/16/1999	16.10	0.00
Stand-by	7/29/1996	8/28/1997	13.95	0.00
Stand-by	4/11/1995	7/10/1996	13.95	0.00

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

	Forthcoming				
	2001	2002	2003	2004	2005
Principal	2.9	3.9	3.9	1.9	1.0
Charges/interest	0.4	0.4	0.2	0.1	0.0
Total	3.3	4.3	4.1	2.0	1.0

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). Estonia has accepted the obligations of Article VIII, Sections 2, 3, and 4. Estonia maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. There are also no restrictions on capital transactions.

VIII. Article IV Consultations

The 2000 Article IV consultation was concluded by the Executive Board on June 30, 2000.

IX. Technical Assistance

Appendix V 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:
Fourth Amendment to Articles:

Passed in April 1999
Passed in April 1999

TECHNICAL ASSISTANCE FROM THE FUND, 1999-2001

Department	Subject/Identified Need	Action	Timing	Counterpart 1/
			1999	
MAE	Banking supervision	Resident advisor	August 98-99	BoE
MAE	Banking 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
MAE	Research	Staff visit(s)	Various	BoE
MAE	Banking supervision	Staff visit	December	BoE
			2001	
FAD	Tax policy	Mission	March	MoF
FAD	Fiscal transparency ROSC	Mission	April	BoE/MoF
STA	Data ROSC	Mission	May	BoE/MoF/Stat
MAE	FSAP/FSSA follow-up	Staff visit(s)	Forthcoming	BoE/MoF
MAE	Research	Staff visit(s)	Forthcoming	BoE

Source: International Monetary Fund.

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

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 June 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. In March 2000, the Board approved a Transport Sector Project (US\$25 million), focusing primarily on road improvements.
4. Bank lending has been limited in recent years and is likely to remain small. The Bank's local office in Tallinn was closed in 2000.

ESTONIA—STATISTICAL ISSUES

1. Estonia is a subscriber to the Special Data Dissemination Standard (SDDS). The Bank of Estonia (BoE) publishes a wide variety of data on the key variables for each of the four sectors—monetary, fiscal, real and external—on its website, with periodic updates.
2. More detailed data are available to Fund staff for purposes of program monitoring. The following is a summary of both the frequency and the timing of key data as made available to Fund staff:

A. Monetary Statistics

3. All monetary data are issued by the Bank of Estonia (BoE).¹
 - Monthly reporting of BoE balance sheet (base money and NIR) are available on the eighth day following the end of the month.²
 - Monthly broad money and its components are available from the BoE on the thirteenth banking day from the beginning of the month.²
 - Monthly interest rate updates on domestic and foreign currency transactions are available on the seventeenth banking day from the beginning of the month.²

B. Financial Statistics

4. All financial data are compiled by the Bank of Estonia (BoE) and are reported on a monthly basis:³
 - Commercial bank reserves data are available on the eleventh banking day from the beginning of the month.²
 - Commercial bank off-balance sheet data are available on the eighteenth banking day from the beginning of the month.²
 - Average capital adequacy ratios are available on the thirteenth banking day from the beginning of the month.²

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

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

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

- Nonperforming loans data are available on the seventeenth banking day from the beginning of the month.²
- Leverage ratios are available on the eighteenth banking day from the beginning of the month.
- Liquidity ratios are available on the eighteenth banking day from the beginning of the month.
- NFA of commercial banks is available on the eleventh banking day from the beginning of the month.²
- Net open foreign exchange positions are available on the eleventh banking day from the beginning of the month.
- Short-term external debt are available on the eighteenth banking day from the beginning of the month.

C. Balance of Payments Statistics

5. All balance of payments data are also compiled by the Bank of Estonia (BoE):
 - Daily exchange rate data are available with a one-working day lag.⁴
 - Monthly imports/exports data are available with a two-month lag.
 - Quarterly current account data is available with a one-quarter lag.⁴
 - Quarterly public and private external debt data is available with a one-quarter lag.⁴

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF).
 - Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government has started to report monthly data on a consolidated government basis in January 1999 (<http://www.fin.ee>).
 - Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag.

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

- Comprehensive annual data on central government and local government operations and debt are reported within three quarters from the end of the fiscal year for use in the *GFS Yearbook*.

E. National Accounts Statistics

- Data on GDP (quarterly, by semester, and annually) are currently being issued by the Statistical Office of Estonia (SOE) with a lag of four months after the end of the quarter. Flash estimates of aggregate GDP are available two months after the end of the quarter.⁵
- Monthly CPI inflation data are available seven days after the end of the accounting period, and are received directly from the SOE. Monthly PPI and Export Price Index data are available four weeks after the end of the accounting period.⁵
- Monthly indicators of output, i.e., retail trade, industrial output, industrial sales, are reported approximately six weeks to two months after the end of the accounting period.⁵

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

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

Estonia: Core Statistical Indicators

(As of May 21, 2001)

	Exchange Rates	Inter-national 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	4/30/01	4/30/01	4/30/01	4/30/01	4/30/01	4/01	4/01	03/01	Q4/00	3/01	Q4/00	Q4/00
Date received	5/8/01	5/8/01	5/8/01	5/8/01	5/21/01	5/8/01	5/8/01	5/8/01	3/19/01	4/30/01	4/30/01	3/27/00
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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2001 Article IV Consultation—Supplementary Information

Prepared by European II Department

Approved by Jorge Márquez-Ruarte and Mark Allen

June 22, 2001

1. This supplement provides information on economic developments since the Staff Report was issued (SM/01/161). In the staff's view, these developments do not call for changes in the staff appraisal.
2. GDP estimates for the first quarter of 2001 confirm the moderation of economic growth (to 5.1 percent (y-o-y) compared with 6 percent in the fourth quarter of 2000; the annualized seasonally adjusted increase over the previous quarter was 5.2 percent.¹) Coincident indicators suggest a further softening of growth in April-May 2001 because of weaker growth in Estonia's main export markets.
3. The CPI increase of 0.7 percent in May over April was higher than expected, largely reflecting the continued weakness of the euro, the feed-through of high fuel prices, and higher food prices. CPI increases are expected to moderate in the second half of 2001 as the effects of import price increases fade. In the staff's view, no policy response is called for.
4. The budget of the general government recorded a small surplus in the period January-April 2001. Both tax collection and expenditures were somewhat stronger than expected. While parliament has recently added some transport and agricultural subsidies to the 2001 budget and the City of Tallinn increased its borrowing plans, these amounts total only about 0.2 percent of GDP, and the staff continues to expect a broadly balanced budget outcome for 2001.
5. Balance of payments estimates for the first quarter of 2001 show a moderation of the growth of both exports and imports (GNFS) to 26 percent (y-o-y). There were very large net FDI inflows into the energy, communications, gas and water supply, and manufacturing sectors in the first quarter (14 percent of GDP), which more than financed the current account deficit of 7 percent of GDP. (The latter is consistent with the staff's projections for the year.)

¹ A breakdown by the components of GDP growth is not yet available. Also, the authorities have revised their estimate for GDP growth in 1999 from -1.1 percent to -0.7 percent, but have not yet released revisions to earlier years.

As explained already in SM/01/161, lower reserve requirements led to a shift in foreign assets from the Bank of Estonia to commercial banks; NFA of the banking system, however, rose substantially.

6. The current account deficit in 1999 was revised from 5.8 percent of GDP to 4.7 percent, and for 2000 from 6.8 percent of GDP to 6.4 percent. A revised balance of payments table is attached.
7. In April-May, there was a welcome slowdown in the growth of bank credit to leasing companies and the growth of M2 and M1 also moderated.
8. Parliament approved the unemployment insurance law along the lines described in SM/01/161, but recessed before completing the second reading of the organic budget law and passing the legislation for the second pillar of the pension system. Introduction of the latter is now expected to be delayed to June 2002.
9. The environmental chapter of the EU's *acquis communautaire* was provisionally closed in early June with agreement on transitional arrangements up to 2013.

Attachment

Table 1. Estonia: Summary Balance of Payments 1997-2001 1/
(in millions of DM)

	1997	1998	1999 Rev.	2000 Rev.	2001 Q1
Current Account	-977	-845	-451	-680	-183
Trade Balance	-1,957	-1,966	-1,512	-1,687	-385
Exports	3,981	4,723	4,624	7,002	2,018
<i>Of which: goods for processing</i>	990	1,410	1,450	2,967	970
Imports	-5,937	-6,689	-6,137	-8,688	-2,403
<i>Of which: goods for processing</i>	-887	-1,234	-1,315	-2,688	-863
Services Balance	1,029	1,006	1,043	1,149	238
Receipts	2,296	2,601	2,744	3,186	716
of which: travel and tourism	826	947	1,013	1,073	190
Payments	-1,267	-1,594	-1,701	-2,037	-478
Income	-251	-146	-188	-435	-120
Current Transfers	203	260	207	293	83
Capital and Financial Account	1,369	859	740	945	-137
Capital Transfers	0	3	2	35	2
Financial Account	1,369	856	737	910	-139
Direct Investment	223	999	401	700	374
From abroad	462	1,009	556	831	408
Outward (by Estonians)	-239	-10	-155	-130	-34
Net equity investment	66	113	435	-61	54
Loans and other investments	1,081	-256	-99	271	-567
<i>of which:</i>					
Banks	797	37	11	314	-451
Government	-79	-103	-60	24	5
Monetary Authorities	-38	-38	-25	-15	-12
Errors and Omissions	-46	2	-64	19	18
Overall balance	346	16	225	284	-301
<i>Memorandum Items:</i>					
DM/US\$ exchange rate (period average)	1.73	1.76	1.83	2.12	2.12
Gross International Reserves (DM millions)	1,363	1,364	1,667	1,942	1,645
In months of imports 2/	3.2	3.0	4.1	3.9	3.2
Relative to gross short-term debt (ratio) 3/ 4/	0.9	0.9	0.9	0.8	0.8
Trade Balance/GDP (in percent)	-24.3	-21.4	-15.9	-15.8	-14.7
Goods and Non-factor Services balance/GDP (in percent)	-11.5	-10.5	-4.9	-5.0	-5.6
Current Account/GDP (in percent)	-12.1	-9.2	-4.7	-6.4	-7.0
Debt Service/Exports of GNFS (in percent)	8.1	8.2	7.4	6.8	6.5

Sources: Bank of Estonia and Fund staff estimates.

1/ The balance of payments data for 1999 and 2000 were substantially revised in June 2001.

2/ Excluding imports of goods for processing.

3/ Includes trade credits.

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



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with the Republic of Estonia

On June 27, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Estonia.¹

Background

Estonia continues to be a strong performer among transition economies. Cautious macroeconomic policies and a vigorous structural reform effort have resulted in the almost complete transition to a market economy and have supported a solid growth performance. The cornerstones of the reform process have been the currency board arrangement, including the pegging of the exchange rate for the kroon to the deutsche mark (now effectively to the euro), early and full convertibility for current and capital account transactions, and the nearly-completed privatization program with reliance on strategic foreign investors.

The Estonian economy grew by 6.9 percent in 2000. The recovery was driven by the rapid growth of exports, especially in the electronics sector, and a robust expansion in private consumption in the second half of the year. Domestic investment also grew and there was a strong improvement in corporate profitability. Inflation increased moderately, mainly on account of higher import prices. Importantly, the economic recovery also led to a decline in unemployment from its peak in early 2000.

The government successfully implemented an impressive fiscal adjustment in 2000, which cut the budget deficit back to near balance. This was achieved mainly through a general wage and pension restraint (after large real increases in 1999) and a sizable compression in capital

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the June 27, 2001 Executive Board discussion based on the staff report.

spending by both central and local government. As a result, the size of the public sector in GDP was substantially reduced, reversing the trend in the previous three years. Public debt fell to just over 6 percent of GDP. Continuing the positive trend, the general government registered a small surplus in the first quarter of 2001.

The currency board continues to provide a transparent and credible framework for financial operations. Confidence in the currency board is strong and interest rate spreads against euro rates are at historic lows. Monetary and credit aggregates grew briskly in 2000 and in the first quarter of 2001 reflecting in part a further financial deepening. Starting in the second half of 2000, Estonian commercial banks have rapidly expanded their leasing operations in all three Baltic countries. Following the sale of Optiva bank in June 2000 and the buyout at end-2000 of the minority stake in the second largest bank, the banking system is now entirely in private hands and virtually all foreign-owned. The banking system has been strengthened through consolidation, improved management, and better supervision.

The current account deficit widened somewhat in 2000, as the economic recovery increased returns on foreign investment. However, the goods and non-factor service deficit (GNFS) remained about unchanged as a percentage of GDP. Subcontracting activity in the electronics sector was particularly strong, but other sectors, such as textiles and wood and furniture, also registered double digit growth. Foreign direct investment again financed most of the current account deficit. The overall balance of payments position strengthened substantially, with the Bank of Estonia adding more than \$120 million to its gross international reserves in 2000.

The government has recently submitted a pre-accession economic program to the European Commission (available on the website of the Estonian Ministry of Finance at http://www.fin.ee/majandus/estonia_pre_accession_economic_programme.pdf). The government envisages (i) fiscal policies that would balance the budget, excluding the transitional cost of the pension reform, and maintain a broadly stable tax burden over the medium term; (ii) the maintenance of the currency board and current exchange rate peg until the introduction of the euro; and (iii) the implementation of pension and health sector reforms, as well as large investments in the environment and transportation.

Executive Board Assessment

Executive Directors welcomed that the recovery had gained momentum in 2000, led by rapid export growth, and that unemployment was declining. Directors observed that the effective depreciation of the kroon, resulting from euro weakness, and the increase in oil prices had led to a modest increase in inflation, which would likely recede as these effects faded. The current account deficit had widened somewhat as a result of a sharp rise in profits accruing to foreign investors, but was again financed by non-debt creating capital flows.

Directors were of the view that appropriate economic policies, in particular, the successful implementation of the authorities' economic program, have contributed substantially to these favorable developments. They welcomed the impressive fiscal adjustment which has brought

the budget close to balance in 2000, and is consistent with Estonia's medium-term strategy of reversing the rising share of government in GDP.

Directors recognized that the currency board arrangement has underpinned the rapid recovery from recession and continues to provide a stable economic policy framework. It should remain a cornerstone of Estonia's economic strategy in the run-up to EU accession and the adoption of the euro.

Directors agreed that Estonia's medium-term economic prospects remain favorable, but that the short-term outlook could become clouded if the slowdown in the world economy proves sharper than currently expected. They noted that under the currency board arrangement, fiscal policy remains the primary macroeconomic policy instrument, and they endorsed the target of a balanced budget in 2001.

Looking forward, Directors supported the government's target of a broadly balanced budget for 2002 and the medium term. They acknowledged the budgetary pressures arising from, inter alia, additional EU accession-related spending. Directors emphasized the need to create room for such spending within a balanced budget envelope, while avoiding tax increases or real cuts in essential public spending programs. They agreed that financial support from the EU and continued economic growth, together with efficiency gains within the public sector, would most likely provide the necessary flexibility in this regard. Directors therefore welcomed the government's intention to rationalize the structure of local governments.

Directors welcomed the recent moderation of the growth of money and credit aggregates, but recommended caution before further reducing required reserves. Directors commended the substantial progress made in implementing the recommendations of the 2000 Financial Sector Assessment Program (FSAP) report. They welcomed the establishment of the Unified Financial Supervisory Agency, which would help address remaining weaknesses in the supervision of the nonbank financial sector.

Directors praised the substantial progress that has been made on implementing key structural reforms. They urged the early passage of the new budget law, which would further enhance fiscal transparency. Directors also welcomed the Report on Standards and Codes (ROSC) module on fiscal transparency and endorsed its conclusions.

Directors commended the maintenance of a very open trade and payments system and the creation of an attractive environment for foreign investors. They encouraged the authorities to move ahead with privatization of the remaining public enterprises.

Directors noted that, despite its recent decline, unemployment remains high. They welcomed Estonia's flexible labor market policies, which remain crucial under a currency board arrangement, and supported further steps to reduce unemployment, including through active labor market policies and a reorientation of the education system. Directors also welcomed recent pension reforms and the intention to strengthen further the social safety net. They were,

however, concerned that increased pension contributions and the proposed new unemployment insurance scheme will raise non-wage costs, which were already relatively high.

Directors commended the authorities on the high quality of statistical data and the transparency of public policy making, and they also welcomed the intention to again publish the Article IV report and the ROSC modules on fiscal transparency and data quality.

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

Republic of Estonia: Selected Economic Indicators

	1996	1997	1998	1999	2000
Real Economy					
	<i>Changes in percent</i>				
Real GDP 1/	4.0	10.4	5.0	-0.7	6.9
CPI (period average)	23.1	11.2	8.1	3.3	4.0
Unemployment rate (in percent) 2/	10.0	9.7	9.9	12.3	13.7
Domestic saving (in percent of GDP) 3/	18.6	18.7	20.2	19.7	18.0
Domestic investment (in percent of GDP) 3/	27.8	30.9	29.4	24.4	24.4
Public Finance					
	<i>In percent of GDP</i>				
General government balance	-1.5	2.2	-0.3	-4.6	-0.3
General government external debt					
Excluding government assets held abroad	5.2	4.3	4.3	4.9	4.0
Including government assets held abroad	5.2	3.2	2.6	2.2	2.3
Money and Credit					
	<i>Changes in percent</i>				
Base money	21.6	37.7	6.4	27.1	14.6
M1	37.6	24.0	-6.3	32.1	20.4
Broad money	36.8	37.8	4.2	23.7	25.7
Domestic credit to nongovernment	70.0	79.0	11.7	6.3	30.3
Balance of Payments					
	<i>In percent of GDP</i>				
Goods and non-factor services balance	-11.5	-11.6	-10.4	-4.9	-5.0
Current account balance	-9.2	-12.2	-9.2	-4.7	-6.4
Gross international reserves (in millions of deutsche mark)	995	1,363	1,364	1,667	1,942
Exchange Rate					
Exchange rate regime	Currency Board Arrangement				
Present	EEK 8 = DM 1				
Real effective exchange rate (1996=100) 3/	100.0	103.8	129.0	123.4	118.6

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

1/ Reflects revised GDP data published by the Estonian Statistical Office on June 29, 2001.

2/ Based on the definition of the International Labor Organization (ILO).

3/ Fund staff estimates pending a full revision of the GDP components by the Estonian authorities.

4/ Export-share weighted real exchange rate (CPI-based) against 15 major trading partners.

**Statement by Åke Törnqvist, Alternate Executive Director for the Republic of Estonia
June 27, 2001**

First of all, I would like to thank the staff for a very thorough report on the Estonian economic developments and a well-balanced assessment of the challenges facing the authorities. My authorities highly appreciate the extensive consultations with the staff during the year 2000 and the spring of 2001. My authorities have been strongly committed to the implementation of the program under the current stand-by arrangement which expires in August 2001. They have decided that Estonia will not seek a new arrangement, but they would like to maintain close collaboration with the staff, including on issues related to EU accession. My authorities would like to express their gratitude to the Fund staff, Management and the Executive Board for their support during Estonia's six consecutive arrangements with the Fund. The Fund's policy advice has been instrumental in helping the authorities making difficult but successful policy choices during the period of transition.

The time schedule for Estonia's accession negotiations with the European Union is tight and macroeconomic policy choices challenging. The years 2000 and 2001 mark a new phase in the economic policy dialogue between Estonia and the EU containing deeper and longer-term analysis and policy programming. The Pre-accession Economic Program, which the Estonian authorities have submitted to the European Commission, is a strategic document. It contains medium-term macroeconomic forecast and determines general quantitative objectives of the economic policy, policy instruments and structural reforms for the next four years. In addition, government statistics is by now almost in full compliance with the EU standards.

Economic developments and outlook

In the year 2000 it was fully confirmed that the Estonian economy had recovered from the downturn of 1998–1999. GDP growth, supported by healthy export demand and increasingly also by domestic consumption, reached 6.4 percent. The general government balance, which deteriorated sharply in 1999, improved significantly in 2000 and showed a surplus in the first quarter of 2001. Average inflation in 2000 was contained at 4 percent, but increasing external pressures on food and oil prices as well as continuous adjustment of prices of non-tradable services (including those of the utilities and electricity) have raised the 12-month inflation numbers considerably since the second half of 2000. The difference in inflation with the euro area remains around 3 percent in 2001, the Balassa-Samuelson effect being estimated at around 2 percentage points over the euro area average.

Estonia's trade and services balance in 2000 remained at a deficit of 5 percent of GDP. Due to high profitability of foreign direct investment, last year's negative investment income balance drove the current account deficit to 6.5 percent of GDP. However, half of this recorded investment income outflow was reinvested into the Estonian economy, allowing

the FDI inflow to reach 7.9 percent of GDP. Higher investment needs in 2001 for the renovation of privatized infrastructure and EU accession related investment projects are expected to widen the deficit for the current year. However, the better than expected current account position in the first quarter of 2001 lays a good foundation for keeping the deficit for the year below 8 percent. The deficit in trade and services is expected to be in the range of 5 to 7 percent.

Monetary conditions have been supportive of economic growth and the real sector financing through the domestic financial sector and directly from foreign direct investors or international capital markets has grown by 20 percent. Money and bank-financed domestic credit growth has been somewhat higher over the first months of 2001, 26 percent and 30 percent respectively. During the first half-year of 2001 money and credit aggregates have recorded smaller monthly increases and the annual growth rate is expected to reflect the decline in the coming months.

The Estonian authorities see the near term outlook as broadly favorable. Due to uncertainty in the global economic outlook the external demand is expected to slow down and growth expectations are slightly lower than the outcome of 2000. The authorities expect the Estonian economy to expand by 4.5 to 5.5 percent in the year 2001 and by 5.1 to 5.7 percent in 2002. Inflation is expected to cut back in the second half-year and remain on average in the range of 5.5 to 5.9 percent in 2001 and 3.5 to 4.2 percent in 2002.

As to the near term risks to the outlook, the authorities' broadly share the Staff's views. If a possible hard landing of the US economy results in a substantial slowdown in Europe, it will hurt a big part of Estonia's export demand. However, the potential impact of a US driven shock is estimated to be somewhat smaller by the authorities than by the Staff. The main differences seem to lie in the assumptions for European growth rates as well as the Euro exchange rate and different weights assigned to different export sectors and their contribution to the Estonian GDP. The Estonian authorities estimate that one percentage point of slowdown in GDP growth in Europe would result in 1 to 1.5 percentage points slowdown of Estonia's GDP.

Fiscal policy and structural issues

In 2000 government sector deficit amounted to 0.7 percent of GDP, excluding Maapank deposits recovery, compared to 4.6 percent in 1999. This remarkable decline in the deficit, a better outcome than required according to the performance criteria was achieved through a conservative policy in budgeting. In the 2000 central government budget nominal expenditures were kept close to their level of 1999.

The first quarter of 2001 shows the continuity in conservative fiscal policy as the revenues exceeded the expenditures 0.1 percent of GDP. The authorities expect to keep the general government budget roughly in balance although local governments' borrowing may in the end cause a minor deficit at the general government level. For 2002 the government aims at keeping general government revenues and expenditures balanced, allowing an

exception for costs related to the pension reform. The pension reform will result in a deficit of 0.5–1.0 percent of GDP a year in the medium term.

My authorities continue to give high priority to structural issues. The overhaul of the current pay-as-you-go (PAYG) pension system, health care and education framework, as well as the strengthening of public administration, are on the top of the authorities' reform agenda. In order to improve the quality and to increase the efficiency of public expenditure, priorities are established and a unified cost planning and assessment system is being introduced.

Monetary policy

My authorities continue to see the currency board arrangement (CBA) as the appropriate framework up to Estonia's accession to the EMU and the peg will be maintained at the current level. This of course rules out inflation or monetary targeting and lets the domestic monetary conditions depend entirely on capital mobility and integration with international financial markets. Nine years of experience under the CBA have demonstrated that it has brought substantial nominal and real convergence of the Estonian economy with that of the EU.

While the CBA remains intact, the operational reform foresees technical changes in the commercial banks' reserve requirement system but it does not alter the liquidity situation of the domestic financial sector. Implementation of the first stage, allowing banks as of January, 2001 to meet 25 percent of the reserve requirement by holding high quality euro-denominated foreign assets, has confirmed this approach. Starting from July 2001, the foreign assets component will be extended to 50 percent of the reserve requirement. The overriding objective of the operational framework reform is to enhance the efficiency of the system, facilitate cross-boarder liquidity management within the framework of the currency board regime, and reduce market distortions without lowering overall liquidity buffers. As a by-product, credit institutions investing part of their required reserves in the international markets will bring along a moderate reduction of the base money and of the gross reserves of the Bank of Estonia. It is important to stress that this reduction of base money and central bank reserves is of a purely technical nature.

Financial sector issues

In May 2000, the Parliament passed the legislation establishing the Unified Financial Supervisory Agency. This creates important synergy effects in financial market supervision of banking, securities and insurance activities. The new supervisory agency is scheduled to start operating as of January 1, 2002. Connected to the central bank and using its administrative support, the Agency will nevertheless conduct its mandatory tasks independently in compliance with the internationally recognized best practice in financial sector supervision.

Meanwhile, the institutional and operational weaknesses in the non-bank financial sector supervision have been addressed by the 2000 Insurance Activities Act and the draft Securities Market Law. The latter was submitted to the Parliament in April 2001 and is expected to be passed after the legislators' summer recess.

Due to the small size of the domestic financial market, Estonia's financial sector remains by nature comparatively concentrated. However, the authorities intend to minimize the potential risks stemming from this trend to the extent possible. In this respect, the planned merger of two major Swedish banks would have a strong impact on Estonia as these banks are strategic owners of two major Estonian financial institutions. In terms of the Competition Law, it would result in a new financial group that would have a dominant position in virtually all sub-sectors of the financial system. Against that background, the Estonian authorities have reiterated that all necessary measures will be taken to maintain the competitiveness on financial markets.

The Estonian financial sector is increasingly to be seen as part of the wider Scandinavian financial system. Apart from high Scandinavian ownership and an increasing number of Estonian kroon bond issues in the integrated market, the owner of Helsinki Stock Exchange HEX Group has acquired a majority holding in the Tallinn Stock Exchange and the first priority is to develop a common trading environment.

Finally, my Estonian authorities wish to reiterate their commitment to the highest standards of transparency and consent to the publication of the present Article IV staff report as well as the Reports on the Observance of Standards and Codes on fiscal transparency and data quality.