

Republic of Estonia: 2002 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 2002 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 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 30, 2002**, with the officials of the Republic of Estonia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 14, 2002.** 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 July 1, 2002 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.

Report on the Observance of Standards and Codes—Banking Supervision,
Data Module, Fiscal Transparency Module, Insurance Supervision, Payment
Systems, Securities Supervision, and Transparency in Monetary and
Financial Policies—Updates
Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation
with the Republic of Estonia

Approved by John Dodsworth and Anne McGuirk

June 14, 2002

- The discussions were held in Tallinn during April 18–30, 2002
- The mission met with Prime Minister Kallas, Minister of Finance Õunapuu, the Bank of Estonia's Governor Kraft, Minister of Economic Affairs Tõnisson, Minister of Social Affairs Oviir, the chairperson of the Financial Supervision Authority as well as with representatives of commercial banks, industry, and the European Union.
- The mission team consisted of Messrs. Haas (head), Burgess, Schipke, Ms. Sheridan (all EU2), Mr. Mitchell (PDR), and Mr. MacFarlan (RES). Mr. Knöbl, the Fund's senior resident representative, assisted the mission. Mr. Andersen, Alternate Executive Director for Estonia, and Mr. Alber, Assistant to the Executive Director, participated in the discussions.
- Estonia accepted the obligations of Article VIII, sections 2,3 and 4, in 1994 and maintains no restrictions on payments and transfers in respect of current or capital account transactions. A fourth Stand-By Arrangement (SBA), which the authorities regarded as precautionary, expired on August 31, 2001. The authorities do not intend to seek another arrangement.
- The FSSA and associated ROSC modules on banking supervision, insurance supervision, monetary and financial policy transparency, payments systems, and securities regulation were completed in 2000. ROSC modules on fiscal transparency and data were issued in July and October 2001, respectively. Information updates for each ROSC will be issued as supplements to the staff report.
- As background to the forthcoming Board discussion, a paper on "The Baltic Countries: Medium-Term Fiscal Issues Related to EU and NATO Accession" (IMF Occasional Paper No. 213), as well as a paper providing statistical information (SM/02/187, 6/17/02), have been issued.

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Estonia: Basic Data

Social and demographic indicators, 2000					
Area	45,227 sq. km.				
Population	1.3642 million				
Rate of population growth	-0.4 percent per year				
Life expectancy at birth 1/	70.6 years				
Male	65.3 years				
Female	76.1 years				
Infant mortality rate (per 1,000 births) 1/	9.5				
Hospital beds (per 10,000 inhabitants) 1/	71.9				
Physicians (per 10,000 inhabitants) 1/	39.9				
	1997	1998	1999	2000	2001
Nominal GDP (in million of EEK)	64,045	73,538	76,327	85,436	95,275
GDP per capita (in US\$)	3158	3594	3597	3670	3969
Real GDP (percentage change)	10.4	5.0	-0.7	6.9	5.4
Sectoral distribution of GDP (In percent of value added)					
Agriculture, hunting, forestry, and fishing	7.9	7.2	6.7	6.3	6.3
Mining, manufacturing, and energy	23.0	22.6	21.1	22.3	22.1
Construction and services	69.1	70.2	72.2	71.4	71.6
Trade (In millions of kroons, unless otherwise specified)					
Total exports of goods	31,847	37,786	36,995	56,013	58,640
(in percent of GDP)	49.7	51.4	48.5	65.6	61.5
Total imports of goods	47,499	53,512	49,092	69,507	72,450
(in percent of GDP)	74.2	72.8	64.3	81.4	76.0
General government (In millions of kroons, unless otherwise specified)					
Total revenue	25,478	28,887	29,083	33,062	36,881
(in percent of GDP)	39.8	39.3	38.1	38.7	38.7
Total expenditure	24,068	29,115	32,622	33,638	36,485
(in percent of GDP)	37.6	39.6	42.7	39.4	38.3
Net lending	264	-77	-81	329	63
(in percent of GDP)	0.4	-0.1	-0.1	0.4	0.1
Overall surplus / deficit(-)	1,410	-228	-3,539	-575	396
(in percent of GDP)	2.2	-0.3	-4.6	-0.7	0.4
Money and credit (end-period) (In millions of kroons, unless otherwise specified)					
Net foreign assets	5,083	5,112	8,022	9,098	12285
Broad money (M3)	20,466	21,328	26,390	33,162	40,803
Domestic credit	20,797	24,223	26,542	33,758	41994
Claims on general government (net)	-1,716	-930	-197	-1,078	-575
Other selected indicators (Annual percentage change)					
GDP at current prices	22.1	14.8	3.8	11.9	11.5
Average CPI	11.2	8.1	3.3	4.0	5.8
Average nominal wage (in EEK) 2/	19.6	14.7	10.6	10.6	12.9

Sources: Estonian authorities; and Fund staff estimates.

1/ Data for 1999.

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

EXECUTIVE SUMMARY

The economy has been surprisingly resilient despite the slowdown in Estonia's main EU trading partners and further fiscal consolidation. GDP growth slowed moderately, reaching 5.4 percent in 2001, compared to 6.9 percent in 2000. Domestic demand—especially investment—grew strongly, while export weakness has been concentrated mainly in the low-value-added electronics sector (and matched by a similar fall in imports). The current account deficit stabilized at 6½ percent of GDP and was more than covered by strong foreign direct investment (FDI) inflows. The banking system is in a strong financial position, public debt is very low, and confidence in the currency board remains high. The authorities indicated that, despite a change in coalition members in January 2002, their economic agenda will remain broadly unchanged until parliamentary elections in March 2003.

In the near term, the main policy issue concerns the appropriate fiscal stance given uncertainties about the cyclical position. The authorities' target of a fiscal deficit of about ¾ percent of GDP in 2002 was broadly appropriate when adopted. But with the recent strength of the economy likely to be at least partly sustained through 2002, especially given the recent easing of monetary conditions resulting from lower interest rates in the euro area and a fall in risk premia, a somewhat tighter stance would be appropriate. This could be accomplished by allowing the automatic stabilizers to operate fully. The authorities intend, however, to use the margin built up by last year's revenue overperformance to finance additional spending increases through a mid-year supplementary budget. While the proposed fiscal path does not threaten sustainability, the mission expressed concern that the supplementary budget would add to the already substantial planned increases in current expenditure. This would increase budgetary tensions in future years when additional EU- and NATO-related expenditures will need to be accommodated. Political pressures on the budget in the run-up to forthcoming elections could exacerbate these concerns.

With transition-related reforms largely complete, structural reforms are geared toward sustaining growth. With its favorable policy environment and economic flexibility, Estonia is well placed to benefit from EU accession and attract continued strong FDI inflows. As a result, recent robust growth rates are likely to be sustainable over the **medium term**. Policy measures to improve education and training, and ensure that small- and medium-sized enterprises have adequate access to financing, would help to support this process. Inevitably, however, there are risks in the way ahead, and the economy is likely to remain sensitive to external developments.

I. INTRODUCTION

1. **In concluding the 2001 Article IV consultations on June 27, 2001, Directors noted that appropriate economic policies had contributed substantially to economic recovery.** They welcomed the impressive fiscal adjustment, which had brought the budget to near balance in 2000, and agreed with the target of a broadly balanced budget for 2001 and the medium term. Directors also welcomed the good progress on key structural reforms but noted that unemployment remained high.

2. **Estonian politics entered into a period of moderate uncertainty with the fall of the center-right coalition government in January 2002.** The economic agenda remains broadly unchanged under the new minority government, however, which is headed by Prime Minister Kallas, the (neo-liberal) Reform Party leader and outgoing Minister of Finance. Local elections will be held in October 2002 and parliamentary elections are scheduled for March 2003.

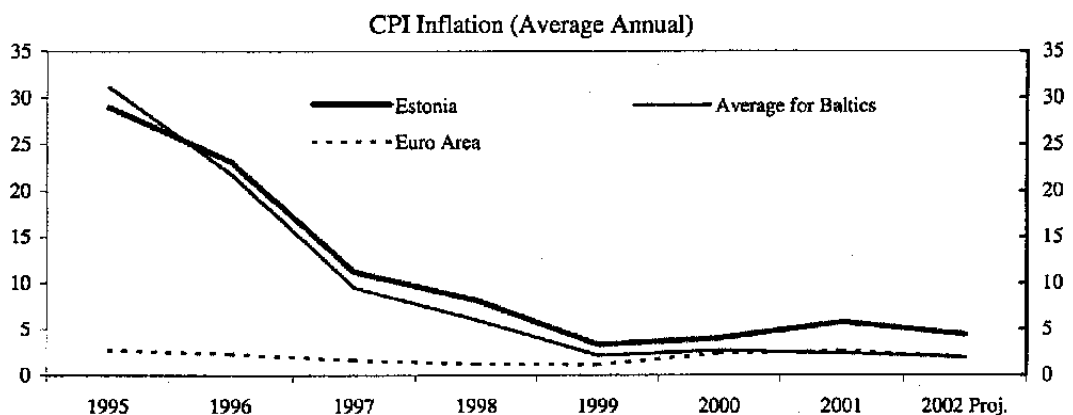
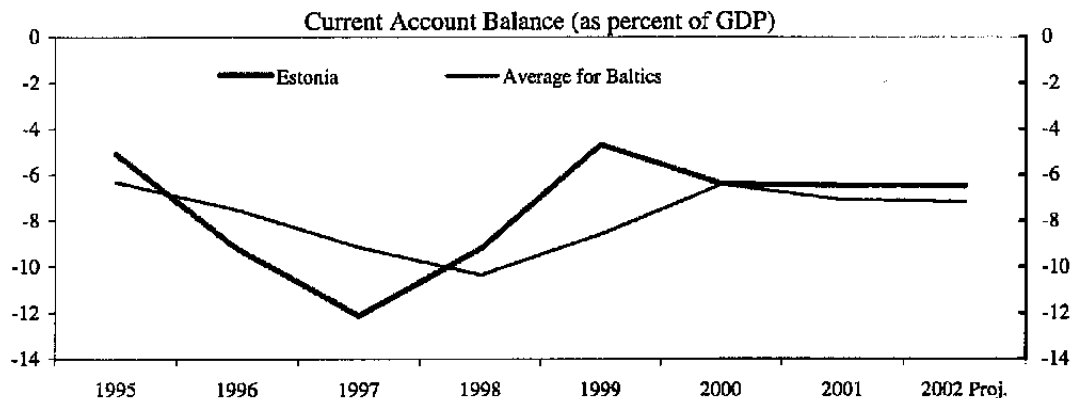
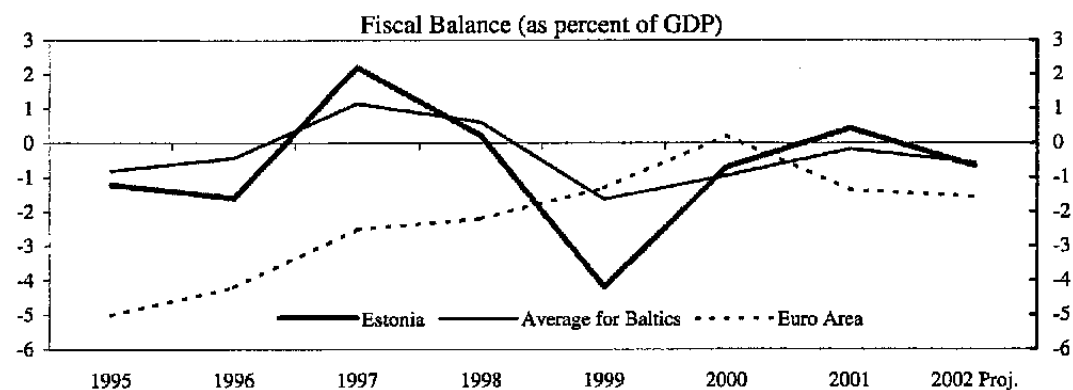
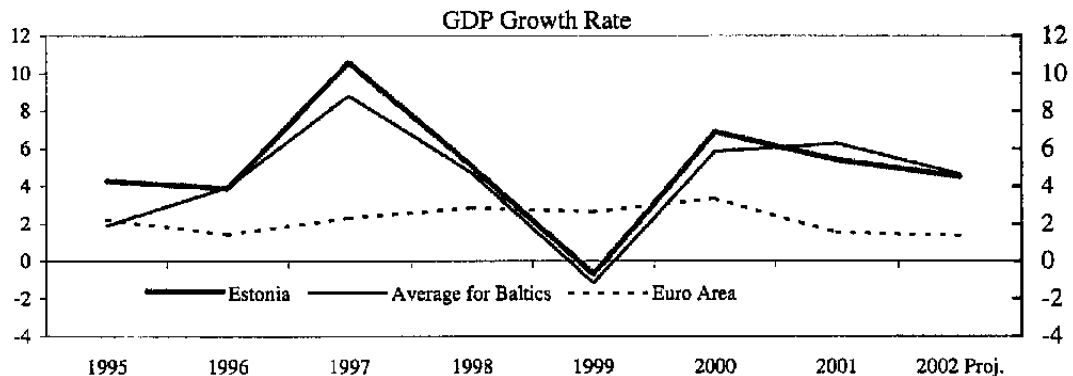
II. RECENT DEVELOPMENTS

3. **Growth remained relatively strong in 2001, despite the slowdown in Estonia's main EU trading partners and further fiscal consolidation** (Figure 1 and Table 1). Activity was supported by a robust expansion of domestic demand, especially gross fixed capital formation, which increased rapidly during the second half of 2001. Consumption growth, although slower than in previous years, remained relatively strong as a result of real wage growth coupled with a modest increase in employment.¹ The unemployment rate declined in 2001 and has continued to fall to 11.2 percent in the first quarter of 2002—from a peak of 14.8 percent in early 2000.² Inventories returned to near-normal levels by the end of 2001 following a build up in the first half of the year, especially in the telecommunications sector.

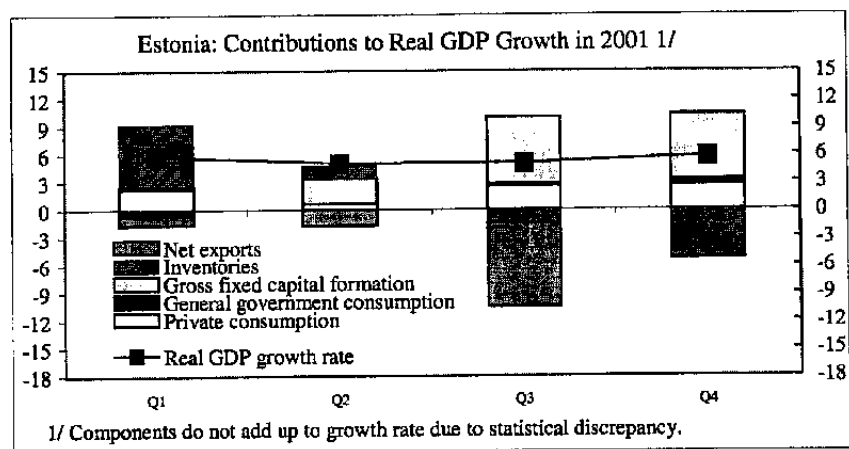
¹ Officially recorded wages increased by 7 percent in real terms in 2001. Such an increase exceeds likely productivity growth and thus raises potential concerns about competitiveness. However, based on national accounts data, which also reflects cash-in-hand (“envelope”) wages, the increase in real wages was significantly lower (and below the rate of economic growth) at about 3 percent. Moreover, other indicators tend to mitigate concerns about competitiveness. Exports have performed relatively well (see paragraph 8) and enterprise profitability remained strong.

² On an ILO basis. Registered unemployment is far lower (at 6.0 percent in May 2002) because of strict eligibility rules and the relatively low level of benefits.

Figure 1. Baltic Countries and Euro Area: Selected Economic Indicators, 1995-2002



Source: Country authorities; and Fund staff estimates.



Estonia: Selected Indicators, 1998-2002
(In units as indicated)

	1998	1999	2000	2001	2002 Proj.
Real GDP (year-on-year in percent)	5.0	-0.7	6.9	5.4	4.5
Private consumption	5.4	-0.8	8.2	3.2	3.2
General government consumption	4.5	3.8	0.1	0.3	3.7
Gross fixed capital formation	11.3	-14.6	2.0	17.2	12.2
Net exports 1/	-1.7	5.5	-1.2	-2.7	0.2
Average CPI (year-on-year in percent)	8.1	3.3	4.0	5.8	4.4
Unemployment rate (ILO definition, percent)	9.9	12.3	13.7	12.6	...
Fiscal Balance (in percent of GDP)	-0.3	-4.6	-0.7	0.4	-0.4
Current Account Deficit (in percent of GDP)	9.2	4.7	6.4	6.5	6.8

Sources: Estonian authorities and Fund staff estimates and projections.

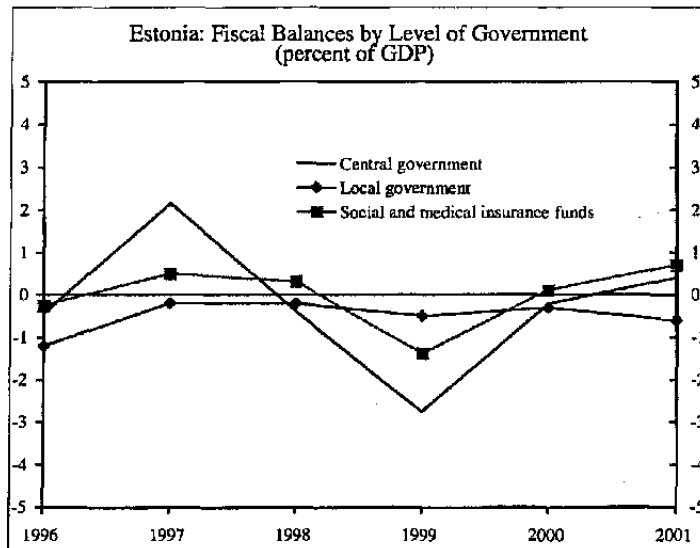
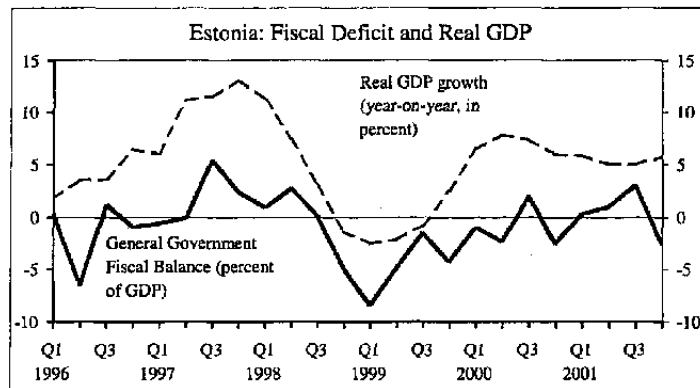
1/ Contribution to growth

4. Inflation, although initially driven up by external factors, has been slow to fall and remains above levels in the euro area and other Baltics.³ Consumer price inflation peaked at nearly 7 percent in mid-2001 before falling gradually over the second half of the year as the impact of transitory external factors—higher energy prices, higher food prices

³ Given that productivity growth will continue to be strong in the traded sector compared to the non-traded sector, Estonia would be able to sustain slightly higher inflation rates compared to its major trading partners without losing competitiveness. In line with estimates for other advanced transition economies, this (Balassa-Samuelson) effect is likely to be in the order of 2 percentage points.

(partly the result of food scares in the EU), and the lagged effects of the earlier weakness of the euro—began to fade. The 12-month CPI inflation rate stood at 4.1 percent in May 2002, but underlying inflationary pressures are slightly lower as price increases partly reflect the impact of an administered increase in electricity prices in April.

5. **The budget registered a small surplus of 0.4 percent of GDP in 2001** (Tables 2 and 3). Staff estimates that the fiscal stance was only mildly contractionary in 2001, following a major withdrawal of stimulus in 2000. Taxes and spending unfolded broadly as anticipated in the budget, although a small deficit at the local government level was offset by a central government surplus. Increases in government wages and salaries were below the rate of inflation for a second successive year. In line with the government's objective, overall public spending fell further relative to GDP. Tax revenues also fell slightly relative to GDP because of a 25 percent increase in the personal income tax threshold, and the delayed impact of the abolition of corporate income tax on reinvested earnings in 2000. These effects were more than offset, however, by higher dividend payments from public companies and EU grants. The resulting surplus, together with privatization receipts equal to 2 percent of GDP, led to a net repayment of debt and a build-up of government deposits abroad.



6. Monetary and credit aggregates grew relatively strongly in 2001, helping to support domestic demand, but slowed slightly during the first quarter of 2002. (Figure 2 and Table 5). Credit growth was fueled by lower interest rates in the euro area and a decline in the risk premium for Estonia. The rapid expansion of financial leasing continued in 2001 and through the first quarter of 2002, albeit at a slightly slower pace, and leasing now accounts for almost one third of credit to the private sector.⁴ The domestic currency component of the reserve requirements was eased (in two stages) in 2001, with a view to eventual convergence on lower ECB levels, by allowing commercial banks to fulfill a proportion of their reserves in high-quality euro-denominated foreign assets. This led to a decline in gross international reserves and base money and an increase in the money multiplier. The modest reduction in net foreign assets at the BoE was more than matched, however, by a sharp increase in the net foreign assets of commercial banks.

7. Prudential indicators show the banking system to be in a strong financial position (see Box 1 and Table 8). The average capital adequacy ratio increased slightly to 14½ percent by the end of 2001, well above the required 10 percent. The volume of nonperforming loans remains low, at 1.3 percent of total loans, and continues to be fully provisioned.

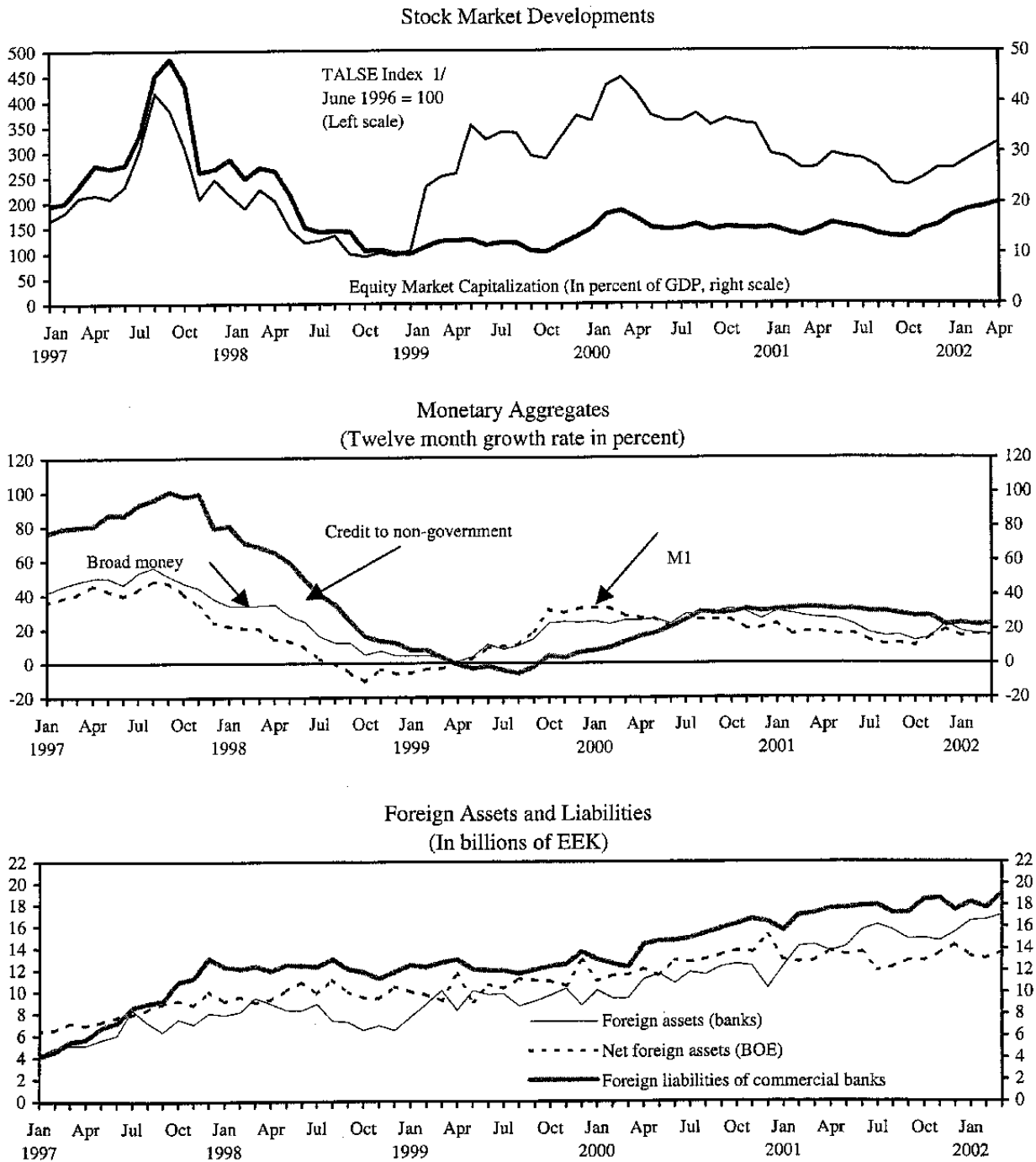
8. The current account deficit was broadly unchanged at 6½ percent of GDP in 2001 (Figure 3 and Table 4). The trade deficit in goods and services narrowed further to 4.2 percent of GDP, current transfers increased a little (reflecting higher EU grants), while outflows on the income account were again substantial:⁵

- The growth of exports of goods and services slowed sharply to 7 percent in 2001. This largely reflected the global downturn in the mobile telecommunications sector, which led to a collapse in trade flows (both exports and imports) associated with subcontracting for Scandinavian electronics companies. Exports excluding goods for processing performed relatively well, rising by 13 percent. The latter appears to reflect a number of factors, including: the relatively rapid growth of the Russian and some other eastern European markets; competitive pressures within the EU, which may have increased the attractiveness of lower-cost Estonian goods; and an increase in EU quotas that has encouraged exports of food products.

⁴ Despite the strong credit growth and increase in lease financing, household debt remains relatively low, amounting to 15 percent of GDP. See also box 1.

⁵ The trade balance benefited from an improvement in the terms of trade in 2001, reflecting an increase in export prices. The latter appears to be concentrated in one or two sectors and may reflect specific intra-company pricing practices. The trade position in volume terms was less favorable, with a significant negative contribution of net exports to GDP growth.

Figure 2. Estonia: Monetary and Financial Indicators, 1997-2002



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

Box 1. Estonia's Banking System

Financial intermediation in Estonia is unusual in that it relies to a very large degree on foreign-owned banks. Faced with a number of banking crises in the mid-to-late 1990s, the authorities restructured the banking system and started to seek strategic foreign investors. As a result, the number of banks has fallen from 40 to 7 since 1992. In addition, the largest two banks (Hansabank and Union Bank of Estonia) control about two-thirds of total assets and banks' share capital. The consolidation of the banking system has been associated with an increase in the stability of the system. All of the banks are privately owned.

Table: Bank Performance Indicators in Selected Countries 1/
(Average for 1999-2000)

	Problem Loans/Total Loans		Cost-to-income Ratio		Return on average equity	
	Foreign banks 2/	All banks	Foreign banks 2/	All banks	Foreign banks 2/	All banks
Baltic States						
Estonia	2.8	2.7	57.0	56.0	8.3	8.0
Latvia	3.3	6.6	105.2	86.6	8.5	10.9
Lithuania	9.3	9.0	76.8	84.6	3.9	4.8
Central Europe						
Czech Republic	18.8	48.3	72.3	68.6	-0.3	34.8
Hungary	4.9	6.4	86.0	84.0	3.8	5.9
Poland	9.5	9.3	36.7	60.2	2.5	5.8
Western Europe						
Netherlands	1.1	0.4	49.9	56.9	16.0	23.6
Spain	1.6	1.4	81.0	65.9	5.1	8.6

Source: Fitch IBCA's BankScope Database, Bank of Estonia.

1/ Based on available data in IBCA's BankScope Database.

2/ Ratio of assets of banks where foreigners own more than 50 percent of total equity to total bank assets.

collateral can be seized more easily.

Estonia's banking system performed quite well with respect to key indicators as reflected, for example, in the low ratio of non-performing loans. The reduction in required reserves in 2001 from 13 percent to 6.5 percent has given the profitability of banks an additional boost, and a further reduction to 2 percent over the medium term will improve the position even further.

A disadvantage of the concentration of banks is that they have effectively become "too large to fail". While adequate prudential regulation and supervision reduces the probability of bank failures, the creation of banks that are "too large to fail" could lead to suboptimal behavior by these banks.

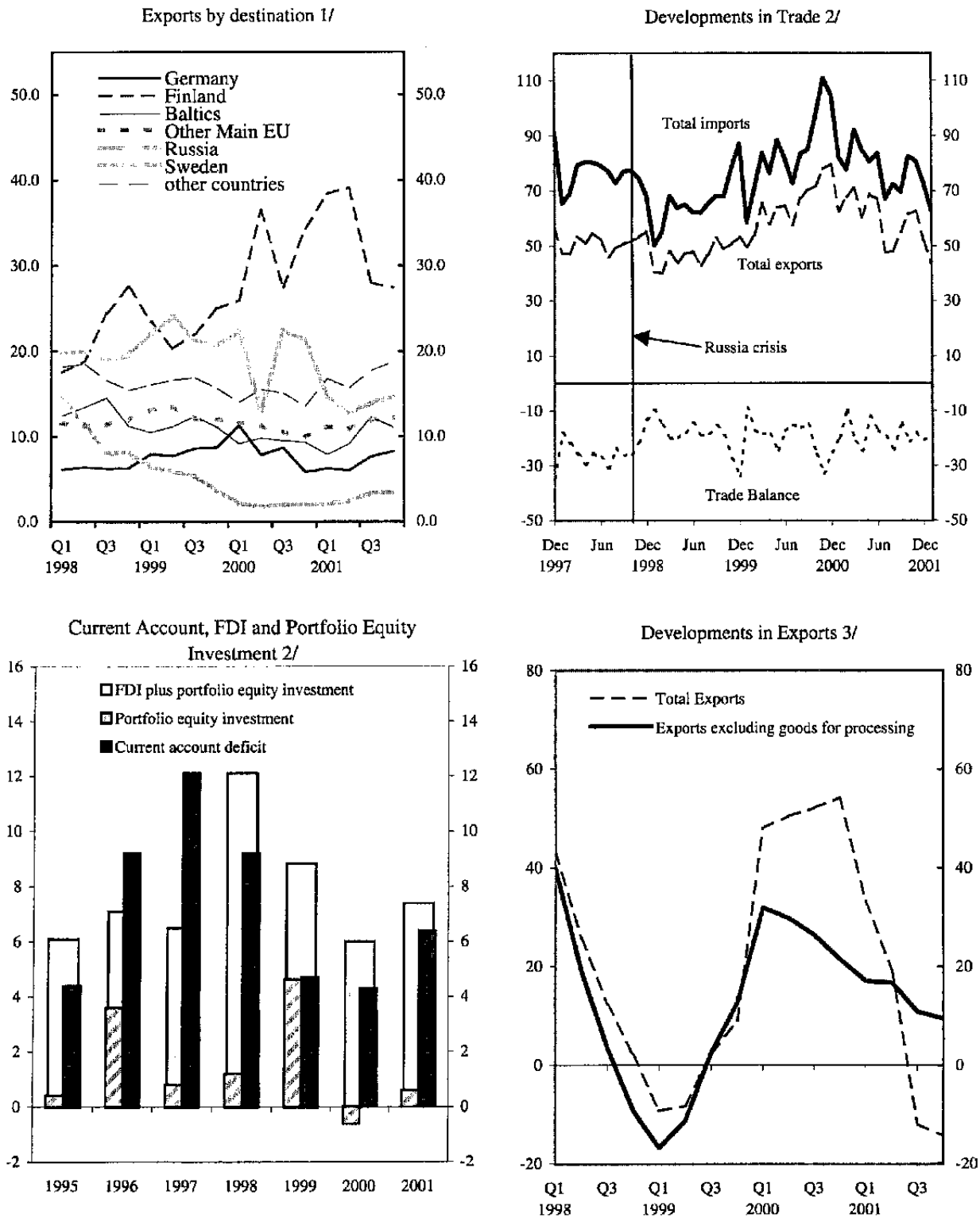
Table: Foreign Bank Ownership in Selected Countries

	Dec. 1995		Dec. 2000	
	Total Assets (In billions of US dollars)	Foreign Control 1/ (In percent)	Total Assets (In billions of US dollars)	Foreign Control 1/ (In percent)
Baltic States				
Estonia	2.6	40	6.2	82
Latvia	2.2	34	7.6	32
Lithuania	2.0	19	7.4	64
Total	6.8	29	21.3	58
Central Europe				
Czech Republic	114.3	46	80.3	56
Hungary	98.7	21	87.1	32
Poland	89.8	23	170.5	52
Total	302.9	35	338.0	48
Western Europe				
Netherlands	1,248.2	38	2,739.3	24
Spain	2,488.6	13	2,276.9	26
Total	3,736.7	21	5,016.2	25

Source: Fitch IBCA's BankScope Database, Bank of Estonia.

While credit growth has been strong over the past year, some market participants point out that the current structure of the banking system limits the access of small- and medium-sized enterprises to bank financing. An unusual feature of Estonia's banking system is the importance of lease financing. For the most part, leasing companies are owned by banks and banks encourage lease financing because under such contracts the

Figure 3. Estonia: External Sector Developments, 1995-2001



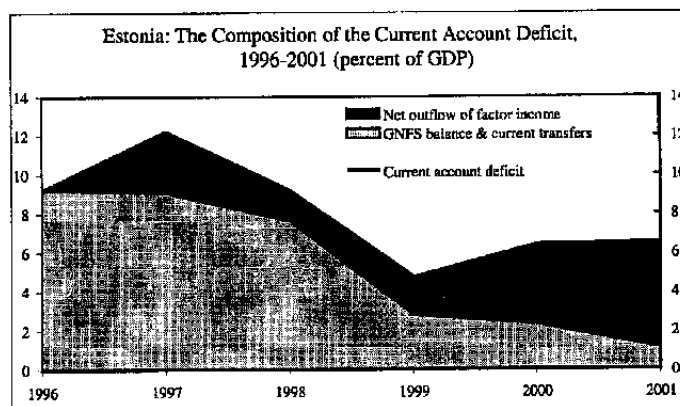
Source: Bank of Estonia; and Fund staff estimates.

1/ Percent of total exports.

2/ In percent of GDP.

3/ Percent change over same period in preceding year.

- Income outflows reflect the large number of profitable foreign companies in Estonia. Most of these profits were reinvested in Estonia, contributing to record FDI inflows that more than covered the current account deficit.⁶



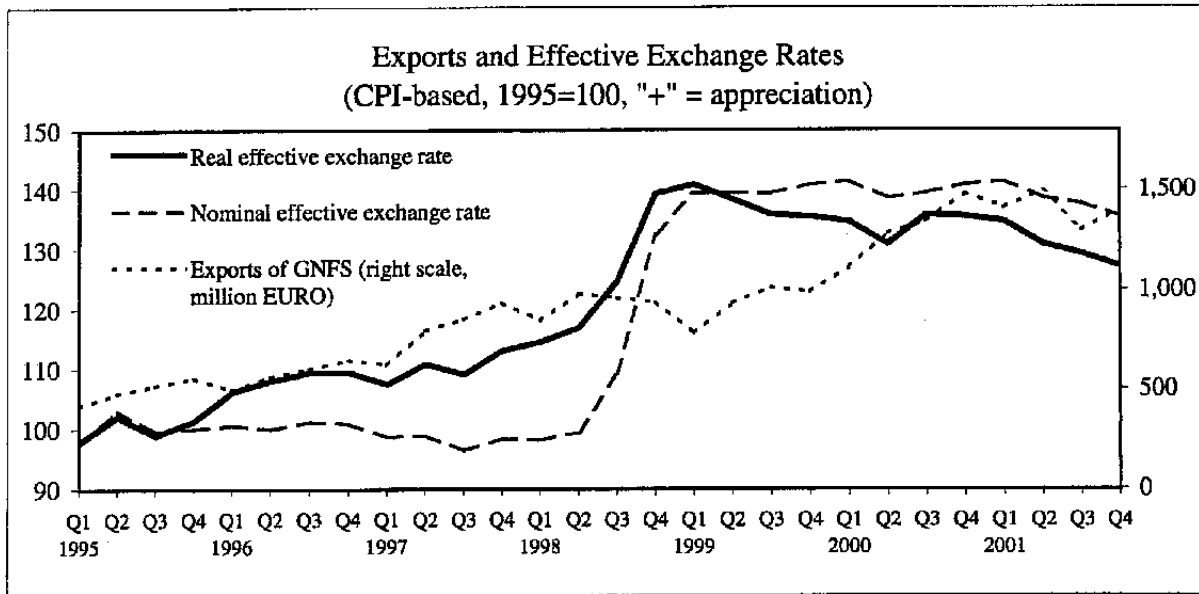
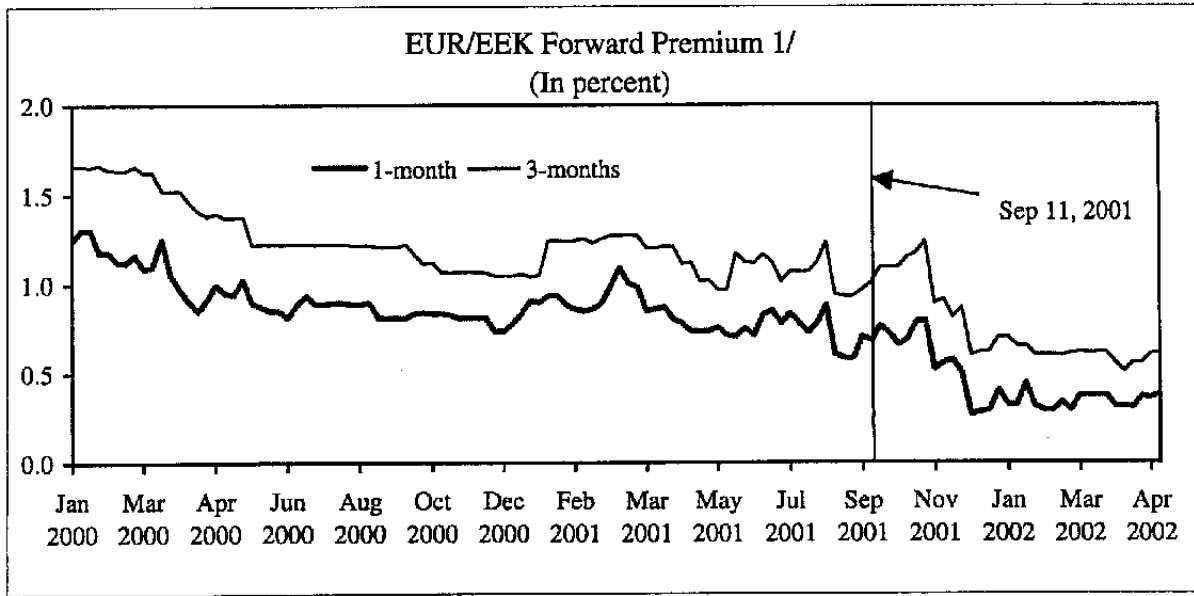
9. **External debt indicators remain at moderate levels by international standards** (Table 7). Gross external debt increased marginally to 61 percent of GDP in 2001, while the debt service ratio remained slightly below 7 percent of exports of goods and services.⁷ The ratio of reserves to imports declined in 2001 to 3.2 months.

10. **There have been no significant pressures on the exchange market and confidence in the currency board remains strong** (Figure 4). Spreads have been unaffected by the crises in Argentina and Turkey and remain near historic lows. In November 2001, Standard and Poor's upgraded Estonia's sovereign credit rating to A- from BBB+ (the highest among accession candidates with the exception of Slovenia). The Bank of Estonia's net international reserves comfortably exceed currency board cover.

⁶ Foreign-owned firms have contributed significantly to Estonian output in recent years. As a result, the level of GDP is now approximately 5 percent above GNP. The share of profits reinvested in Estonia increased to 76 percent in 2001, compared to 47 percent in 1999.

⁷ Around two-thirds of gross external debt reflects inter-company lending associated with FDI, and the short-term liabilities of the banking sector. A large proportion of the latter are matched by high quality euro denominated assets of similar duration. Net external debt is much lower at 15 percent of GDP. As such the 1.0 ratio of reserves to net short-term debt may be a more meaningful indicator of reserve adequacy than the 0.7 ratio of reserves to gross short-term debt.

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.

11. **Estonia's transition to a market economy is largely complete.** The privatization of the few remaining public enterprises continued last year, with the sale of the main railway company to an international consortium. The structural reform agenda is increasingly driven by the need to sustain high-quality growth and the specific requirements of EU accession. A new unemployment insurance scheme was introduced in January 2002, financed by payroll contributions of 1 percent for employees and 0.5 percent for employers. The first payments from the fund will not, however, be made for another year, given the eligibility requirements. A second pension pillar, financed through social security contributions, will become effective in July 2002. Early indications are that initial participation in the second pillar is likely to be low.

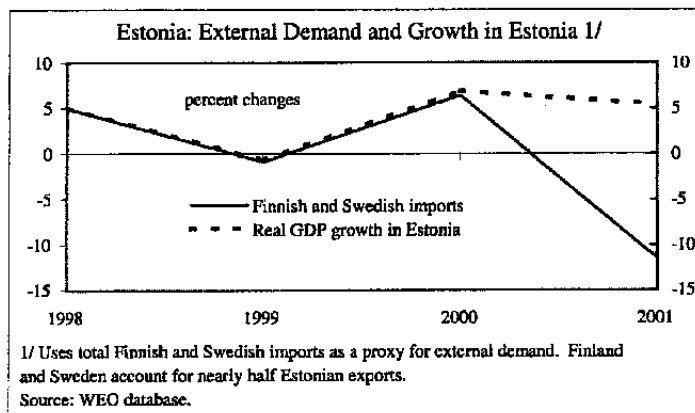
12. **EU accession discussions are proceeding smoothly and Estonia is in the first wave of countries in line for accession, expected in 2004.** By mid June 2002, 26 of the 31 chapters of the *acquis communautaire* had been closed.

III. DISCUSSIONS WITH THE AUTHORITIES

13. **Discussions with the authorities focused on the appropriate fiscal stance in the light of uncertainties about the business cycle, fiscal issues related to EU accession, Estonia's longer-term growth potential, and the prospects for continued high FDI inflows.**

A. The Cyclical Position

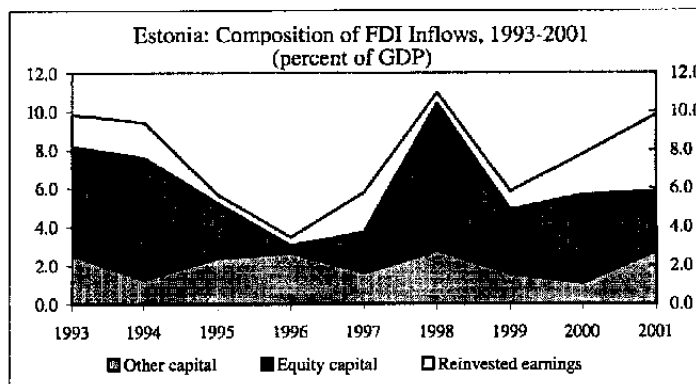
14. **Given the openness of the economy, growth held up surprisingly well during the recent European slowdown and the sharp contraction in the global information technology sector.** Estonia's business cycle has, in recent years, been closely aligned with that of its major EU trading partners, especially Finland and Sweden. This relationship appeared to break down in 2001 when, as in most other EU accession countries, robust domestic demand helped to offset the effects of weaker export performance.



15. **Growth is expected to slow to about 4½ percent in 2002** as the very rapid recent expansion of domestic demand begins to ease. It is possible, however, that the slowdown could be even more modest. With growth in the EU expected to increase through 2002, net exports are likely to contribute modestly to growth during the second half of the year. In addition, the recent easing of monetary conditions could, for a period, continue to fuel the growth of domestic demand. The current account deficit may widen a little further, however, to about 6¾ percent of GDP reflecting a further increase in profits by foreign companies. This is unlikely to be a cause for concern given the high level of expected financing from FDI inflows, in part through reinvested earnings (see Box 2).

Box 2: Foreign Direct Investment

Estonia has attracted substantial foreign direct investment in recent years and now has one of the largest stocks of FDI per capita among EU accession candidates. During the early years of transition, FDI inflows were driven in part by the opportunities created by privatization. The consolidation and restructuring of the banking sector also attracted substantial foreign investment, as a result of which one quarter of the stock of FDI is in the financial intermediation sector. A sharp increase in outward FDI in 2001 is also concentrated in this sector following the purchase by Hansabank of a Lithuanian bank. Recently, even as bank restructuring and privatization have drawn to a close, FDI has been sustained at high levels, with most investments in existing rather than new enterprises. Over the last two years, the reinvested earnings component of FDI inflows has grown rapidly, increasing to 4 percent of GDP in 2001 (from 1 percent in 1999). The increase coincides with the exemption of reinvested earnings from corporate income tax since 2000. There is also some evidence to suggest that profits recorded in Estonia may have been boosted by transfer pricing activity.



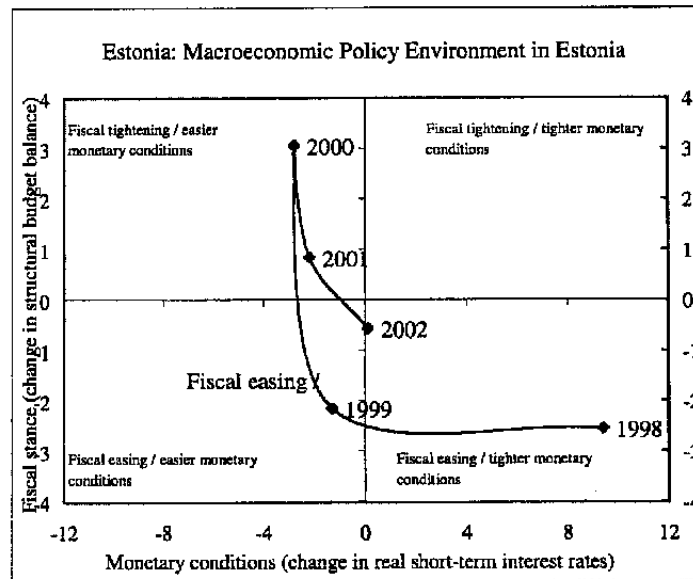
Estonia represents an attractive destination for foreign investors. Surveys of foreign investors indicate the importance of potential market growth in the region, low production costs, political and exchange rate stability, the absence of capital controls and the rapid pace of economic reform. Estonia has also benefited from its geographical proximity to and historical ties with Finland and Sweden, as these countries have used Estonia as a bridge into the Baltic market. Finland and Sweden account for two thirds of the stock of FDI. The weakness of the global telecommunications market poses a risk to continued FDI inflows into this sector (which accounts for less than a quarter of

the stock of FDI and, in 2001, under 12 percent of inflows). However, the response of some Scandinavian companies has been to seek additional cost advantages by expanding the elements of their production process that are located in Estonia. Estonia could possibly benefit from increased investment from the CIS as these countries seek to gain access to the EU markets. And in the near term, investments required to meet EU standards are providing further impetus. Overall, while FDI inflows may not be sustained at recent record levels, the prospects for continued strong inflows are good.

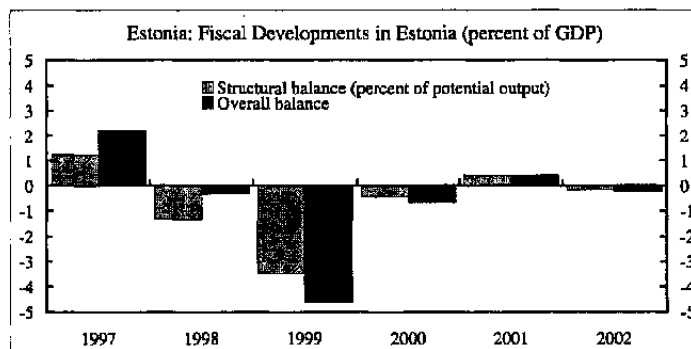
There is a strong relationship between FDI and the current account through both trade and income flows. Foreign-owned enterprises are typically more export-oriented than domestic enterprises and have helped to raise Estonia's export capacity. The import intensity of FDI depends on its nature, with new inflows typically associated with higher import demand (especially for capital goods) than reinvested earnings. The relationship in terms of income flows is more mechanical: the profits of foreign-owned enterprises are recorded as income outflows on the current account and the reinvested share of those profits as FDI inflows on the capital account. The reinvested share of profits has typically been high. This introduces a counter-cyclical element into both sides of the balance of payments: in a recession, for example, the resulting fall in profits will reduce both FDI inflows and the current account deficit.

B. Fiscal Policy

16. The outlook for the Estonian economy has improved significantly since the budget for 2002 was adopted in late 2001. Growth in 2001 was about one percentage point higher than had been estimated at the time of the budget discussions, suggesting that last year's improvement in revenues was largely cyclical and that the structural budget surplus was thus lower than first thought. In addition, growth in 2002 is likely to be higher than the 4.0 percent assumed in the budget plans. In line with this, tax revenues in the first four months of 2002 have been significantly higher than budget expectations, resulting in a sizable budget surplus. In these circumstances, the mission argued that while the authorities' target of a fiscal deficit of about $\frac{3}{4}$ percent of GDP in 2002 appeared broadly appropriate when the budget was framed, a tighter fiscal stance would now be warranted and could be achieved by allowing automatic stabilizers to operate fully.⁸



⁸ The targeted deficit reflects a discretionary stimulus from increased public spending and, to a lesser extent, the costs of pension reform and a small cyclical deterioration in revenues. The authorities' plans are formally balanced, however, by treating the transfer of assets from the Compensation Fund (a repository for privatization proceeds) as revenue. According to international standards, this transfer of assets should be recorded as deficit financing rather than as revenue.



17. **The authorities, however, intend to use the margin built up by last year's revenue overperformance to finance a further increase in public spending in 2002.** To this end, a mid-year supplementary budget reflecting the priorities of the new coalition government, would result in increased spending on pensions and transfers to local governments of about 0.4 percent of GDP. Staff agreed that the proposed fiscal path did not threaten sustainability and that the structural budget position would likely be close to balance in 2002.⁹ Nevertheless, the mission expressed concern that the planned increases in recurring current spending programs were already high and that, following the supplementary budget, these increases would amount to over 5 percent in real terms in 2002. This would increase the tensions within the budget in future years, when additional EU- and NATO-related expenditures will also need to be accommodated.¹⁰ The mission also encouraged the authorities to use any further overperformance to reduce the size of the fiscal deficit.

⁹ The budget projections assume a sharp increase in EU grants and that recent increases in dividends and other non-tax revenues are sustained. Staff estimates are based on more cautious assumptions regarding these items but also assume another substantial shortfall in investment expenditures from budgeted amounts. Assuming real GDP growth of 4½ percent, staff estimates that the fiscal deficit would be about 0.4 percent of GDP in 2002, or 0.2 percent of GDP excluding the costs of pension reform. The latter would be consistent with a structural budget deficit of 0.1 percent of GDP in 2002, compared with a structural budget surplus of 0.4 percent of GDP in 2001. The structural budget balance estimates are based on the standard IMF methodology (see IMF Working Paper WP/99/95) and on the basis of potential output growth of around 4¾ percent.

¹⁰ Staff's projections underlying the medium-term scenario assume an increase in financial support from the EU following accession together with a modest increase in tax revenues resulting from the harmonization of the indirect tax regime with EU requirements. Under this scenario, and assuming growth remains close to potential, Estonia could accommodate an increase in annual outlays on EU-related programs of around 2 percent of GDP within a balanced-budget framework. This would, however, require rationalization of current spending. Discretionary spending would continue to fall relative to GDP but would still rise

(continued)

18. **The mission supported the authorities' objective of return to a balanced budget in 2003, when growth is expected to increase a little in line with a recovery in external demand.** With some further increases in expenditure already pre-committed—in part because the impact of this year's supplementary budget will not be fully felt until next year—spending restraint together with efficiency savings in some areas will be necessary to avoid the need for tax increases. In this regard, the mission noted that pensions had been raised by significantly more than the statutory indexed amount in 2002 and urged caution regarding further discretionary increases.¹¹ The mission also noted the rapid increases in some social benefits in recent years and encouraged the authorities to review the provision of social benefits to ensure that they are effectively targeted.

19. **The balanced budget strategy has served Estonia well in recent years and has contributed significantly to the establishment of macroeconomic stability.** The mission argued that the authorities should continue to adhere to this strategy over the medium term, while responding flexibly to short-term variations in cyclical conditions, by seeking to balance the budget over the economic cycle. Such a strategy would be consistent with Estonia's prospective fiscal obligations as a member of the EU and would, therefore, avoid the need for potentially procyclical adjustments to meet the fiscal provisions of the Maastricht Treaty and Stability and Growth Pact.

C. Monetary and Financial Sector Issues

20. **On the basis of Estonia's prudent fiscal policy and low public debt levels, the currency board arrangement continues to serve Estonia well.** In addition to a prudent fiscal policy, the government constrained real wage growth in the public sector over the past two years. The mission encouraged the government to maintain a restrictive public sector wage policy to set an example for the private sector. The mission agreed with the authorities'

in real terms by around 2½ percent per year on average over the next five years. Assuming that EU-related spending is evenly phased, however, most of the savings would need to be concentrated in the next two years with discretionary spending remaining broadly unchanged in real terms over this period. Staff's medium-term fiscal projections are set out in more detail in Chapter V of IMF Occasional Paper 213, "The Baltic Countries: Medium-Term Fiscal Issues Related to EU and NATO Accession", which provides background for the Board discussion.

¹¹ The statutory indexation formula was introduced in April 2002 as part of a package of pension reforms (discussed in more detail in SM/01/161, appendix I). Pensions under the pay-as-you-go first pillar are indexed to the average of CPI inflation and the growth in social tax contributions. The formula ensures that the pension system's capacity to pay is taken into account, and thus formed a key element the authorities' strategy to ensure the long-term viability of the public finances despite an aging population. In 2002, pensions were raised by 14 percent, of which 9 percentage points reflected statutory indexation.

intention to maintain the current exchange rate arrangement until eventual adoption of the euro following membership in the European Monetary Union.

21. **While money and credit aggregates have recently grown more slowly, credit to leasing companies continues to be strong.** Particularly pronounced has been the growth in lease financing in the automobile and real estate sector, which contributed to a sharp increase in real estate prices.¹² The mission encouraged the authorities to monitor these developments closely, and to reevaluate and, if necessary, tighten prudential standards on leasing.

22. **There is a concern that small- and medium-sized enterprises do not have access to adequate financing because of the concentration of the banking system and the lack of a developed domestic capital market.** The authorities responded that the government had implemented a program (KredEx) that in addition to providing export guarantees would also provide support to small enterprises. While the mission did not object in principle to an institution such as KredEx, it pointed out the potential dangers that could arise and encouraged the authorities to limit its operations and to assure a high degree of transparency especially with respect to government guarantees. It further encouraged the authorities to improve the efficiency of credit markets including the elimination of a tax that penalizes non-bank borrowing (see Box 3).

23. **While the authorities indicated that they intend to reduce the cash reserve requirement further over the medium term, no decisions have been made yet with respect to when and how this will be done.** The mission cautioned the authorities against hastening further reductions, especially if these were to imply an increase in liquidity that could have inflationary consequences.¹³

24. **The Financial Supervision Authority (FSA) has become fully operational since the beginning of 2002, which should improve the scope and effectiveness of financial supervision.** According to the authorities, the staffing of the institution has been sufficient to conduct an adequate number of on-site inspections during the transition period and commit

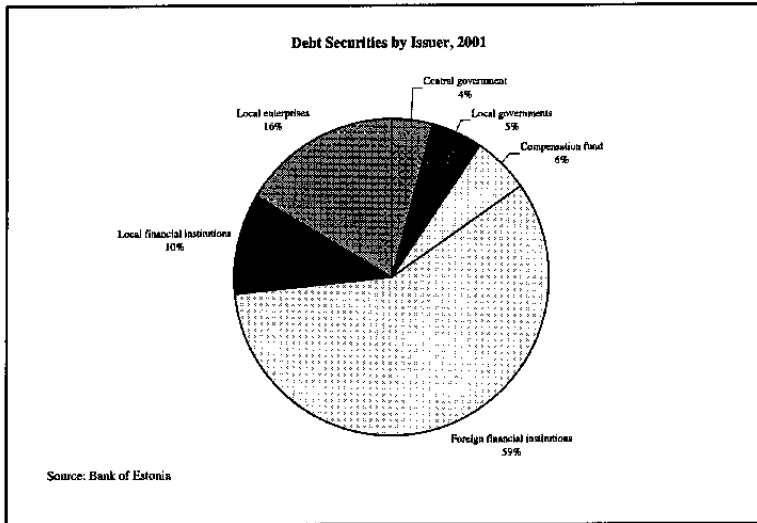
¹² House prices have risen at an annualized rate of about 20 percent over the first five months of 2002. These increases also reflect some structural factors, such as prospective increases in VAT on heating fuel, which are thought to have boosted demand for smaller-sized apartments.

¹³ Depending on the modalities, a further reduction of required reserves could have implications for Estonia's payments system. In general, commercial banks can sell an unlimited amount of foreign currency or eligible foreign fixed income securities to the BoE to increase liquidity. In order to manage the liquidity after a further reduction of required reserves, the BoE is considering the introduction of an intraday repo facility. The BoE is also interested in integrating its payments system (RTGS) with the centralized payments system of the euro area (TARGET).

Box 3: Financial Markets

Estonia's money and capital markets are relatively underdeveloped. This reflects a very prudent fiscal policy resulting in little government debt, the currency board arrangement, the size of the country, and increasing integration with EU financial markets.

While market capitalization of Estonia's equity market relative to GDP is about as high as market capitalization of the Euro area was in 1997, the secondary market is dominated by only two internationally rated entities, which together represent almost 85 percent of total market capitalization. As part of an effort to integrate its capital market with western Europe, Estonia became the first country of the former Soviet Union and eastern Europe to merge with a foreign (Helsinki) stock exchange in 2002.



The government and corporate debt market, measured by outstanding stock of securities, amounted to about 4 percent of GDP at the end of 2001. There is practically no market for government securities. However, in order to refinance (more expensive) World Bank loans and to "test" the market, the government intends to issue its first Eurobond (€100 million) in 2002. Estonia's sovereign rating was recently increased by Standard and Poor's to A- from a BBB+. The largest amount of corporate debt was issued by foreign owned financial institutions.

The introduction of the second pension pillar (in mid 2002) will boost the amount of funds that are channeled through

capital markets. The regulations governing investments of these funds are extremely liberal compared to regulations in other countries that moved from a pay-as-you-go to a partly funded system since there are no limits on the share that can be invested in EU and OECD countries. Furthermore, 50 percent of the assets of a pension fund can be invested in equities. While the absence of any restrictions vis-à-vis investments abroad allows for a broad diversification, it also implies that the reform will only marginally improve the development of domestic capital markets.

The lack of a domestic capital market and the continued effort of the authorities to integrate Estonia's financial system into global markets contributed to the stability of the system. However, this strategy has not come without costs. Given the concentrated structure of the banking system (see box on banking system), a more developed domestic capital market could increase competition and put pressure on bank lending rates and provide an alternative to bank financing especially for medium-size companies. Because of high information and transaction costs associated with borrowing in international capital markets, the access to such markets is most likely limited to larger enterprises. In addition to purely financing issues, a more developed domestic capital market would provide more information about market expectations and real sector developments.¹

While it is questionable to what degree the government should create the framework for and actively encourage the development of a domestic capital market, there are a number of issues that should be addressed to eliminate distortions. Investment income from sources other than bank deposits is taxed at the prevailing income tax rate of 26 percent while income from bank deposits is tax free. The latter tax exemption is likely to distort investment decisions and should therefore be eliminated.

¹ Some information on the term structure of interest rates can, for example, be derived from bank lending rates for different maturities, however, the interpretation of changes and shifts in such a yield curve is less clear.

sufficient resources to the supervisory work related to the establishment of the second pillar of the pension system. The mission inquired whether leasing companies that contribute to the strong growth in domestic credit are adequately supervised. The authorities pointed out that leasing companies are part of bank conglomerates and financial institutions that are supervised on a consolidated level. Furthermore, lending to leasing companies would fall under the credit risk analysis of the lending institution. The mission cautioned that regulatory arbitrage could encourage the establishment of standalone leasing companies that would not be covered by the current supervisory system and should therefore be monitored.

25. Estonia's system for combating money laundering and the financing of terrorism appears to be relatively well developed. The authorities provided a full and detailed response to the Fund's questionnaire regarding anti-money laundering (AML) measures and combating the financing of terrorism. The main AML legislation was amended in 2000, and is expected to be amended again in 2002 or early 2003 to bring it into line with the latest EU directive in this area. One of the explicit objectives of the newly-established FSA is to prevent the abuse of the financial sector for criminal purposes. The FSA is expected to harmonize AML regulations and supervisory practices across the banking, insurance, and securities sectors. A Financial Intelligence Unit (FIU) has been established and is a member of the Egmont Group of FIUs.¹⁴ The authorities also affirmed that Estonia's legislation allows for the full implementation of all relevant U.N. Security Council Resolutions relating to the financing of terrorism. Explicit provisions criminalizing the financing of terrorism will come into force by the end of 2002.

D. Medium-Term Prospects

26. Growth is expected to remain strong over the medium term (Appendix I and Table 6). Since the mid-1990s, growth has been underpinned by: a stable macroeconomic policy environment, anchored by the currency board arrangement and a prudent fiscal position; a liberal trade regime, which was instrumental in reorientating trade to western Europe; wide-ranging structural reforms, including rapid privatization, which have contributed to a favorable business climate and increasing inflows of foreign investment; and, more recently, a healthy banking sector with strong international links. These developments provide strong foundations for continued growth.

27. With its favorable policy environment and economic flexibility, Estonia appears well suited to reap the potential benefits of EU accession, including through further trade and financial integration, institutional strengthening, and further reductions in risk premia. Under the current baseline scenario, these factors are expected to sustain real GDP growth at an average rate of about 5 percent over the medium term. The savings-investment behavior of the private sector is expected to stabilize around recent levels,

¹⁴ For more information on the Egmont Group of Financial Intelligence Units, see http://www1.oecd.org/fatf/Ctry-orgpages/org-egmont_en.htm

although private savings may eventually increase somewhat as the mandatory second pension pillar becomes more established. Assuming that the government continues to target a broadly balanced budget over the medium term, and that an increase in public savings (resulting from an increase in revenues and a rationalization of current expenditure) creates room for substantial EU-related increases in public investment, the current account deficit should stabilize at about 6 percent of GDP. The authorities are aware of the need to sustain their reform agenda to maintain the high level of investor confidence in the Estonian economy, so that non-debt-creating capital inflows will continue to finance a large part of the current account deficit.

E. Structural Policies

28. **Unemployment has proved to be a persistent problem despite recent economic growth.** A skills mismatch (with workers laid off in traditional sectors unable to find jobs in the new services and high-tech sectors) has resulted in a high proportion of long-term unemployment, large numbers of discouraged workers, and geographical concentration of unemployment, especially in the north east. Recent reductions in unemployment, however, are encouraging. The authorities are seeking to bring about further reductions through targeted job training for both the young and long-term unemployed, and reform of the education system to provide new school leavers with more relevant vocational skills.

29. **The authorities' budget presentation has improved although the revised Organic Budget Law has not yet been passed.**¹⁵ Central government control over local government borrowing has also been improved through the introduction of tighter borrowing limits, broader coverage, and stiffer penalties. Despite earlier plans to sharply reduce the number of municipal governments from 247, there have been only a handful of voluntary mergers to date. The mission thus stressed the continuing need for a more ambitious rationalization of the structure of local governments, including a review of their revenue sources and expenditure assignments, which could be expected to lead to improved control over public expenditure and substantial gains in efficiency.

30. **The authorities intend to proceed with the restructuring and environmental clean-up of the oil shale sector.** Following the collapse of the partial sale of the main power generator to a U.S. company, Estonian Energy (a public corporation) will finance the renovation of the Narva Power Plants itself, through long-term international borrowing, including a proposed 15 year loan from the EBRD. The renovations, which form a key part of the reforms necessary to satisfy EU requirements relating to energy and the environment, are expected to cost about 4 percent of GDP, spread over several years. The mission

¹⁵ Enactment of the amended Organic budget law was one the key recommendations of last year's fiscal ROSC. The amendments would further enhance fiscal transparency by improving the coverage of the general government. Details of recent changes are set out in the ROSC information update (SM/02/188).

cautioned that financing arrangements should not include any government guarantees. In other areas, **privatization is more or less complete**. The Estonian Privatization Agency was wound up at the end of 2001, and there are no current plans to sell the government's remaining shareholdings, which are small but include the port of Tallinn and minority stakes in Estonian Telecom and Estonian Air.

31. **The trade system remains fully liberal, with the exception of import tariffs on selected agricultural products that were imposed in January 2000 primarily to demonstrate the administrative capacity for handling the EU's tariff and trade system.**

¹⁶As a result, Estonia's index of overall trade restrictiveness (according to the staff scale) continues to be 1, the most liberal level.

IV. OTHER ISSUES

32. **The authorities continue to demonstrate a high degree of transparency in public policymaking.** Estonia subscribes to the Fund's Special Data Dissemination Standard and provides all core data necessary for surveillance on a timely basis. The 2001 ROSC data module concluded that the quality of data was generally good. The authorities are addressing most of the issues noted in the ROSC in the context of their multi-year program to meet the demanding statistical requirements of EU membership.

V. STAFF APPRAISAL

33. **The Estonian economy showed remarkable resilience in 2001 and early 2002, despite the slowdown in its major western European trading partners.** Growth was driven largely by domestic demand, especially investment. The weakness in the export sector was less than expected and concentrated in the low-value added electronics assembly sector. FDI reached record levels and more than covered the current account deficit.

34. **These results are, in large measure, the result of sound macroeconomic policies and structural reforms, which have provided a strong foundation for continued robust economic growth.** With its favorable policy environment and economic flexibility, Estonia is also well placed to benefit from EU accession.

¹⁶ These tariffs are below WTO bindings and only affect those countries that do not have a free trade agreement with Estonia. They therefore affect only a small portion of agricultural trade, mostly with Canada, Russia, and the United States. Estonia's trade prospects would benefit from prospective Russian WTO membership through the extension by Russia of tariff rates on a most-favored-nation (MFN) basis. This may also provide a further spur to FDI in Estonia if, as a result, foreign companies seek to use Estonia as a gateway to the Russian market.

35. **While Estonia's fiscal position is currently very healthy, large planned increases in current spending will add to budgetary tensions in future years.** The authorities' fiscal target for 2002—a deficit on the order of $\frac{3}{4}$ percent of GDP—was broadly appropriate when adopted, but with the recent strength of the economy likely to be at least partly sustained through 2002, a somewhat tighter policy would be appropriate. This could be accomplished by allowing automatic stabilizers to operate fully. The authorities' intention to finance additional mid-year increases in spending by using the unexpected cyclical improvement in revenues that has already taken place will not undermine sustainability. Any further overperformance in 2002, however, should be used to reduce the size of the fiscal deficit. In addition, the supplementary budget will add to the already substantial planned increases in current spending. This is a concern as it will increase budgetary tensions in future years when additional EU- and NATO-related expenditures will need to be accommodated.

36. **The currency board arrangement continues to serve Estonia well and confidence in it remains high.** The authorities' intention to adopt the euro as soon as possible after EU accession provides a clear exit strategy from the currency board arrangement. Their intention to maintain the latter until the eventual adoption of the euro is sensible. Strong financial supervision is particularly important within currency board arrangements and Estonia has done well in this regard.

37. **The authorities have adroitly managed to lower the domestic currency component of reserve requirements towards levels in the euro area.** In order to preclude an undesirable increase in liquidity, commercial banks have to fulfill the reserve requirement in the form of high-quality euro-denominated foreign assets. This process is not yet complete and it is important to avoid an unintended inflationary increase in liquidity. Monetary and credit aggregates have begun to grow more slowly and this is desirable. However, credit to leasing companies remains strong and needs to be monitored.

38. **The successful establishment of the Financial Supervision Authority at the beginning of 2002 will enable the authorities to monitor more effectively the financial system.** However, the authorities should also remove distortions that might undermine an efficient allocation of savings and prevent small- and medium-sized enterprises from having access to adequate financing. In particular, the authorities should eliminate the current tax exempt status on income earned from bank deposits. This in turn would encourage the development of more market-based financing and therefore lead to more competition.

39. **Recent developments in the labor market have been encouraging although unemployment remains high, especially in some regions.** Employment rose and unemployment fell for the first time in 2001. This suggests that labor shedding may be coming to an end. If true, this marks an important milestone in the transition process. More generally, Estonia's liberal labor market policies are to be welcomed; they are particularly important in a country with a currency board arrangement where labor markets play an important role in the adjustment process. The authorities are working to bring about further reductions in unemployment, by ensuring macroeconomic stability and targeted job training and education reforms. This is the right approach, but the authorities should also guard against disincentives arising from the interaction of tax and benefit systems at low incomes.

40. **Inevitably, there are risks ahead.** The economy is likely to remain sensitive to external developments, especially as the pace of domestic demand growth starts to ease. Higher oil prices, although unlikely to have a strong and direct effect on the economy, could indirectly affect growth prospects by dampening the economic growth of Estonia's major trading partners. The main policy risk stems from the increasing pressure on the government to increase public spending or reduce taxes in the run-up to local elections in the fall of 2002 and parliamentary elections in March 2003.

41. **Estonia continues to have a commendable reputation for transparency in public policymaking.** Staff welcomes their intention to publish the Staff Report again, as well as the information updates to the Reports on the Observance of Standards and Codes (ROSC). The authorities' efforts to guard against money laundering and combat the financing of terrorism are also commendable.

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

Table 1. Estonia: Selected Macroeconomic Indicators, 1998-2002

(In units as indicated)

	1998	1999	2000	2001	2002 Proj.
National income, prices and wages					
Nominal GDP (kroons, millions)	73,538	76,327	85,436	95,275	104,034
GDP (US dollars, millions)	5,225	5,200	5,035	5,424	6,069
Real GDP growth (year-on-year in percent)	5.0	-0.7	6.9	5.4	4.5
Average CPI (year-on-year change in percent)	8.1	3.3	4.0	5.8	4.4
12-month CPI (end of period change in percent)	4.2	3.8	5.0	4.2	4.3
GDP deflator (year-on-year change in percent)	9.3	4.5	4.7	5.8	4.5
Average monthly wage (end-of-period, US dollars)	360	345	341	359	...
Unemployment rate (ILO definition, percent)	9.9	12.3	13.7	12.6	...
Saving-investment balances (in percent of GDP)					
Domestic saving	20.1	19.8	18.3	20.2	20.7
Private	16.2	20.2	15.7	16.5	17.0
Public	3.9	-0.4	2.5	3.7	3.7
Domestic investment	29.3	24.5	24.6	26.7	27.5
Private	25.1	20.3	21.4	23.4	23.4
Public	4.2	4.2	3.2	3.3	4.0
Foreign saving	9.2	4.7	6.4	6.5	6.8
General government (in percent of GDP)					
Revenue	39.3	38.1	38.7	38.7	38.9
Expenditure and net lending	39.6	42.7	39.4	38.3	39.2
Fiscal balance 1/	-0.3	-4.6	-0.7	0.4	-0.4
External sector (euro, millions)					
Trade balance	-998	-773	-862	-882	-959
Exports	2,398	2,364	3,579	3,747	3,994
Imports	-3,395	-3,137	-4,441	-4,629	-4,953
Service balance	511	533	587	629	673
Receipts	1,320	1,403	1,628	1,840	1,983
Payments	-809	-870	-1,041	-1,211	-1,310
Current account	-429	-231	-348	-394	-449
Change in net foreign asset position of commercial banks (euro, millions)	20	7	-74	258	...
Gross international reserves (euro, millions) 2/	696	852	993	931	988
in months of imports (excluding imports of goods for processing)	3.0	4.1	3.9	3.2	...
in months of imports	2.4	3.3	2.7	2.4	2.4
Relative to gross short-term debt (including trade credits)	0.9	0.9	0.8	0.7	0.7
Gross external debt/GDP (in percent) 3/ 4/	53.3	58.7	59.4	61.0	62.3
Net external debt/GDP (in percent) 5/	15.0	15.2	13.0	15.0	15.3
General government external debt/GDP (in percent) 6/					
Excluding government assets held abroad	4.3	4.9	3.8	3.1	3.1
Including government assets held abroad 7/	2.5	2.2	2.1	1.3	1.1
Exchange rate (EEK/US\$ - period average) 8/	14.1	14.7	17.0	17.6	...
Money and credit (year-on-year growth in percent)					
Domestic credit to nongovernment 9/	11.7	6.3	30.3	22.2	23.1
Base money 2/ 9/	6.4	27.1	14.6	-9.8	5.6
Broad money 9/	4.2	23.7	25.7	23.0	16.6
Base money multiplier (end of period) 9/	2.4	2.3	2.5	3.4	3.7

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

1/ For 2002, it includes the cost of the pension reform, estimated at 0.1 percent of GDP.

2/ Lower reserve requirements introduced in 2001 have led to a decline in international reserves under the mechanics of the currency board (and a 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 Estonian kroon has been pegged to the deutsche mark at EEK 8=DM 1 since June 20, 1992. Since January 1, 2002, it is pegged to the euro at EEK 15.65 to €1.

9/ March 2002 data.

Table 2. Estonia: Summary of General Government Operations, 1998-2002
(In millions of EEK)

	1998	1999	2000	2001	2002	
	Year Actual	Year Actual	Year Actual	Year Actual	Budget 1/ Year	Proj.
Revenue and Grants 2/	28,887	29,083	33,062	36,881	40,625	40,424
Revenue	28,887	29,083	32,803	36,257	39,224	39,424
Tax revenue	27,126	27,383	30,209	32,890	35,827	36,348
Direct taxes	17,320	17,518	18,214	19,775	21,813	22,154
Corporate profits tax 3/	1,914	1,639	855	748	800	800
Personal income tax	6,233	6,531	6,594	7,099	7,735	7,894
Social security tax 4/	5,303	5,520	6,297	6,988	7,370	7,478
Medical insurance tax	3,573	3,518	4,093	4,542	4,890	4,960
Unemployment insurance tax 5/	...	...	...	...	568	572
Land tax	297	310	375	398	450	450
VAT	6,413	6,419	8,153	8,639	9,410	9,534
Excises	2,789	2,685	2,819	3,434	3,532	3,589
Other taxes (incl. on intern. trade)	606	761	1,023	1,042	1,073	1,073
Nontax revenue 6/	1,761	1,700	2,594	3,367	3,396	3,076
Grants 2/	...	...	259	624	1,401	1,000
Expenditure 2/ 6/	29,038	32,541	33,967	36,548	41,531	40,875
Current expenditure	25,945	29,317	31,231	33,389	36,911	36,679
Expenditure on goods and services	17,226	19,443	20,368	21,650	23,563	23,442
Wages and salaries	6,775	8,149	8,718	9,052	9,846	9,846
Other goods and services	10,450	11,294	11,650	12,599	13,717	13,596
Current transfers and subsidies	8,381	9,565	10,568	11,481	12,998	12,946
Subsidies	693	690	682	805	1,182	1,130
Transfers to households 7/	7,688	8,876	9,886	10,676	11,816	11,816
of which: Pensions	5,200	6,425	6,445	6,610	7,569	7,569
Interest payments	339	309	295	258	350	290
Capital expenditure	3,093	3,225	2,736	3,158	4,620	4,196
Financial surplus (+) / deficit (-)	-151	-3,458	-905	333	-906	-450
Net lending (-) 8/	-77	-81	329	63	70	70
Overall surplus (+) / deficit (-)	-228	-3,539	-576	396	-836	-380
Borrowing requirement	228	3,539	576	-396	836	380
Domestic financing	711	3,888	919	1,639	-350	836
Of which: Privatization 9/	25	3,024	812	1,970	836	836
Foreign financing	-483	-349	-343	-2,035	350	...
Of which: change in government deposits held abroad (	-565	-431	-23	-1,841	...	-456
Memorandum items:						
Primary fiscal balance (+, surplus)	111	-3,230	-282	654	-486	-90
Balance in government deposits held abroad	1,265	1,696	1,719	3,560	...	4,015
Total general government debt					...	
Excluding government assets held abroad	4,301	4,967	4,302	4,384	...	4,384
Including government assets held abroad	3,036	3,271	2,584	824	...	368
Government guarantees on foreign loans	701	902	931	1,454	...	...
National defense expenditure	824	1,061	1,367	1,715	2,060	2,081

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

1/ Including supplementary budget

2/ Foreign grants (reflecting pre-accession financial support from the EU) and grant-financed expenditures have been reported in the government financial statistics since August 2001. Figures for 2000 are staff estimates.

3/ Starting from 2000, profits retained within an Estonian company are not taxed. Profits are taxed at the point of distribution (whether in the form of dividends, fringe benefits, or certain other payments). Figures for 2000 include some tax receipts on 1999 profits.

4/ For 2002, it includes the revenue loss from the introduction of the second pillar of the pension system, estimated by staff at around EEK150 million.

5/ Additional payroll contributions of 1 and 0.5 percent from employees and employers respectively. Benefits from the scheme are payable from 2003.

6/ From 2000, includes spending agencies own revenue and outlays financed from spending agencies own resources.

7/ From 2000, includes prescription drug benefits (previously included in current spending on goods and services) and newly-introduced disability benefits.

8/ Net lending in 2000 includes EEK 303 million recovery of deposits from failed banks. Overall deficit excluding deposit recovery was EEK 879 million.

9/ Used for financing the general government deficit. 2002 figures reflects transfer of assets from partial liquidation of Compensation Fund.

Table 3. Estonia: Summary of General Government Operations, 1998-2002
(In percent of GDP)

	1998	1999	2000	2001	2002	
	Year	Year	Year	Year	Year	
	Actual	Actual	Actual	Actual	Budget 1/	Proj.
Revenue and Grants 2/	39.3	38.1	38.7	38.7	39.4	38.9
Revenue	39.3	38.1	38.4	38.1	38.1	37.9
Tax revenue	36.9	35.9	35.4	34.5	34.8	34.9
Direct taxes	23.6	23.0	21.3	20.8	21.2	21.3
Corporate profits tax 3/	2.6	2.1	1.0	0.8	0.8	0.8
Personal income tax	8.5	8.6	7.7	7.5	7.5	7.6
Social security tax 4/	7.2	7.2	7.4	7.3	7.2	7.2
Medical insurance tax	4.9	4.6	4.8	4.8	4.7	4.8
Unemployment insurance tax 5/	...	...	...	...	0.6	0.6
Land tax	0.6	0.4	0.4	0.4	0.4	0.4
VAT	8.7	8.4	9.5	9.1	9.1	9.2
Excises	3.8	3.5	3.3	3.6	3.4	3.4
Other taxes (incl. on intern. trade)	0.8	1.0	1.2	1.1	1.0	1.0
Nontax revenue 6/	2.4	2.2	3.0	3.5	3.3	3.0
Grants 7/			0.3	0.7	1.4	1.0
Expenditure 2/ 6/	39.5	42.6	39.8	38.4	40.3	39.3
Current expenditure	35.3	38.4	36.6	35.0	35.8	35.3
Expenditure on goods and services	23.4	25.5	23.8	22.7	22.9	22.5
Wages and salaries	9.2	10.7	10.2	9.5	9.6	9.5
Other goods and services	14.2	14.8	13.6	13.2	13.3	13.1
Current transfers and subsidies	11.4	12.5	12.4	12.1	12.6	12.4
Subsidies	0.9	0.9	0.8	0.8	1.1	1.1
Transfers to households 7/	10.5	11.6	11.6	11.2	11.5	11.4
of which: Pensions	7.1	8.4	7.5	6.9	7.3	7.3
Interest payments	0.5	0.4	0.3	0.3	0.3	0.3
Capital expenditure	4.2	4.2	3.2	3.3	4.5	4.0
Financial surplus (+) / deficit (-)	-0.2	-4.5	-1.1	0.3	-0.9	-0.4
Net lending (-) 8/	-0.1	-0.1	0.4	0.1	0.1	0.1
Overall surplus (+) / deficit (-)	-0.3	-4.6	-0.7	0.4	-0.8	-0.4
Borrowing requirement	0.3	4.6	0.7	-0.4	0.8	0.4
Domestic financing	1.0	5.1	1.1	1.7	...	...
Of which: Privatization 9/	0.0	4.0	1.0	2.1	0.8	0.8
Foreign financing	-0.7	-0.5	-0.4	-2.1	...	...
Of which: change in government deposits held abroad (-, i	-0.8	-0.6	0.0	-1.9	...	-0.4
Memorandum items:						
Primary fiscal balance (+, surplus)	0.2	-4.2	-0.3	0.7	-0.5	-0.1
Balance in government deposits held abroad	1.7	2.2	2.0	3.9	...	3.9
Total general government debt						
Excluding government assets held abroad	5.8	6.5	5.0	4.8	...	4.2
Including government assets held abroad	4.1	4.3	3.0	0.9	...	0.4
Government guarantees on foreign loans	1.0	1.2	1.1	1.6	...	...
National defense expenditure	1.1	1.4	1.6	1.8	2.0	2.0
GDP (in million of kroons)	73,538	76,327	85,436	95,275	103,000	104,034

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

1/ Including supplementary budget

2/ Foreign grants (reflecting pre-accession financial support from the EU) and grant-financed expenditures have been reported in the government financial statistics since August 2001. Figures for 2000 are staff estimates.

3/ Starting from 2000, profits retained within an Estonian company are not taxed. Profits are taxed at the point of distribution (whether in the form of dividends, fringe benefits, or certain other payments). Figures for 2000 include some tax receipts on 1999 profits.

4/ For 2002, it includes the revenue loss from the introduction of the second pillar of the pension system, estimated by staff at around 0.1 percent of GDP.

5/ Additional payroll contributions of 1 and 0.5 percent from employees and employers respectively. Benefits from the scheme are payable from 2003.

6/ From 2000, includes spending agencies own revenue and outlays financed from spending agencies own resources.

7/ From 2000, includes prescription drug benefits (previously included in current spending on goods and services) and newly-introduced disability benefits.

8/ Net lending in 2000 includes recovery of deposits from failed banks. Overall deficit excluding deposit recovery was 1.0 percent of GDP.

9/ Used for financing the general government deficit. 2002 figures reflects transfer of assets from partial liquidation of Compensation Fund.

Table 4. Estonia: Summary Balance of Payments 1998-2007 1/
(in millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
	<i>-----Projections-----</i>									
Current Account	-428	-231	-348	-394	-449	-519	-510	-522	-527	-551
Trade Balance	-997	-773	-862	-882	-959	-981	-1,034	-1,107	-1,185	-1,267
Exports	2,398	2,364	3,579	3,747	3,994	4,458	4,736	5,016	5,312	5,625
<i>Of which: goods for processing</i>	716	741	1,517	1,409	1,550	...	...	...	...	...
Imports	-3,395	-3,137	-4,441	-4,629	-4,953	-5,439	-5,771	-6,123	-6,496	-6,892
<i>Of which: goods for processing</i>	-618	-672	-1,374	-1,144	-1,380	...	...	...	...	...
Services Balance	511	533	587	629	673	629	671	707	746	787
Receipts	1,320	1,403	1,628	1,840	1,983	2,052	2,181	2,309	2,446	2,590
of which: travel and tourism	481	518	549	568	...	...	...	...	...	...
Payments	-809	-870	-1,041	-1,211	-1,310	-1,423	-1,510	-1,602	-1,700	-1,803
Income	-74	-96	-223	-327	-358	-373	-362	-339	-315	-297
Current Transfers	132	106	150	187	196	206	216	216	227	227
Capital and Financial Account	436	378	399	366	506	587	588	588	645	635
Capital Transfers	2	1	18	6	7	15	24	29	41	41
Financial Account	434	377	381	360	499	572	564	559	604	594
Direct Investment	507	205	358	391	441	428	390	364	339	319
From abroad	512	284	425	598	...	...	...	...	...	...
Outward (by Estonians)	-5	-79	-67	-207	...	...	...	...	...	...
Net equity investment	57	222	-31	49	51	51	51	51	51	51
Loans and other investments 2/	-130	-50	54	-79	7	93	123	143	215	224
<i>of which:</i>										
Banks	19	6	134	-118	...	...	...	...	...	...
Government	-52	-31	-22	-7	...	...	...	...	...	...
Monetary Authorities	-19	-13	-8	-12	...	...	...	...	...	...
Errors and Omissions	1	-33	13	6	0	0	0	0	0	0
Overall balance	8	115	64	-22	57	68	78	66	119	84
<i>Memorandum Items:</i>										
euro/US\$ exchange rate (period average)	1.17	1.10	1.13	1.11	...	...	...	...	...	...
Gross International Reserves (euro millions) 3/ 4/ 5/	696	852	993	931	988	1,056	1,134	1,200	1,318	1,402
In months of imports (excluding imports of goods for processing)	3.0	4.1	3.9	3.2	3.3	...	...	...	...	...
Relative to gross short-term debt (ratio) 6/ 7/	0.9	0.9	0.8	0.7	0.7	0.8	0.8	0.8	0.8	0.9
Trade Balance/GDP (in percent)	-21.2	-15.8	-15.8	-14.5	-14.4	-13.6	-13.3	-13.2	-13.1	-13.0
Goods and Non-factor Services balance/GDP (in percent)	-10.4	-4.9	-5.0	-4.2	-4.3	-4.9	-4.7	-4.8	-4.8	-4.9
Current Account/GDP (in percent)	-9.1	-4.7	-6.4	-6.5	-6.8	-7.2	-6.5	-6.2	-5.8	-5.6
Total external debt/GDP (in percent) 8/										
Gross 9/	53.3	58.7	59.4	61.0	62.3	58.3	55.2	52.5	50.5	48.5
Net 10/	15.0	15.2	13.0	15.0	15.3	12.4	10.2	8.6	7.5	6.9
General government external debt/GDP (in percent) 11/										
Excluding Govt. assets held abroad	4.3	4.9	3.8	3.1	3.1	...	...	...	...	...
Including Govt. assets held abroad	2.5	2.2	2.1	1.3	1.1	...	...	...	...	...
Debt Service/Exports of GNFS (in percent)	8.2	7.4	6.8	6.9	7.1	...	...	...	...	...

Sources: Bank of Estonia and Fund staff estimates.

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

2/ Includes operations in debt securities.

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

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

5/ 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.

6/ Includes trade credits.

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

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

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

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

11/ Includes government guaranteed debt.

Table 5. Estonia Banking Survey and Monetary Authorities: 1998-2002 1/
(in millions of EEK, unless otherwise indicated)

	1998	1999	2000	2001	2002		
					Jan.	Feb.	Mar.
Banking Survey							
Net foreign assets	5,112	8,022	9,098	12,285	11,572	11,948	11,655
Net foreign assets (BOE)	10,493	12,932	15,167	14,319	13,274	13,034	13,644
Foreign assets 2/ 3/	10,909	13,334	15,540	14,573	14,591	14,315	15,476
Foreign liabilities	-415	-402	-373	-254	-1,318	-1,281	-1,832
Net foreign assets (commercial banks)	-5,381	-4,910	-6,068	-2,034	-1,701	-1,086	-1,988
Foreign assets	6,481	8,772	10,359	15,475	16,519	16,619	17,040
Foreign liabilities	-11,862	-13,682	-16,427	-17,510	-18,220	-17,705	-19,028
Net domestic assets	16,216	18,368	24,064	28,518	28,558	28,361	29,267
Domestic credit	24,223	26,542	33,758	41,994	41,878	42,003	43,169
Net credit to general government	-930	-197	-1,078	-575	-1,325	-1,346	-1,475
Credit to government (banks)	955	1,172	1,268	1,742	1,710	1,693	1,656
Government deposits (banks)	-1,882	-1,345	-2,343	-2,311	-3,028	-3,032	-3,166
Net credit to government (BOE)	3	3	3	1	2	1	1
Government deposits (BOE)	-6	-27	-7	-8	-9	-7	-7
Credit to non-government	25,153	26,739	34,837	42,570	43,203	43,349	44,644
Credit to nonfinancial public enterprises	226	372	263	142	140	140	112
Credit to private sector	18,590	19,877	22,203	26,321	26,531	26,437	27,245
Credit to enterprises	14,369	14,571	15,376	17,161	17,233	17,009	17,619
Credit to households	4,221	5,306	6,827	9,160	9,297	9,428	9,625
Credit to nonbank financial institutions	6,337	6,489	12,370	16,107	16,532	16,772	17,288
Other items (net)	-8,007	-8,174	-9,695	-13,476	-13,321	-13,642	-13,901
Broad money	21,328	26,390	33,162	40,803	40,130	40,308	40,923
M1	13,120	17,336	20,869	24,948	24,072	23,919	23,964
Currency outside banks	4,539	5,711	6,201	6,952	6,761	6,763	6,848
Demand deposits	8,581	11,624	14,668	17,996	17,311	17,156	17,116
Time and savings deposits	8,208	9,054	12,293	15,855	16,059	16,389	16,958
Monetary Authorities							
Net foreign assets	10,493	12,932	15,167	14,319	13,274	13,034	13,644
Foreign assets 2/ 3/	10,909	13,334	15,540	14,573	14,591	14,315	15,476
of which: currency board cover 4/	9,070	11,526	13,207	11,910	10,640	10,444	11,123
Foreign liabilities	-415	-402	-373	-254	-1,318	-1,281	-1,832
Net domestic assets	-1,423	-1,406	-1,960	-2,409	-2,633	-2,590	-2,520
Net claims on Government	-3	-24	-4	-6	-7	-7	-5
Claims on financial institutions	281	268	10	8	8	8	8
Claims on private sector	57	66	70	75	76	76	75
Other	-1,758	-1,716	-2,035	-2,486	-2,710	-2,667	-2,599
Base money	9,070	11,526	13,207	11,910	10,640	10,444	11,123
Currency issue	5,391	6,649	7,277	8,067	7,662	7,679	7,736
Deposits of commercial banks with the BOE	3,676	4,824	5,718	3,815	2,947	2,734	3,355
Other deposits at BOE	4	54	211	28	32	32	31
Memorandum items:							
Base money multiplier	2.35	2.29	2.51	3.43	3.77	3.86	3.68
Currency-to-deposit ratio	0.27	0.28	0.23	0.21	0.20	0.20	0.20
Bank reserves-to-deposit ratio	0.27	0.28	0.25	0.14	0.12	0.11	0.12
Velocity (period average)	3.40	3.19	2.81	2.57	...	...	...
Required reserves (in millions of EEK) 5/	2,675	2,734	4,634	5,904	5,963	6,078	6,140
Gross international reserves (in millions of US\$) 2/	813	856	923	823	804	791	861
Net international reserves (in millions of euro) 6/	124	115	149	179	186	183	179
(In percent change)							
Net foreign assets of banking system	0.6	56.9	13.4	35.0	19.5	21.2	17.3
Net domestic assets of banking system	5.4	13.3	31.0	18.5	17.9	15.3	16.3
Domestic credit	16.5	9.6	27.2	24.4	24.2	21.6	22.2
Credit of banking system to non-government	11.7	6.3	30.3	22.2	23.2	22.0	23.1
Credit to the private sector	9.7	6.9	11.7	18.5	19.5	18.5	20.6
Credit to nonbank financial institutions	21.1	2.4	90.6	30.2	31.2	29.2	28.5
Broad money	4.2	23.7	25.7	23.0	18.4	17.0	16.6
M1	-6.3	32.1	20.4	19.5	15.5	17.0	16.2
Base money 7/	6.4	27.1	14.6	-9.8	-2.0	-1.0	5.6

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 money in 2001 is associated with a reduction in the cash reserve requirements.

Table 6. Estonia: Macroeconomic Framework, 1998-2007
(in percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
			Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Domestic saving	20.1	19.8	18.3	20.2	20.7	19.3	20.5	20.8	21.2	21.4
Private	16.2	20.2	15.7	16.5	17.0	15.6	16.1	16.3	16.5	16.7
Public	3.9	-0.4	2.5	3.7	3.7	3.7	4.4	4.5	4.6	4.7
Investment	29.3	24.5	24.6	26.7	27.5	26.5	27.0	27.0	27.0	27.0
Private	25.1	20.3	21.4	23.4	23.4	22.4	22.3	22.3	22.3	22.3
Public	4.2	4.2	3.2	3.3	4.0	4.1	4.7	4.7	4.7	4.7
Foreign saving	9.2	4.7	6.4	6.5	6.8	7.2	6.5	6.2	5.8	5.6
<i>Memorandum items:</i>										
Fiscal balance 1/	-0.3	-4.6	-0.7	0.4	-0.4	-0.3	-0.3	-0.2	0.0	0.0
Revenues	39.3	38.1	38.7	38.7	38.9	38.5	40.2	40.2	40.3	40.3
Expenditures 2/	39.6	42.7	39.4	38.3	39.2	38.8	40.5	40.4	40.3	40.3
Net non-debt creating capital inflows ("+" inflow)	12.1	8.8	6.0	7.2	7.4	6.6	5.7	4.9	4.3	3.8
Net equity investment	1.2	4.6	-0.6	0.8	0.8	0.7	0.7	0.6	0.6	0.5
Net foreign direct investment	10.9	4.2	6.6	6.4	6.6	5.9	5.0	4.3	3.7	3.3
GDP real growth (year-on-year in percent)	5.0	-0.7	6.9	5.4	4.5	5.0	5.0	5.0	5.0	5.0
CPI inflation (average, year-on-year in percent)	8.1	3.3	4.0	5.8	4.4	3.6	3.5	3.5	3.5	3.5
CPI inflation (end-period, in percent)	4.2	3.8	5.0	4.2	4.3	3.8	3.5	3.5	3.5	3.5
GDP (millions of kroons)	73,538	76,327	85,436	95,275	104,034	113,059	121,917	131,469	141,770	152,878

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, 1998-2002
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	
					Projection	Date Actual data
Financial indicators						
Public sector debt 1/	6.8	7.7	6.1	6.4	5.8	
Broad money (percent change, 12-month basis)	4.2	23.7	25.7	23.0	17.0	
M1 (percentage change, 12-month basis)	-6.3	32.1	20.4	19.5	17.0	
Private sector credit (percent change, 12 month basis)	11.7	6.3	30.3	22.2	16.7	
External Indicators						
Exports (percent change, 12-month basis in euro)	16.7	1.3	38.3	7.3	7.0	
Imports (percent change, 12-month basis in euro)	15.0	-4.7	36.8	6.5	7.2	
Current account balance	-9.1	-4.7	-6.4	-6.5	-6.8	
Capital and financial account balance	9.3	7.8	7.3	6.1	7.6	
<i>of which:</i> Inward portfolio investment (debt securities etc.)	0.1	2.7	1.5	1.9	...	
Other investment (loans, trade credits etc.)	0.3	0.1	-0.1	0.2	...	
Inward foreign direct investment	10.9	5.8	7.8	9.9	...	
in the form of debt or loans	3.0	1.9	1.5	3.6	...	
Gross official reserves (in euro millions) 2/	696	852	993	931	988	
NFA of the consolidated banking system (in euro millions)	327	513	581	785	788	
Central Bank short-term foreign liabilities (in euro millions)	0.0	0.2	3.2	1.1	1.2	
Short term foreign assets of the financial sector (in euro millions) 3/	309	422	490.3	760.4	864.3	
Short term foreign liabilities of the financial sector (in euro millions)	485	684	868.4	978.7	1,070.2	
Foreign currency exposure of the financial sector (in euro millions)	228	469	510	1,063	1,180	3/31/02
Official reserves in months of imports (excluding imports of goods f	3.0	4.1	3.9	3.2	3.3	
Broad money to reserves	2.0	2.0	2.1	2.8	3.1	
Total short term external debt to reserves 4/	0.9	0.9	0.8	0.7	0.7	
Total external debt 5/ 6/	53.3	58.7	59.4	61.0	62.3	
<i>of which:</i> Public sector debt 1/	4.3	4.9	3.8	3.1	3.1	
Net external debt 7/	15.0	15.2	13.0	15.0	15.3	
Debt service to exports of GNFS	8.2	7.4	6.8	6.9	7.1	
External interest payments to exports of GNFS	2.6	2.1	1.9	1.9	1.9	
External amortization payments to exports of GNFS	5.6	5.3	4.9	5.0	5.2	
Exchange rate (per US\$, period average)	14.1	14.7	17.0	17.6	17.6	2/28/02
REER appreciation (+) (12 month basis)	23.1	-2.7	-5.5	3.6	1.2	2/28/02
Financial Market Indicators						
Stock market index 8/	90.7	125.5	138.2	144.7	183.9	5/23/02
Foreign currency debt rating 9/	BBB+	BBB+	BBB+	A-	A-	4/30/02
Spread of benchmark bonds (basis points, end of period) 10/	13.5	0.7	0.4	0.04	-0.04	5/17/02

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

1/ Total general government and government guaranteed debt excluding government assets held abroad.

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

3/ Excluding reserve assets of the Bank of Estonia.

4/ By original maturity.

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

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

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

8/ Tallinn stock exchange index (TALSE).

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

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

Table 8. Estonia: Selected Financial Indicators, 1998-2001

	1998	1999	2000	2001
	(In percent of total deposits)			
Banking sector reserves	24.2	28.1	23.2	13.6
Cash	4.6	4.5	3.7	3.1
Reserves held at the BoE 1/	19.6	23.4	19.6	10.5
of which: Required reserves	14.3	13.3	15.9	...
Average risk-weighted capital adequacy ratio 2/	17.0	16.1	13.2	14.4
Non-performing loans (in percent of total loans) 3/	1.4	1.7	1.0	1.3
Leverage ratio 4/	4.8	5.2	6.6	6.6
	(In millions of EEK; unless otherwise indicated)			
NFA of commercial banks	-5,381	-4,910	-6,068	-2034
Net open foreign exchange position of banks 5/	3,562	7,335	7,985	16642
In percent of total assets	9	16	14	24
of which : net forward contracts 6/	-3,363	246	538	615
Banking sector's net external obligations maturing within 30 days 7/	255	-651	2,102	3,832
Net international reserves of BoE 8/	1,786	1,737	2,165	2,533
Interest spread (in percent per annum) 9/				
Domestic currency short-term	8.6	5.5	3.2	5.4
Foreign currency (DM/euro) short term	4.6	6.9	5.7	9.2
Domestic credit to non-government (annual growth, in percent)	11.7	6.3	30.3	22.2

Source: Bank of Estonia.

1/ Banks must meet reserve requirements on the basis of average reserve holdings over each reporting period. End of period levels can, therefore, be below the level of required reserves. In 2001, required reserves were lowered from 13 to 6.5 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/ Includes forward contracts. A minus sign indicates a short position. Switches from positive to negative positions are normally associated with short-lived speculation against the kroon in the form of forward sales (e.g., December 1997 and August 1998). The reversal of these positions has been associated with a sharp improvement in the net open position (e.g., December 1998).

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

7/ 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.

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

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

MEDIUM TERM GROWTH IN ESTONIA: TRENDS AND PROSPECTS

Estonia's economic performance has been impressive since growth resumed in the mid-1990s, with output increasing by 40 percent between 1995 and 2001. Growth has been underpinned by sound macroeconomic and structural policies that have contributed to a favorable business climate, strong inflows of foreign direct investment (FDI), extensive reorientation of trade to western Europe, and a healthy banking sector with strong international links. Favorable external conditions have also helped, including relatively healthy growth in western Europe during most of this period, and—until recently—the strength of the information technology sector in Finland and Sweden.

Against this background, what growth rate can Estonia expect in the years ahead, including in the context of prospective accession to the EU? Will the domestic and external factors that have driven growth since the mid-1990s continue with the same force? And, in that case, does an extrapolation of trend growth over this period—which suggests a growth rate of 4½ to 5 percent—provide a reasonable indication of Estonia's medium-term prospects?

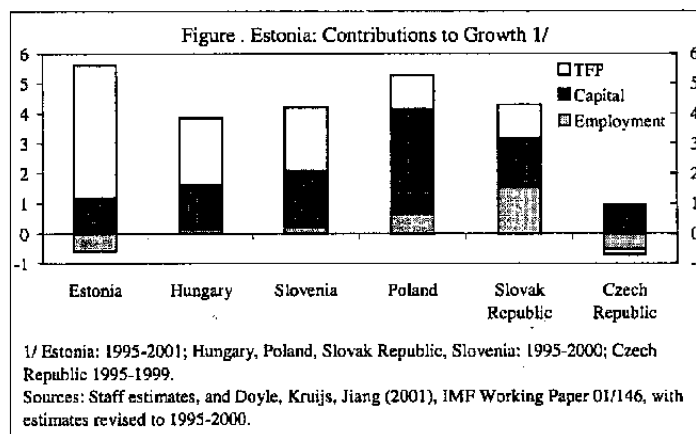
One perspective on these questions comes from a decomposition of growth into contributions from factor inputs and from the Solow residual, or total factor productivity (TFP). This approach has been widely used to assess sources of underlying growth among advanced, transition, and developing economies, but is nevertheless subject to a number of theoretical and empirical uncertainties.¹ These difficulties may be particularly acute in the case of transition economies, where the process of labor shedding may lead to an underestimation of the real contribution of labor to growth.² In practice, the main value in this analysis of growth

¹ For discussion of some of these problems, together with growth decompositions for a wide range of countries, see, for example, Nicholas Crafts, *East Asia Growth Before and After the Crisis* (IMF Working Paper WP/98/137).

² During their adjustment to market-based arrangements, these countries have experienced extensive reallocation of labor, obsolescence of capital, and other significant changes in the level and use of factor inputs. As a result, measurement of “effective” labor and capital inputs are likely to be approximate at best, and the countries concerned have probably been operating well inside their “true” production capabilities (whereas the growth decomposition properly applies on the production possibility frontier). To illustrate the difficulties that could arise, the standard practice in this literature is to measure labor inputs using the level of employment. According to official data, employment generally fell in the earlier stages of transition, but this may partly reflect hidden unemployment and poorly allocated labor under the previous economic system. Hence, using employment levels—rather than by some broader measure showing labor effectively applied or the input of human capital—will tend to understate the real contribution of labor to growth, and overstate that of the residual TFP.

may come not from the specific numbers that arise, but from the general similarities (and differences) than emerge in growth patterns across a range of countries and time periods. Some such comparisons are considered below.

A decomposition of Estonia's growth from 1995 to 2001 highlights the dominant role of TFP relative to capital accumulation and employment.³ TFP is estimated to have contributed just over 4 percentage points on average to the 5 percent annual average GDP growth rate from 1995 to 2001. Capital accumulation contributed a little over 1 percentage point, while (declining) employment subtracted around ½ a percentage point from growth. While the TFP contribution appears particularly strong in Estonia, this breakdown is broadly similar to recent results obtained for Hungary and Slovenia, where TFP also appears to have been more significant than capital accumulation in driving growth during the 1990s.⁴ In part, this finding may reflect similarities in these countries' underlying production structures compared, for example, with the greater industrial intensity of the Czech and Slovak Republics. It is also notable that Estonia, Hungary, and Slovenia are among the most open of the EU accession candidates in terms of trade flows, and that Estonia and Hungary (together with the Czech Republic) have the highest levels of FDI per capita. These influences are likely to have contributed to the strength of productivity growth, including through technology transfer.



³ Measuring the capital stock is particularly difficult among transition economies, given the extent of scrapping etc.. For a more detailed discussion and estimates for other transition economies, see Peter Doyle, Louis Kuijs, and Guorong Jiang, *Real Convergence to EU Income Levels: Central Europe from 1990 to the Long Term* (IMF Working Paper WP/01/146). Partial data of revalued capital were provided by the Estonian Statistical Office; these suggest that the overall capital/output ratio could be around 2½ at present, implying a ratio of about 2 at the start of transition. This would be consistent with estimates for Hungary and Slovenia reported in Doyle et al.. In the Cobb-Douglas production function used in the growth decomposition, weights of 65 percent and 35 percent are applied to labor and capital, respectively (as in Doyle et al. and other studies), and capital is assumed to depreciate at an 8 percent rate.

⁴ See Doyle et al., *ibid.*

Productivity will need to continue as the mainstay of growth in Estonia if recent economic performance is to be sustained in the face of an aging population and a weak outlook for employment (which is currently projected to grow at a diminishing pace until around 2012, and then decline).⁵ An encouraging indication of the potential durability of productivity growth comes from the western Europe “golden age” of 1950 to 1973.⁶ TFP in France, Italy, and West Germany grew by 3 to 3½ percent per year on average during these years, making the principal contribution to GDP growth rates averaging 5 to 6 percent. As a result, these countries were able to reduce significantly their income gap with the United States over this period. Forward-looking estimates of TFP growth in Europe and Asia have also been derived from the interaction of convergence effects and education—the latter illustrating both human capital improvements and countries’ ability to absorb catch-up influences.⁷ Under this approach, annual TFP growth rates of 2 to 3 percent (inversely related to income gaps with advanced economies) have been estimated for EU accession countries in Central Europe.⁸ On a comparable basis, TFP growth in Estonia would be projected to be around 3½ percent—only slightly below recent trends.

With EU accession approaching, a further perspective on Estonia’s prospects for growth and convergence come from the experiences of countries that joined the EU in the past. The examples of Ireland, Portugal, and Spain may be particularly useful, given their relatively low levels of income per capita at the time of accession and hence scope for substantial catch-up.⁹ Somewhat different patterns emerge, however. From the time of their accession in 1986, incomes in Portugal and Spain have converged quite steadily with those of countries that joined the EU earlier, with annual GDP growth averaging about 1 percent above other members (Figure). Strong real exchange rate appreciation immediately following accession also contributed to initial convergence of income levels. In contrast, Ireland (which joined the EU in 1973) made no progress with convergence until the late 1980s, but has clearly

⁵ Clearly, these labor market constraints on growth could also be eased through higher immigration.

⁶ See Nicholas Crafts (1998).

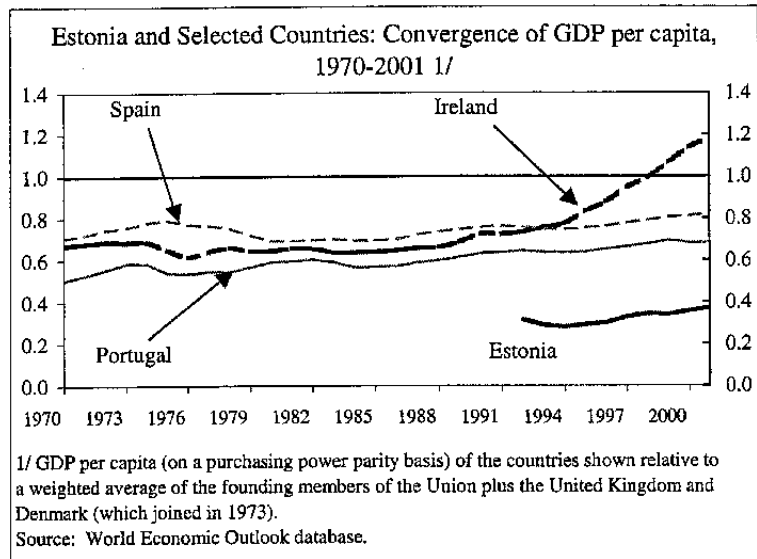
⁷ See Jess Benhabib and Mark Spiegel (1994), The role of human capital in economic development, *Journal of Monetary Economics* 34, pp. 143-173. Using these results, Crafts (1998) provides TFP estimates for western Europe and Asia, and Doyle et al. (2001) provide estimates for Central Europe.

⁸ See Doyle et al. (2001).

⁹ Greece, which joined the EU in 1981, could also be included in this group. Over much of the period since accession, however, economic policies and performance in Greece appear to have diverged substantially from those of other new members (see the October 2000 World Economic Outlook, Chapter IV).

achieved remarkable growth since then. Trends in FDI and trade openness were more uniform, with FDI rising sharply in all three countries in the period following accession, and trade generally picking up steadily.¹⁰

EU accession in itself is not a guarantee of more rapid growth, as the example of Ireland during much of the 1970s and 1980s illustrates. However, accession offers the prospect of further trade and financial integration, institutional strengthening, and reduction in risk premia. The Estonian economy appears well placed to benefit from these developments, especially in view of the capacity it has shown over the past ten years for economic adjustment, supported by policies conducive to investment and growth. Estonia's openness to trade and levels of FDI are already high in comparison to Ireland, Portugal, and Spain when they joined the EU, but are not high compared with some current EU members (or other small open economies)¹¹; hence, there is scope for ongoing growth and convergence through these channels. Support will also need to come from progress with human capital development, especially through education and training, so that Estonia can overcome potential skill shortages and take full advantage of technological advances. While the sizeable undervaluation of real exchange rates at the start of transition in Estonia and elsewhere appears to have largely corrected, ongoing real appreciation can be expected in proportion to the real growth differential over advanced economies, speeding the convergence of nominal (euro) incomes.¹²



¹⁰ See Box 4.2 in the October 2000 *World Economic Outlook*.

¹¹ For example, direct investment liabilities are about 20 percent of PPP-based GDP in Estonia, compared with nearly 60 percent in the Netherlands and 70 percent in Belgium.

¹² Estimates in the October 2000 *World Economic Outlook* suggest that for each 1 percent growth differential above the advanced economies, relative price levels in the transition economies could increase by 0.4 percent. For example, if Estonia's potential growth rate were to be around 5 percent compared with 2½ percent in the EU, this could lead to a sustainable real exchange rate appreciation of 1 percent in Estonia.

In conclusion, the quantitative and comparative indicators noted above provide little basis for thinking that Estonia would be unable to sustain its recent trend growth rate of around 5 percent over the medium to long term. Ongoing productivity growth will be the key, supported by further capital deepening and human capital accumulation. In this regard, economic and policy conditions—including the prospect of EU accession—appear to provide a favorable climate for Estonia to take full advantage of the large potential for catch up that currently exists.

ESTONIA: FUND RELATIONS¹
(As of April 30, 2002)

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	73.91	113.4
Reserve position in Fund	0.01	0.0

III. SDR Department:	SDR Million	Percent of Allocation
Holdings	0.08	N.A.

IV. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
Systemic Transformation	8.72	13.4

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):

	Overdue	Forthcoming					
	(3/31/02)	2002	2003	2004	2005	2006	2007
Principal	0	1.9	3.9	1.9	1.0	0.0	0.0
Charges/interest	0	0.2	0.1	0.1	0.0	0.0	0.0
Total	0	2.1	4.0	2.0	1.0	0.0	0.0

¹ Updated information relating to members' positions in the Fund can be found on the IMF web site (<http://www.imf.org/external/np/tre/tad/index.htm>).

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.

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. It appears that Estonia does not maintain restrictions on capital transactions.

IX. Article IV Consultation:

The 2001 Article IV consultation was concluded by the Executive Board on June 27, 2001.

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.

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

XI. Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 2000–2001

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
LEG	Income tax and EU laws	Mission	Forthcoming	Ministry of Finance
INS	Financial Markets	Training	Forthcoming	

XII. Resident Representative:

Mr. Adalbert Knöbl assumed the position of senior resident representative in Estonia and Latvia starting October 1999.

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 in Tallinn 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

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

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

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

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

C. Balance of Payments Statistics

5. All balance of payments data are also compiled by the Bank of Estonia (BoE):
- Daily exchange rate data are available with a one-working day lag.²
 - Monthly imports/exports data are available with a two-month lag.
 - Quarterly current account data is available with a one-quarter lag.²
 - Quarterly public and private external debt data is available with a one-quarter lag.²

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF).
- Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government has started to report monthly data on a consolidated government basis in January 1999 (<http://www.fin.ee>).
 - Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag.
 - Comprehensive annual data on central government and local government operations and debt are reported within three quarters from the end of the fiscal year for use in the *GFS Yearbook*.

E. National Accounts Statistics

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

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

Estonia: Core Statistical Indicators
(As of June 5, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	4/30/02	4/30/02	4/30/02	4/30/02	4/30/02	4/02	4/02	3/02	Q4/01	3/02	Q4/01	Q4/01
Date Received	5/2/02	5/8/02	5/8/02	5/8/02	5/20/02	5/24/02	5/6/02	5/6/02	3/18/02	4/30/02	3/28/02	3/25/02
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—unrestricted.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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Public Information Notice (PIN) No. 02/68
FOR IMMEDIATE RELEASE
July 3, 2002

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

IMF Concludes 2002 Article IV Consultation with the Republic of Estonia

On July 1, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Estonia.¹

Background

Estonia continues to be an outstanding performer among the transition economies reflecting the authorities' continued commitment to market based reforms, pursuit of sound macroeconomic policies, emphasis on institution-building, and a commitment to transparency. The cornerstone of Estonia's success is based to a large degree on sound fiscal policies with an extremely low level of public debt, a credible foreign exchange regime in form of a currency board, broad ranging structural changes, which led to the near completion of the privatization process, and a view toward integrating the country into western Europe. Furthermore, Estonia opted to eliminate restrictions on current and capital account transactions early in the transition process.

In 2001, the Estonian economy showed remarkable resilience given the slowdown in economic activity among its main trading partners. While growth decelerated somewhat compared to the previous year, the economy grew at a healthy 5.4 percent, driven largely by a pickup in investment demand. Despite some temporary adverse external and administrative price shocks, consumer price inflation increased only slightly to 5.8 percent on average in 2001. Although Estonia is confronted with a unique structural unemployment problem that is largely limited to a

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.

particular region of the country, conditions in the labor market improved somewhat and the unemployment rate fell slightly to 12.6 percent.

The government was successful in generating a small fiscal surplus. While local governments continued to generate a deficit, this was offset by a corresponding surplus in the central government. The improvement in the fiscal position reflected the authorities' commitment to reduce the overall size of the government. For a second year in a row, salary and wage growth stayed below the rate of inflation and there was no increase in public pensions. The government used the surplus and receipts from privatization to retire public debt and to build up deposits abroad.

The reduction of short-term interest rates in Europe and a fall in the country's risk premium contributed to a loosening of monetary conditions. Money and credit aggregates grew strongly in 2001. Lease financing in particular, which accounts for about one-third of credit to the private sector, grew substantially. To bring the ratio of required reserves more in line with those in the European Monetary Union (EMU), the authorities initiated a gradual reduction. However, since at the same time commercial banks are now required to hold a correspondingly higher proportion of high-quality euro-demoninated foreign assets, the reduction did not have any adverse liquidity implications.

The 2001 current account deficit remained broadly unchanged at 6½ percent. With respect to exports, most sectors performed relatively well and exports to Russia experienced a substantial boost albeit from a very low level. The adverse implications of a fallout in the telecommunications sector for the trade account was limited since most production in Estonia in this sector is largely based on low-value-added subcontracting for Scandinavian electronics companies which led to a simultaneous fall in both exports and imports.

Executive Board Assessment

Directors commended the authorities for their steadfast reform effort and prudent macroeconomic policies, noting that in many respects Estonia has become a model for successful transition to a market-based economy. They encouraged the authorities to consolidate this progress and continue to ready Estonia's institutions for further European Union (EU) integration, while remaining vigilant to domestic and external developments.

Directors were encouraged that Estonia was able to withstand the recent economic slowdown among its trading partners and that domestic demand—especially private investment—has remained relatively strong. Despite a less favorable external environment, exports in the higher-value-added sectors are performing well, while the current account deficit continues to be fully financed by non-debt-creating foreign direct investment.

Directors welcomed the sustained implementation of conservative fiscal policies, which had resulted in impressively low levels of public debt and a small budget surplus in 2001. They agreed that the authorities' proposed fiscal path for 2002, which envisages a modest weakening of the budget position, would not undermine the sustainability of the public finances. They noted, however, that increases in current expenditure would add to budgetary tensions in future years when additional EU- and NATO-related spending will need to be accommodated.

Directors cautioned against adding to these pressures through a second mid-year supplementary budget this year—and they encouraged the authorities to allow automatic stabilizers to operate fully in the event of higher-than-expected growth. This would also help to limit the external current account deficit, which is important in the setting of Estonia's currency board arrangement. Directors agreed that the authorities should continue to aim broadly for budget balance over the medium term, while responding flexibly to short-term variations in cyclical conditions.

Directors noted that inflation remains above the EU average. They agreed, however, that—with productivity growth likely to be stronger in the tradable than the nontradable sector—Estonia should be able to sustain slightly higher inflation over the medium term without losing competitiveness. At the same time, Directors cautioned that wage growth in excess of productivity gains would undermine Estonia's competitiveness.

Turning to monetary issues, Directors commended the authorities for their careful reduction in required reserves, and noted that the money and credit aggregates have started to grow more slowly. While they agreed with the authorities' goal of reducing required reserves to levels in the euro area, they cautioned them to guard against an undesirable increase in liquidity and inflationary pressure in the nontradable sector. In addition, Directors encouraged the authorities to monitor carefully credit to leasing companies, which now accounts for about one third of credit to the private sector.

Directors considered that the currency board continues to serve the economy well, noting that the key requirements—sound fiscal policy, low public debt, and willingness to implement structural reforms—continue to be met. They agreed that it should remain a cornerstone of Estonia's economic strategy in the run-up to EU accession, participation in ERM II, and eventual adoption of the euro.

Directors welcomed the successful establishment of the Financial Supervision Authority, which should further enhance the oversight of Estonia's financial institutions and sustain the recently gained stability in this sector. In addition to maintaining stability, however, the authorities should eliminate remaining distortions in the financial system in order to improve the allocation of savings and investment and to ensure that small- and medium-sized enterprises have adequate access to financing. The latter would be important, Directors stressed, to foster the development of a vibrant entrepreneurial sector, which in turn is necessary to maintain high growth rates over the medium term and to foster strong employment gains. Directors considered that the

authorities should eliminate the current tax-exempt status on income earned from bank deposits.

Directors welcomed the authorities' continued commitment to increasing transparency and looked forward to the promulgation of the amended organic budget law, which will reinforce the already high degree of fiscal transparency. Directors also commended the authorities on their efforts to combat money laundering and the financing of terrorism.

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 2002 Article IV Consultation with Estonia is also available.

Republic of Estonia: Selected Economic Indicators

	1997	1998	1999	2000	2001
Real Economy					
	<i>Changes in percent</i>				
Real GDP	10.4	5.0	-0.7	6.9	5.4
CPI (period average)	11.2	8.1	3.3	4.0	5.8
Unemployment rate (in percent) 1/	9.7	9.9	12.3	13.7	12.6
Domestic saving (in percent of GDP)	18.8	20.1	19.8	18.3	20.2
Domestic investment (in percent of GDP)	31.0	29.3	24.5	24.6	26.7
Public Finance					
	<i>In percent of GDP</i>				
General government balance	0.0	-0.3	-4.6	-0.7	0.4
General government external debt					
Excluding government assets held abroad	4.3	4.3	4.9	3.8	3.1
Including government assets held abroad	3.7	2.5	2.2	2.1	1.3
Money and Credit					
	<i>Changes in Percent</i>				
Base money	37.7	6.4	27.1	14.6	-9.8
MI	24.0	-6.3	32.1	20.4	19.5
Broad money	37.8	4.2	23.7	25.7	23.0
Domestic credit to nongovernment	79.0	11.7	6.3	30.3	22.2
Balance of Payments					
	<i>In percent of GDP</i>				
Goods and non-factor services balance	-11.6	-10.4	-4.9	-5.0	-4.2
Current account	-12.2	-9.2	-4.7	-6.4	-6.5
Gross international reserves (in millions of euro)	760	696	852	993	931
Exchange Rate					
Exchange rate regime	Currency Board Arrangement				
Present	EEK 15.64664 = 1				
Real effective exchange rate (1995=100) 2/	110.1	123.8	137.6	130.7	131.6

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

**Statement by Benny Andersen, Alternate Executive Director and Andrus Alber,
Assistant to the Executive Director for the Republic of Estonia
July 1, 2002**

Our Estonian authorities would like to thank Mr. Haas and his team for their cooperation and dedication during the discussions in Tallinn. In addition to the present team, we would like to recognize also the work of the previous head of mission to Estonia, Mr. Keller.

The staff has written a well balanced document and our authorities are in broad agreement with the staff's conclusions and policy recommendations. With the last precautionary Stand-By Arrangement expiring almost a year ago, this was the first stand-alone Article IV consultation with Estonia. Our authorities appreciate this new level of cooperation with the Fund and staff's willingness to explore more medium- and long-term growth perspectives for Estonia, as described *inter alia* in Appendix I. We are also pleased with the background paper which discusses fiscal issues in Estonia's accession process towards the EU and NATO. This document provides a good insight into the challenges and options Estonia and other Baltic countries are faced with in a medium-term perspective. Estonia has closed 26 chapters out of 31 of the EU *acquis communautaire* and wishes to complete the accession negotiations by the end of 2002.

Economic developments and outlook

During last year's Article IV Board discussion, Directors were concerned whether the growth forecasts for Estonia were too optimistic. However, as it turned out the Estonian economy weathered the economic slowdown in its major trading partners quite well and the GDP growth was 5.4 percent in 2001.

The beginning of this year has been somewhat less favorable to Estonia. Economic growth in Estonia's major export markets has been slow and most European Union members are importing fewer goods than a year ago. The subcontracting industry has experienced a major trade contraction, but direct export has preserved a 10 percent growth rate. Domestic demand, both investment and consumption, has been strong, supported by low interest rates in the eurozone, which, due to the euro-based currency board, are transmitted to the local market. According to preliminary data economic growth in the first quarter slowed to 3.6 percent year-on-year, which is still significantly higher than in Estonia's major trading partners. For 2002 as a whole, the authorities expect growth in the order of 4.2 percent.

The current account deficit remained at 6.5 percent of GDP in 2001 and was more than fully covered by the inflow of FDI. In the first quarter of 2002, high overall investment demand, including several one-off factors (launching of some major projects in energy and export sectors), caused the four-quarter average current account deficit to increase to approximately 8 percent of GDP. The overall 2002 deficit is expected to increase to 7 percent, remaining still in the range of the authorities' medium-term projections expressed in the EU Pre-Accession Economic Program.

The inflationary pressures that brought the 12-month CPI close to 7 percent in mid-2001 eased during the second half of 2001 and in the first part of 2002 in line with developments in the euro area, bringing the inflation rate down to 4.1 percent in May. The current inflation differential of about 2 percentage points above the euro area inflation may more or less prevail also in the coming years reflecting the productivity growth in the tradables sector and the convergence process.

Monetary policy and financial sector issues

The fixed exchange rate of the Estonian kroon against the euro and the currency board arrangement (CBA) continue to be cornerstones for the Estonian economy 10 years after the currency reform. The CBA will be maintained during both the pre- and post-accession periods. Estonia plans to adopt the euro in three phases—it will accede to the European Union, join the exchange rate mechanism ERM2 and upon meeting the Maastricht criteria, join the euro area. The Estonian authorities are highly satisfied that institutions of the European Union have confirmed that the euro-based fixed exchange rate and the CBA are in principle in compliance with the *acquis* and the requirements set to the monetary policy of pre-ins.

Starting from January 1, 2002 the independent unified Estonian Financial Supervision Authority (FSA) is responsible for banking, insurance and securities market supervision. In addition to this institutional change, further steps have been made to improve the financial sector soundness and enhance supervision. With the enforcement of the Credit Institutions Act Amendment Act from January 2002, Estonia's legislation will be fully harmonized with the current EU *acquis* in the area of banking services, with the exception of the provision of the minimum guaranteed limit of deposits in which Estonia has been granted a transition period. In the field of non-banking financial sector, there has been improvement of securities market regulation—the new Securities Market Act was adopted last October. In addition, for deposit insurance implemented in 1998, the adoption of Guarantee Fund Act in February 2002 also provides protection to clients of investment institutions and unit-holders of mandatory pension funds .

Banks continue to dominate the financial market, being responsible for 80 percent of the Estonian financial sector. In Box 1, the staff argues that “the creation of banks that are ‘too large to fail’ could lead to suboptimal behavior by these banks.” The authorities believe that adequate supervision and majority owners from Scandinavian banks reduce this risk significantly.

Lower interest rates boosted the loan demand considerably in 2001. Despite the increase of credit, Estonian domestic deposits were sufficient in 2001 to finance the credits the financial sector had mediated to the real sector. As staff mentions, a significant amount of financing to the real sector took place through leasing companies. At the same time it is important to note that most leasing companies are part of consolidated banking groups and thus under the supervision of the FSA. Because of the limits to risk concentration for the banks, there is little incentive to create independent leasing companies that could grow and pose serious

risks for the financial system. Nevertheless, the Bank of Estonia and the FSA monitor closely developments in all areas of the financial sector, including in lease financing.

In July 2000, the government created an institution called KredEx whose goal is to provide guarantees to exporters, SMEs and housing programs for young families. These guarantees are not directly managed by the KredEx; they are provided through commercial banks and the criteria to obtain those guarantees are transparent. The users of guarantees are charged and from those guarantee charges the KredEx creates reserves that can be used to cover future loan losses. It is also important to add that KredEx is an independent institution with its own assets and liabilities. The government provided only the start-up capital and is not providing any further financing. The only potential risk for the budget may occur from export guarantees, but this is also by the law limited to the maximum of 300 million kroons.

Estonia has tried to maintain a very simple tax system with few exceptions. One of them is the non taxation of the income earned from bank deposits. The authorities recognize that this can create some market distortions. So far the authorities have concluded that as the total amount of interest payments that can be taxed is quite small, it would not provide significant contributions to the budget revenues. Also, the additional administrative burden for the individuals, banks and Tax Board would probably be more costly than the revenues. When the level of savings increases, the authorities may come back to this issue.

Fiscal policy

In 2001, the government reached one of its main fiscal goals. For the first time since 1997, the general government budget was balanced reaching a small surplus of 0.4 percent of GDP. This was achieved mainly through increased tax revenues after better than expected economic growth and improved expenditure management at the central government level.

For 2002 the government expects a small deficit lesser than 1 percent of GDP. As the tax collection was better than projected in first months of 2002 the parliament passed a supplementary budget in June aimed primarily at raising the pensions and supporting local governments. Although the authorities do not intend to propose a second supplementary budget at this stage the approaching elections may increase the pressure for such actions substantially. Despite two elections within the next nine months, the government is committed to a balanced budgetary policy.

On June 20th, the Parliament approved amendments to the State Budget Act and the Act is now subject to approval by the President of the republic. The new Act defines clearly the general government for Estonia and introduces the new concept of budget revenues and expenditures. The amended Act also establishes a new classification for the budget revenues and the expenditures and a definition of the financing transaction in order to capture all public financial transactions (including foreign aid and loans) in the annual budget. The Act ensures that the framework is in full compliance with international standards.

In June, the Estonian state had its first bond issue directed at foreign markets. The 5-year, 100 million euro issue was very successful, with a 2.7-fold oversubscription. The price of the issue was 5.19 percent yearly, i.e., approximately 60 basis points over the benchmark German Government Bond. The bonds were issued under British law and included Collective Action Clauses. The main aim of the bond issue was to refinance thirteen foreign loans (approximately 73 million out of the 100 million) as well as to finance the purchases of long-range radar system and sea radars.

Structural issues

As the staff has rightly pointed out, recent developments in the labor market have been encouraging. In 2001 employment increased and unemployment decreased. Unemployment has continued to fall to 11.2 percent in the first quarter of 2002. Further decrease of unemployment and continuing job creation remain key policy objectives for the Estonian authorities. Maintaining labor market flexibility is essential for further progress in that respect. In addition, the Estonian authorities have initiated several targeted programs in regions with the highest unemployment level and have introduced special programs for young unemployed, and are reforming the vocational education system.

This spring the government launched the second pillar of the pension system. Participation is voluntary for most people, except for the new entrants to the employment market. Taking into account the very short history of private pension insurance in Estonia and that the first "second pillar pension funds" received their licenses only in April this year, the fact that 37,000 people, i.e. more than 6 percent of tax payers joined within less than one month is remarkable.

The privatization process came almost to an end in 2001. The government intended to finish also with the privatization of the state owned energy company, AS Narva Elektriijaamad (Narva Power Plants). As the strategic foreign investor was unable to guarantee financing of the transaction, in January 2002 the Government of Estonia decided to terminate negotiations concerning the sale of minority shares. The restructuring of the power plants has nevertheless started as the oil shale based electricity generation has an important role in the Estonian economy and the ongoing renovation of Narva Power Plants is, among others, aimed to secure local energy supplies. The management of the company is given the right to hold loan negotiations with financial institutions and the government has decided not to give any state guarantees to these loans.

In order to maintain the high level of transparency the authorities agree to publish the staff report and all ROSC updates as well.