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

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

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

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

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

Economic developments and outlook

Recent economic data supports the view that the Estonian economy has firmly returned to the growth path and that the recession was short-lived. Following four quarters of contraction, the economy started to revive in the fourth quarter of 1999, driven primarily by the rebound in domestic demand. Further broadening of the recovery in the beginning of 2000 was largely due to the increasingly favorable external conditions – the positive outlook for the global economy and, in particular, strengthening growth in Europe – and Estonia's healthy competitive position. This allowed export volumes to reach their all-time-high as export growth accelerated sharply and reached 47% over the previous year in the first quarter of 2000. Although domestic demand was somewhat weaker than expected, exports lifted economic growth to around 5.2% in the first quarter of this year.

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

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

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

Monetary policy in the light of forthcoming EU accession

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

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

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

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

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

Fiscal policy in the short and medium term

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

The authorities have also advanced in refining the medium-term framework of fiscal policy. Two issues are central in this respect. First, the government has submitted to the parliament the new draft Budget Law. When passed, the law will enhance fiscal transparency and will bring Estonian budget legislation in line with the EU requirements and with the IMF's code of good practices on fiscal transparency. Second, the government has approved the main principles of the fiscal strategy for the period 2001-2004. The strategy foresees a lowering of the tax burden; an increase in the quality of public expenditures; speeding up European integration, *inter alia* via strengthening the administrative capacity of the public sector; and streamlining public debt management. As a result, by 2004, the tax burden should decline to 34% of GDP and government expenditures to 34% of GDP; Estonia should be ready to join the European Union by 2003; and the public debt is not expected to increase.

Financial sector issues

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

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

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

Main challenges in the structural arena

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

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

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

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

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

Transparency initiatives

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