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Republic of Estonia: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for 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 2003 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 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **August 1, 2003,** 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 October 3, 2003.** 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 Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 22, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of Estonia.

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

Selected Issues and Statistical Appendix

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation
with the Republic of Estonia

Approved by Oleh Havrylyshyn and Liam P. Ebrill

October 3, 2003

- The discussions were held in Tallinn, July 21–August 1, 2003.
- The mission team consisted of Messrs. Haas (head), Schipke, Stavrev, Rasmussen, and Mr. Maliszewski (all EU2) and Ms. Immers (administrative assistant in EU2).
- The mission met with Prime Minister Parts, Governor Kraft of the Bank of Estonia, Minister of Finance Palts, Minister of Economy Atonen, Minister of Social Affairs Pomerants, and members of their staffs. The mission also met with commercial bankers and an export-oriented clothing manufacturer. On the way to Tallinn, Mr. Schipke and Mr. Rasmussen met with ECB and European Commission officials, respectively, to discuss EU accession and harmonization issues. Also, to explain the position of the staff to the public, the mission had substantial contact with the local electronic and print media.
- 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. Estonia does not maintain restrictions on capital transactions.
- Estonia's fourth precautionary stand-by arrangement (SBA) expired on August 31, 2001.
- The quality of data remains high. Estonia subscribes to the Fund's Special Data Dissemination Standard, and a wide variety of data are made freely available on a timely basis (Appendix III).
- Estonia demonstrates a high degree of transparency in public policy making and, since 1999, has published all its staff reports and ROSCs modules. The authorities have agreed to the publication of the 2003 Article IV staff report.
- It is proposed that Estonia remain on a standard 12-month consultation cycle.

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Estonia: Basic Data

Social and demographic indicators, 2003	
Area	45,227 sq. km.
Population	1.3642 million
Rate of population growth	-0.9 percent per year
Life expectancy at birth 1/	70.6 years
Male	65.1 years
Female	76.4 years
Infant mortality rate (per 1,000 births) 1/	11.0
Hospital beds (per 10,000 inhabitants) 1/	74
Physicians (per 10,000 inhabitants) 1/	30

	1998	1999	2000	2001	2002
Nominal GDP (in million of EEK)	73,538	76,327	87,379	97,895	108,024
GDP per capita (in US$)	3594	3,597	3,760	4,086	4,786
Real GDP (percentage change)	4.6	-0.6	7.3	6.5	6.0
Sectoral distribution of GDP	(In percent of value added)				
Agriculture, hunting, forestry, and fishing	7.2	6.7	6.1	5.7	5.4
Mining, manufacturing, and energy	22.6	21.1	22.5	22.5	22.8
Construction and services	70.2	72.2	71.4	71.8	71.9
Trade	(In millions of kroons, unless otherwise specified)				
Total exports of goods	37,786	36,995	56,346	58,667	58,100
(in percent of GDP)	51.4	48.5	64.5	59.9	53.8
Total imports of goods	53,512	49,092	69,490	72,451	76,324
(in percent of GDP)	72.8	64.3	79.5	74.0	70.7
General government	(In millions of kroons, unless otherwise specified)				
Total revenue	29,558	29,688	33,062	36,887	42,786
(in percent of GDP)	40.2	38.9	37.8	37.7	39.6
Total expenditure	29,710	33,187	33,968	36,548	41,634
(in percent of GDP)	40.4	43.5	38.9	37.3	38.5
Net lending	77	-14	-329	-63	-132
(in percent of GDP)	0.1	0.0	-0.4	-0.1	-0.1
Overall surplus / deficit(-)	-229	-3,485	-577	402	1,284
(in percent of GDP)	-0.3	-4.6	-0.7	0.4	1.2
Money and credit (end-period)	(In millions of kroons, unless otherwise specified)				
Net foreign assets	5,112	8,022	9,098	12,285	7,756
Broad money (M3)	21,328	26,390	33,162	40,803	45,374
Domestic credit	24,223	26,542	33,758	41,994	53,568
Claims on general government (net)	-930	-197	-1,078	-575	-834
Other selected indicators	(Annual percentage change)				
GDP at current prices	14.8	3.8	14.5	12.0	10.3
Average CPI	8.1	3.3	4.0	5.8	3.6
Average nominal wage (in EEK) 2/	14.7	10.6	10.5	12.3	10.9

Sources: Estonian authorities; and Fund staff estimates.

1/ Data for 2001.

2/ Annual average calculated as arithmetic mean of monthly average wages.

Executive Summary

On the basis of expected EU membership in May 2004, buoyant investment and consumption demand ensured strong economic growth despite continued sluggishness in Estonia's key trading partners. Real GDP grew by 6 percent in 2002 compared to 6.5 percent in 2001 facilitating a fall in unemployment. Inflation fell but would have exceeded the Maastricht criteria. Money and credit continued to grow strongly with a highly capitalized and profitable banking system. At the same time, the external position of the country weakened substantially, as the current account deficit increased to 12.3 percent in 2002 from 6 percent the year before. However, based on a number of indicators, Estonia remains competitive in export markets. Confidence in the currency board remains strong and the country's risk premium has fallen further.

Despite a positive outlook for 2003 and beyond, the authorities need to address the increased external vulnerability through appropriate and immediate policies. While staff projects the economy to grow by 4.5 percent in 2003, the current account deficit is projected to increase to 12.8 percent of GDP. The low level of public debt and the positive credit rating of the country ensure that the financing of the current account does not pose any difficulties in the very near term. However, continued current account deficits of the current magnitude are not sustainable in the long run and make the economy more vulnerable to external shocks. Given the confines of the currency board arrangements, the authorities need to tighten fiscal policies and target a fiscal surplus by letting the automatic stabilizers operate fully and by curtailing expenditure increases that were passed in a supplementary budget.

Staff also expressed concerns about the fiscal implications of the government's policy initiatives for 2004 and beyond. The combined impact of a scheduled income tax reform and an increase in parents' benefits is estimated to amount to 1.6 percent of GDP. Given the expenditure pressures associated with EU accession, these initiatives could undermine the government's balanced budget policy and further increase external vulnerability. To minimize the potential budget tensions in 2004 and beyond, the mission suggested a number of revenue-raising measures that would eliminate existing distortions such as the tax deductibility of mortgage interest payments and the tax exemption of interest income from bank deposits.

The next 2-3 years will be critical as Estonia prepares itself for EMU membership. The authorities' intention is to join ERM2 as soon as possible with a unilateral commitment to the currency board. This strategy seems appropriate since the exchange rate system has served the country well by providing a nominal anchor and contributing to macroeconomic stability. Furthermore, this strategy would avoid a double regime shift. To ensure that the conditions for an early adoption of the euro are in place, the authorities need to move forward with the remaining structural reforms and be willing to use fiscal policies resolutely to address macroeconomic imbalances.

I. Introduction

1. **The positive outcome of Estonia's national referendum on EU membership paves the way for EU accession on May 1, 2004 and solidifies the accomplishments of the country's rapid and successful transformation into an open and flexible market economy**. Estonia has been a star performer among EU accession countries.

Nominal Convergence

	Public deficit 1/		Public debt 1/		Inflation 2/		Interest rate 3/	
	1999-2002	2002	1999-2002	2002	1999-2002	2002	1999-2002	2002
Euro Area	**-1.3**	**-2.3**	**70.3**	**69.2**	**2.0**	**2.3**	**6.3**	**6.1**
Estonia	*-1.2*	*1.2*	*5.3*	*5.1*	*4.2*	*3.6*	*8.3*	*6.7*
Accession countries 4/	-3.8	-4.1	29.1	29.9	5.2	3.2	11.9	9.2
Czech Republic	-3.5	-4.2	17.3	19.5	3.1	1.8	7.3	6.2
Poland	-4.4	-6.3	41.3	45.7	6.2	1.9	16.9	12.2

Sources: IFS; and country authorities.

1/ In percent of GDP.
2/ Annual average.
3/ Long term lending rate.
4/ Unweighted average excluding Cyprus and Malta.

2. **In concluding the 2002 Article IV consultation on July 1, 2002, Directors encouraged the authorities to allow the automatic stabilizers to operate fully in the event of higher than expected growth to help limit the external current account deficit.** Furthermore, Directors agreed that the authorities should target a broadly balanced budget over the cycle. Directors cautioned that wage growth in excess of productivity gains would undermine Estonia's competitiveness and encouraged the authorities to monitor carefully credit to leasing companies, which now accounts for about one-third of credit to the private sector.

II. Recent Developments

3. **A new coalition government took office in April.** While all three coalition parties are generally fiscally conservative, election-related promises by the respective parties prompted the new government to announce policy initiatives that have substantial fiscal implications and could, potentially, undermine the macroeconomic stability of the country.

4. **Despite a further softening of demand conditions in Estonia's major export markets, economic developments continued to be very favorable (Figure 1).** Driven primarily by strong domestic investment and consumption demand, economic performance remained strong ; the economy grew by 6 percent in 2002 compared to 6.5 percent in 2001.[1] More recent preliminary data suggests that economic activity—driven by domestic demand— continued to be buoyant in the first half of 2003.[2] Labor market developments

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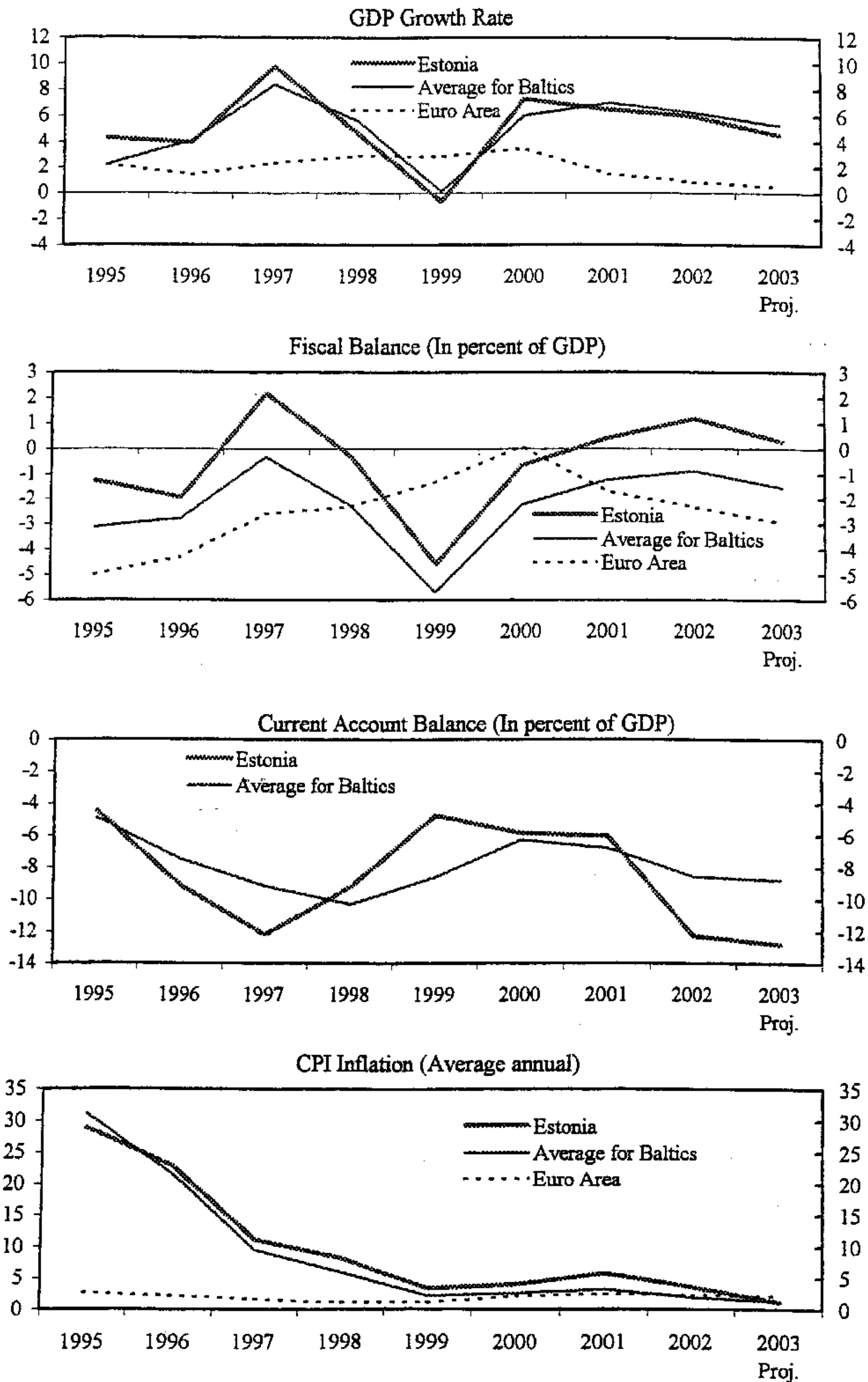
[1] The Statistical Office revised its historical real GDP series upward for the period 2000–2002.

[2] A recent recovery of the market for telecommunication equipment had a modest impact on manufacturing in Estonia through sub-contracting activities. However, sub-contracting is a relatively low-value-added activity with a high import content and its contribution to GDP growth and the current account deficit is limited.

Figure 1. Baltic Countries and Euro Area: Selected Economic Indicators, 1995-2003



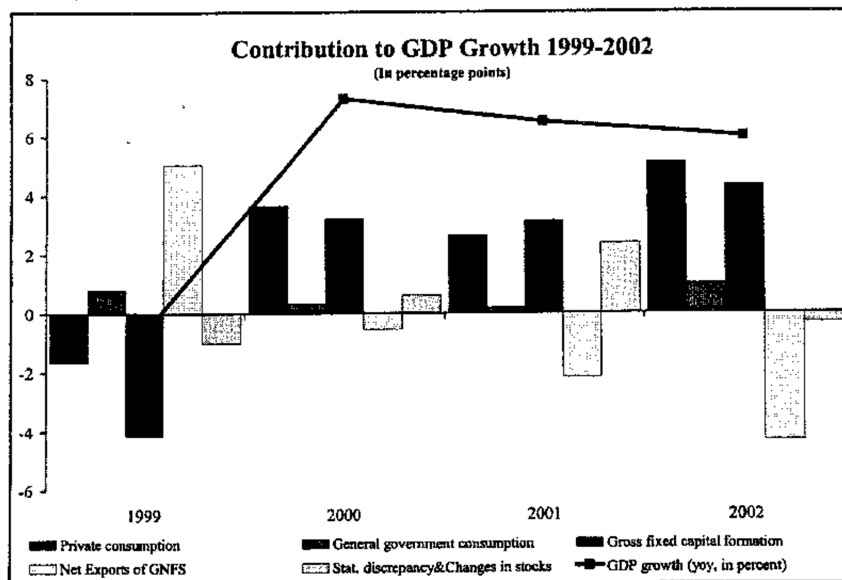
Sources: Country authorities; and Fund staff estimates.

were also positive, as employment increased while unemployment fell to 10.3 percent in 2002 from 12.6 percent in 2001. Estonia's inflation rate declined to 2.7 percent at end 2002 from 4.2 percent in 2001; however, the 2002 average inflation rate of 3.6 percent would have exceeded the Maastricht criterion. Declining import prices and positive "one-off" factors such as lower food prices during the first half of 2003 contributed to a further temporary fall in the inflation rate.

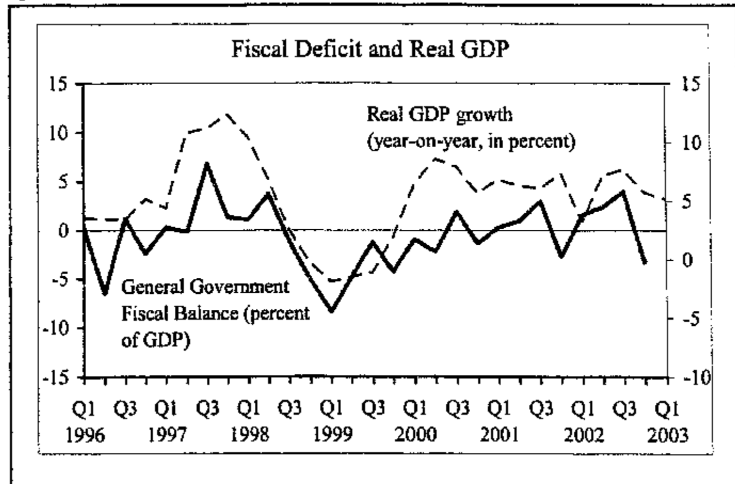
Selected Indicators, 1999-2003
(In units as indicated)

	1999	2000	2001	2002	2003 Proj.
Real GDP (year-on-year in percent)	-0.6	7.3	6.5	6.0	4.5
Private consumption	-2.9	6.5	4.8	9.3	6.0
General government consumption	3.8	1.5	0.9	5.0	5.0
Gross fixed capital formation	-14.8	13.3	12.2	16.1	8.0
Exports	0.5	28.6	-0.2	6.0	6.8
Imports	-5.4	27.9	2.1	10.2	8.3
Average CPI (year-on-year in percent)	3.3	4.0	5.8	3.6	1.7
Unemployment rate (ILO definition, percent)	12.2	13.7	12.6	10.3	...
Fiscal Balance (in percent of GDP)	-4.6	-0.7	0.4	1.2	0.3
Current Account Deficit (in percent of GDP)	4.7	5.8	6.1	12.3	12.8

Sources: Estonian authorities and Fund staff estimates and projections.



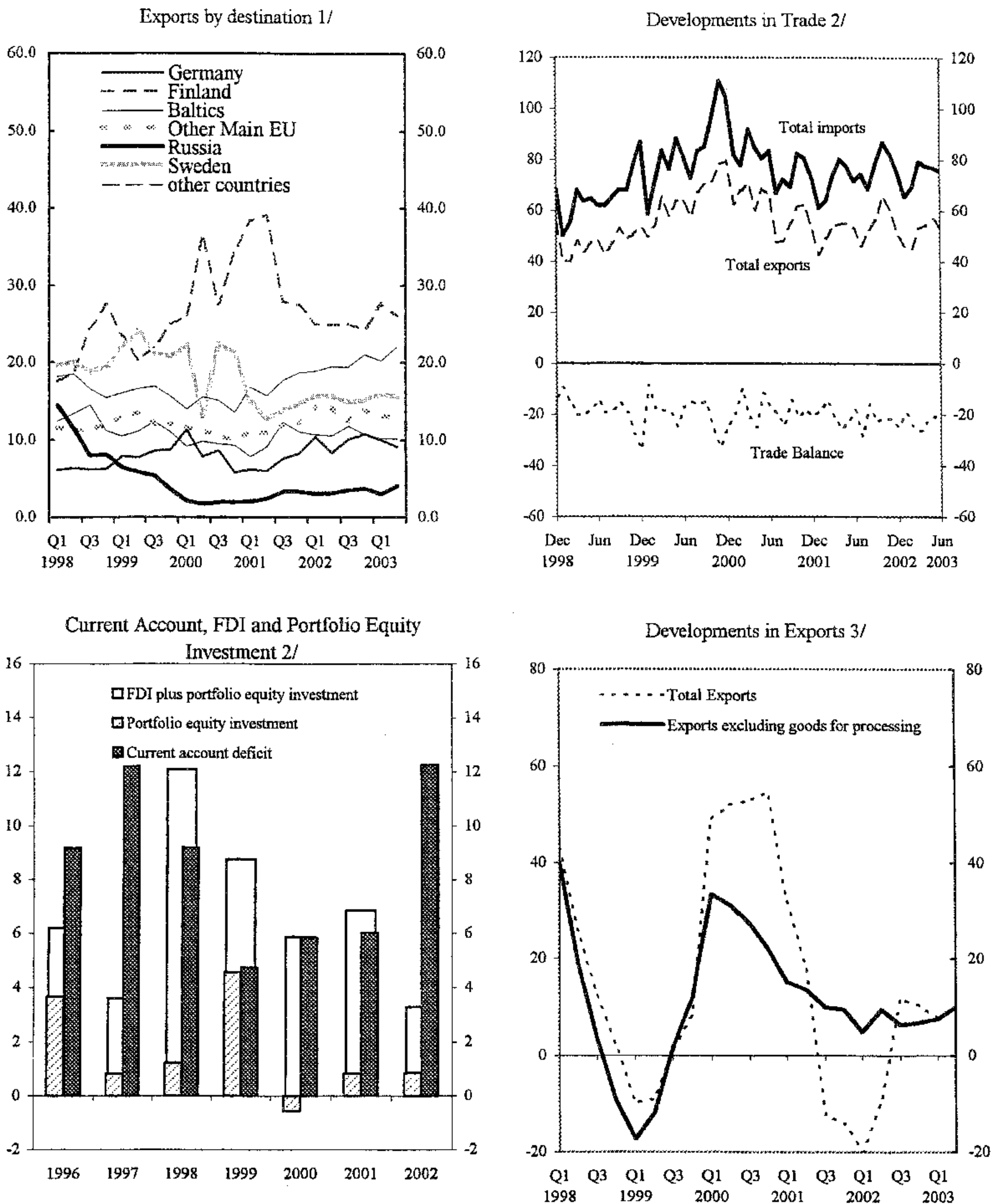
5. **Fiscal performance was very strong in 2002 and the general government registered a budget surplus of 1.2 percent of GDP, compared to a surplus of 0.4 percent in 2001**. Rapid growth in domestic demand contributed to higher-than-expected tax revenue, which more than offset the expenditure increases from two supplementary budgets. Also, the introduction of the unemployment insurance tax resulted in a net budgetary gain of 0.5 percent of GDP, as eligibility requirements meant that payouts of benefits did not start until 2003. Public expenditure, as a share of GDP, rose by 1.2 percentage points, reversing the decline of the previous years. Municipalities showed continued difficulties in controlling expenditure, recording a combined deficit of 0.6 percent of GDP, compared to the central government's surplus of 1.8 percent. The positive revenue performance continued during the first five months of 2003 with rapid growth in revenue from the VAT and the corporate income tax, and a general government surplus of 0.8 percent of projected annual GDP. This allowed a further build-up of government financial assets to 8.8 percent of annual GDP.



6. **The external current account has deteriorated substantially**. Given Estonia's high productivity growth, historically large external deficits have reflected the country's growth potential. However, the sharp jump in the deficit from 6 percent of GDP in 2001 to 12.3 percent in 2002 renders the economy more vulnerable to external shocks. Even after adjusting for a large increase in bulky "one-off" imports, the underlying current account deteriorated by about 3 percent of GDP in 2002[3] (Figure 2). The deterioration in the current account is particularly worrisome since it was associated with a fall in FDI coverage (see box 1). While the 2001 current account deficit was fully financed by FDI, the coverage fell to 25 percent in 2002. Although preliminary information for the first half of 2003 suggests a renewed increase in FDI coverage, the trend of substantially higher deficits and less-than-full FDI coverage remains.

[3] These "one-off" bulky imports amount to about 3.8 percent of GDP and include imports relating to the upgrading of Estonian Energy (Eesti Energia, 2.4 percent of GDP), new locomotives for the recently privatized railway system, and installation of capital equipment for the metallurgical industry.

Figure 2. Estonia: External Sector Developments, 1996-2003



Sources: Bank of Estonia; and Fund staff estimates.

1/ Percent of total exports.

2/ In percent of GDP.

3/ Percent change over same period in preceding year.

Main Components of Current Account 1996-2003

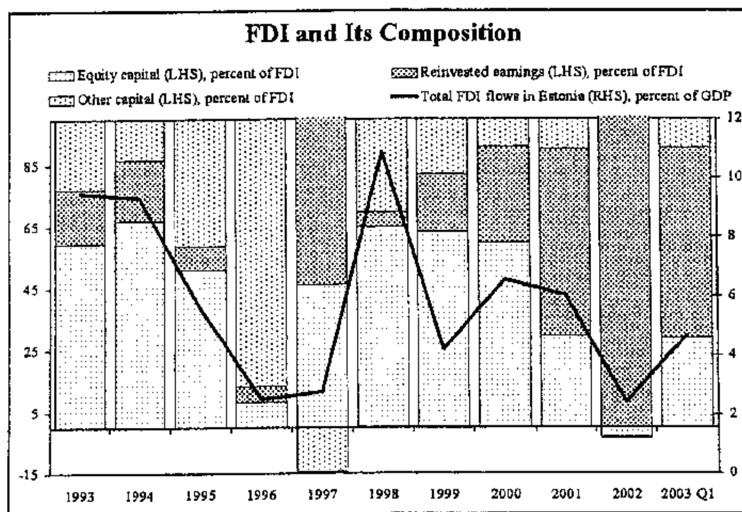
	1996	1997	1998	1999	2000	2001	2002	2003 Proj.
	(In percent of GDP)							
Current Account	-9.2	-12.2	-9.2	-4.7	-5.8	-6.0	-12.3	-12.8
Primary Current Account, excluding interest and reinvested earnings	-8.8	-10.1	-8.3	-3.9	-3.7	-2.1	-9.5	-10.2
Trade Balance	-23.4	-24.4	-21.4	-15.8	-15.1	-14.1	-16.9	-17.9
Services	11.9	12.9	10.9	10.9	11.0	10.4	7.5	8.0
Goods and Non-factor Services balance	-11.5	-11.6	-10.4	-4.9	-4.1	-3.7	-9.4	-9.9
Income	0.05	-3.1	-1.6	-2.0	-4.0	-5.0	-5.1	-5.1
Reinvested earnings	0.1	1.9	0.5	0.8	2.0	3.7	2.5	1.9

Sources: Bank of Estonia and Fund staff estimates.

Box 1. Foreign Direct Investment

The flow of foreign direct investment (FDI) in Estonia has been substantial over the last decade, averaging more than 6 percent of GDP per year. At the beginning of the transition period, FDI inflows were driven largely by privatization and the consolidation and restructuring of the banking sector, with the latter attracting a quarter of the FDI stock. In 2002, as bank restructuring and privatization drew to a close, FDI declined substantially to 2.5 percent of GDP, with most investments in existing rather than new enterprises. FDI increased to 4.5 percent of GDP in Q1 2003 (4-quarter moving average at an annual rate) due to the purchase of a large Estonian timber company (with a 50 percent share of the industry) by a Finnish-Swedish enterprise, but nonetheless remains below the last decade's historical average of 6 percent of GDP.

FDI and Its Composition



Since 1999, the reinvested earnings component of FDI inflows has grown rapidly, increasing to 60 percent of FDI in 2001from around 5 percent in 1998. The increase coincides with the exemption of reinvested earnings from corporate income tax since 2000. Overall, although FDI inflows may not be sustained at levels seen in the past, the prospects for growth are good. Over the medium term, Estonia is expected to remain an attractive destination for foreign investors. According to business surveys of foreign investors, the importance of potential market growth in the region, low production costs, political and exchange rate stability, the absence of capital controls, and the rapid pace of economic reform are the main factors driving foreign investment. Geographical proximity and historical ties with Finland and Sweden have been also beneficial for Estonia, as these countries, which account for two-thirds of the stock of FDI in Estonia, use the country as a bridge into the Baltic market.

7. **A further easing of monetary conditions and, more recently, more aggressive lending behavior by some banks, contributed to continued strong money and credit growth in 2002 and the first half of 2003 (Figure 3).** Given the high level of integration of money and credit markets with those of the Euro area, the country was confronted with an expansionary monetary shock due to a fall in Euro area interest rates. Interest rates fell further as a result of a decline in the country's risk premium.[4] Furthermore, foreign financial institutions, such as Nordea, started to lend more aggressively to increase their market share, putting additional downward pressure on lending rates, especially in the real estate sector. Credit grew by about 28 percent in 2002 and remained strong during the first half of 2003. Lease financing, which is a substitute for standard bank financing, continued to grow especially rapidly, increasing by about 41 percent in 2002.

8. **Estonia's banking system remains financially very sound.**[5] Despite an increase in competition driven by some smaller banks, as well as by larger financial institutions that are headquartered in the EU but have become more active in Estonia, indicators of profitability were strong. This reflects increases in efficiency and the ability of some Estonian banks to generate sizeable profits from operations in other Baltic states with higher spreads between lending and deposit rates. Non-performing loans fell from 2.3 percent in 2001 to 0.9 percent in 2003, partly reflecting the strong performance of the economy.

Banking Indicators, 1999-2003
(in percent, unless otherwise indicated)

	1999	2000	2001	2002	2003 1/
Capital Adequacy					
Capital adequacy—risk-weighted average	16.1	13.2	14.4	15.3	14.6
Liquidity					
Liquidity ratio	58.3	64.4	72.5	57.5	51.9
Total reserves/total deposits	28.1	25.4	14.5	14.4	16.6
Excess reserves/total reserves	43.3	19.0	16.7	1.5	1.5
Asset quality					
Nonperforming loans (in millions of domestic currency)	792.0	716.0	590.0	408.4	508.1
Nonperforming loans/total loans	4.0	3.2	2.3	0.8	0.9
Loan-loss provisioning/gross loans	4.4	2.6	2.1	1.0	0.9
Loan-loss provisioning/nonperforming loans	118.3	81.4	91.7	123.3	106.7
Profitability					
Return on equity	9.2	8.4	20.9	12.4	12.5
Return on assets	1.5	1.2	2.7	1.6	1.5
Net interest margin	4.6	4.7	4.1	3.8	3.5
Loans and deposits					
Loans/deposits	100.9	98.5	95.3	102.4	109.3
Loans/total assets	56.6	59.2	59.5	61.2	64.7
Nonresident deposits as a share of total deposits	16.9	16.0	14.3	13.1	11.3
Nominal interest rate spread	4.5	3.9	5.4	3.7	3.5
Foreign currency deposits as a share of total deposits	31.1	34.0	30.1	28.7	26.4
Foreign currency loans as a share of total loans	76.1	77.9	78.7	82.6	81.9
Concentration					
C3	92.0	91.0	91.0	90.0	90.3
C5	99.0	99.0	99.0	99.1	99.4
Memorandum items		(in percent of GDP)			
Total assets	28.7	33.5	48.0	75.6	80.2
Deposits (resident)	22.5	26.1	30.1	39.3	40.6

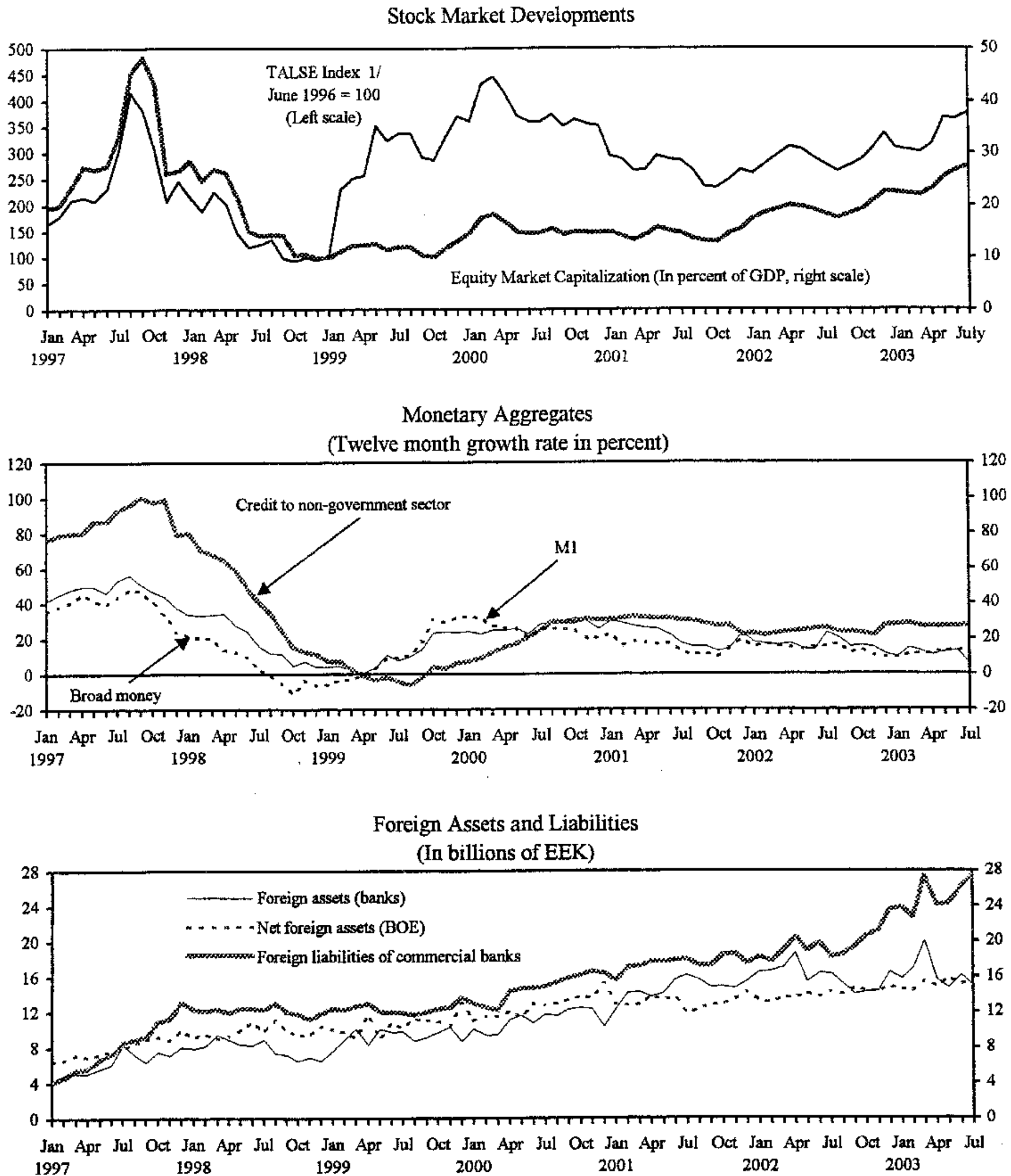
Source: Country authorities and Fund staff estimates.

1/ Most recent data.

[4] Estonian Eurobond spreads have fallen from 45 basis points in 2002 to 34 basis points in 2003.

[5] Banking sector reserves held at the BOE fell in 2001 because commercial banks were allowed to fulfill up to 50 percent of their reserve requirement by holding high quality euro-denominated assets instead of cash reserves.

Figure 3. Estonia: Monetary and Financial Indicators, 1997-2003



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

The financial system remains highly capitalized, with a capital adequacy ratio about 5 percentage points above the minimum requirement of 10 percent.

9. **As a result of the change in the structure of external financing and the increase in the current account deficit, external debt indicators deteriorated somewhat.** Gross external debt increased from about 60 percent of GDP in 2001 to about 65 percent in 2002. During this period the debt service ratio increased slightly from 6.9 percent to 7.3 percent of exports of goods and services. The ratio of reserves to imports remained unchanged at 2.4 months in 2002.

10. **Despite these adverse developments, confidence in the currency board remains strong**. An upgrade of Estonia's credit rating to A1 by Moody's and to A- by Standard & Poors in 2002 led to a further reduction in the country's risk premium. Estonia's credit rating is now equal to that of Greece and better than that of Chile. Furthermore, the reserve coverage of base money continued to increase.

11. **Estonia's scheduled EU membership marks the completion of the country's transition-related structural reforms**. After a failed attempt to privatize the state-owned energy company, there were no large privatizations in 2002. Prices remained largely determined by market forces, with the exception of some administratively regulated energy prices. Structural reforms in 2002 and the beginning of 2003 were limited to the introduction of the second pillar of the pension system and the establishment of a new unemployment insurance scheme. The introduction of the second pillar, which aims at moving from the pay-as-you-go system to a fully-funded, defined-contribution system, was substantially more successful than anticipated (Appendix I). Although the new unemployment system, financed by payroll contributions of 1 percent for employers and 0.5 percent for employees, was established in January 2002, the first payments were not made until the beginning of 2003.

III. Discussions with the Authorities

12. **The discussions with the authorities focused on the increased vulnerability of the economy, especially with respect to the growing current account deficit, and the need for appropriate and immediate fiscal policy action given Estonia's monetary policy constraints under a currency board system.** The underlying current account deteriorated as households and firms increased their borrowing due to lower interest rates and expectations of high future incomes and profitability. This happened against the background of a change in the structure of financing reflected in the fall of FDI coverage. While in the past, a key determinant of FDI was the sale of public enterprises and a relatively underdeveloped banking system, the completion of most large-scale privatizations and the integration of Estonia's banking system into European capital markets means that the share of FDI financing is likely to be permanently lower. However, it is expected that—due to Estonia's improved credit rating and further integration into European capital markets—the maturity length of external debt will increase. Against this background of a less benign external position, staff also discussed the government's policy initiatives for the coming year,

focusing on the 2004 draft budget. Other areas of discussion were related to EU and EMU membership.

13. **In addition, staff discussed with the authorities the effectiveness of Fund surveillance.** The authorities were of the view that the Fund had been instrumental in Estonia's successful transition. In particular, the authorities indicated that Fund recommendations contributed to the continuity of Estonia's economic policies across administrations with different policy priorities.[6] At the same time, the authorities felt that Fund recommendations—at times—put too much emphasis on risks, while not sufficiently taking into account political constraints. The authorities and staff broadly agreed on the causes of and risks associated with Estonia's vulnerabilities. In the recent past—and given the currency board arrangement—staff emphasized the need to strengthen financial sector supervision and regulation and to let the automatic fiscal stabilizers operate fully. While the authorities have moved forcefully with respect to the financial sector and have pursued a balanced budget policy, they have tended to increase spending when strong domestic demand led to a surge in revenues.

A. The Short- and Medium-term Outlook

14. **Overall, Estonia's growth prospects both in the short- and medium-term remain quite favorable.** While part of the historical contribution to growth took place in the form of a "one-off" increase in efficiency, a stable macroeconomic environment and an almost completely privatized and fairly deregulated economy will provide the foundation for strong growth in the future.

15. **For 2003, weaker than anticipated demand in Estonia's main export markets led to a downward revision of the staff's growth projections; the economy is now expected to grow by 4.5 percent.** However, since demand conditions in Estonia's trading partners are expected to improve in the coming year, and EU-related grants will increase, economic activity is expected to temporarily accelerate in 2004. Staff projects growth to accelerate temporarily to 5.5 percent before returning to its long-run growth potential estimated to be about 5 percent.

16. **Due to a further monetization of the economy, inflation is projected to remain low despite expected strong money growth.** Inflation is projected to accelerate from the projected 1.1 percent in 2003 to 3.0 percent in 2004 largely as a result of EU tax harmonization and stronger demand conditions in the Euro area, and fall to about 2.0 to 2.5 percent thereafter. In line with the performance over the past several years, the position of the general government is expected to stay broadly in balance, while the current account

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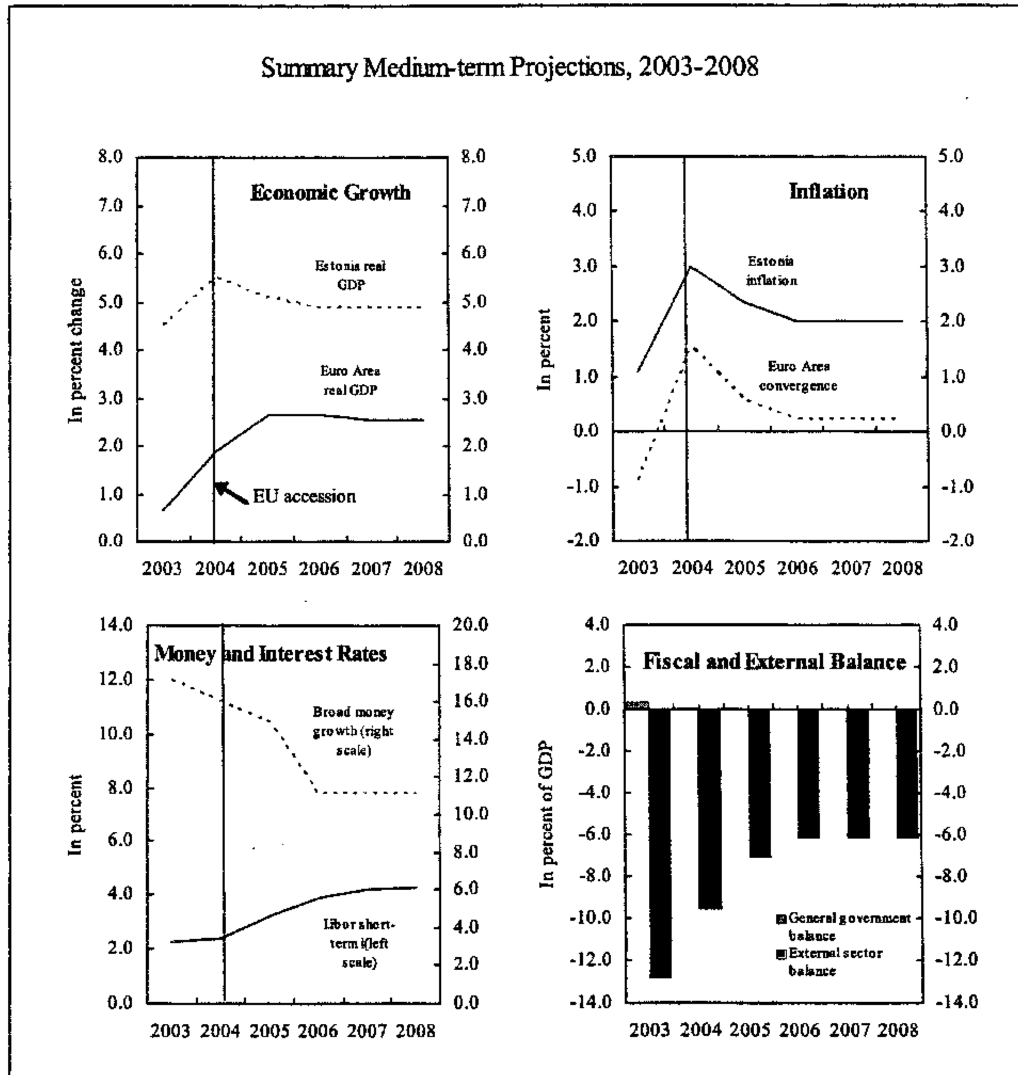
[6] It was also the view that the country benefited substantially from Fund technical assistance.

deficit is expected to fall to about 6 percent once projects associated with the jump in the deficit, such as investments in the energy sector, are completed.[7]



[7] The sustainability of Estonia's current account deficit in the medium term is linked to Estonia's growth potential. Based on a number of methods (see Appendix I in IMF Country Report No. 02/134), the economy is expected to grow by about 5 percent over the medium term.

17. **Risks to this scenario come primarily from a further weakening of demand conditions in the EU.** Although Estonia's growth performance is currently not synchronized with those of its major trading partners, a prolonged output gap in the EU would ultimately dampen growth prospects in Estonia as well. However, over the longer term, Estonia's growth prospects appear to be robust.[8]

B. External Sector

18. **Despite the overall positive economic outlook, the recent deterioration in the external position has increased the vulnerability of the economy.** The current account deficit is projected to reach 12.8 percent of GDP in 2003. While the country's positive credit rating—including the ratings of Estonia's key financial institutions—and the low level of public debt ensure that the financing of the current account does not pose any difficulties in the very near term, the economy has become more vulnerable to external shocks and these large current account deficits are not sustainable over the longer term (see box 2).[9]

C. Fiscal Policy

19. **The central topic of the discussions with the authorities was the need to address the widening current account deficit through appropriate fiscal policy.** Staff argued that the government should tighten the fiscal position and run a temporary surplus. The size of the adjustment needs to be large enough to start reducing the size of the current account both

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[8] Assuming that the economy will remain deregulated and that the government continues to pursue sound macroeconomic policies, Estonia will be able to continue to profit from its high level of education (Appendix II), its strategic geographic location between East and West, and its advantageous tax system.

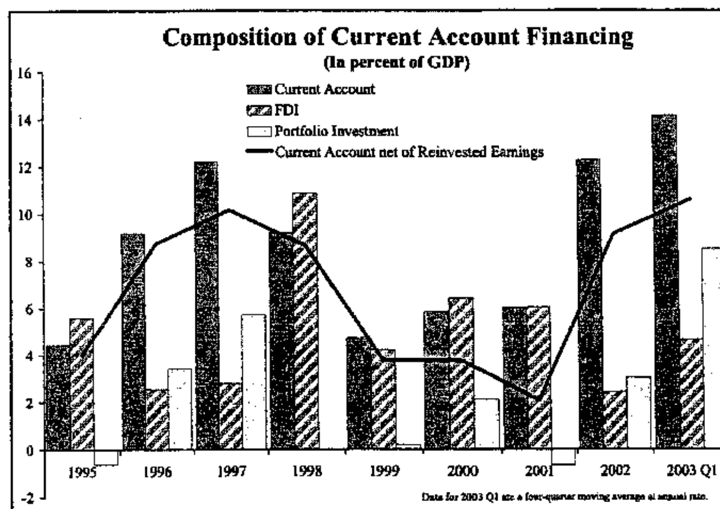
[9] In this context, staff also discussed with the authorities the dynamics of Estonia's external debt (Table 8). Almost all of Estonia's external debt, roughly 62 percent of GDP, is held by the private sector. According to the Fund's standard stress tests, adverse two-year shocks to nominal interest rates or real GDP growth would lead to a sizable increase in the external debt ratios to slightly above 85 percent of GDP, declining only slowly to around 73 percent over the medium term. While the authorities concurred with the staff that the recent magnitude of the current account deficit is not sustainable, they were of the view that the probability of a shock of the size assumed in this scenario would be rather small and that using historical data exaggerates substantially the magnitude of possible future shocks due to the large structural reforms that took place in the past decade.

Box 2. Current Account Sustainability

Over the last decade, Estonia has run much higher current account deficits than central European accession countries such as the Czech Republic, Poland, Hungary, and Slovak Republic (CEAC) and also much higher than Spain and Portugal during their 1975-1985 pre-accession period to EU. This raises the question of what is the size of a sustainable current account deficit.[1]

A number of factors affect the size of the current account deficit and its sustainable level, among others, the openness of the economy, composition of financing, consumption smoothing, level of external debt, macroeconomic fundamentals, and the health of banking system.

Although it is difficult to determine a particular threshold with respect to the sustainable level of the current account deficit, the above factors are useful in assessing the external vulnerability of the economy. For example, over the last 9 years, Estonia registered robust growth at an annual average of around 5 percent, with FDI covering over 80 percent of the current account deficit. The healthy banking system is accommodating expectations of higher future income and allowing for consumption smoothing with relatively high current account deficits. While high levels of FDI have historically kept external debt relatively modest, in 2002 and the first half of 2003, FDI coverage declined to around 25 percent as the current account deficits increased to around 13 percent of GDP. This resulted in an increase in external debt to 65 percent of GDP from 59.4 percent in 2001. Although FDI coverage is expected to increase to roughly 50 percent over the medium term, current account deficits of about 13 percent are not sustainable.



Staff used several methods of assessing the sustainable level of the current account. First, we estimated the underlying current account deficit by identifying and excluding "one-off" factors. Such "one-off" factors amounted to 3.8 percent in 2002 and 5 percent in 2003, suggesting that the underlying deficit was near the historical average of 8 percent. Second, we estimated a consumption smoothing current account using panel data for the Baltic countries. This estimation suggests that the actual current account is in excess of what is implied by consumption smoothing. Third, we estimated a long-run current account deficit that is consistent with a stable debt-to-GDP ratio finding that this implies a threshold of about 5 percent of GDP. Finally, we used estimated relationships found in other countries to evaluate the current account deficit in Estonia and obtained similar results.[2]

Overall, our findings suggest that the recent high current account deficits—even adjusted for the one-off factors and consumption smoothing—are in excess of the estimated longer-term sustainable levels. While the robust macroeconomic conditions and healthy banking system allow Estonia to have temporary current account deficits of 10-13 percent without creating macroeconomic instability, these levels render the economy more vulnerable to external shocks and are not sustainable over the longer term.

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[1] The seven year average of the current account deficit in Estonia was over 8 percent, in the CEAC 4 percent, and in Spain and Portugal 5.5 percent.

[2] On the different methodologies, see also the Selected Issues Paper "Current Account Sustainability in the Baltic States".

directly and indirectly, by impacting peoples' expectations and demonstrating that the government is prepared to counteract external vulnerabilities. The authorities were receptive to staff's arguments but pointed to upcoming spending pressures that will make this difficult to achieve.

20. **The 2003 fiscal outlook is marked by increasing expenditure and continued buoyant tax revenue.** A supplementary budget for 2003 was passed in June involving extra expenditure of 1.2 percent of GDP (EEK 1,339 million).[10] In addition, the basic pension was increased on July 1, implying extra expenditure of about 0.2 percent of GDP. The increase in pensions is offset by lower-than-expected outlays for pension benefits, while higher-than-expected tax revenue is likely to more than compensate for the cost of the supplementary budget. Consequently, the general government is projected to show a small surplus of about 0.3 percent of GDP in 2003. The strong revenue performance is largely associated with the rapid growth of domestic demand. Nevertheless, the recent trend of rapidly increasing receipts from the corporate profits tax is somewhat surprising, and there is a risk of a sudden reversal that would put pressure on the budget.[11]

21. **Municipalities continue to suffer from poor administration.** Expenditure increases among municipalities are expected to lead to a combined deficit again in 2003, although it is likely to be somewhat smaller than in 2002. Several municipalities appear to be seeking to circumvent borrowing limits (amounting to 60 percent of projected annual revenues) by planning unorthodox practices such as selling public assets and then renting them back after they have been renovated. The City of Tallinn, by far the largest contributor to municipal deficits, stands out in this context, with plans for a transaction of this type that could amount to upward of 1 percent of GDP.

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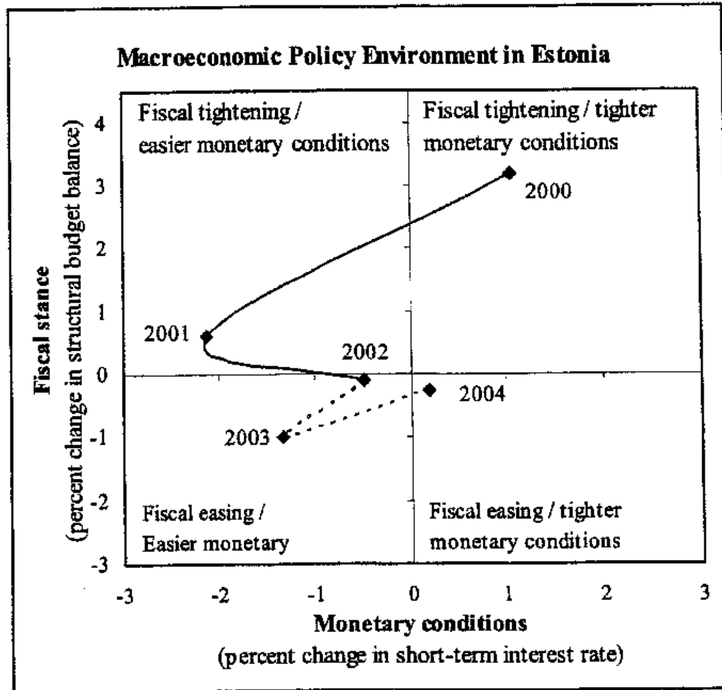
[10] This figure includes the purchase of equity in a publicly owned real estate company for EKK 350 million (0.3 percent of GDP) to finance construction projects related to a hospital and a prison to be rented by the government. Technically, this operation does not affect the general government deficit, and it appears that the arrangement was chosen for that reason. For present purposes, however, the amount is recorded "above-the-line" to show the macroeconomic implications.

[11] In 2000, Estonia introduced a system of business taxation whereby only the distribution of dividends, and not retained earnings, are taxed. Despite the incentives for retaining profits, higher distribution of dividends has caused revenue to increase, with revenue for the first five months of 2003 more than 60 percent higher than during the same period in 2002.

22. **Staff argued that the government should address the deterioration in the current account by targeting a 2003 budget surplus greater than the 1.2 percent of GDP realized in 2002, on the order of about 2 percent.** Staff was of the view that such a target would be quite realistic, since it could largely be reached by postponing planned but not yet implemented expenditure increases, which had only recently been approved in a supplementary budget. In addition, staff encouraged the authorities to let the automatic stabilizers operate fully and to target a budget balance over the business cycle rather than on an annual basis. Therefore, and as a first and immediate step, staff urged the government to announce publicly that it would not pass a second supplementary budget to increase spending further, even if revenues were to overperform. Staff also expressed concern about municipal financing and encouraged the authorities to vigilantly enforce the borrowing limits. The authorities assured the mission that they had no intention of abandoning their balanced budget policy. Furthermore, at the beginning of August, the government announced that it would not pass a second supplementary budget and that it would transfer any additional revenues to the stabilization fund. Although the government said that it would take staff's advice into consideration, it also indicated that it would be difficult politically to run a surplus of the magnitude recommended by the staff.



23. **For 2004, the government has launched an agenda of ambitious policy initiatives.** It plans to lower the flat income tax rate by two percentage points, from 26 to 24 percent, and raise the basic income tax threshold by EEK 400 per month to EEK 1400 (63 percent of the current minimum wage). In each of the following two years, the income tax rate will be reduced by another two percentage points and the threshold increased by EEK 300. Also, as part of a package of parents' benefits aimed at increasing the birthrate, parental leave benefits will be extended from 140 days to 12 months at full pay (with a cap at three times the average salary). Combined with the cost of the recent increase in the basic pension, these initiatives are estimated to cost about 1.6 percent of GDP in 2004. The authorities plan to offset most of the additional expenditure by implementing a freeze on central government wages and operational expenditure, as well as by making VAT on finance leases payable up front rather than with each lease payment (beginning May 1, 2004), and by instituting a number of minor revenue-raising measures.

Expected Impact on 2004 Budget of Policy Changes and EU Accession 1/		
	(In percent of GDP)	(In millions of EEK)
Policy Changes	-0.4	-559
Costs	-1.6	-2,056
Reduction in the income tax rate and higher threshold	-1.2	-1,495
Higher parents benefits	-0.3	-370
Pension increase from July 1, 2003	-0.2	-191
Gains	1.2	1,497
Keep central government wages at 2003 level	0.4	514
Keep central government operational expenses at 2003 level	0.3	361
VAT gain due to change in treatment of finance leases	0.3	400
Discontinue subsidies to student loans	0.1	100
Income tax on higher parents benefits	0.0	62
Introduction of tax on heavy vehicles	0.0	60
EU-Related Changes	0.4	481
Costs	-1.6	-1,952
VAT loss due to change in declaration date for imports from the EU	-0.6	-700
Payments to the EU	-0.7	-902
EU-related bridge financing needs	-0.3	-350
Gains	1.9	2,433
Introduction of VAT on EU projects	0.3	400
Harmonization requirements	0.6	759
Increase in excises on tobacco, alcohol, and fuel	0.3	350
Abolishment of tax-free trading on trips within the EU	0.3	325
Custom duties on imports from third countries and other	0.1	85
Lumpsum grants from the EU	0.2	274
Use EU funds to save on expenditure financed by domestic sources	0.8	1,000
Net Total	-0.1	-78

Source: Estonian authorities and Fund staff estimates
Note: Items may not sum due to rounding.
1/ Changes relative to baseline with unchanged policy.

24. **EU accession also has substantial fiscal implications.** Upon accession, VAT on intra-EU acquisitions will be treated in line with domestic purchases rather than paid at the border, implying an additional time lag of approximately half a month and an estimated onetime cost of about 0.6 percent of GDP. With the payments to the EU budget and additional bridge-financing needs, this implies combined expenditures of about 1.6 percent of GDP. This cost, however, is expected to be more than offset by EU-related gains of about 1.9 percent of GDP. Included in this figure is 0.3 percent of GDP in extra revenue from the introduction of VAT on EU-funded projects, and 0.6 percent of GDP due to harmonization requirements. In addition, Estonia will receive 0.2 percent of GDP in lump-sum grants that may be used to cover budgetary expenditure, and will save an expected 0.8 percent of GDP by using EU grants to replace expenditure currently relying on national funds (Box 3).

25. **Staff discussed with the government the planned policy initiatives and the draft budget proposal for 2004.** Although the Ministry of Finance had drafted a balanced budget for 2004, staff expressed concern that the draft is predicated on potentially over-optimistic assumptions, especially regarding EU grants and the ability to institute a complete freeze on central government outlays for wages and operational expenses. Past experience suggests that it is difficult to absorb all available EU funds, and holding the wage bill unchanged in nominal terms may also prove difficult, given the need to increase administration capacity in

Box 3. EU Grants

EU accession, scheduled for May 2004, will involve a significant increase in EU-related income and expenditure. The inflow of grants under pre-accession programs has been rapidly increasing and is expected to reach 1.5 percent of GDP in 2003. In 2004, with availability of new EU funds, the Estonian authorities are expecting EU grant receipts to increase by 2.7 percent of GDP. These funds will support a wide range of areas, including infrastructure investment, agriculture, and education, stimulating economic growth and helping to raise income levels. EU-related expenditure will increase with the initiation of payments to the EU budget and higher co-financing requirements. In addition, higher grants will imply higher expenditure since the grants are generally tied to project financing. The lump-sum budget support is an exception. In 2004, however, lump-sum budget support funds will be more than offset by higher bridge financing needs (mostly due to upfront payments for agricultural support) so that expenditure will exceed receipts. This brings the total increase in expected EU-related expenditure to 3.7 percent of GDP.

Fiscal Impact of EU Acession, 2003-06

	2003	2004	2005	2006
	(In millions of EEK)			
Net cash flow	1,696	4,305	3,113	4,202
EU grants	1,696	5,206	4,519	5,746
Pre-accession instruments	1,696	1,850	1,377	1,080
Post-accession instruments	...	2,733	2,742	4,266
Lumpsum budget support	...	274	50	50
Other	...	350	350	350
Payments to the EU (-)	...	-901	-1,407	-1,544
EU-related expenditure	2,196	6,854	6,446	7,591
Payments to the EU	...	901	1,407	1,544
Disbursement of grants	1,696	5,252	4,369	5,245
Co-financing	500	700	670	802
	(In percent of GDP)			
General government revenue and grants	41.5	42.6	40.8	40.6
Of which: EU grants	1.5	4.2	3.3	3.9
General government expenditure and net lending	41.2	42.6	40.8	40.6
Of which: EU-related	1.9	5.5	4.7	5.1

Sources: Estonian authorities and Fund staff estimates.

The increase in EU-related expenditure does, however, not necessarily imply a corresponding increase in overall public spending. EU-related outlays may, to some extent, replace expenditures financed from national funds. EU funds are subject to the principle of additionality, which, as a general rule, requires that national outlays not be decreased as a result of increased use of EU funds (measured as an annual average over certain program periods). Nevertheless, with underlying expenditure growth and possibilities for redistributing expenditure between different years, this leaves some room for reducing the reliance on national funds. The draft budget for 2004 is based on EEK 1 billion of such replacement taking place in areas including road building and enterprise support programs. Similarly, the expected increase in co-financing of EEK 200 million is expected to be accommodated within the existing expenditure envelope. In 2004, the combined saving, amounting to 1 percent of GDP is thus expected to cover the difference between the rise in EU-related expenditure and the rise in receipts of EU grants.

relation to EU accession. Staff also expressed the concern that without an overall spending cap, the cost of higher parents' benefits might well exceed projections. In order to relieve budget tensions, the mission suggested possible revenue-raising measures, including gradually eliminating the tax deductibility of mortgage interest payments and the tax exemption on interest income from bank deposits. The authorities reiterated their firm commitment to balancing the budget and noted that any shortfall in EU grant receipts would require ministries to institute additional expenditure cuts.[12]

[12] Staff encouraged the government to take advantage of a scheduled FAD technical assistance mission that would focus on multiyear expenditure planning, operational risk management in budget execution, and the development of performance-based budgeting.

26. **Staff indicated to the authorities that some recent fiscal transactions could undermine Estonia's high standard of fiscal transparency and the credibility of the government**. Estonia's past performance and advanced standing among all EU accession countries is directly related to its prudent and easily understood fiscal policy. However, one of the mission's findings was that the government may be taking its own stated fiscal objectives less seriously, as reflected by the off-budget transfer of EEK 350 million to a publicly owned real estate company. The same applies to municipalities. Staff pointed out that it has taken Estonia a decade to achieve a record for fiscal transparency that is the envy of the world and that it would be a step in the wrong direction if a reversal is allowed.

D. Exchange Rate Issues and EMU Membership

27. **Estonia's competitive position remains relatively strong, supporting the country's strategy of maintaining a fixed exchange rate system.** Price-based indicators of competitiveness, including unit labor costs, have remained broadly unchanged over the last couple of years. Furthermore, Estonia was able to increase its market share in the EU by more than 10 percent in 2002 (Appendix III).

28. **The authorities indicated that it was their intention to join ERM2 immediately after EU accession, with the currency board as an unilateral commitment.**[13] Staff concurred with the authorities that they should avoid a double regime shift prior to the adoption of the euro, given that the currency board has served the country well, provided a nominal anchor, and withstood adverse external shocks (such as the international financial crises in the second half of the 1990s). The authorities indicated that they wanted to adopt the euro at the earliest possible date. Staff agreed that an early adoption of the euro would solidify Estonia's successful economic convergence and the overall reform process, while eliminating remaining exchange rate risks (Figure 4). To ensure that the conditions for an early adoption of the euro are in place, staff urged the authorities not to become complacent and to continue moving forward with the remaining structural reforms while using fiscal policy resolutely to address macroeconomic imbalances.

E. Monetary and Financial Sector Issues

29. **The mission encouraged the authorities to consider increasing prudential regulations in sectors that experience particularly strong credit growth, such as real estate.**[14] While some of the determinants that contributed to the strong credit and money growth in the past are likely to be less pronounced in the future, additional competitive

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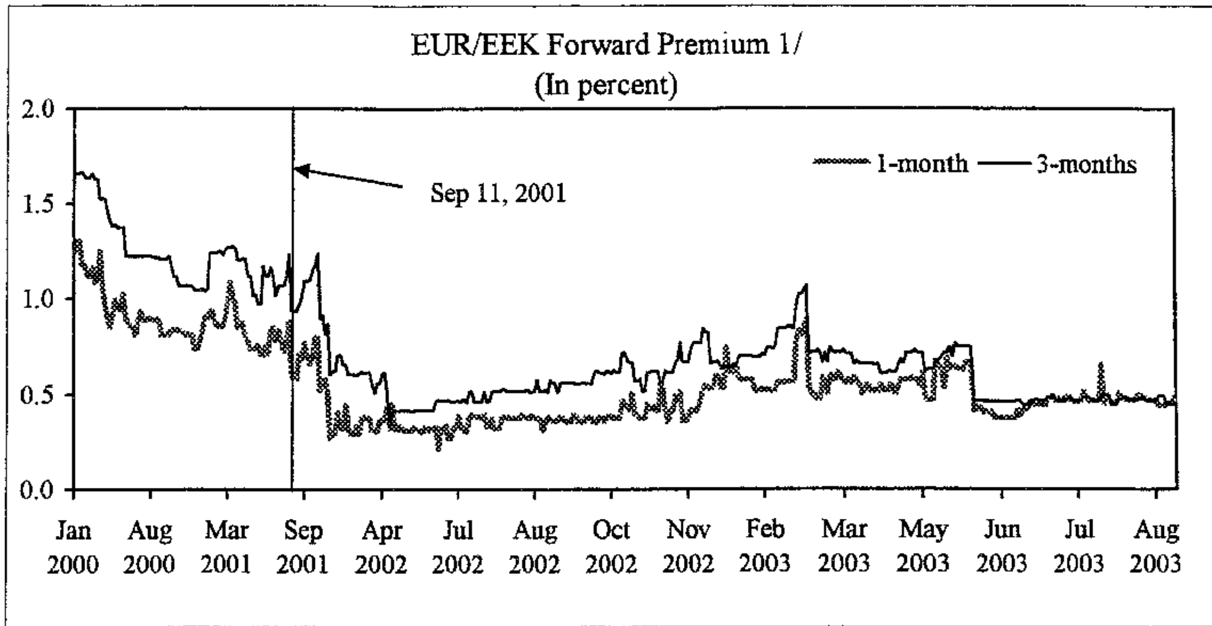
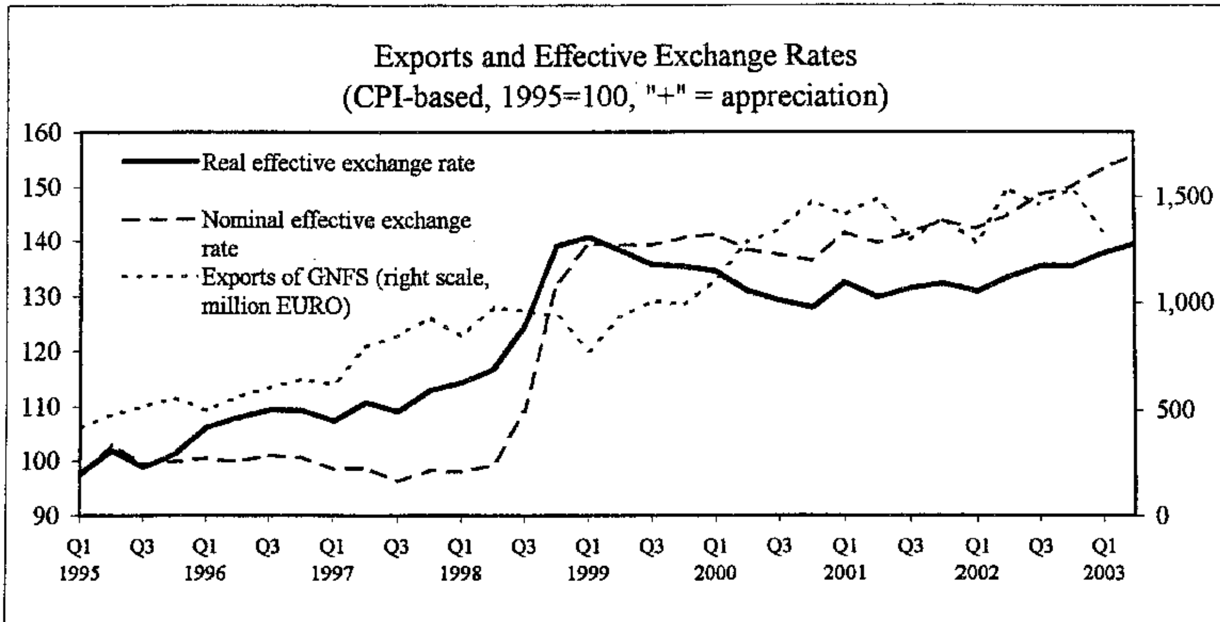
[13] Entry into ERM2 would require a multilateral agreement with the euro area Member States, the ECB and the other Member States participating in the mechanism about the key modalities of participation in ERM2, especially the central parity. Furthermore, the appropriateness of currency board frameworks as a unilateral commitment complementing ERM2 membership will have to be assessed in the course of the ERM2 entry procedure on a case-by-case basis.

[14] This would introduce a macroprudential element that would have the advantage of tightening capital requirements during economic upswings and loosening them during downturns. This feature is particularly useful—given Estonia's currency board system— during the period leading to EMU membership.

Figure 4. Estonia: External Sector Financial Indicators, 1995-2002





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

1/ Difference between EEK and Euro money market rates.

pressure from EU financial institutions after accession will put further downward pressures on lending rates. Staff estimates that credit to the private sector will continue to grow strongly and increasing prudential requirements on a selective and temporary basis would minimize the risk that subsidiaries of foreign banks could circumvent changes in capital requirements by converting the subsidiaries into branches.[14] Staff pointed out that such a measure should be temporary and should not be considered a substitute for fiscal action. The authorities indicated that they have used a number of instruments to address the strong credit growth, including moral suasion; the sterilization of government deposits; effectively increasing required reserves by broadening the base; and encouraging banks to adopt best international practices, especially in the use of collateral. The authorities indicated, though, that they would be prepared to increase prudential requirements, especially if housing prices were to increase substantially.[15] Also, the authorities agreed with staff's position to keep reserve requirements at the current rate and to make the harmonization of the monetary policy framework with the one of the Eurozone a function of the monetary and overall macroeconomic environment (Appendix IV).

30. **Because of the strong performance of the financial system, staff inquired whether the good performance of the banking sector would be sustainable and whether the risk management capacities of the banks that have been lending more aggressively are adequate to intermediate the strong credit expansion prudently**. In particular, staff expressed concern that part of the strong performance of the banking sector might be related to transfer pricing. Foreign parent banks of Estonian subsidiaries would have an incentive to engage in such activities, since under Estonian laws, only paid-out dividends are taxed.[16] The authorities were of the view that they did not have any evidence of transfer pricing activities and that the large profits of Estonian banks were partly related to the revenues generated in the other Baltic countries. Also, financial supervisors were of the view that risk management capabilities of the institutions that were lending more aggressively were adequate, given that they were branches of larger foreign institutions. Furthermore, the authorities indicated that they had undertaken stress tests and found the banking system to be sufficiently resilient. However, they indicated that they had not analyzed the implications of different exchange rate assumptions, but would consider doing so in the near future.

31. **Given the dominance of foreign financial institutions in Estonia (Appendix V), staff inquired to what degree the FSA cooperates with supervisors from other countries.**

[14] The largest banks operating in Estonia are subsidiaries of foreign banks.

[15] In the past, especially housing prices increased sharply largely as a result of strong credit growth to the sector. However, prices for new homes have stabilized over the last 6 months, while price increases for existing homes have decelerated.

[16] Sweden, among others, considered amending its tax laws to tax directly the profits of Estonian subsidiaries, as well as those in Ireland and Switzerland.

The authorities indicated that memoranda of understandings (MOU) are in place with supervisory institutions from the Nordic countries, Germany, and the other Baltic states. The authorities pointed out that they wanted to do more to improve the cooperation at an operational level and indicated that they had started to work with Swedish supervisors to undertake joint on-site inspections.

32. **The authorities have addressed the main areas that were identified in Estonia's FSAP, largely in the context of EU harmonization.**[17] The FSAP indicated that policy action would be warranted in the areas of financial supervision and insurance and securities regulations. In the meantime, Estonia adopted insurance laws that are in line with EU directives, except in the area of insurance intermediaries. The authorities intend to amend the laws in the fall of 2003 and expect them to be in line with EU directives prior to EU membership. With respect to securities regulation, Estonia's new Securities Market Act is broadly in line with the guidelines set by the Committee of European Securities Regulators. Also, Estonia has joined the International Commission Organization of Securities Commission (IOSCO). Concerning the potential lack of legal protection of financial supervisors, Estonia now limits the liability of supervisors in the State Liability Act, which was modeled after German law.

33. **Estonia has implemented a mechanism to combat money laundering and the financing of terrorism.** Estonia's anti-money laundering legislation was amended to bring it in line with the latest EU directive in this area. One of the explicit purposes of the newly established FSA is to prevent the abuse of the financial sector for criminal purposes. Systems used by the Financial Intelligence Unit appear to work effectively, as reflected in the number of cases that are ultimately judged suspicious.[18] Estonia allows for the full implementation of all relevant U.N. Security Council Resolutions relating to the financing of terrorism, and explicit provisions criminalizing the financing of terrorism came into force in 2003. However, the authorities have not implemented any specific measures that would undermine payments and transfers.

F. Structural Policies

34. **The structural reform agenda is largely driven by the EU integration process and the implementation of the *acquis communautaire*.** Overall, the pace of structural reforms has slowed somewhat, partly reflecting the fact that major reforms, such as large-scale privatization, have been almost fully completed.[19]

[17] The authorities inquired about the availability of MFD technical assistance related to operational aspects of preparing the monetary policy framework for the adoption of the euro.

[18] Compared to 2001, the number of suspicious cases increased in 2002 and, based on current trends, will be higher in 2003.

[19] The Estonian Privatization Agency was terminated at the end of 2001.

35. **The new government does not have any firm plans for additional privatizations in the near future.** The central government maintains shares in Estonian Air (34 percent) and the Estonian telecom (27.3 percent) and fully owns the Port of Tallinn, the national post office, and Estonian Energy. The government intends to re-evaluate the sale of its remaining shares in these strategic enterprises and intends to continue with the sale of assets such as land and buildings; the potential receipts from the sale of such assets are expected to be minor.[21]

36. **Persistent unemployment remains a problem in Estonia.** The strong growth performance over the past two years led to a fall in the unemployment rate, although the decline was not observed in the northeastern part of Estonia. Regional differences in property prices, aggravated by language barriers faced by non-Estonian speaking residents, contributed to the problem of low labor mobility. The government has embarked on a program of vocational training reform and enhanced active labor market programs, which will benefit from EU post-accession funding (Appendix VI). At the same time, the EU will not bring significant changes to the Estonian labor market code, which is already comparable to EU standards. However, the social charter of the EU—which is not legally binding for Estonia—may intensify the political pressure to tighten the labor code and to increase unemployment benefits and the minimum wage. This could exacerbate the problem of long-term unemployment.

37. **The energy market continues to be dominated by a single state-owned company (Estonian Energy), which has a monopolistic position in energy production, transmission, and distribution.** A new law governing the sector—which entered into force in July 2003—requires legal separation of the three sectors. However, the activities will be carried out by subsidiaries of Estonian Energy, which has a monopoly in energy production, transmission, and distribution. In negotiations with the EU, Estonia's energy market has been granted a transition period allowing for gradual liberalization due to adverse socio-economic implications of the reforms and the restructuring of oil shale-based electricity production.[22]

38. **Reform efforts to streamline the structure of the government at the local level has been very slow**. The mission pointed out that despite some mergers, which have reduced the number of municipalities from 253 to 241, the number of local governments remains too large for a country of this size. Staff encouraged the authorities to accelerate the reform

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[21] The Government has retained for 5 years special powers ('golden share') in Estonian Telecom, which will expire in May 2004. Also, under the Security Service Act, the Government may restrict participation of foreign investment in security service enterprise. Foreign capital in aviation and maritime transport sectors have been restricted to 49 percent; this will be abolished upon accession to the EU.

[22] Currently, 10 percent of energy customers are free to choose electricity providers. This share will be increased to 35 percent in 2008 and the market will be fully liberalized by 2012.

process, pointing out that the excessive number of municipalities constituted a waste of scarce resources. While the authorities agreed with staff's position, they indicated that mergers at the local level would be voluntary, but that the central government would encourage mergers through small financial incentives.

39. **The Estonian trade system remains fully liberal, with Estonia having free trade agreements with Ukraine and all EU accession countries except Romania.** In terms of legislation, the Estonian trade system is harmonized with the EU trade system, but the implementation is currently different: the EU trade system will be fully applied starting May 1, 2004. However, the implementation of the EU trade system is not expected to have a major effect on Estonian trade pattern, since approximately 90 percent of Estonian trade is with the EU and EU accession countries. Nevertheless, EU accession is expected to have a negative impact on a few imports like steel, grain, and fertilizers, which are imported mostly from Russia and Ukraine. At the same time, the EU accession will have a positive effect on some exports, mainly to Russia, since Russian tariffs on Estonian exports will halve after EU accession. An exception is the export of fishery products to Ukraine, but Estonian firms are already searching for alternative markets in this sector.

IV. Other Issues

40. **Staff discussed with the authorities the use of Collective Action Clauses in sovereign bond issues**, pointing out that the Executive Board encourages the use of such clauses. The authorities indicated that given the balanced budget policy and the very low level of public debt outstanding, they were not considering issuing new debt in the medium term. In addition, the authorities pointed out that the country's first international bond issue in 2002 is governed by English law, which includes a provision for majority restructuring. Staff encouraged the authorities to continue with this practice in the future.

41. **Overall, Estonia continues to be at the forefront of transparency efforts**. The country subscribes to the Fund's Special Data Dissemination Standard and provides the key data for surveillance on a timely basis. Estonia has also made substantial progress in addressing outstanding issues that were identified in the original ROSCs and updated the ROSCs in 2002. The adoption of the organic budget law in 2002 addressed several of the outstanding recommendations from the fiscal ROSC. Among others, the law introduced a new unified definition of the general government and (from the beginning of 2003) a new budget classification in line with ESA95 and GFS 2001.

42. **The mission made its views public and engaged in a number of outreach activities by meeting with representatives of both the local electronic and print media.** The authorities confirmed that they would, as in the past, publish the staff report.

V. STAFF APPRAISAL

43. **Expectations of EU membership have provided the foundation for continued confidence and strong growth driven by domestic investment and consumption demand.** Estonia's positive economic performance took place despite sluggish economic developments in the country's major export markets. The short- and medium-term outlook remains positive.

44. **But developments of the current account have increased the vulnerability of the economy.** The sudden increase in the current account deficit from 6 percent of GDP in 2001 to above 12 percent of GDP from 2002 onward, combined with a simultaneous fall in FDI coverage, has rendered the economy more susceptible to adverse shocks. While the financing of the deficit in the immediate term does not pose any difficulties, the size of the deficit raises questions of sustainability over the longer term. These developments are taking place at a critical time when the country is preparing itself for ERM2 membership and the adoption of the euro.

45. **Although Estonia has pursued a conservative fiscal policy, which is reflected in the country's balanced budget policy and the corresponding low level of public debt, given the increasing external imbalances and the currency board arrangement, fiscal policy should be used more pro-actively to maintain macroeconomic stability.** As a first step, the authorities should allow the automatic stabilizers to operate fully. The government's public announcement that it will not pass an additional supplementary budget in 2003, even if revenues were to over-perform, is a welcome step in the right direction. However, given the size of the current account deficit—and in order to signal to market participants that the government is willing to tighten policies in the face of increased vulnerabilities—the authorities should postpone planned, but not yet executed, expenditure increases envisaged in the first supplementary budget.

46. **While the government has drawn up a balanced budget proposal for 2004, a number of policy initiatives (such as the large increase in parents' benefits to increase the birth rate) in combination with the sizeable reduction in the income tax rate could put unforeseen pressure on the budget, further increasing the vulnerability of the economy.** Additional budgetary tensions are likely to arise due to an increase in EU related expenditures and potentially lower than planned inflows of EU funds. To avoid any adverse implications, new entitlement programs should be implemented gradually and expenditures need to be capped.

47. **Confidence in the currency board arrangement continues to be strong and the authorities intention to join ERM2 with a fixed exchange rate as a unilateral commitment immediately after EU membership seems warranted as long as it is supported by appropriate fiscal and structural policies.** Indicators of competitiveness suggest that Estonia remains competitive in export markets. The intention of the authorities

to eliminate remaining exchange rate risks by adopting the euro at the earliest possible date is sensible.

48. **Estonia's financial system remains sound and highly capitalized. However, continued strong credit growth needs to be monitored closely and the authorities should be ready to increase prudential requirements on a selective and temporary basis, especially if housing prices were to increase sharply.** The authorities should take the opportunity to eliminate the tax exempt status of income earned from bank deposits as well as the deductibility of mortgage interest payments. In addition to curtailing credit growth, this would offset part of the revenue loss associated with the income tax reform and create a level playing field in financial markets.

49. **Despite a positive outlook, Estonia's economy is faced with risks.** Given Estonia's high degree of openness, a prolonged slowdown in Estonia's trading partners would ultimately impact exports, consumer confidence, and investment activities. At the same time, the continuation of large current account deficits could ultimately call into question the sustainability of the external position. Furthermore, the fiscal implications of the planned policy initiatives for 2004 and beyond have reduced the government's degree of freedom to maneuver to counter adverse developments.

50. **Estonia has achieved a level of transparency in public policymaking including simple fiscal rules that are exemplary.** However, some of the recent fiscal transactions by the central government to increase spending without impacting the publicly visible fiscal deficit and by municipalities to circumvent borrowing limits should be avoided since they could undermine Estonia's high transparency standard. Staff welcomes the authorities' intention to publish this year's Staff Report.

51. **Staff recommends that Estonia remain on the standard 12-month consultation cycle.**

Table 1. Estonia: Selected Macroeconomic Indicators, 1998-2004

(In units as indicated)

	1998	1999	2000	2001	2002	2003 Proj.	2004 Proj.
National income, prices and wages							
Nominal GDP (kroons, millions)	73,538	76,327	87,379	97,895	108,024	114,263	125,104
GDP (US dollars, millions)	5,225	5,200	5,149	5,574	6,503	8,217	9,114
Real GDP growth (year-on-year in percent)	4.6	-0.6	7.3	6.5	6.0	4.5	5.5
Real GNI growth (year-on-year in percent)							
Average CPI (year-on-year change in percent)	8.2	3.3	4.0	5.8	3.6	1.1	3.0
12-month CPI (end of period change in percent)	4.3	3.9	5.1	4.2	2.7	1.0	2.5
GDP deflator (year-on-year change in percent)	9.8	4.5	6.7	5.2	4.1	1.2	3.8
Average monthly wage (end-of-period, US dollars)	343	366	338	361	436	567	610
Unemployment rate (ILO definition, percent)	9.8	12.2	13.7	12.6	10.3	10.0	10.0
Saving-investment balances (in percent of GDP)							
Domestic saving	20.1	19.8	21.9	22.8	19.2	19.3	20.9
Private	16.1	20.0	19.5	19.2	14.1	15.1	16.4
Public	4.1	-0.2	2.5	3.6	5.1	4.2	4.5
Domestic investment	29.3	24.5	27.8	28.9	31.4	32.1	30.5
Private	24.9	20.1	24.6	25.6	27.5	28.1	26.0
Public	4.4	4.4	3.1	3.2	3.9	3.9	4.5
Foreign saving	9.2	4.7	5.8	6.0	12.3	12.8	9.6
General government (in percent of GDP)							
Revenue	40.2	38.9	37.8	37.7	39.6	41.5	42.6
Expenditure and net lending	40.5	43.5	38.5	37.3	38.4	41.2	42.6
Fiscal balance 1/	-0.3	-4.6	-0.7	0.4	1.2	0.3	0.0
External sector (euro, millions)							
Trade balance	-998	-773	-840	-881	-1165	-1310	-1324
Exports	2399	2364	3601	3750	3713	3875	4195
Imports	-3397	-3138	-4441	-4630	-4878	-5185	-5520
Service balance	511	533	612	649	517	586	684
Receipts	1321	1403	1629	1845	2098	2369	2684
Payments	-810	-870	-1017	-1196	-1581	-1782	-1990
Current account	-429	-231	-326	-376	-846	-936	-767
Change in net foreign asset position of commercial banks (euro, millions)	-27	30	-74	258	-326	-8	-48
Gross international reserves (euro, millions) 2/	696	852	993	931	989	1032	1086
in months of imports	2.4	3.3	2.7	2.4	2.6	2.4	2.4
Relative to gross short-term debt (including trade credits)	0.9	0.9	0.8	0.7	0.6	0.7	0.7
Gross external debt/GDP (in percent) 3/ 4/	53.3	58.7	58.1	59.4	65.1	69.3	68.6
Net external debt/GDP (in percent) 5/	15.0	15.2	12.7	14.6	18.1	24.2	27.0
General government external debt/GDP (in percent) 6/							
Excluding government assets held abroad	4.3	4.9	3.7	3.0	3.0	3.0	2.7
Including government assets held abroad 7/	2.5	2.2	2.0	1.3	1.1	...	...
Exchange rate (EEK/US$ - period average)	14.1	14.7	17.0	17.6	16.6	...	...
Money and credit (year-on-year growth in percent)							
Domestic credit to nongovernment	11.7	6.3	30.3	22.2	27.8	22.4	18.5
Base money 9/	6.4	27.1	14.6	-9.8	-1.5	10.5	9.5
Broad money	4.2	23.7	25.7	23.0	11.2	14.3	11.0
Base money multiplier (end of period) 8/	2.4	2.3	2.5	3.4	3.9	4.0	4.2

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

1/ For 2003, no supplementary budget is assumed.

2/ Lower reserve requirements introduced in 2001 have led to a decline in international reserves under the mechanics of the currency board (and A87a decline in base money), which was more than compensated by the improvement in the net foreign asset position of commercial banks. In addition, net short term debt of the banking system has become negative.

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

4/ Includes use of Fund credit and trade credits.

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

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

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

8/ The government transferred EEK 1 billion from the commercial banks to the BOE.

Table 2. Estonia: Summary of General Government Operations, 1998-2004
(In millions of EEK)

	1998	1999	2000	2001	2002	2003 Proj.	2004 Proj.
Revenue and Grants	29,558	29,688	33,062	36,887	42,786	47,415	53,312
Revenue	29,432	29,385	32,795	36,257	42,073	45,608	48,003
Tax revenue	26,684	26,849	29,393	32,073	37,173	40,520	42,829
Direct taxes	17,356	17,622	18,250	19,812	22,826	24,921	25,259
Personal income tax	6,239	6,531	6,594	7,099	7,806	8,619	8,133
Corporate profits tax	1,914	1,635	855	748	1,348	1,714	1,535
Social security tax	5,303	5,520	6,297	6,988	7,712	8,024	8,479
Medical insurance tax	3,573	3,588	4,093	4,542	5,048	5,557	6,011
Unemployment insurance tax	...	...	...	...	493	565	611
Land and property taxes	327	347	411	435	418	443	490
VAT	6,413	6,417	8,153	8,639	10,172	11,225	12,397
Excises	2,789	2,685	2,819	3,434	3,938	4,104	4,804
Other taxes (incl. on intern. trade)	126	126	170	187	238	270	369
Nontax revenue	2,748	2,536	3,402	4,185	4,901	5,088	5,174
Grants	127	304	267	630	713	1,807	5,309
Expenditure	29,710	33,187	33,968	36,548	41,634	46,793	53,382
Current expenditure	26,477	29,827	31,232	33,389	37,415	42,288	47,773
Expenditure on goods and services	17,757	19,764	20,368	21,650	24,219	27,518	29,644
Wages and salaries	5,647	6,752	7,085	7,355	8,346	9,234	9,596
Other goods and services	12,110	13,012	13,284	14,296	15,873	18,284	20,049
of which: healthcare	...	...	2,878	2,792	2,970	3,683	4,032
Current transfers and subsidies	8,381	9,755	10,568	11,481	12,929	14,269	17,727
Subsidies	693	689	682	805	1,138	1,291	2,472
Transfers to households	7,688	9,066	9,886	10,676	11,791	12,978	14,354
of which: Pensions	5,200	6,425	6,445	6,610	7,279	8,160	8,809
Family benefits	1,159	1,156	1,317	1,314	1,394	1,446	1,853
Sickness benefits	662	607	716	738	804	877	960
Unemployment benefits	57	120	120	133	104	348	381
Income maintenance	390	315	315	358	342	221	242
Disability benefits	0	0	64	441	564	550	602
Prescription drug benefits	0	0	430	644	766	760	832
Other	221	442	480	439	538	616	675
Transfers to the EU budget	...	...	...	...	...	...	902
Interest payments	339	309	296	258	267	502	402
Capital expenditure	3,233	3,360	2,736	3,158	4,219	4,505	5,609
Financial surplus (+) / deficit (-)	-152	-3,499	-906	339	1,152	622	-70
Net lending 1/	77	-14	-329	-63	-132	315	-70
Overall surplus (+) / deficit (-)	-228	-3,485	-577	402	1,284	307	0
Borrowing requirement	228	3,485	577	-402	-1,284	-307	0
Domestic financing	710	3,833	920	1,639	670	58	-400
Of which: Privatization	25	3,024	812	1,970	474	200	200
Foreign financing	-482	-349	-343	-2,035	-1,954	-365	400
Of which : change in government deposits held abroad (-	-563	-431	-23	-1,841	-2,692	-365	0
Memorandum items:							
Overall balance excluding cost of pension reform	...	...	...	...	1,339	832	769
Primary fiscal balance (+, surplus)	111	-3,176	-281	660	1,551	808	402
Balance in government deposits held abroad	1,265	1,696	1,719	3,560	6,252	6,617	6,617
Total general government debt							
Excluding government assets held abroad	4,301	4,967	4,303	4,384	5,597	5,855	6,055
Including government assets held abroad	3,036	3,271	2,584	824	-655	-762	-562
National defense expenditure	824	1,061	1,396	1,762	2,028	2,324	2,502

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

1/ 2003 includes a transfer to the State Real Estate Company of EEK 350 million for construction projects.

Table 3. Estonia: Summary of General Government Operations, 1998-2004
(In percent of GDP)

	1998	1999	2000	2001	2002	2003 Proj.	2004 Proj.
Revenue and Grants	40.2	38.9	37.9	37.7	39.6	41.5	42.6
Revenue	40.0	38.5	37.6	37.0	38.9	39.9	38.4
Tax revenue	36.3	35.2	33.7	32.8	34.4	35.5	34.2
Direct taxes	23.6	23.1	20.9	20.2	21.1	21.8	20.2
Personal income tax	8.5	8.6	7.6	7.3	7.2	7.5	6.5
Corporate profits tax	2.6	2.1	1.0	0.8	1.2	1.5	1.2
Social security tax	7.2	7.2	7.2	7.1	7.1	7.0	6.8
Medical insurance tax	4.9	4.7	4.7	4.6	4.7	4.9	4.8
Unemployment insurance tax	...	...	...	...	0.5	0.5	0.5
Land and property taxes	0.4	0.5	0.5	0.4	0.4	0.4	0.4
VAT	8.7	8.4	9.3	8.8	9.4	9.8	9.9
Excises	3.8	3.5	3.2	3.5	3.6	3.6	3.8
Other taxes (incl. on intern. trade)	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Nontax revenue	3.7	3.3	3.9	4.3	4.5	4.5	4.1
Grants	0.2	0.4	0.3	0.6	0.7	1.6	4.2
Expenditure	40.4	43.5	38.9	37.3	38.5	41.0	42.7
Current expenditure	36.0	39.1	35.8	34.1	34.6	37.0	38.2
Expenditure on goods and services	24.1	25.9	23.3	22.1	22.4	24.1	23.7
Wages and salaries	7.7	8.8	8.1	7.5	7.7	8.1	7.7
Other goods and services	16.5	17.0	15.2	14.6	14.7	16.0	16.0
of which: healthcare	...	...	3.3	2.9	2.7	3.2	3.2
Current transfers and subsidies	11.4	12.8	12.1	11.7	12.0	12.5	14.2
Subsidies	0.9	0.9	0.8	0.8	1.1	1.1	2.0
Transfers to households	10.5	11.9	11.3	10.9	10.9	11.4	11.5
of which: Pensions	7.1	8.4	7.4	6.8	6.7	7.1	7.0
Family benefits	1.6	1.5	1.5	1.3	1.3	1.3	1.5
Sickness benefits	0.9	0.8	0.8	0.8	0.7	0.8	0.8
Unemployment benefits	0.1	0.2	0.1	0.1	0.1	0.3	0.3
Heating & housing allowance	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income maintenance	0.5	0.4	0.4	0.4	0.3	0.2	0.2
Disability benefits	0.0	0.0	0.1	0.5	0.5	0.5	0.5
Prescription drug benefits	0.0	0.0	0.5	0.7	0.7	0.7	0.7
Other	0.3	0.6	0.6	0.4	0.5	0.5	0.5
Transfers to the EU budget	...	...	...	...	...	...	0.7
Interest payments	0.5	0.4	0.3	0.3	0.2	0.4	0.3
Capital expenditure	4.4	4.4	3.1	3.2	3.9	3.9	4.5
Financial surplus (+) / deficit (-)	-0.2	-4.6	-1.0	0.3	1.1	0.5	-0.1
Net lending 1/	0.1	0.0	-0.4	-0.1	-0.1	0.3	-0.1
Overall surplus (+) / deficit (-)	-0.3	-4.6	-0.7	0.4	1.2	0.3	0.0
Borrowing requirement	0.3	4.6	0.7	-0.4	-1.2	-0.3	0.0
Domestic financing	1.0	5.0	1.1	1.7	0.6	0.1	-0.3
Of which: Privatization	0.0	4.0	0.9	2.0	0.4	0.2	0.2
Foreign financing	-0.7	-0.5	-0.4	-2.1	-1.8	-0.3	0.3
Of which: change in government deposits held abroad	-0.8	-0.6	0.0	-1.9	-2.5	-0.3	0.0
Memorandum items:							
Overall balance excluding cost of pension reform	...	...	...	...	1.2	0.7	0.6
Primary fiscal balance (+, surplus)	0.2	-4.2	-0.3	0.7	1.4	0.7	0.3
Balance in government deposits held abroad	1.7	2.2	2.0	3.6	5.8	5.8	5.3
Total general government debt							
Excluding government assets held abroad	5.8	6.5	4.9	4.5	5.2	5.1	4.8
Including government assets held abroad	4.1	4.3	3.0	0.8	-0.6	-0.7	-0.4
National defense expenditure	1.1	1.4	1.6	1.8	1.9	2.0	2.0
Nominal GDP	73,538	76,327	87,236	97,895	108,024	114,263	125,104

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

1/ 2003 includes a transfer to the State Real Estate Company of EEK 350 million for construction projects.

Table 4. Estonia: Summary Balance of Payments 1998-2008

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
								Proj.			
						(In millions of EURO)					
Current Account	-432	-231	-326	-376	-846	-936	-767	-613	-564	-602	-649
Trade Balance	-1,005	-773	-840	-881	-1,165	-1,310	-1,324	-1,217	-1,232	-1,348	-1,495
Exports	2,415	2,364	3,601	3,750	3,713	3,875	4,195	4,612	5,010	5,335	5,665
Of which: goods for processing	721	741	1,523	1,422	1,144	1,194	1,292	1,421	1,543	1,643	1,745
Imports	-3,420	-3,138	-4,441	-4,630	-4,878	-5,185	-5,520	-5,829	-6,242	-6,683	-7,160
Of which: goods for processing	-631	-673	-1,374	-1,141	-965	-1,025	-1,091	-1,153	-1,234	-1,321	-1,416
Services Balance	514	533	612	649	517	587	694	746	802	870	962
Receipts	1,330	1,403	1,629	1,845	2,098	2,369	2,684	2,958	3,229	3,526	3,849
of which: travel and tourism	484	518	549	569	585	660	748	824	900	982	1,073
Payments	-815	-870	-1,017	-1,196	-1,581	-1,782	-1,990	-2,212	-2,428	-2,656	-2,887
Income	-74	-96	-223	-315	-350	-373	-304	-304	-304	-304	-304
Current Transfers	133	106	125	170	152	160	168	162	170	179	188
Capital and Financial Account	439	378	480	311	869	979	820	654	605	645	694
Capital Transfers	2	1	18	6	20	15	24	29	41	41	41
Financial Account	437	377	462	305	848	964	796	625	564	605	653
Direct Investment	511	205	358	377	167	326	320	320	320	320	320
From abroad	516	284	425	603	307	474	475	484	493	502	512
Outward (by Estonians)	-5	-79	-67	-225	-140	-148	-156	-164	-173	-183	-193
Net equity investment	58	222	-31	51	59	72	51	51	51	51	51
Loans and other investments 1/	-131	-50	135	-124	622	566	425	254	193	234	282
of which:											
Banks	19	6	161	-104	340	336	299	128	86	133	182
Government	-53	-31	12	-133	-142	-134	-43	-43	-43	-43	-43
Monetary Authorities	-19	-13	-8	-13	38	-19	-19	-19	-19	-19	-19
Errors and Omissions	1	-33	-9	19	36	0	0	0	0	0	0
Overall balance	8	115	145	-47	59	43	54	41	41	43	45
Memorandum Items:											
EEK/EURO exchange rate (period average)	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
Gross International Reserves (EURO millions) 2/ 3/ 4/	697	852	993	931	989	1,032	1,086	1,127	1,168	1,211	1,256
In months of imports	2.4	3.3	2.7	2.4	2.4	2.4	2.4	2.3	2.2	2.2	2.1
Relative to gross short-term debt (ratio) 5/ 6/	0.9	0.9	0.8	0.7	0.6	0.7	0.7	0.7	0.8	0.8	0.8
						(In percent of GDP)					
Trade Balance	-21.4	-15.8	-15.0	-14.1	-16.9	-17.9	-16.6	-13.9	-13.1	-13.3	-13.8
Goods and Non-factor Services balance	-10.4	-4.9	-4.1	-3.7	-9.4	-9.9	-7.9	-5.4	-4.6	-4.7	-4.9
Current Account	-9.2	-4.7	-5.8	-6.0	-12.3	-12.8	-9.6	-7.0	-6.0	-6.0	-6.0
Total external debt 7/											
Gross	53.3	58.7	58.1	59.4	65.1	69.3	68.7	65.6	62.9	61.1	59.7
Net 8/	15.0	15.2	12.7	12.7	18.1	24.2	27.1	27.4	27.3	27.6	28.2
General government external debt 9/											
Excluding Govt. assets held abroad	4.3	4.9	3.7	3.0	3.1	3.0	2.7	2.5	2.3	2.1	2.0
Including Govt. assets held abroad	2.5	2.2	2.0	-0.6	-2.8	-2.7	-2.4	-2.2	-2.1	-1.9	-1.8
Debt Service/Exports of GNFS (in percent)	8.2	7.4	6.8	6.9	7.3	7.6	8.0	7.6	7.2	7.0	6.8

Sources: Bank of Estonia and Fund staff estimates.

1/ Includes operations in debt securities.

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

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

4/ 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.

5/ Includes trade credits.

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

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

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

9/ Includes government guaranteed debt.

Table 5. Estonia Banking Survey and Monetary Authorities: 1999-2003 1/

(In millions of EEK, unless otherwise indicated)

	1999	2000	2001	2002	2003		
					Mar	June	July
Banking Survey							
Net foreign assets	8,022	9,098	12,285	7,756	8,135	5,113	3,288
Net foreign assets (BOE)	12,932	15,167	14,319	14,890	15,466	15,092	15,687
Foreign assets 2/ 3/	13,334	15,540	14,573	14,995	15,651	15,300	16,049
Foreign liabilities	-402	-373	-254	-105	-185	-208	-362
Net foreign assets (commercial banks)	-4,910	-6,068	-2,034	-7,134	-7,332	-9,979	-12,399
Foreign assets	8,772	10,359	15,475	16,504	20,068	16,185	15,013
Foreign liabilities	-13,682	-16,427	-17,510	-23,638	-27,400	-26,164	-27,412
Net domestic assets	18,368	24,064	28,518	37,619	38,200	42,656	44,404
Domestic credit	26,542	33,758	41,994	53,568	54,832	59,440	61,221
Net credit to general government	**-197**	**-1,078**	**-575**	**-834**	**-1,948**	**-1,750**	**-1,809**
Credit to government (banks)	1,172	1,268	1,742	2,439	2,289	2,637	2,566
Government deposits (banks)	-1,345	-2,343	-2,311	-3,268	-4,231	-4,382	-4,370
Net credit to government (BOE)	3	3	1	0	0	0	0
Government deposits (BOE)	-27	-7	-8	-6	-5	-5	-5
Credit to nongovernment	**26,739**	**34,837**	**42,570**	**54,402**	**56,779**	**61,190**	**63,030**
Credit to nonfinancial public enterprises	372	263	142	245	339	292	274
Credit to private sector	19,877	22,203	26,321	31,512	33,147	35,402	36,485
Credit to enterprises	14,571	15,376	17,161	18,625	19,496	20,153	20,620
Credit to households	5,306	6,827	9,160	12,887	13,651	15,250	15,865
Credit to nonbank financial institutions	6,489	12,370	16,107	22,644	23,294	25,496	26,271
Other items (net)	-8,174	-9,695	-13,476	-15,949	-16,632	-16,785	-16,817
Broad money	**26,390**	**33,162**	**40,803**	**45,374**	**46,335**	**47,769**	**47,692**
M1	17,336	20,869	24,948	27,275	26,654	29,223	29,445
Currency outside banks	**5,711**	**6,201**	**6,952**	**6,995**	**6,781**	**7,098**	**7,150**
Demand deposits	11,624	14,668	17,996	20,280	19,873	22,125	22,295
Time and savings deposits	9,054	12,293	15,855	18,100	19,681	18,546	18,247
Monetary Authorities							
Net foreign assets	12,932	15,167	14,319	14,890	15,466	15,092	15,687
Foreign assets 2/ 3/	13,334	15,540	14,573	14,995	15,651	15,300	16,049
of which: currency board cover 4/	11,526	13,207	11,910	11,732	12,235	11,768	12,547
Foreign liabilities	-402	-373	-254	-105	-185	-208	-362
Net domestic assets	-1,406	-1,960	-2,409	-3,158	-3,232	-3,324	-3,140
Net claims on Government	-24	-4	-6	-5	-5	-5	-5
Claims on financial institutions	268	10	8	9	9	10	10
Claims on private sector	66	70	75	79	79	75	75
Other	-1,716	-2,035	-2,486	-3,240	-3,315	-3,405	-3,220
Base money	**11,526**	**13,207**	**11,910**	**11,732**	**12,235**	**11,768**	**12,547**
Currency issue	6,649	7,277	8,067	8,113	7,719	8,129	8,137
Deposits of commercial banks with the BOE	4,824	5,718	3,815	3,565	4,464	3,586	4,362
Other deposits at BOE	54	211	28	54	52	53	47
Memorandum items:							
Base money multiplier	2.29	2.51	3.43	3.87	3.79	4.06	3.80
Currency-to-deposit ratio	0.28	0.23	0.21	0.18	0.17	0.17	0.18
Bank reserves-to-deposit ratio	0.28	0.25	0.14	0.12	0.14	0.11	0.13
Velocity (period average)	3.19	2.81	2.57	2.20	2.14	2.08	2.07
Required reserves (in millions of EEK) 5/	2,734	4,634	5,904	6,945	8,289	8,642	8,994
Net international reserves (in millions of euro) 6/	115	149	179	210	216	213	210
Net foreign assets of banking system	56.9	13.4	35.0	-36.9	-30.2	-50.0	-73.5
Net domestic assets of banking system	13.3	31.0	18.5	31.9	30.5	33.6	36.5
Domestic credit	9.6	27.2	24.4	27.6	27.0	29.8	31.1
Credit of banking system to non-government	6.3	30.3	22.2	27.8	27.2	26.8	28.1
Credit to the private sector	6.9	11.7	18.5	19.7	21.7	22.4	24.8
Credit to nonbank financial institutions	2.4	90.6	30.2	40.6	34.7	32.8	32.6
Broad money	23.7	25.7	23.0	11.2	13.2	13.3	6.1
M1	32.1	20.4	19.5	9.3	11.2	12.7	14.6
Base money 7/	27.1	14.6	-9.8	-1.5	10.0	6.2	11.8

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 could be met with high quality euro-denominated foreign instruments. In July 2001, this foreign share of reserve requirements was raised to 50 percent.

6/ Net of currency board cover. ECU through 1998, euro thereafter.

7/ The fall in base mony in 2001 is associated with a reduction in the cash reserve requirements.

Table 6. Estonia: Macroeconomic Framework, 1998-2008
(in percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Domestic saving	20.1	19.8	21.9	22.8	19.2	19.3	20.9	21.8	21.8	21.5	21.5
Private	16.1	20.0	19.5	19.2	14.1	15.1	16.4	17.8	17.7	17.4	17.5
Public	4.1	-0.2	2.5	3.6	5.1	4.2	4.5	4.0	4.1	4.1	4.0
Investment	29.3	24.5	27.8	28.9	31.4	32.1	30.5	28.8	27.8	27.5	27.5
Private	24.9	20.1	24.6	25.6	27.5	28.1	26.0	24.7	23.7	23.4	23.5
Public	4.4	4.4	3.1	3.2	3.9	3.9	4.5	4.0	4.1	4.1	4.0
Foreign saving	9.2	4.7	5.8	6.0	12.3	12.8	9.6	7.0	6.0	6.0	6.0
Memorandum items:											
Fiscal balance 1/	-0.3	-4.6	-0.7	0.4	1.2	0.3	0.0	0.0	0.0	0.0	0.0
Revenues	40.2	38.9	37.8	37.7	39.6	41.5	42.6	39.7	38.9	37.9	37.0
Expenditures 2/	40.5	43.5	38.5	37.3	38.4	41.2	42.6	39.7	38.9	37.9	37.0
Net non-debt creating capital inflows ("+" inflow)	12.1	8.8	5.9	6.9	3.8	5.4	4.6	4.2	3.9	3.7	3.4
Net equity investment	1.2	4.6	-0.6	0.8	0.9	1.0	0.6	0.6	0.5	0.5	0.5
Net foreign direct investment	10.9	4.2	6.4	6.0	2.9	4.5	4.0	3.7	3.4	3.2	3.0
GDP real growth (year-on-year in percent)	4.6	-0.6	7.3	6.5	6.0	4.5	5.5	5.0	5.0	5.0	5.0
CPI inflation (average, year-on-year in percent)	8.2	3.3	4.0	5.8	3.6	1.1	3.0	2.5	2.5	2.5	2.5
CPI inflation (end-period, in percent)	4.3	3.9	5.1	4.2	2.7	1.0	2.5	2.5	2.5	2.5	2.5
GDP (millions of kroons)	73,538	76,327	87,379	97,895	108,024	114,263	125,104	136,973	147,589	157,974	169,015

Sources: Estonian authorities, and Fund staff estimates.

1/ Includes the impact of the pension reform.

2/ Includes net lending.

Table 7. Estonia: Indicators of External Vulnerability, 1998-2003
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003 Projection	2003 Date Actual data
Financial indicators							
Public sector debt 1/	6.8	7.7	6.1	6.4	5.8	5.8	
Broad money (percent change, 12-month basis)	4.2	23.7	25.7	23.0	11.2	6.1	7/31/2003
M1 (percentage change, 12-month basis)	-6.3	32.1	20.4	19.5	9.3	8.2	7/31/2003
Private sector credit (percent change, 12 month basis)	11.7	6.3	30.3	22.2	27.8	28.1	7/31/2003
External Indicators							
Exports (percent change, annual average, in EURO)	18.7	-2.1	52.3	4.1	-1.0	4.4	
Imports (percent change, annual average, in EURO)	12.7	-8.3	41.5	4.3	5.3	6.3	
Current account balance	-9.2	-4.7	-5.8	-6.0	-12.3	-12.8	
Capital and financial account balance	9.3	7.8	8.6	5.0	12.6	13.4	
of which: Inward portfolio investment (debt securities etc.)	0.1	2.7	1.4	1.5	5.2	6.5	
Other investment (loans, trade credits etc.)	-1.5	3.3	-0.3	-0.4	6.9	7.8	
Inward foreign direct investment	11.0	5.8	7.6	9.6	4.4	6.5	
in the form of debt or loans	3.0	1.9	1.5	2.9	1.3	1.9	
Gross official reserves (in EURO millions)	697	852	993	931	989	1,032	
NFA of the consolidated banking system (in EURO millions)	327	513	581	785	496	210	7/31/2003
Central Bank short-term foreign liabilities (in EURO millions)	0.0	0.2	3.2	1.1	0.0	1.0	
Short term foreign assets of the financial sector (in EURO millions) 2/	309	422	490.3	759.7	684.0	728.5	
Short term foreign liabilities of the financial sector (in EURO millions)	485	684	868.4	978.7	975.0	1049.1	
Foreign currency exposure of the financial sector (in EURO millions)	228	469	510	1,063	1,835	1,793	7/31/2003
Official reserves in months of imports (excluding imports of goods for processing)	3.0	4.1	3.9	3.2	3.0	3.0	
Broad money to reserves	2.1	2.0	2.2	2.8	3.0	3.2	
Total short term external debt to reserves 3/	1.1	1.1	1.2	1.4	1.6	1.5	
Total external debt 4/ 5/	53.3	58.7	58.2	59.4	65.1	69.3	
of which: Public sector debt 1/	4.3	4.9	3.7	3.0	3.1	3.0	
Net external debt 6/	15.0	15.2	12.8	12.7	18.1	24.2	
Debt service to exports of GNFS	8.2	7.4	6.8	6.9	7.3	7.6	
External interest payments to exports of GNFS	-2.3	-2.0	-1.8	-1.8	-1.6	-1.4	
External amortization payments to exports of GNFS	10.5	9.4	8.6	8.7	8.8	9.1	
Exchange rate (per US$, period average)	14.1	14.7	17.0	17.5	16.6	13.8	7/31/2003
REER, eop, appreciation (+)	24.1	-4.4	-3.5	0.9	3.3	5.5	5/31/2003
Financial Market Indicators							
Stock market index 7/	90.7	125.5	138.2	144.7	212.5	276.3	8/13/2003
Foreign currency debt rating 8/	BBB+	BBB+	BBB+	A-	A-	A-	8/13/2003
Spread of benchmark bonds (basis points, end of period) 9/	13.5	0.7	0.4	0.04	0.18	0.21	8/13/2003

Sources: Country authorities, Bloomberg, Standard & Poor's, and Fund staff estimates.

1/ Total general government and government guaranteed debt excluding government assets held abroad.
2/ Excluding reserve assets of the Bank of Estonia.
3/ By original maturity.
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/ Tallinn stock exchange index (TALSE), end of period.
8/ Standard & Poor's long-term foreign exchange sovereign rating.
9/ One-month spread between Tallinn interbank borrowing rate (TALSE) and the corresponding EURIBOR rate.

Table 8. Estonia: External Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Actual					Projections					
	I. Baseline Medium-Term Projections										
1 **External debt**	53.3	58.7	58.2	59.4	65.1	69.3	69.4	67.1	64.1	61.7	59.6
2 Change in external debt	-4.0	5.4	-0.5	1.2	5.8	4.2	0.1	-2.3	-3.0	-2.5	-2.0
3 Identified external debt-creating flows (4+8+11)	-10.3	-6.0	-7.4	-7.2	3.4	3.9	-0.8	-2.4	-2.9	-2.3	-1.8
4 Current account deficit, excluding interest payments	7.2	3.1	4.1	4.3	10.8	9.4	5.7	3.8	3.0	3.1	3.3
5 Deficit in balance of goods and services	10.4	4.9	4.1	3.7	9.4	9.9	7.3	5.5	4.7	4.9	5.1
6 Exports	79.7	77.2	93.8	89.4	84.2	85.5	87.7	87.2	86.7	85.2	83.9
7 Imports	90.1	82.1	97.9	93.1	93.6	95.4	94.9	92.7	91.4	90.1	88.9
8 Net non-debt creating capital inflows (negative)	-12.1	-8.8	-5.9	-6.9	-3.3	-5.4	-4.7	-4.3	-4.0	-3.7	-3.4
9 Net foreign direct investment, equity	10.9	4.2	6.4	6.0	2.4	4.5	4.0	3.7	3.5	3.2	3.0
10 Net portfolio investment,equity	1.2	4.6	-0.6	0.8	0.9	1.0	0.6	0.6	0.6	0.5	0.5
11 Automatic debt dynamics 1/	-5.4	-0.3	-5.6	-4.7	-4.1	-0.1	-1.8	-1.9	-1.9	-1.8	-1.7
12 Contribution from nominal interest rate	2.0	1.6	1.7	1.7	1.5	3.5	3.5	3.4	3.2	3.1	3.0
13 Contribution from real GDP growth	-2.3	0.3	-3.7	-3.4	-3.2	-2.8	-3.5	-3.2	-3.1	-3.0	-2.9
14 Contribution from price and exchange rate changes 2/	-5.1	-2.3	-3.7	-2.9	-2.3	-0.8	-1.8	-2.0	-2.0	-1.9	-1.8
14 Residual, incl. change in gross foreign assets (2-3)	6.3	11.4	6.8	8.4	2.3	0.3	0.9	0.1	-0.1	-0.2	-0.2
External debt-to-exports ratio (in percent)	66.9	76.0	62.0	66.4	77.4	81.1	79.2	77.0	74.0	72.3	71.1
Gross external financing need (in billions of EURO) 3/	1.2	1.3	1.4	1.4	1.9	2.1	2.1	2.1	2.1	2.3	2.4
in percent of GDP	25.8	27.2	24.5	22.7	27.7	28.7	27.1	24.6	23.2	22.5	21.9
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	4.6	-0.6	7.1	6.6	6.0	4.5	5.5	5.0	5.0	5.0	5.0
GDP deflator in EURO (change in percent)	9.8	4.5	6.7	5.2	4.1	1.2	2.6	3.0	3.0	3.0	3.0
Nominal external interest rate (in percent)	4.1	3.2	3.4	3.2	2.7	5.6	5.4	5.2	5.2	5.2	5.2
Growth of exports (in EURO, in percent)	16.7	0.6	38.8	7.0	3.9	7.4	11.0	7.6	7.5	6.3	6.4
Growth of imports (in EURO, in percent)	15.0	-5.4	36.2	6.7	10.9	7.9	7.8	5.6	6.7	6.7	6.7
	II. Stress Tests for External Debt Ratio										
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2008					65.1	59.9	55.7	51.1	46.6	42.4	38.5
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004					65.1	74.7	80.8	78.2	74.9	72.1	69.8
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					65.1	74.3	80.6	78.1	74.8	72.0	69.7
4. Change in EURO GDP deflator is at historical average minus two standard deviations in 2003 and 2004					65.1	73.0	78.2	75.7	72.5	69.7	67.5
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004					65.1	72.3	79.0	76.5	73.3	70.5	68.2
6. Combination of 2-5 using one standard deviation shocks					65.1	73.5	83.7	81.1	77.7	74.9	72.5
7. One time 30 percent nominal depreciation in 2003 4/					65.1	97.2	96.5	93.5	89.8	86.6	83.9

Historical Statistics for Key Variables (past 9 years, GDP deflator past 7 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	6.5	3.0	4.7
Net non-debt creating capital inflows	6.8	2.7	4.3
Nominal external interest rate (in percent)	5.0	4.7	5.3
Real GDP growth (in percent)	4.4	3.7	5.0
GDP deflator in EURO (change in percent)	9.3	6.8	2.6

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ Standard excercise undertaken for all member countries irrespective of their exchange rate regime according to SM/02/166 and SM/03/206.

Table 9. Estonia: Selected Financial Indicators, 1997-2003

	1997	1998	1999	2000	2001	2002	2003 July
	(In percent of total deposits)						
Banking sector reserves	21.2	24.2	28.1	23.2	13.6	11.2	11.9
Cash	4.6	4.6	4.5	3.7	3.1	2.7	2.2
Required reserves	11.7	14.3	13.3	15.9	16.3	16.7	20.0
Reserves held at the BoE 1/	16.6	19.6	23.4	19.6	10.5	8.6	9.7
Average risk-weighted capital adequacy ratio 2/	13.5	17.0	16.1	13.2	14.4	15.3	14.4
Non-performing loans (in percent of total loans) 3/	1.2	1.4	1.7	1.0	1.3	0.8	0.6
Leverage ratio 4/	7.1	4.8	5.2	6.6	6.6	7.3	7.8
	(In millions of EEK; unless otherwise indicated)						
NFA of commercial banks	-5,013	-5,381	-4,910	-6,068	-2,034	-7,134	-12,399
Net open foreign exchange position of banks 5/	-1,930	3,562	7,335	7,985	16,642	24,666	28,056
In percent of total assets	-4.8	8.7	15.6	13.8	24.3	30.2	31.4
Banking sector's net external obligations maturing within 30 days 8/	731	255	-651	2,102	3,832	539	3,113
Net international reserves of BoE 9/	1,658	1,786	1,737	2,165	2,533	3,119	3,102
Interest spread (in percent per annum) 10/							
Domestic currency short-term	7.6	8.6	5.5	3.2	5.4	2.6	-0.6
Foreign currency (Euro) short term	5.7	4.6	6.9	5.7	9.2	1.0	0.6
Domestic credit to non-government (annual growth, in percent)	79.0	11.7	6.3	30.3	22.2	27.8	26.8

Source: Bank of Estonia and Fund staff estimates

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. Starting in January 2001, 3 percentage points of the 13 percent reserve requirement could be met with high quality euro-denominated foreign instruments. In July 2001, this foreign share of reserve requirements was raised to 50 percent.

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/ A (-) sign indicates a short position and includes forward contracts. Switches from positive to negative positions were 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 loans and deposits.

THE ESTONIAN PENSION REFORM

Estonia's low birth rate is leading to a pronounced change in Estonia's demographs, with the total population projected to decline by over 20 percent in the coming decades. In recognition of the burden this will place on the pension system, an ambitious pension reform has been launched, following the three-pillar model recommended by the World Bank.[1] Within the existing pay-as-you-go (PAYG) system, which represents the first pillar, the retirement age has been gradually increased to 63 for men and 59 for women. (The retirement age for women will be raised further to 63 by 2016.) Also, an indexation formula has been implemented that increases pensions by the unweighted average of the change in the consumer price index and the change in social security tax revenue. In addition, a fully-funded second pillar was introduced in May 2002, with mandatory participation for younger workers and voluntary participation for most older cohorts. Those switching from the first to the second pillar will pay 6 percent of their gross wages into competing private pension funds, of which 4 percentage points will be diverted from the 33 percent social tax. Finally, legislation with generous tax treatment has been established to stimulate the development of voluntary retirement savings (the third pillar).

Projections for the Pension System

	2003	2004	2005	2015	2030	2045	2060
Total population (in thousands)	1,354	1,348	1,343	1,296	1,208	1,135	1,073
Population aged 18 to 60 (in thousands)	788	791	796	768	676	587	532
Contributors (in thousands)	503	504	507	519	469	411	372
Ratio of contributors to old-age pensioners	1.70	1.72	1.73	1.90	1.72	1.47	1.31
II pillar pensioners (in percent of all old-age pensioners)	...	...	...	11	40	77	94
Social tax to II pillar (in percent of GDP)	0.5	0.6	0.7	1.1	1.2	1.3	1.3
	Current system						
Balance of PAYG system (in percent of GDP)	-0.2	-0.3	-0.2	1.1	2.0	2.7	3.2
Replacement rates (all pensioners) 1/	37	36	34	28	25	36	41
Non-switchers	37	36	34	27	18	13	9
Switchers	...	...	...	34	35	43	43
	With 100 percent indexation to social tax revenue starting in 2004						
Balance of PAYG system (in percent of GDP)	-0.2	-0.5	-0.6	-0.7	-0.6	-0.3	0.1
Replacement rates (all pensioners) 1/	37	37	36	38	38	48	50
Non-switchers	37	37	36	37	32	28	23
Switchers	...	...	...	42	46	54	52

Source: Ministry of Finance and Fund staff estimates

1/ Average pension as a share of the average net of tax wage.

With already more than 300 thousand switchers—over ⅓ of the population aged 18 to 60—interest in the second pillar has far exceeded expectations. For 2003, it is expected that inflows into the new pension funds will amount to about 0.8 percent of GDP, with a corresponding cost to the government of about 0.5 percent of GDP. The share of the working

[1] See Holzmann, Robert, 2000, "The World Bank Approach to Pension Reform," International Social Security Review, Volume 53 Issue 1, 11-33.

age population participating in the second pillar is projected to increase gradually until coverage becomes near universal by about 2045, at which point the cost to the government will stabilize at about 1.3 percent of GDP. With participants in the second pillar receiving lower first-pillar pensions, this will reduce the pressure of ageing on the PAYG system, which now is projected to run increasingly large surpluses in the coming years.

The indexation formula is central to the PAYG system. One implication of the current formula is that pensions are projected to grow by less than the average wage, which over the coming years will reduce the replacement rate, especially for those without second-pillar pensions. With many regarding even the current replacement rate as too low, there is strong political pressure to increase pensions, and an option under consideration is to replace the indexation formula with one based entirely on changes in social tax revenue. This would keep the overall replacement rate broadly stable, but would cause deficits in the PAYG system of 0.5-0.7 percent of GDP for the next three decades, compared to the large surpluses projected under the current system. Alternative, and less costly, approaches would be to address poverty issues more directly with targeted programs or to offset the cost of a more generous indexation formula with a further increase in the statutory retirement age.

ESTONIA: A STRATEGY TO FOSTER EDUCATION, R&D AND ECONOMIC GROWTH

Estonia has a large public educational system and a relatively highly-educated society: schooling amounts to 14 years for men and 15 years for women (compared to 15 and 17 years in Sweden, and 15 years for both sexes in Germany). The educational system provides a good basis for absorbing technology transfers and expanding domestic research and development, but the research and development activities in Estonia have been very limited during the period of transition: expenditures on R&D stood at 0.9 percent of GDP in 1999 compared to 0.6 percent in 1995.

The government's new education strategy, "Learning Estonia", envisages a further development of the higher education system and a support for a continuous upgrading of skills at all educational levels. While the system of general education has been good, vocational training—often linked to industries extinguished during transformation—has been lagging. The new coalition government wants to reform the educational system and bring it closer to a general education model, which is reflected in the coalition agreement. While limited support for some skill-specific training may still be necessary, general education enables workers to adopt faster to new technologies, raising opportunities for groups left behind in society to benefit from technological advances[1].

The Estonian R&D strategy, "Knowledge-based Estonia", envisages the creation of a "knowledge-based society where new knowledge, the application of knowledge and skills, as well as the development of human capital, constitute the source of economic and labor force competitiveness and an enhanced quality of life". R&D expenditures are targeted to increase to 1.5 percent of GDP by 2006 financed by a combination of state and private funds, as well as EU grants. Particular support will be granted to information technologies, biomedicine and materials' technologies, where Estonia has a comparative advantage based on the existing research base.

In developing its R&D and educational reform strategies, Estonia could draw on the experiences from other countries promoting transition to the knowledge-based economy. In the last decade, economic growth in Finland— based on the rapid development in the information and telecommunication sector—brought attention to industrial and educational policies followed in the country. It has been claimed that the Finish approach toward the innovation-based economy has been paved by the support of its research activities[2]. This

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[1] See Krueger, D. and K. B. Kumar, 2002, "Skill-specific rather than General Education: A Reason for US-Europe Growth Differences?" NBER Working Paper No. 9408.

[2] See Blomström, M., A. Kokko, and F. Sjöholm, 2002, "Growth and Innovation Policies for a Knowledge Economy: Experiences from Finland, Sweden , and Singapore", Stockholm School of Economics, Working Paper 156. The authors note that several other elements also contributed to the Finish success, most notably in the form of improved access to capital after

(continued)

view is consistent with endogenous growth theories, emphasizing the government's role in supporting research and knowledge accumulation in order to overcome market imperfections associated with under-investment in education and R&D. In Finland, since the early 1980s, a government agency for the promotion of R&D activities (Tekes) has encouraged the cooperation between industries and academic institutions. There has been no attempt to select "winners" in particular industries, but, in order to maximize the likelihood of knowledge spillovers, public funds have been used to subsidize R&D in industries linked in clusters. The presence of highly skilled labor facilitated the initial investment in information and telecommunication sector, and further developments have been possible with a significant expansion of the higher education system starting since mid-1990s. R&D expenditures (mostly in the private sector) increased from 1.6 percent of GDP in 1985 to 3.6 percent in 2001 and Finland became one of the largest exporter of new technologies among OECD countries.

The Finish approach contrasts substantially with the policy followed by Singapore, which, as in Estonia, has relied on its ability to attract foreign direct investments (FDI) and a gradual climb on the value-added ladder supported by the technology transfer from multinational corporations (MNC). The R&D remained low compared to other developing economies at the early stage of the "catching up" process and it has been argued that very rapid development since the 1970s has been based on factor accumulation rather than technological progress. In the early 1990s, the government started an aggressive campaign to attract R&D activities, mostly based on the research conducted by MNCs. The strategy led to an increase in the share of R&D expenditures in GDP from 0.8 percent in 1990 to 1.9 percent in 2000. The figures, however, reflect developments of existing products rather than research activities. Furthermore, they imply that cutting-edge technologies are still transferred from MNC's home countries. In order to encourage research in the country, the government has been promoting development of the regional educational hub in Singapore in cooperation with Western academic institutions.

Finland and Singapore followed different ways to achieve the high growth objective, but both countries significantly expanded their educational systems, especially in the field of higher education. Experience from Singapore suggests that reliance on FDI for the transfer of technology might be insufficient to insure long-term competitiveness and therefore an increase in R&D expenditures may be warranted to insure long-term growth prospects. The government of Estonia, however, may want to rely more on the private sector in financing and selecting R&D priorities. The Finish experience suggests that the government could play a catalytic role in coordinating R&D activities between industry and the academic community.

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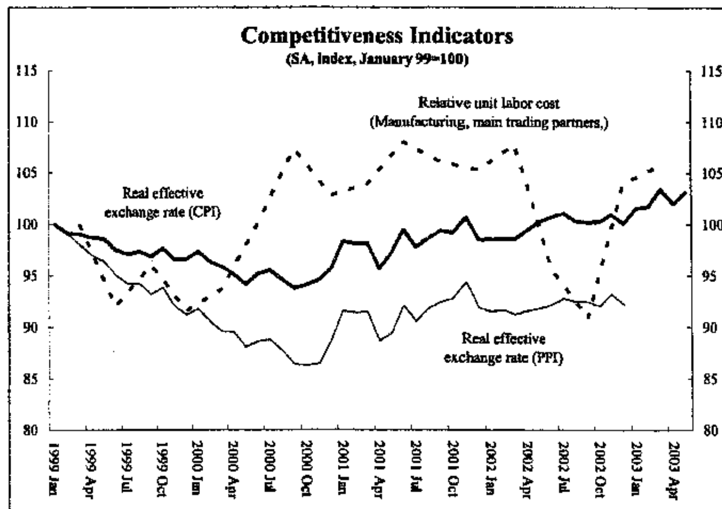
financial market liberalization in the early 1990s and strong competition in the domestic telecommunication market.

External Competitiveness[1]

Most competitiveness indicators, with the exception of average wages, suggest that the Estonian economy continues to be competitive in external markets.



In particular, the **CPI-based** real effective exchange rate has remained roughly constant since the beginning of 1999 while the **PPI-based** real effective exchange has stabilized since the beginning of 2000, after depreciating by approximately 10 percent in 1999. Relative to Estonia's main trading partners, **unit labor costs** in manufacturing have been somewhat more volatile, but appear unchanged over the last four years, reflecting that strong productivity growth matched wage growth in the manufacturing sector.

External competitiveness, as measured by the **market penetration** of Estonian exports in EU markets, improved in 2002. The share of total exports to EU markets increased by more than 10 percent in 2002 after declining by 5 percent in 2001.Excluding low-value-added machinery and electric equipment exports, the export share increased by approximately 15 percent after a small decline of 1 percent in 2001.

Market Shares of Estonian Exports to EU
(indexes, 1997 = 100)

	1997	1998	1999	2000	2001	2002
Total exports						
Estonia	100.0	120.3	124.8	166.2	157.6	173.4
Total excl. mach. & electr.						
Estonia	100.0	112.2	118.5	127.8	126.2	145.2

Sources: Comtrade database and Fund staff estimate.

Survey-based indicators of competitiveness suggest a roughly stable position. According to a survey by the World Economic Forum,

Global Competitiveness Ranking

	2001	2002	2003
World Economic Forum	29	26	n.a.
Institute for Management Development	16	16	17

Sources: World Economic Forum and Institute for Management Development

[1] For a detail discussion of external competitiveness of Estonia and the Baltics see Country Report 03/114, "Competitiveness in the Baltics in the Run-Up to EU Accession."

Estonia's growth competitiveness improved in 2002 relative to 2001, while a survey by the Institute for Management Development shows an unchanged competitiveness position in 2002 and a minor deterioration in 2003.

In contrast, **average wage growth** in Estonia has been excessive. From 1999 to 2002, the cumulative increase in average euro wages was 35 percent, while the cumulative increase in overall labor productivity was 20 percent. However, the recent high growth of nominal wages may, in part, reflect changes to the social insurance system, which has encouraged increased formal declaration of wages. Because of the change in the social insurance system, employees now have an incentive to declare wages, which were paid but not declared before. Therefore the recorded higher wage growth tends to overstate developments.

Harmonization of Estonia's Monetary Policy Framework

Under Estonia's currency board arrangement, harmonizing the monetary policy framework and changing the structure of the Bank of Estonia's (BOE) balance sheet to bring it more in line with those of euro area national central banks (NCBs), is somewhat more challenging than for non-currency board accession countries, because some of the changes could undermine the currency board system.

Monetary policy instruments are, by definition, limited in the context of a currency board arrangement. The facilities of the BOE currently consist of a standing deposit facility, reserve requirements, a foreign exchange facility, and a facility for banks to sell foreign securities to the BOE. In the absence of a marginal lending facility, reserve requirements (required reserves are averaged on a monthly basis) play a role as a potential shock absorber. As a result of the turbulence during the 1997Asia crisis, reserve requirements were increased. Since then they have amounted to 13 percent. Reserve requirements are remunerated at the ECB deposit rate, while penalty interest rates are 20 percent. This, in effect, sets both a floor and a ceiling for money market interest rates. Excess reserves held at the central bank (standing deposit facility) are also remunerated at the ECB deposit rate. A forex facility allows commercial banks to move funds across the border the same day. Given that the BOE does not charge spreads and transactions are settled the same day (i.e. on a $t+0$ basis), the forex facility effectively serves as a liquidity buffer.

Prior to joining the EMU, the monetary authorities must change their current operational framework. In principle, the authorities can harmonize the monetary policy framework gradually over the next two or three years, or hold off until the adoption of the euro. Each approach has certain risks. As a first step, the authorities have allowed commercial banks to fulfill up to 50 percent of their required reserves with eligible foreign assets. That is, euro–denominated, high-quality fixed income securities issued or guaranteed by sovereign debtors. While this has not led to a reduction in required reserves, it was a first step toward creating a level playing field for commercial banks and has improved their income position. In addition, it led to an increase in high-quality securities that the BOE could accept as collateral once an open market facility has been put in place. The increase in high-quality securities should also foster the ability of commercial banks to borrow short term in the case of adverse shocks. As a second step, the BOE adjusted the base for required reserves to bring it more in line with ECB standards.

Ultimately, Estonia has to lower reserve requirements to the average in the Euro area of 2 percent and have in place a functioning system of open market operations. Given the strong credit growth and the potential for additional cuts in Euro area interest rates, a reduction in the overall level should be postponed and be implemented in a more optimal macroeconomic environment. Greece, for example, opted to lower its high reserve requirements only shortly before joining EMU. In the meantime, the authorities could increase further the share of required reserves that banks are allowed to hold in the form of foreign securities. The establishment of an open market facility not only requires the set-up of a technical platform, but also ensures that market participants become accustomed to securitized borrowing from

the BOE ahead of EMU membership. However, to ensure that such a facility does not undermine the currency board arrangement and lead to spillovers into the money market, such a facility should initially be set up as an intra-day facility.

In line with all other accession countries, Estonia's banking system has a structural liquidity surplus. The Eurosystem, in turn, was set up with a view to ensuring that the banking system is in constant need of central bank financing, since a system with a structural deficit improves the effectiveness of regular open market operations and ultimately the transmission of monetary policy signals. The main reason for the difference between the structure of the balance sheet of the BOE and the NCBs of the euro area is related to the level of net foreign assets. In the case of Estonia, a higher share of net foreign assets is driven by the fixed exchange rate system. A convergence of the balance sheet of the BOE with those of NCBs is likely to take place gradually after EMU membership. In this respect, Estonia is not an exception from other accession countries.

FOREIGN BANK OWNERSHIP[1]

Foreign bank ownership is often associated with an improvement in the stability and efficiency of a country's financial system. However, the dependence of a domestic banking system on foreign institutions, especially if the banks are owned by institutions of a single country, could make the system vulnerable to shocks generated abroad. In Estonia, about 90 percent of total bank assets are foreign owned, with more than 80 percent of bank capital held by two Swedish groups (SEB and Swedbanken). Estonia's banking system is similar to that of New Zealand, whose banking system is almost fully owned by Australian banks.[2] The high degree of foreign ownership is at least partly the result of the authorities' strategic decision to attract foreign capital in the aftermath of the 1997/98 banking crisis.

Diversification of Swedish Parent and Baltic Subsidiaries (in percent of total assets)

Parent banks Swedish		Baltic Subsidiaries Estonia		Lithuania		Latvia	
Swedbank		***Hansabank***		***Hansabank***		***Hansabanka***	
Sweden	90	Estonia	54	Lithuania 1/	100	Latvia 1/	100
Estonia	4	Lithuania	28				
Other (Norway, Denmark)	6	Other (Latvia)	18				
SEB (Swedish parent)		***Eesti Uhispank***		***Vilniaus Bankas***		***Latvijas Unibanka***	
Sweden	42	Estonia 1/	100	Lithuania 1/	100	Latvia 1/	100
Germany	37						
Baltics	3						
Other	18						

Source: Based on information from respective banks.

1/ No major assets held abroad.

In addition to attracting badly needed capital, foreign ownership has contributed to a fall in the cost of capital due to the high credit rating of the parent banks; led to a more rapid integration with European capital markets; resulted in the transfer of knowledge, especially with respect to risk management; and improved efficiency as a result of economies of scale. The risk is, however, that shocks originating in the country of the parent banks (Sweden) could be transmitted to Estonia. The adverse implications of such a shock are even more pronounced due to fact that Sweden is Estonia's second largest export market, making it more difficult for the country to smooth out any real shocks.

The risk of a potential banking crisis in Sweden, which could spill over into Estonia, depends on —among other things— the exposure of Swedish bank assets to the home country's real economy. Of the two Swedish banks that dominate the Estonian banking system, the lending portfolio of at least one is highly diversified within Europe. The implications of a business-cycle induced downturn in Sweden on the balance sheet of one of the two Swedish parent banks (SEB)—and therefore the probability of spillovers to Estonia—are consequently judged to be limited. The other Swedish parent bank (Swedbank) is regionally less diversified, making transmission of shocks more likely. However, given the probability of future mergers and acquisition within the EU, and hence increased regional diversification, the transmission of adverse shocks to the Estonian banking system should diminish with further EU integration.

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[1] See also Country Report No. 03/115.

[2] Malta is another small economy in which the banking system is almost fully foreign owned.

LABOR MARKET AND UNEMPLOYMENT[1]

High and persistent unemployment continues to be a major challenge for policymakers in Estonia. Unemployment is concentrated in the northeastern part of the country, which is largely populated by the Russian-speaking community and was severely hit by a demise of industries operating before the collapse of the Soviet Union. Labor market institutions, skill mismatches, and low labor mobility are considered to be the main causes for the high unemployment rate.

Despite far-reaching, market-oriented reforms, the level of employment protection is slightly higher in Estonia than in the EU on average[2] and a number of empirical studies demonstrate that excessive labor market regulation has a significant negative impact on employment[3]. The way in which employment is affected depends on the interactions between shocks hitting the economy and labor market institutions[4]. For example, a negative shock, in the presence of long-lasting unemployment benefits and a high level of employment protection, leads to a more pronounced and persistent increase in unemployment than in the case of a more liberal labor market structure. The institutional makeup of Estonia's labor market together with large shocks related to the transition period may be responsible for the high level of unemployment.

The high unemployment phenomenon has been also attributed to a mismatch between the demand for high-skilled workers and the abundance of low-skilled labor. The share of the labor force with tertiary and university education is lower in northeastern Estonia than in other parts of the country. The relatively low skill level may partly explain the fact that growth has been below average in the Northeast and unemployment here has been higher. However, the empirical evidence about the link between unemployment and educational achievements is weak. For example, in high-unemployment regions of Southern Europe, the

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[1] For a detailed discussion on labor market developments in Estonia see Selected Issues Paper "The Labor Market and Unemployment in Estonia".

[2] See Paas, Tiiu, Raul Eamets, Marit Room, Rena Selliov, Anne Jürgenson, Jaan Masso, 2002, Labour Flexibility and Migration in the EU Eastward Enlargement Context: The Case of the Baltic States", Ezoneplus Working Paper No. 11

[3] See Nickell, Stephen,, and Richard Layard, 1999, "Labor Market Institutions and Economic Performance," in Handbook of Labor Economics, Vol. 3C, ed. by Orley Ashenfelter and David Card (New York and Oxford: Elsevier Science, North-Holland), pp. 3029–84.

[4] See Blanchard, Olivier and Justin Wolfers, 1999, "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence", NBER Working Paper No. 7282

duration of unemployment tended to rise with the level of education, as better qualified young people started to reject unattractive job offers more often[4].

Recent research analyzes to what degree unequal regional developments impact the labor market[5]. In the "New Economic Geography" models, certain "core" regions grow faster than "peripheries" due to horizontal linkages between industries. Regional disparities are therefore expected to deepen with economic development, aggravating—if combined with low labor mobility—the unemployment problem in poor areas. In Estonia, labor mobility has been low due to regional differences in property prices and the language barrier faced by people of Russian origin.

Policies to combat unemployment should depend on the origin of the problem. Liberalization of labor market institutions in the presence of limited labor mobility works only if economic growth rebounds in the depressed regions. Labor market policies combined with lower labor costs and a relatively tight labor market in the Tallinn area, may encourage large foreign and domestic companies to invest in the less developed regions of Estonia. Educational reform, in turn, should promote a model of general education in place of job-specific vocational training. While such a policy may lead to a temporary increase in the duration of unemployment, the general education model increases labor force flexibility and the capacity to absorb foreign investments. In addition, the government could support specific vocational training in cooperation with large investors. Preliminary econometric evidence suggests that active labor market policies in Estonia, mainly in the form of vocational training, have been effective[6]. While these programs provide job-specific rather than general skills, they might be an appropriate policy to support older unemployed in the job search process, especially if these policies are implemented in tandem with policies that encourage foreign and domestic companies to locate to the less developed regions.

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[4] See Kostoris, Fiorella and Padoa Schioppa, 1999, "Regional Aspects of Unemployment in Europe and in Italy" CEPR Discussion Paper No. 2108

[5] See Kostoris, Fiorella, Padoa Schioppa andRoberto Basile "Unemployment Dynamics of the "Mezzogiornos of Europe": Lessons for the Mezzogiorno of Italy", CEPR Discussion Paper No. 3594

[6] See Leetmaa, Reelika and Andres Võrk, 2003, "Evaluation of Active Labour Market Programmes in Estonia", University of Tartu, Estonia

Estonia: Fund Relations[1]
(As of August 31, 2003)

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	65.20	99.9
Reserve position in Fund	0.01	0.01

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.05	N.A.

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	3/1/00	8/31/01	29.34	0.00
Stand-by	12/17/97	3/16/99	16.10	0.00
Stand-by	7/29/96	8/28/97	13.95	0.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs): None

VII. **Safeguards Assessment:**

Under the Fund's safeguards assessment policy, the Bank of Estonia was subject to the transitional procedures with respect to the Stand By Arrangement which was approved on March 1, 2000 and which expired on August 31, 2001. The transitional procedures require a review of only the BOE's external audit mechanism. This assessment determines whether the BOE publishes annual financial statements that are independently audited in accordance with internationally accepted standards. The external audit assessment was completed on December 13, 2000. The assessment concluded that BOE's external audit mechanism is adequate, as reported in 2001 Article IV Staff Report.

[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).

VIII. **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 15.6466 per euro (and EEK 8 per deutsche mark until 31 December, 2001). 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. Estonia does not maintain restrictions on capital transactions.

IX. **Article IV Consultation:**

The 2002 Article IV consultation was concluded by the Executive Board on July 1, 2002.

X. **FSAP Participation and ROSCs:**

A joint World Bank-International Monetary Fund mission conducted an assessment of Estonia's financial sector as part of the Financial Sector Assessment Program (FSAP) in March, 2000. The associated Reports on Observance of Standards and Codes (ROSC), and the Financial Sector Stability Assessment (FSSA) report, were completed in June and August 2000 respectively. IMF missions also conducted assessments of fiscal transparency, and data quality and dissemination practices, in Estonia, in April and May 2001, respectively. These assessments were discussed in the 2001 Article IV consultations, and the resulting ROSC modules were completed later that year. The ROSC modules were updated during the 2002 Article IV consultation. The updates were published on the Fund's external website.

ROSC MODULES

Standard/Code assessed	**Issue date**	**Updated**
Banking Supervision	June 30, 2000	July 3, 2002
Insurance Supervision	June 30, 2000	July 3, 2002
Monetary and Financial Policy Transparency	June 30, 2000	July 3, 2002
Payments Systems	June 30, 2000	July 3, 2002
Securities Regulation	June 30, 2000	July 3, 2002
Fiscal Transparency	July 9, 2001	July 3, 2002
Data Quality and Dissemination	October 19, 2001	July 3, 2002

XI. Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 2000–2002

DEPT	Project	Action	Timing	Counterpart
FAD	Pension Reform	Mission	April 2000	Ministries of Finance and Social Affairs
MAE	Banking Supervision	Staff Visit	December 2000	Bank of Estonia
FAD	Tax Policy	Mission	March 2001	Ministry of Finance
INS	Financial Markets	Training	September 2002	Bank of Estonia

XII. Resident Representative:

Mr. Adalbert Knöbl was senior resident representative in Estonia and Latvia until 2002. Since then the office in Estonia has been run by two local staff. His position was not replaced.

XIII. Fourth Amendment:

Estonia accepted the Fourth Amendment of the Articles of Agreement in April 1999.

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. Work is proceeding on the financial sector regulatory system, and the financing of municipalities and reform of the structure of sub-national governments.

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. The Bank is also assisting the authorities's preparation of a second health project, which will help to promote sustainable and effective financing of public spending on health, and raise the quality of health care delivery.

4. Bank lending has been limited in recent years and is likely to remain small. The Bank's local office inTallinn was closed in June 2001.

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. The following is a summary of both the frequency and the timing of key data as made available to Fund staff:

A. Monetary Statistics

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

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

B. Financial Statistics

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

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

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

[2] Indicates publicly available data on the Bank of Estonia website (http://www.bankofestonia.info/frontpage/en).

[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.

- NFAs of commercial banks are 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.[2]

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

- Quarterly current account data are available with a one-quarter lag.[2]

- Quarterly public and private external debt data are available with a one-quarter lag.[2]

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF). SDDS related data for central government operations and central government debt have not been disseminated since December 2002. The MoF has introduced a new budget system this year together with new budget classifiers based on GFS2001 and has reported ongoing difficulties in matching the source data into the new framework.

- 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/?lang=en). Currently, the MoF is using one of its two allowed SDDS flexibility options on the timeliness of monthly central government operations data, but plans to begin redisseminating these data in July 2003

- Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag. Currently, the MoF is using the second of its two allowed SDDS flexibility options on the timeliness of quarterly central government debt data, but plans to begin redisseminating these data in July 2003.

- 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.* Annual general government operations data (cumulative) for 2002 are available on Estonia's National Summary Data Page (NSDP).

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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.[4]

- 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.[4]

- 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.[4]

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.[4]

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

Estonia: Core Statistical Indicators
(As of September 9, 2003)

	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	9/9/03	7/31/03	7/31/03	7/31/03	7/31/03	7/03	7/03	6/03	Q1/03	5/03	Q1/03	Q1/03
Date Received	9/9//03	8/19/03	8/19/03	8/19/03	8/19/03	8/26/03	7/2/03	8/9/03	6/16/03	6/30/03	6/30/03	6/25/03
Frequency of Data	D	M	M	M	M	M	M	M	Q	M	Q	Q
Frequency of Reporting	D	M	M	M	M	M	M	M	Q	M	Q	Q
Source of Update	N	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	M	M	M	M	M	M	M	Q	M	Q	Q

Explanation of abbreviations:
Frequency of data, reporting and publication: D—daily, M—monthly, Q—Quarterly.
Source of data: A—direct reporting by Bank of Estonia, Ministry of Finance, or Statistical Office of Estonia.
Mode of reporting: E—electronic (e-mail or internet).
Confidentiality: C—unrestricte

Statement by Benny Andersen, Alternate Executive Director for Republic of Estonia and Tanel Ross, Senior Advisor to Executive Director
October 22, 2003

Our Estonian authorities would like to express their appreciation to Mr. Haas and his team for their high quality work as well as for the excellent set of papers on a wide range of issues. The authorities broadly agree with the analysis and recommendations of the staff, including on the key economic challenges in the years ahead.

Fund surveillance and advice as well as technical assistance have been invaluable for Estonia's economic transformation and during the preparations to the EU accession. Indeed, the frank, candid and transparent nature of the policy discussions on a broad range of issues illustrates the very positive role that the Fund can play in supporting the economic policymaking at every level of development. The Estonian authorities would like to take this opportunity and to extend their sincerest appreciation to Mr. Odling-Smee and staff of the European II Department for their dedication and assistance that Estonia has enjoyed over the past decade. They are confident that this mutual commitment and trust will continue to characterize Estonia's relations with the Fund.

With the accession to the European Union to take place in about six months, Estonia's pre-accession economic performance has remained strong. GDP growth has averaged 6.6 percent during the last three years, reflecting a solid track record of policies geared toward the macroeconomic stability and advanced structural reforms. At the same time, these developments have been recently accompanied by a widened current account deficit, increasing the potential external vulnerability.

Recent economic developments and prospects

After expanding by 6 percent in 2002, Estonia's real GDP increased by approximately 4.4 percent in the first half of 2003 as private consumption and investment growth moderated. The recent high-frequency indicators suggest that growth may have accelerated again in the third quarter. For 2003, real GDP growth by 4.5 percent would be expected, somewhat below the medium term potential. For 2004, the authorities expect the economy to expand by 5.6 percent, in line with staff's projection and with net exports providing a significant stimulus to growth. Inflation has remained low, increasing slightly to 1.4 percent in September. The recent stability of the price level has been supported by the relatively large share of traded goods in the consumer basket and the stability of the utility prices. As the impact of these factors is expected to turn around next year, and with the additional effect of tax harmonization related to EU accession, the inflation rate is expected to reach 4 percent in 2004 and would decrease gradually to 3.2 percent by 2006.
The fiscal performance has been broadly in line with the expectations. Public sector revenues exceeded outlays by 2.5 percent of GDP in the first half of 2003, implying a surplus of around 0.4 percent of GDP for the year as a whole. As in previous years, the consolidated central government will record a surplus while local municipalities, most notably the capital city of Tallinn, remain in deficit by some 0.3 percent of GDP.

For 2003, the authorities expect the current account deficit to remain broadly unchanged from 2002 at slightly above 12 percent of GDP. The primary external deficit – defined by the authorities as the total current account deficit less dividend and interest payments on foreign direct investment, and reinvested earnings - would amount to 6 percent of GDP. On the financing side, net foreign direct investments increased to 6 percent of GDP in the first half of 2003.

Medium term adjustment of external accounts

Estonia's competitiveness is fundamentally sound as evidenced *inter alia* by strong exports. Furthermore, the comparative analysis on the competitiveness in the Baltics by the IMF staff and the very recent study by Bank of Estonia's economists confirm that the real exchange rate is close to its medium term equilibrium and not overvalued. Nevertheless, the external imbalance has widened significantly. While public sector surpluses over the last years have contributed to domestic savings, the gap between private savings and investments has increased, buoyed by the relatively high credit ratings, a strong financial system, and the EU accession. The reversal of the increased external vulnerability will be of key importance to sustain high growth rates over the medium term.

The high domestic investment, reaching 34 percent of GDP and maintained by the strong productivity performance and the continuing convergence with the European Union, is the main factor underlying the external deficit. The latest hike in investments is partly attributable to the infrastructure modernization. The additional effect of large projects undertaken by the privatized railways and the restructured energy sector on current account deficit amounts to some 4 to 5 percentage points of GDP in 2002 and 2003. Another driving force behind the widened current account is the ongoing inter-temporal consumption adjustment, sustained by increasing real incomes and efficient financial intermediation. Financial leverage of private individuals is still relatively low with their total debt burden standing at 18 percent of GDP. Furthermore, the relatively modest growth in Estonia's main export markets has had its impact on the external accounts until recently.

The major one-off effect of these special factors is expected to be gradually shaved off. Indeed, the authorities consider that the adjustment has already started in the middle of this year. For 2004, the current account deficit is expected to diminish to 10 percent of GDP (6 percent of GDP for the primary external balance) and to decrease further to 9 percent of GDP by 2006. Estonian gross external debt would stay at around 70 percent of GDP in 2004 and remain broadly unchanged or even decrease gradually thereafter. The net indebtedness, equal to 11 percent of GDP as of 2003, would remain much lower.

On the financing side, capital inflows are expected to remain strong. Foreign direct investments would return to a comfortable level of around 5 percent of GDP, after the temporary decline due to the increased infrastructure-related borrowing in 2002. This projection does not appear to be overly optimistic as the share of foreign direct investments to purchasing-power-parity adjusted GDP is lower in Estonia than in a number of small EU member states. Notwithstanding that, the Estonian authorities expect the relative importance

of other inflows to increase as Estonia's economy and financial system will integrate even further to the EU single market. The very limited direct impact of the so-called convergence play on Estonia's financial markets provides further support to external resilience. The credibility of the currency board and the structure of the financial system have facilitated the convergence of nominal interest rates towards the euro rates for some years already, and the capital inflows have focused mostly on longer term investment opportunities.

Macroeconomic policies in 2004

The overarching macroeconomic objective of the Estonian authorities is to ensure lasting convergence with the European Union and the Euro Area, resulting in the Maastricht criteria to be met in a sustainable manner. In the near term, the increasing external vulnerability is the most important concern. To address these challenges, the policy framework as provided by the authorities in their recent *Pre-Accession Economic Program*, will be centered around the fixed exchange rate and currency board, and supported by prudent financial sector policies. On the fiscal front, the authorities are fully committed to budgetary balance over the business cycle, consistent with the provisions of the Stability and Growth Pact. Consequently, public debt is expected to remain below 6 percent of GDP and the government will retain its net creditor status *vis-à-vis* the rest of the world. Within this framework, the authorities intend to allow the automatic stabilizers to function to the fullest extent possible.

Monetary and financial sector policies

The Estonian government and the central bank intend to seek participation in the ERM-2 exchange rate mechanism immediately after joining the EU, in accordance with all relevant multilateral procedures and within the established framework. Consistent with the provisions of the EU Treaty, the authorities plan to adopt the euro at the earliest possible date thereafter. Estonia intends to maintain the currency board as a unilateral commitment during the ERM-2 membership.

As private credit growth increased in 2002, the authorities took a number of measures to limit its macroeconomic and prudential impact. Government deposits were transferred out from the domestic financial system last year, and the ratio of mandatory liquidity requirements for banks was effectively increased. The authorities have also discussed the possible use of prudential ratios for counter-cyclical purposes. Until now, they have decided to refrain from taking additional actions, not least because Estonia's financial system is fully integrated into large regional financial conglomerates. It is likely that this market structure would render the efficient use of the discretionary policy measures increasingly difficult and may entail unwelcome distortions. However, the authorities will continue to monitor closely the consolidated financial system, and they are ready to act, should the gradual decline of credit growth be reversed. Additionally, in line with staff's recommendations, the government has prepared the amendments to the tax legislation that would reduce the maximum amount of tax deductibility of interest payments on mortgage loans.

On the supervisory front, the authorities issued a number of recommendations to commercial banks in December 2002, to ensure, *inter alia*, strict adherence to good lending practices, the

adequate collateralization of bank credit, and importance of banks' internal stress testing exercises. The follow-up assessment of the efficiency of this step was accomplished in the second quarter of 2003 with the reassuring conclusion that banks have reviewed their internal lending procedures in line with the recommendations. The supervision has also stepped up on-site inspections and analysis of banking groups, including the non-bank affiliates. The ability to take further corrective measures is enhanced by the close cooperation among the central banks and supervisors in the Baltic and Scandinavian region, based *inter alia* on memoranda of understanding.

Fiscal policy

Estonia has pursued a conservative fiscal policy, consistent with the fixed exchange rate regime and fully in line with the EU framework. With a low single digit public debt and small overall surplus in recent years, a joint study by the Ministry of Finance and Bank of Estonia also reveals that the structural position of the general government actually strengthened between 2000 and 2002. The authorities expect the general government surplus for 2003 to reach 0.4 percent of GDP. While they admit that even higher surplus may have been justified, as proposed by staff, the increase in *inter alia* investment expenditures was necessary to complete a number of investment projects, partly related to the EU accession. After enacting these additional expenditures in the supplementary budget in June 2003, the authorities have declared that no more additional budgets will be introduced this year. Additionally, while some additional investments were recorded as a capital injection to the government's real estate management company, both the government and the central bank publicly regard this transaction as net financing for the purposes of economic analysis.

A state budget for 2004, fully balanced on the general government level, was submitted to parliament in mid-September and is expected to be approved before the end of the year. As indicated in the staff report, the Estonian government has launched a number of structural fiscal policy measures for 2004 and beyond, aiming *inter alia* at lowering the direct income taxation and addressing some key social policy concerns. While the authorities consider these steps of being very important for the medium and long term development, they stand ready to take balancing fiscal measures if needed. It should be noted that most of the co-financing requirements related to the EU funds will be accommodated in the current public investment portfolio. Moreover, when assessing the policy stance, the relatively limited contingent pension liabilities should be taken into account.

Whereas the Estonian constitution provides local governments with significant autonomy, the authorities are monitoring the fiscal situation in municipalities very closely. They concur with staff that local fiscal management should be strengthened. As a number of local governments are about to reach in the near future their borrowing limits, the consolidation of finances at the local level is already underway. Additionally, some large municipalities, most notably Tallinn, have announced plans to target explicit medium term budget balance from now on. And last but not least, the fiscal strength of local governments will eventually have impact on their credit ratings and, consequently, on the cost and availability of their financing. The government is also stepping up its efforts to encourage voluntary mergers of the municipalities.

Structural policies

As emphasized by staff, the Estonian structural reform agenda is largely driven by the EU integration process. The authorities continue to promote advanced structural reforms to maintain Estonia's strong competitive position, and have drawn up a long term road map "Estonia 2014" in line with the goals of the Lisbon process. Key objectives in this regard are the sustainability of the pension and health care systems, increasing labor supply and market efficiency, and the promotion of an efficient business environment.

The completion of the pension reform reduces substantially the contingent liabilities of the state budget. Indeed, as noted by staff, the pension reform has been rather successful and over one third of the working age population has joined the fully funded second pillar after its launch in May 2002. In addition, the government is implementing the structural health care reform within the framework of the current solidarity-based insurance system. While the present system is financially stable and does not take recourse to state budget, further reforms are needed to ensure the sustainability of health care expenditures that are expected to rise over the medium term from the current 5 percent of GDP.

Estonia's enterprise restructuring and privatization is virtually accomplished. A small number of large infrastructure enterprises remains in state ownership for the time being. These include the state energy company as its privatization failed in 2002 due to the financial difficulties of the prospective buyer, the post office and Port of Tallinn. In addition, the government's real estate assets are managed by a separate state-owned firm, incorporated under the business legislation. All these entities are profitable and managed in accordance with sound and transparent corporate governance rules. The government is contemplating the divestiture of its non-strategic portfolio in accordance with the market conditions. The main focus of Estonia's industrial policy is now on supporting research, technology development and innovation, mostly by improving access to start-up capital and fostering training programs in line with the EU policies. The full liberalization of the energy market for enterprises will be completed by 2012, in line with the outcome of the EU accession negotiations.

While unemployment has been gradually declining, the Estonian authorities agree with staff that more needs to be done to improve the functioning of the labor market. In that regard, the Selected Issues paper provides some insightful findings that, we believe, should be elaborated even further. In general, the authorities believe that the market structure is still flexible enough to facilitate the increase of employment in the future, and the income tax reform would lower the effective level of the labor taxation. In line with the Employment Action Plan for 2003, the government is pursuing a number of active labor market policy measures, and is supporting the regions that are severely hit due to industrial restructuring. In particular, the respective governmental agencies are implementing two complementary sub-programs to foster SME development and to improve labor market conditions in North-Eastern Estonia.

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

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

IMF Concludes 2003 Article IV Consultation with the Republic of Estonia

On October 22, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Estonia.[1]

Background

The rapid and successful transformation of Estonia into an open and flexible market economy places it as a star performer among European Union accession countries. The foundation for this accomplishment is a prudent macroeconomic policy, based on a balanced budget strategy, the currency board arrangement, and vigorous structural reform. The positive outcome of Estonia's national referendum on EU membership paves the way for EU accession on May 1, 2004, solidifying these accomplishments.

The Estonian economy continues to perform very well despite weakness in major export markets. The economy grew by 6 percent in 2002, driven by both strong domestic investment and consumption demand, and recent data suggest that economic activity continued to be buoyant in the first half of 2003. Labor market developments were also positive with higher employment and lower unemployment. Inflation has declined to a new low, reflecting declining import prices and positive "one-off" factors such as lower food prices.

Fiscal performance has been very strong, as rapid growth in domestic demand contributed to higher-than-expected tax revenue. The general government budget showed a surplus of 1.2

[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.

percent of GDP in 2002, with the positive balance continuing in early 2003 and allowing for a further buildup of deposits. This has occurred despite several supplementary budgets, a rapid increase in public expenditure, and persistent deficits at the municipal level.

A further easing of monetary conditions contributed to continued strong money and credit growth. Interest rates in Estonia declined as a result of a fall in Euro-area interest rates and a decline in the country's risk premium. Furthermore, some financial institutions started to lend more aggressively to increase their market share, putting additional downward pressure on lending rates, especially in the real estate sector. Lease financing continued to grow especially rapidly. Nevertheless, Estonia's banking system remains financially very sound.

The external current account has deteriorated substantially. While large external deficits, to some extent, are a reflection of the country's growth potential, the sudden jump in the deficit from 6 percent of GDP in 2001 to 12.3 percent in 2002 has rendered the economy more vulnerable to external shocks. The deterioration in the current account is particularly worrisome because it was associated with a fall in Foreign Direct Investment (FDI) coverage. Although preliminary information for the first half of 2003 suggests a renewed increase in FDI coverage, the trend of substantially higher deficits and less-than-full FDI coverage remains. Despite these adverse developments, confidence in the currency board remains strong.

Two important structural reforms have been launched: the introduction of a second pillar in the pension system, which aims at moving from the pay-as-you-go system to a fully-funded defined-contribution system, and the establishment of a new unemployment insurance scheme. The introduction of the second pillar was substantially more successful than anticipated.

Executive Board Assessment

Executive Directors welcomed the results of the recent referendum to join the EU and Estonia's successful transformation into an open and flexible market economy. They hoped that the underpinnings of Estonia's success in the past, especially prudent fiscal policy and resolute focus on structural reforms, will continue to be preserved in the future. Directors considered that the overarching economic challenge in the period ahead will be ensuring lasting convergence with the EU in order to ensure a smooth transition to the euro, while maintaining a sound external position.

Directors were encouraged that, despite continued sluggish demand in Estonia's major trading partners, economic growth remains relatively strong, and the outlook positive. However, given the country's degree of openness, a prolonged slowdown in Estonia's trading partners would ultimately impact exports, consumer confidence, and investment activities. Directors also expressed concern that the large current account deficit —in combination with a simultaneous fall in coverage of the deficit by foreign direct investment inflows—has increased the vulnerability of the economy. While the financing of the current account deficit is unlikely to pose difficulties in the immediate future, a deficit of this size will not be sustainable over the longer term.

Directors commended the authorities for their commitment to a prudent fiscal policy, as reflected in the country's balanced budget policy. However, in light of the large current account deficit, most Directors were of the view that a more proactive fiscal policy is required to maintain macroeconomic stability. Directors recommended that the authorities target a balanced budget over the business cycle rather than on an annual basis. In this context, Directors welcomed the government's announcement that it will not pass a second supplementary budget for 2003, but they stressed that the fiscal surplus in 2003 should be higher than that achieved in 2002. They therefore recommended allowing the automatic stabilizers to operate fully and postponing some planned expenditure increases.

Directors welcomed the authorities' ambitious fiscal policy initiatives for the coming years. However, the plan to lower the income tax rate while simultaneously increasing parents' benefits could undermine the fiscal target, in particular given that expectations for inflows of EU funds might prove to be over-optimistic. Directors cautioned that the circumvention of borrowing limits by municipalities, and the use of non-transparent fiscal transactions aimed at financing increased expenditure without affecting the publicly visible deficit, could compromise Estonia's high standards of fiscal transparency and should be resisted. To relieve budgetary pressures and to eliminate potential distortions in the financial system, consideration could be given to gradually eliminating the tax deductibility of mortgage interest payments and the tax exemption on interest income from bank deposits.

Directors noted that confidence in the country's currency board arrangement continues to be strong. They emphasized that Estonia's joining ERM-II with a fixed exchange rate shortly after EU membership—as the authorities intend—will depend on continued implementation of appropriate fiscal and structural policies.

Directors welcomed the authorities' continued effort to foster the soundness of the financial sector through improved supervision, and commended their efforts to address the strong credit growth through measures such as broadening the base for reserve requirements and promoting good lending practices. However, they emphasized the need to be vigilant and to be prepared to increase prudential requirements on a temporary basis if asset prices, especially in the housing sector, increase sharply.

Directors welcomed the implementation of effective mechanisms to combat money laundering and the financing of terrorism. They noted that legislation has been amended to bring it into line with the latest EU anti-money laundering directives, and that explicit provisions criminalizing the financing of terrorism are now in force.

Directors were encouraged by the recent decline in unemployment, but noted that the unemployment rate remains high, especially in the northeastern part of the country. They encouraged the authorities to further improve labor market regulation, facilitate labor mobility, and increase investment in human capital, in terms of both general education and vocational training.

Directors commended the authorities for being at the forefront of efforts to promote data transparency and dissemination. Estonia subscribes to the Fund's Special Data Dissemination Standard and provides key data for surveillance on a timely basis.

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. The Staff Report for the 2003 Article IV Consultation with Estonia is also available.

Republic of Estonia: Selected Economic Indicators

	1998	1999	2000	2001	2002
Real Economy			*Changes in percent*		
Real GDP	4.6	-0.6	7.3	6.5	6.0
CPI (period average)	8.2	3.3	4.0	5.8	3.6
Unemployment rate (in percent) 1/	9.8	12.2	13.7	12.6	10.3
Domestic saving (in percent of GDP)	20.1	19.8	21.9	22.8	19.2
Domestic investment (in percent of GDP)	29.3	24.5	27.8	28.9	31.4
Public Finance			*In percent of GDP*		
General government balance	-0.3	-4.6	-0.7	0.4	1.2
General government external debt					
Excluding government assets held abroad	5.8	6.5	4.9	4.5	5.2
Including government assets held abroad	4.1	4.3	3.0	0.8	-0.6
Money and Credit			*Changes in Percent*		
Base money	6.4	27.1	14.6	-9.8	-1.5
M1	-6.3	32.1	20.4	19.5	9.3
Broad money	4.2	23.7	25.7	23.0	11.2
Domestic credit to nongovernment	11.7	6.3	30.3	22.2	27.8
Balance of Payments			*In percent of GDP*		
Goods and non-factor services balance	-10.4	-4.9	-4.1	-3.7	-9.4
Current account	-9.2	-4.7	-5.8	-6.0	-12.3
Gross international reserves (in millions of euro)	697	852	993	931	989
Exchange Rate					
Exchange rate regime			Currency Board Arrangement		
Present			EEK 15.64664= €1		
Real effective exchange rate (1995=100) 2/	123.8	137.6	131.1	132.0	134.0

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

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

2/ From INS, export-share weighted real exchange rate (CPI) against 15 major trading partners.