July 1999

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Republic of Estonia: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Republic of Estonia on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Republic of Estonia, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Republic of Estonia; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the
1999 Consultation with the Republic of Estonia

Approved by Gérard Bélanger and G. Russell Kincaid

June 4, 1999

Contents

Figures

Figures

Text Box

Tables

Appendices

EXECUTIVE SUMMARY

The stand-by arrangement expired on March 16, 1999 and discussions on a successor arrangement, again precautionary, will continue in late August. Following the parliamentary elections, the **Article IV discussions were concluded with the new government in May**.

The economy cooled in 1998 and early 1999 because of tighter macroeconomic policies (introduced in late 1997 as part of the Fund-supported program), the earlier collapse of the stock market, and export and banking difficulties linked to the Russia crisis. Weak domestic demand and solid export growth to non-CIS markets contributed to **a marked narrowing of the current account deficit**. Largely because of major capital injections into Estonian banks and large privatization proceeds, FDI substantially exceeded the current account deficit in 1998 and early 1999. **The inflation rate declined to 3.6 percent in April 1999 (year on year).**

After a large surplus in the first half of 1998, **the budget swung into a substantial deficit in the second half of the year** primarily because revenue collections weakened with the economic slowdown. The budget registered a small deficit for 1998 as a whole. The 1999 budget was formulated on the basis of unrealistic revenue projections, and the new government is seeking to pass a supplementary budget to contain the deficit to about 3.5 percent of GDP. The authorities agree that larger cuts would be desirable, but see these as politically unattainable. **The Estonian authorities aim at a balanced budget for next year.**

The consolidation in the banking system proceeded in 1998 through a combination of bank mergers and failures. The Bank of Estonia continued to improve banking supervision in 1998; a new credit institutions law will further strengthen its authority.

The currency board and fixed peg to the deutsche mark (and euro) continued to provide a transparent and credible framework for the formation of economic expectations. Solid export growth despite the CIS crisis, low public external debt, the lengthening maturity structure of private debt, substantial deposits abroad in the Stabilization Reserve Fund, and sharply declining domestic interest rates, suggest that **the currency board arrangement is not under any threat**. The authorities are committed to joining the EMU without a change in the peg.

Estonia is a leading reformer among transition economies and has largely completed first generation reforms. Future structural reforms will focus on legislative requirements for EU membership, pension and health reforms, and the resolution of complex economic, social, and environmental issues associated with the energy production and oil shale mining. The government remains committed to maintaining a market-oriented, open, economic system, but will need to adopt in the coming years the EU's system of tariffs, quotas, and agricultural pricing.

I. Introduction

- Missions visited Tallinn during the periods November 4–12, 1998 and February 2–11, 1999 to conduct the 1999 Article IV consultation discussions.[1] After the elections in March, a further staff visit took place on April 28–May 7, 1999 to complete the discussions with the new government.[2] [3] The February and May missions also discussed a possible new Fund-supported program, but at least one further mission will be needed to conclude the program discussions.

- The 1997 Article IV consultation was completed and a 15-month Stand-by Arrangement (SBA) for SDR 16.1 million (34.6 percent of quota) approved on December 17, 1997.[4] Executive Directors commended Estonia's remarkable economic transition as reflected in, inter alia, vigorous output growth and declining inflation. They noted that buoyant domestic demand was contributing to a widening current account deficit and emphasized the need for a tight fiscal stance, strengthening the banking system, and accelerating structural reforms. Directors agreed that the currency board arrangement remained an effective tool in Estonia. On the occasion of the mid-term review of the SBA on September 4, 1998, Directors also voiced concerns about possible adverse repercussions from events in Russia. The SBA expired on March 16, 1999; the authorities, as expected, did not request any purchases. They also had not requested purchases under two earlier SBAs.

- The parliamentary elections held on March 7, 1999, resulted in the formation of a three-party center-right coalition government with a narrow majority in parliament. The new parliament has approved the increase in Estonia's quota under the eleventh general review,

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[1]The staff met with Prime Minister Siimann, Minister of Finance Opmann, Minister of Economy Leimann, Governor of the Bank of Estonia (BoE) Kraft, other government and central bank officials, and representatives of commercial banks and industry.

[2]This mission met, inter alia, with Prime Minister Laar, Minister of Finance Kallas, Minister of Economy Pärnoja, and the Minister of Social Affairs Nestor.

[3]On one or more missions the staff representatives were Mr. Keller (head), Mr. Zavoico, Mr. Hobdari, Mr. Taube, Ms. Thacker, Mr. Zytek (all EU2), Mr. Abrams (MAE) and Mr. Weber (PDR); they were assisted by the Fund's resident representative for Estonia and Latvia, Mr. Demekas. Mr. Odling-Smee participated in some of the policy discussions in November 1998 and called on the new government in May 1999. The Alternate Executive Director, Mr. Lehmussaari, and the assistant to the Executive Director, Ms. Kask, attended the policy meetings.

[4]Fund relations are set out in Appendix I, technical assistance is covered in Appendix II, and relations with the World Bank in Appendix III.

together with the fourth amendment to the Fund's Articles of Agreement. Estonia accepted obligations of Article VIII on August 15, 1994.

- Estonia subscribed to the Fund's Special Data Dissemination Standard on September 30, 1998. The Estonian authorities provide the core data necessary for surveillance on a timely basis (Appendices IV and V). Up-to-date economic and financial data are available in English on the websites of the Statistics Office (www.stat.ee), the Ministry of Finance (www.fin.ee) and the BoE (www.epbe.ee).

- The authorities attach great importance to transparency and routinely agree to the release of Public Information Notices (PINs). The letter of intent and policy memorandum of the (now expired) SBA have been made available on the Bank of Estonia's website and on the Fund's external web site (www.imf.org). The authorities have requested to participate in the pilot project for the voluntary release of Article IV staff reports.

II. Recent Economic Developments

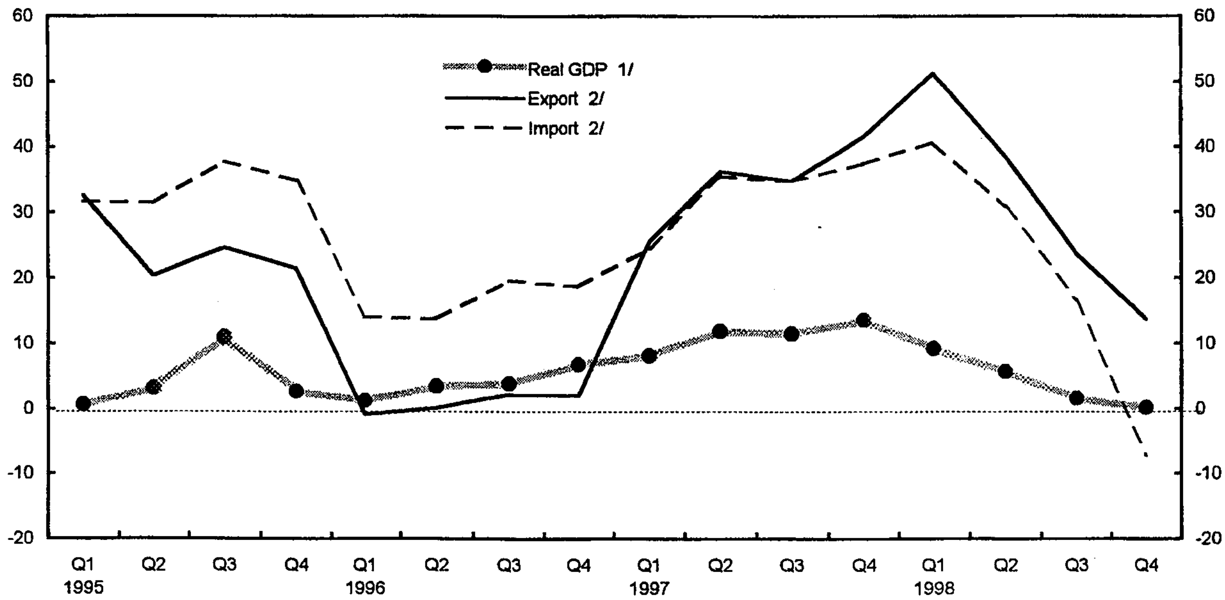
A. Real Sector and External Developments

1. **Real GDP growth faltered in 1998 as the effects of tighter macroeconomic policies were compounded by adverse external developments.** Economic growth reached 10.6 percent in 1997, after growth of 4 percent in 1996, due mainly to a consumption and investment boom that was accompanied by rapid export growth (Tables 1 and 2; Figure 1). Domestic demand was buoyed by a run-up in the stock market in 1996 and 1997 and rapid growth in bank lending (Figures 2 and 3). Concerns that the economy was overheating and a sharp widening of the current account deficit prompted a tightening of financial policies in late 1997 and 1998 in the context of the Fund-supported program.

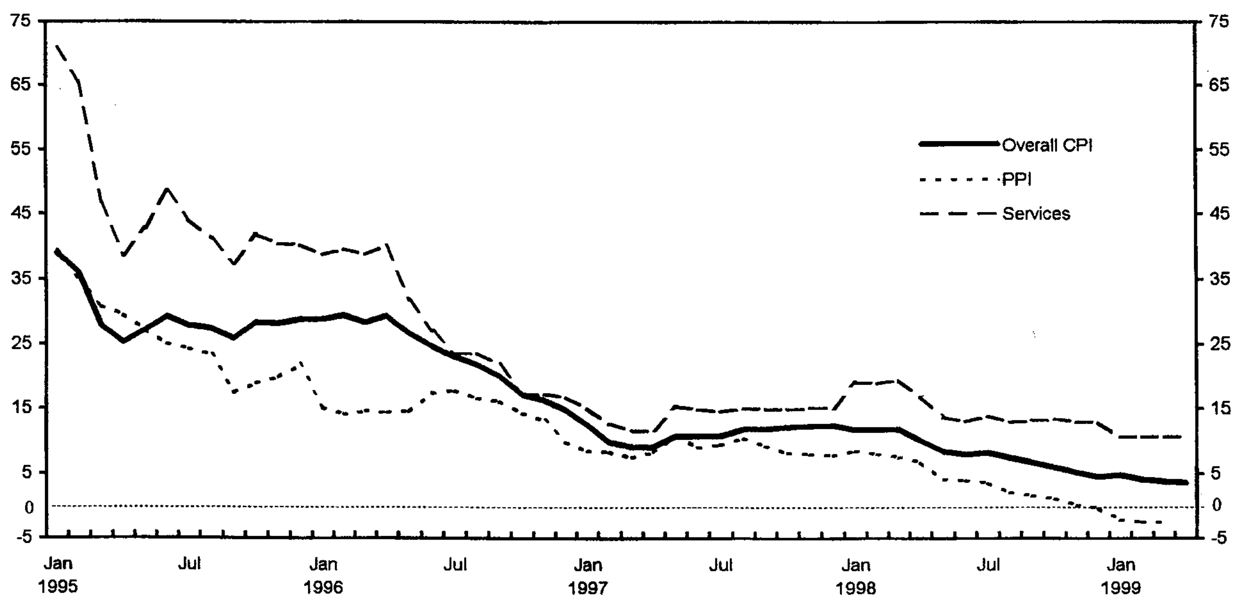
2. **Investment spending and the economy slowed in the first half of 1998**. The stock market collapse in late 1997, the sterilization of substantial budget surpluses and privatization proceeds in the SRF abroad, and the tightening of liquidity and solvency requirements for commercial banks were followed by a broad based retrenchment in domestic bank lending; this was accompanied by a transitory rise in interest rates (Figure 4). These factors contributed to real growth slowing to 7½ percent in the first half of 1998. **Real GDP is estimated to have expanded by less than 1 percent in the second half of 1998**, notwithstanding sustained growth of exports to non-CIS markets. The economy weakened further because of a poor harvest (due to adverse weather), the decline in exports to Russia and Ukraine particularly after August 1998 (which strongly affected the agricultural and food processing sector), and banking problems. Private consumption contracted toward the end of the year and investment slowed further. **Output growth in early 1999 was zero, or negative, as private sector demand declined sharply,** although the widening public sector deficit may have helped sustain overall demand.

Figure 1. Estonia: Output and Prices, 1995-1999
(In percent)

Real GDP and External Trade Growth Rates

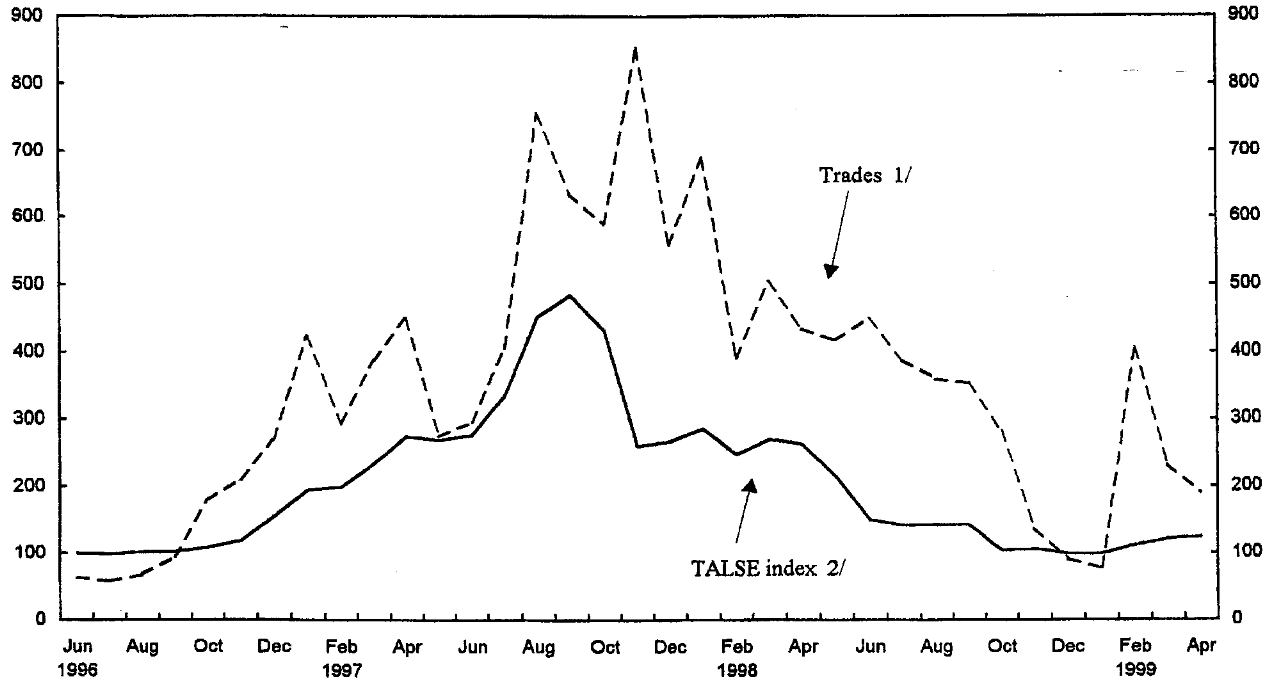


Consumer Price Index and Producer Price Index 3/



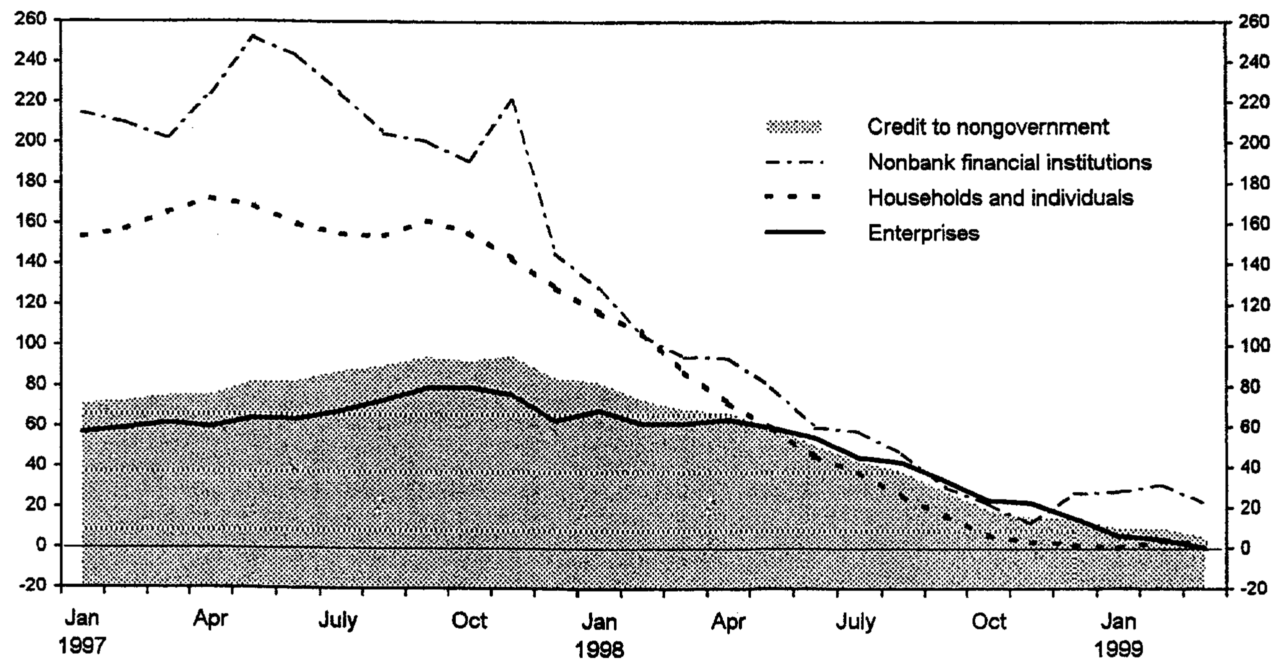
Sources: Bank of Estonia, and Fund staff estimates.
1/ Change over the same quarter of the previous year in constant prices.
2/ Change over the same quarter of the previous year in current DM prices.
3/ Change over same month in previous year.

Figure 2. Estonia: Stock Market Developments, June 1996 - April 1999



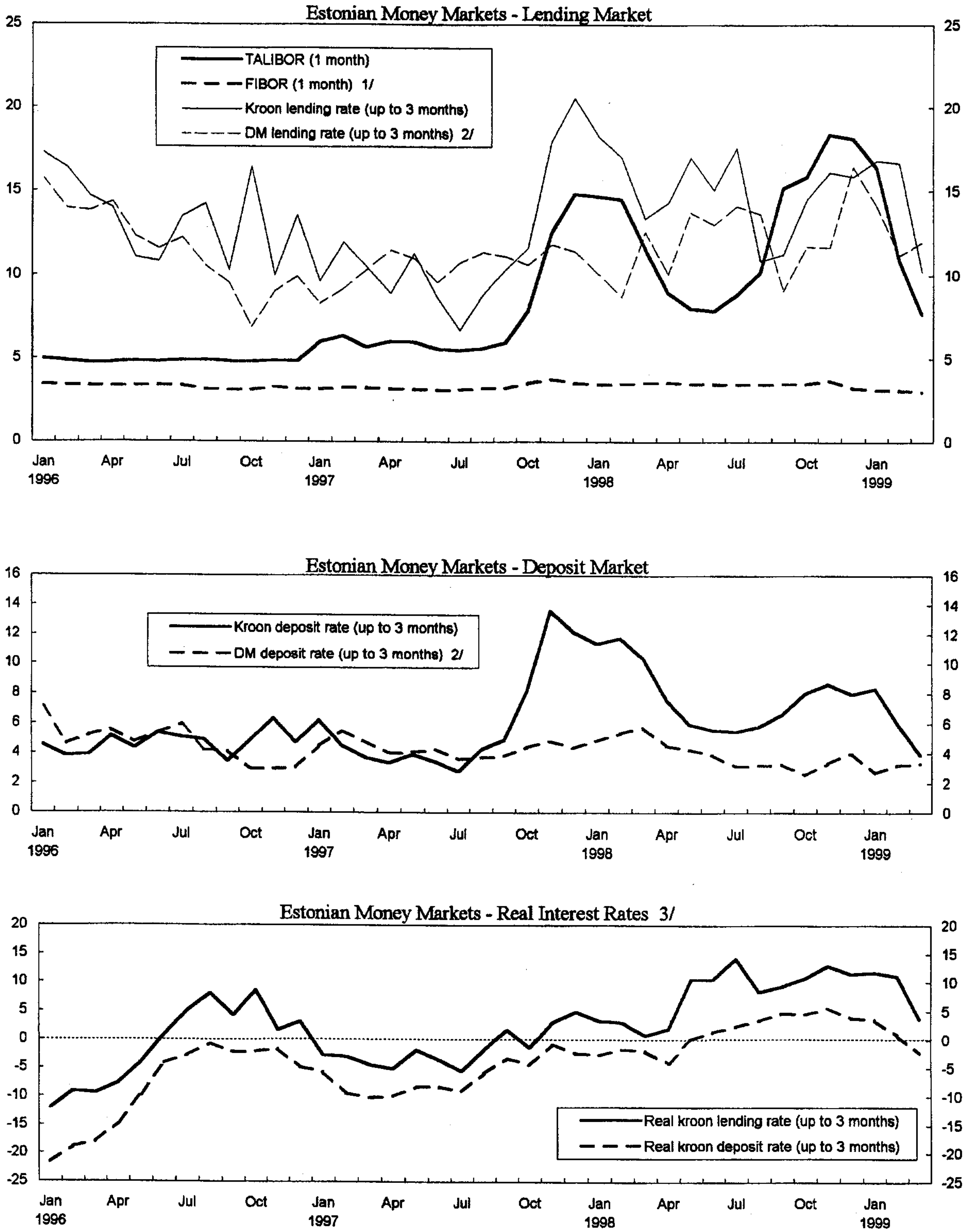
Sources: Tallinn Stock Exchange.
1/ Monthly average of daily trades. Trading volumes in early 1999 reflect hightened activity associated with the Eesti Telekom share offering.
2/ June 1996=100.

Figure 3. Estonia: Domestic Credit to Nongovernment, 1997-99
(12-month growth, in percent)



Sources: Bank of Estonia, and Fund staff estimates.

Figure 4. Estonia: Interest Rates, 1996-99
(In percent per annum)



Sources: Bank of Estonia, Statistical Office of Estonia, IFS, Bloomberg, and Fund staff estimates.
1/ FIBOR from Dec 1997 to Dec 1998, and EURIBOR from Jan 1999 on.
2/ Data before Dec 1997 are for all foreign currency lending (deposit) rates.
3/ Real rates are calculated using centered seven month average CPI inflation (as available).

Table 1. Estonia: A Rapidly Changing Macroeconomic Environment

	1996	1997	1998		1999 1/	1998		1999 (proj.) 1/	
			Prog. 2/	Est.	Proj.	1st half	2nd half	1st half	2nd half
					(In percent)				
Macroeconomic indicators									
Real growth 3/	4.0	10.6	8.0	4.0	2.7	7.4	0.9	0.8	4.6
Average CPI 3/	23.1	11.2	11.1	8.2	4.0	10.3	6.3	4.0	4.1
12-month CPI (end-period)	14.8	12.5	8.8	4.4	4.4	7.9	4.4	4.0	4.4
Credit growth to private sector 4/	70.0	84.0	35.6	14.0	4.0	10.9	3.1	...	...
					(In percent of GDP)				
Fiscal balance	-1.5	2.0	2.5	-0.3	-3.6	2.2	-2.8	-5.0	-2.3
Current account balance	-9.7	-13.2	-10.6	-8.6	-8.0	-10.4	-6.9	-7.2	-8.7
Competitiveness and trade indicators									
Production cost (index 1995=100) 5/	127	114	...	112	...	...	...	...	...
Relative wages (ratio) 6/	1.03	1.02	...	1.03	...	1.03	1.03	...	...
Unit labor costs relative to: 7/									
Finland	131	132	...	118	...	...	...	...	...
Germany	126	116	...	119	...	...	...	...	..
Sweden	126	115	...	114	...	...	...	...	..
					(In percent)				
Total export growth 3/ 8/	0.8	34.8	15.6	30.5	1.7	44.6	18.3	-3.1	6.6
Of which:									
Non-CIS 3/	0.7	34.5	...	42.4	6.8	52.3	33.1	3.3	10.7
CIS 3/	1.3	36.0	...	-12.7	-29.9	14.3	-32.0	-36.9	-22.4
Shares of exports to:									
Non-CIS	78.5	78.4	...	85.5	90.0	83.9	87.0	89.5	90.5
CIS	21.5	21.6	...	14.5	10.0	16.1	13.0	10.5	9.5

Sources: Estonian authorities; and Fund staff estimates.

1/ Based on expectation that parliament will pass by June 1999 budget cuts amounting to EEK 1 billion (1.3 percent of GDP).

2/ As revised on the occasion of the September 1998 mid-term review.

3/ Growth rates for 1998 and 1999 H1 and H2 are relative to the same six -month period in the preceding year.

4/ Growth rates for 1998 and 1999 H1 and H2 are relative to immediately preceding six- month periods.

5/ Defined as the average manufacturing wage bill divided by nominal output.

6/ Defined as the ratio of average wages in Estonia to average wages in Latvia, Lithuania, Poland, Hungary, and Czech Republic (equally weighted).

7/ Defined as the ratio of Estonia's production cost index to individual trading partner's unit labor cost index. A decrease signifies an improvement in Estonia's competitiveness. Finland, Germany, and Sweden are Estonia's main export markets, and exports to these countries together accounted for about 50 percent of Estonia's total exports in the second half of 1998.

8/ Growth rates derived from exports denominated in terms of deutsche mark, so as to abstract DM/$ fluctuations.

3. **The direct impact of the Russia crisis on real GDP growth was felt** mainly through the trade channel, but was moderate because Estonia had reoriented most of its trade to the West. GKO holdings and claims by Estonian banks on CIS banks and enterprises in mid-1998 were also relatively limited. However, during the boom in 1997 banks had become highly dependent on foreign funding. Transitory difficulties in securing rollover or new foreign credits in the wake of the Russia and emerging market crises reduced bank liquidity and contributed to the stagnation in bank lending and sharply rising real and nominal interest rates through November 1998. The closure of Maapank in June 1998 and of several small banks in September 1998 constrained bank lending further.

4. **Inflation continued to abate in 1998 and early 1999.** Prices of imported goods remained stable, or declined, and food prices declined after the collapse of the Russian export market. The 12-month CPI inflation rate fell to about 3½ percent in early 1999, while the change in the producer price index was negative. In the private sector, nominal and real wage growth slowed in 1998 and early 1999. Public sector wages rose faster than wages in the private sector, which were restrained by the slowdown of the economy.

5. **Registered unemployment** remained around 2.5 percent of the labor force during 1998, but rose to 3.8 percent in March 1999 as enterprises started to shed labor in response to the deteriorating economic situation. Largely because of low unemployment benefits, many unemployed are not registered. Total unemployment reportedly has reached close to 10 percent of the labor force in early 1999.

6. **Despite the Russian crisis, the current account deficit contracted more than programmed, owing to weaker domestic demand** (Tables 3 and 4). The current account narrowed by 4 percentage points of GDP in 1998, because of the slowdown in the growth of consumption and also investment-related imports and a substantial increase in exports to non-CIS countries.[5] Exports to the CIS declined sharply and traditional exporters suffered substantial losses as there is little evidence that these exports—mostly food products—could be redirected to the non-CIS area. Based on preliminary trade data, the current account deficit appears to have narrowed further in the first quarter of 1999, with imports declining fast. There are conflicting indications regarding export developments. The estimates in the tables for the first quarter 1999 are based on the least favorable results, which suggest a moderate decline in exports relative to the high level that had been reached in early 1998.

7. **Foreign direct investment reached record levels in 1998.** Late in 1998, two Swedish banks acquired large holdings in the two largest Estonian banks amounting to

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[5]Imports in 1998 were slightly larger than projected because of the substantial import content of much higher than programmed exports.

US$310 million.[6] Other foreign direct investment (FDI) amounted to US$255 million and total FDI reached 10.9 percent of GDP in 1998, which was substantially higher than the current account deficit. Short-term external debt declined in part because banks refinanced maturing obligations for longer periods. Also, in the first three quarters of 1998, the government transferred a part of its fiscal surplus to the SRF, which was invested abroad.

8. **Government (net) external debt declined in 1998 and contracted sharply in early 1999**. Net of balances in the SRF (US$190 million), public sector external debt fell to only US$70 million (1.3 percent of GDP) by end-March 1999. The external public debt service ratio has remained below 1½ percent of exports since 1995. The private sector's gross external debt (trade credit plus loans) is estimated by the BoE at 32 percent of GDP and net external debt at 14 percent at end-1998. Total gross external debt is estimated at 37 percent of GDP at end-1998. Excluding balances in the SRF, international reserves are nearly equal to gross short-term debt and substantially exceed net short-term debt.

B. Fiscal and Monetary Developments

9. **Revenues in the latter part of 1998 were lower than projected, which overwhelmingly reflected the weaker than envisaged growth of the economy.** Revenue performance in the first half of 1998 had been better than programmed, but revenues fell short of projections in the second half of 1998 as growth slowed and private consumption declined (Tables 5 and 6). Tax collection may have also been slowed by a temporary reduction in the interest rate payable on overdue tax payments by enterprises.[7] Moreover, increases in excise taxes originally planned for October 1998 were delayed in parliament until December 1998, and in some instances beyond. Overall, revenues for the year as a whole fell short of the

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[6]Substantial stakes were acquired by Swedbank and Skandinaviska-Enskilda Banken (the two largest Swedish banks) in Hansa Bank and Uhis Bank (the two largest Estonia banks), respectively. These two Estonian banks held about 80 percent of total assets of the Estonian banking system at the time the investment took place. These acquisitions were part of a broader strategy by these two Swedish banks—which also included acquisitions in Latvia and Lithuania—to expand their capacity to provide financial services throughout the Nordic-Baltic region. In the case of Skandinaviska-Enskilda Banken, it also acquired roughly one-third interests in Unibanka (Latvia) and Vilniaus Bankas (Lithuania) in the latter part of 1998—both significant banks in their respective countries. Hansa Bank, which is the largest Baltic bank, initiated a regional expansion program in June 1996 with the acquisition of a Latvian bank and opened a branch in Lithuania in May 1999.

[7]The government reduced the interest rate payable on overdue tax payments in the context of their rescheduling to well below market borrowing rates effective October 1, 1998 through January 15, 1999 to offer temporary relief to enterprises affected by the Russian crisis.

program target by EEK 1.5 billion (2.1 percent of GDP), although relative to GDP, revenues were substantially higher than projected.

10. **The government's share in GDP rose by 2½ percentage points in 1998.** Government expenditures during the first half of 1998 were in line with program targets. As described in EBS/98/90, Sup. 1 (8/11/98), the second half of the year started with the passage of a supplementary budget (EEK 314 million) that provided additional funds for both a deposit compensation package for a failed bank (Maapank) and new public investment. In the event, the deposit compensation package proved more expensive, unanticipated support was extended to agriculture, and end-year wage bonuses were larger than usual. Although nominal expenditures exceeded program targets by only EEK 400 million (½ percent of GDP) in 1998, in real terms, expenditures were much higher than programmed because of the faster decline in inflation. As a result also of slower than expected economic growth, the size of the public sector—as measured by the scale of general government expenditures—rose to 39.6 percent of GDP in 1998.

11. **The general government's budget swung from a surplus in the beginning of the year to a substantial deficit in the second half of 1998** (Figures 5 and 6). Fiscal policy early in 1998 had been directed at restraining domestic demand and constraining the current account deficit. In the event, the general government achieved a surplus of 2.2 percent of GDP in the first half of 1998, as compared to the targeted 1.5 percent of GDP. However, in the second half of 1998, the general government deficit was equivalent to 2.8 percent of GDP; it was largely financed through running down domestic bank balances that were the counterpart of earlier budget surpluses. The deficit for 1998 as a whole of 0.3 percent of GDP excludes the loss of EEK 500 million (0.7 percent of GDP) in deposits on account of bank failures.

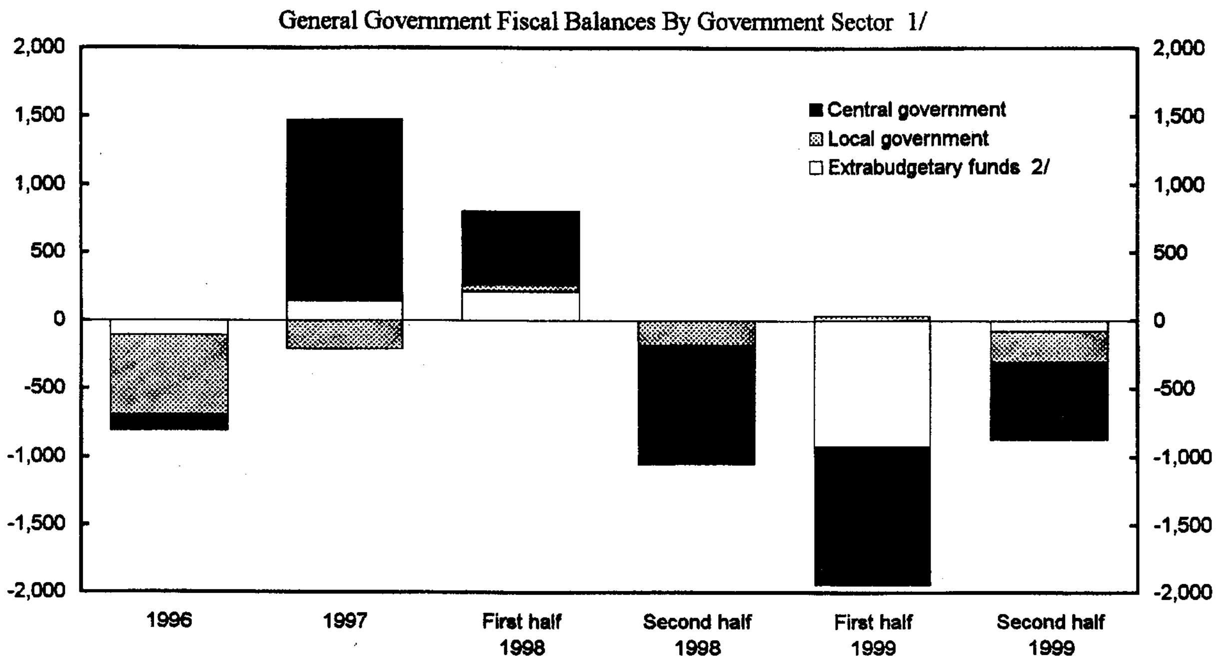
Box 1. Estonia: Performance Under the Precautionary Stand-By Arrangement

Key program objectives were achieved—including the reduction in the current account deficit and the inflation rate—although some quantitative targets were missed as growth slowed more sharply than expected.

- After the quantitative targets for June 1998 were easily met, fiscal targets were set at more ambitious levels for the second half of the year at the time of the mid-term review, when the full extent of the slowdown in economic growth was not yet understood (Table 7).

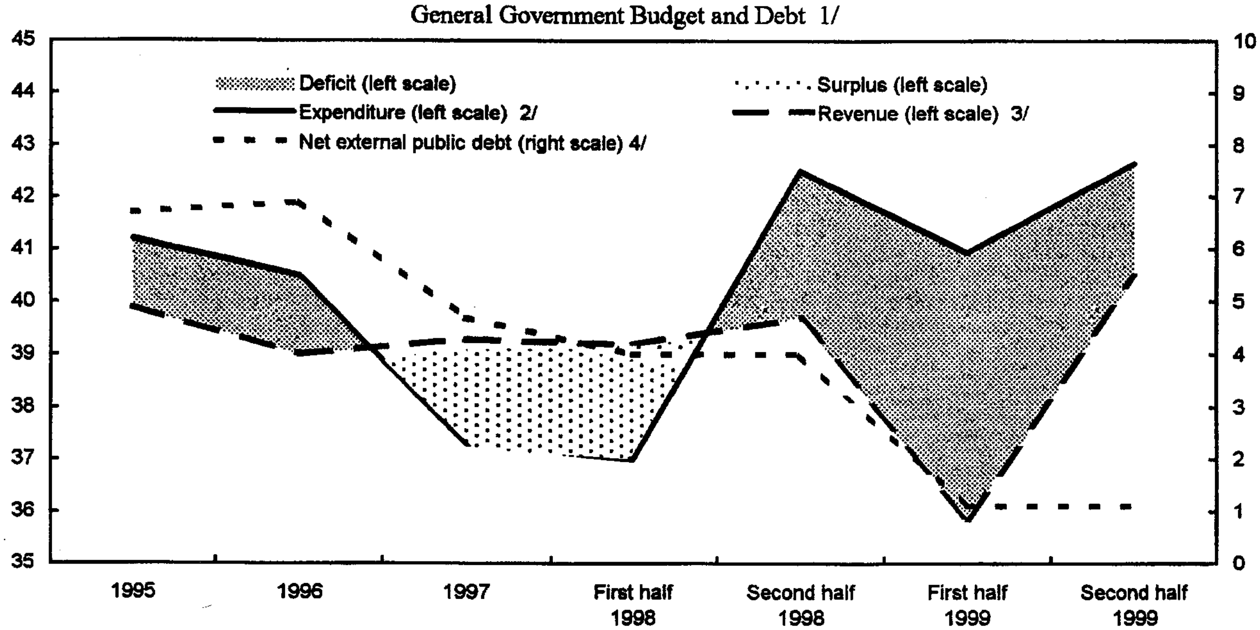
- In the event, the fiscal targets—including transfers to the Stabilization Reserve Fund (SRF) for end-September 1998 and end-December 1998—were missed primarily because of the impact of slower growth on budget revenues and a brief delay in the privatization of Eesti Telekom. The net international reserve target was met at end-September 1998, but missed by a small margin at end-December 1998 as a result of a bank rescue operation. The requirements that the currency board remain fully backed with foreign exchange, that there be no external payment arrears throughout the program period, and that the contracting of foreign debt be limited were also met. Structural and institutional reforms were largely implemented as planned, but as set out in Table 8, there were some delays in important areas, including land privatization, legislation pertaining to the stabilization reserve fund, and banking supervision.

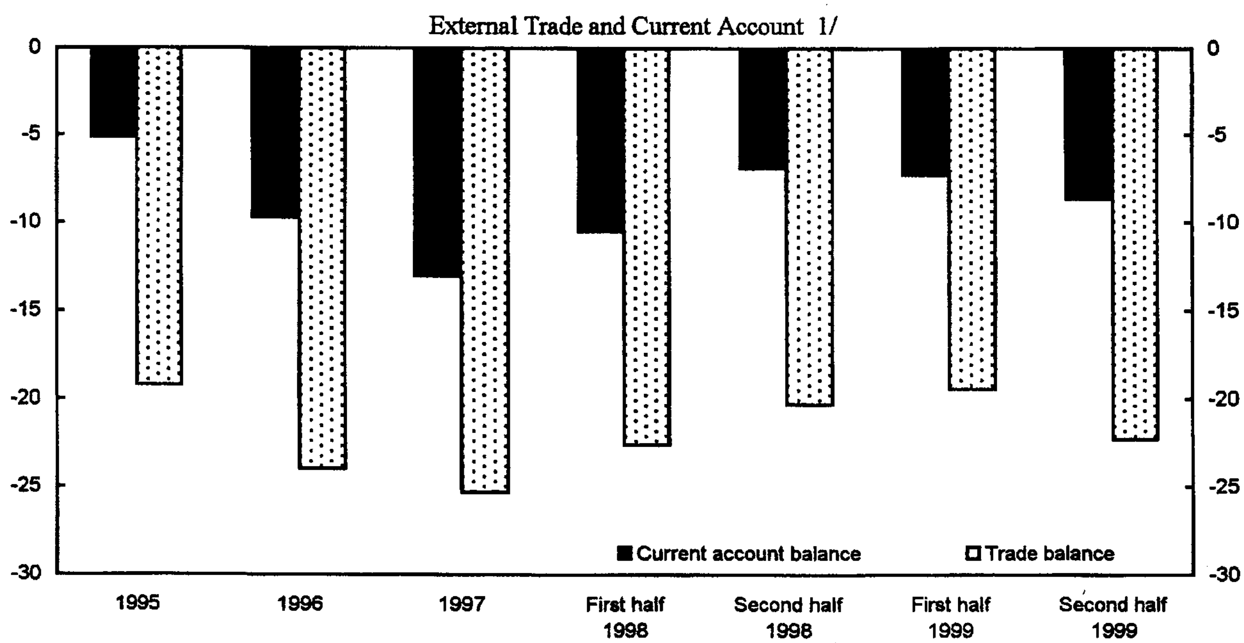
Figure 5. Estonia: General Government Balances, 1996-1999
(In millions of EEK)



Sources: Estonian authorities and Fund staff estimates.
1/ Actual data for 1996-97, estimates for 1998, and projections for 1999.
2/ Includes the Social Insurance Fund, Medical Insurance Fund, and the Environment and Forestry Funds.

Figure 6. Estonia: Fiscal and External Indicators, 1995-1999
(In percent of GDP)





Sources: Bank of Estonia and Fund staff estimates.

1/ Actual data for 1995-97, estimates for 1998, and projections for 1999.

2/ Includes net lending and the changes in the balances of the Environment and Forestry Funds.

3/ Excludes privatization receipts.

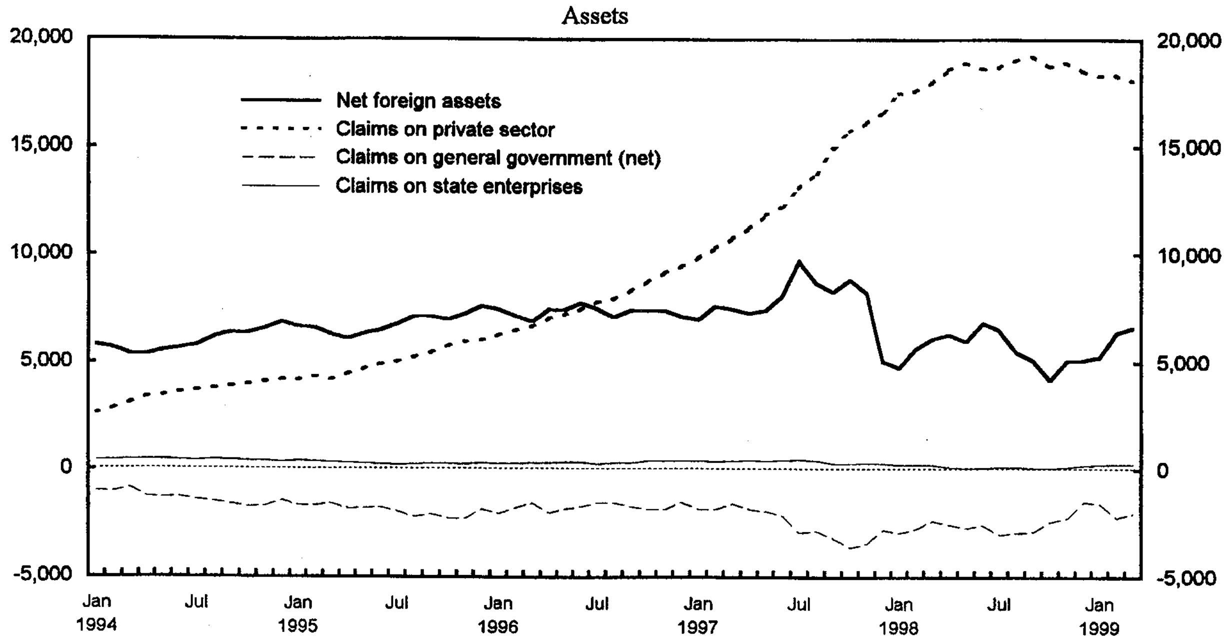
4/ Includes guarantees, net of holdings in the Stabilization Reserve Fund (SRF). Domestic public debt was less than 0.5 percent of GDP in 1998.

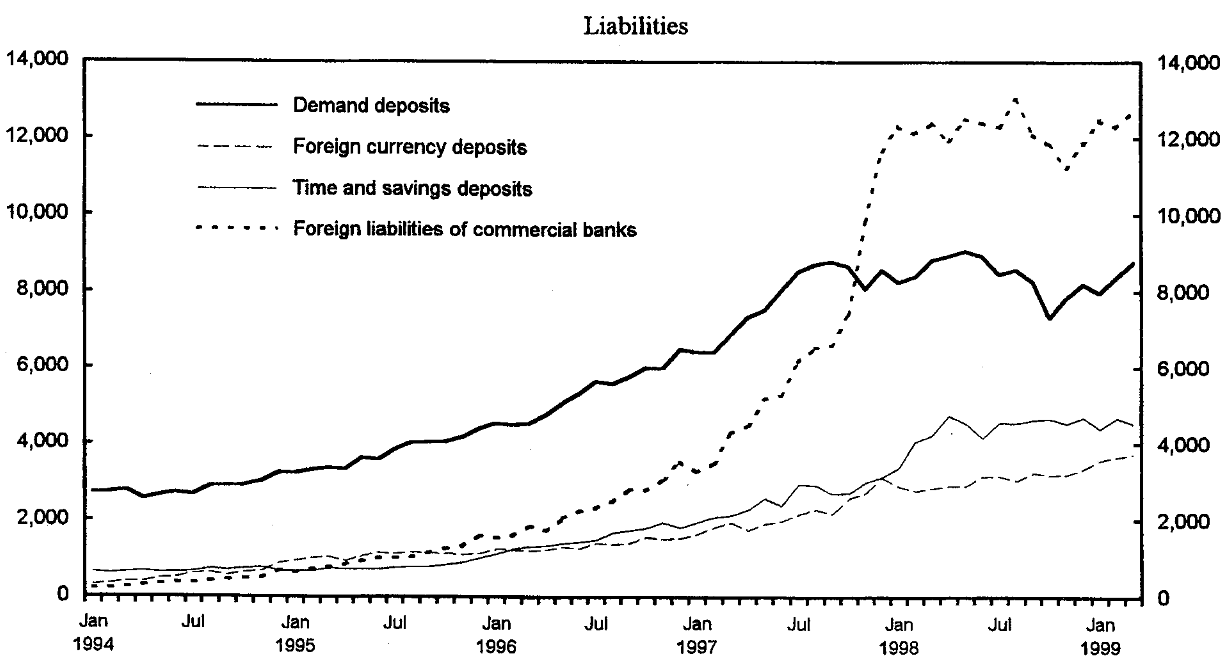
12. **The 1999 budget was based on unrealistic revenue projections**. The 1999 budget, which was passed by parliament in December 1998, anticipated nominal growth of revenues and expenditures of 16 percent and 17 percent, respectively, relative to the 1998 results. At the time of initial budget preparation (August 1998), the government projected real GDP growth for 1999 at around 6 percent and inflation at 8 percent. Although the government and parliament, when debating the draft budget in November 1998, realized that these projections were no longer realistic, the impending parliamentary elections made agreement on revisedbudget projections difficult and the budget was approved with only minor changes related to the composition rather than the level of expenditures. On the revenue side, the draft budget included the (delayed) implementation of excise tax measures agreed as part of the program, estimated to yield close to 1 percent of GDP per year. On the expenditure side, it included nominal increases of 24 percent in both the wage bill and in pensions, as well as large increases across most expenditure categories.

13. **The deficit of the consolidated government widened sharply in the first quarter of 1999**, mainly because of (i) increased wages and pensions, (ii) pre-election spending as large privatization revenues became available, (iii) falling private consumption outlays, which reduced VAT and excise tax collection, (iv) one-time factors such as an accelerated rebate of VAT to exporters and a shift in the timing of social security tax payments, and (v) transitional difficulties associated with the shifting of responsibility for social security tax collection to the National Tax Board. The social security system, which is part of the consolidated government, sharply reduced its deposits to cover the increased pension payments. Although the income position of the social security system can be expected to strengthen substantially during the balance of 1999 as transitional effects are overcome, it may need to have some recourse to transfers from the central government later in the year. By April, tax and social security collection reportedly approached normal levels as the importance of one-time factors faded.

14. **Under the currency board arrangement the BoE continued to abstain from extending credit to the government or banks**. Large foreign borrowing by Estonian banks had fueled a rapid credit expansion in 1996 and 1997 (Tables 9–11; Figures 7 and 8). For 1998 as a whole, credit to the private sector only grew by 11 percent after rising by 84 percent in 1997, while growth in broad money slowed to 7 percent from 38 percent in 1997. In the first half of 1998, external funding constraints, increased liquidity and capital ratios, and the reduction of liquidity through transfers to the SRF, had limited bank lending. External funding concerns gained in importance after the Russia crisis, but constraints on bank liquidity were substantially eased with the capital injections and refinancing operations in late 1998 and early 1999. However, since then, the general slowdown in the economy has reduced credit demand, and this has been reflected in the sharp decline in interest rates. Bank profitability suffered in 1998, reflecting losses on both stock and loan portfolios related to the earlier stock market crash, the general slowdown in the economy, and the Russia crisis. This experience appears to have made banks more cautious in their lending decisions. Commercial banks as a group experienced a loss equivalent to 0.7 percent of GDP in 1998 as compared to

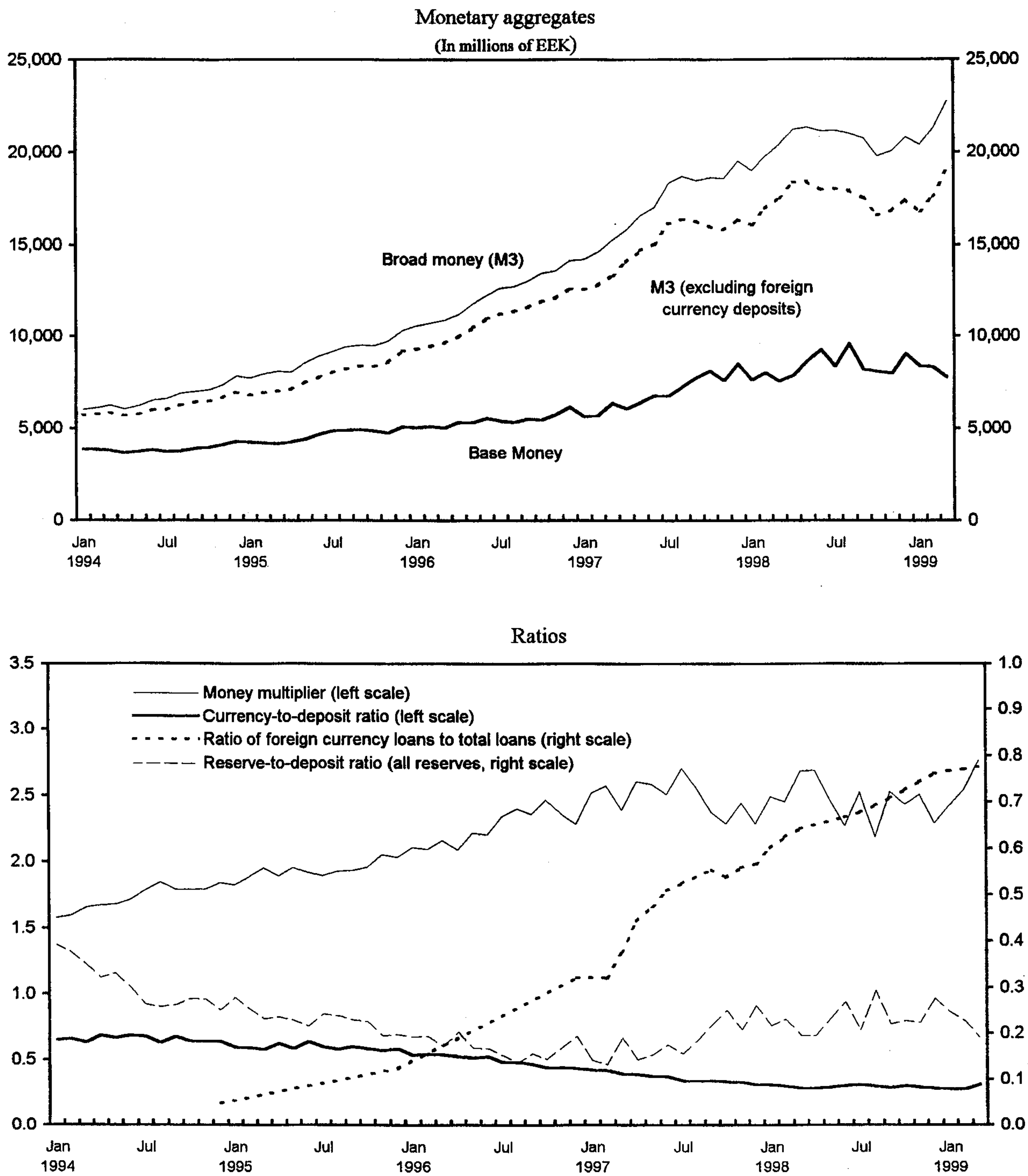
Figure 7. Estonia: Banking System Assets and Liabilities, 1994-99
(In millions of EEK)





Sources: Bank of Estonia and Fund staff estimates.
1/ Includes only deposits in EEK.

Figure 8. Estonia: Monetary Indicators, 1994-99



Sources: Bank of Estonia and Fund staff estimates.

a profit equivalent to 1.5 percent of GDP in 1997. In part, this reflected increased write-offs of nonperforming assets. Banks reported moderate profits in early 1999.

15. **The Bank of Estonia strengthened bank supervision.** After introducing higher reserve and capital adequacy requirements in 1997, the BoE followed through with a series of measures to improve its banking system oversight function, including supervising banks on a consolidated basis (June 1998) and allowing for market risk in determining capital adequacy ratios (July 1998). Following the Maapank failure, the capacity of the supervisory department was strengthened, a report by a foreign expert on this failure made public, and a new Credit Institutions Law was passed. The latter materially strengthens the Bank of Estonia's supervisory function by, inter alia, creating greater scope for imposing penalties on banks failing to comply with its directives and introducing a "fit and proper" requirement for bank owners and managers. However, delays were encountered in the implementation of regulations on loan classification and loan loss provisioning, and the introduction of country and transfer risk components to the capital adequacy requirements.

16. **Consolidation in the banking sector continues.** As a result of bank closures and mergers, the number of licensed banks fell from 11 to 5 during the course of 1998. The closures included that of Maapank in June 1998 [8] plus 2 smaller banks that failed in September 1998 due to losses associated with investments in Russian GKOs. In July 1998, Estonia's 4 largest banks merged into 2 banking groups. In September, the BoE acquired Forekspank, which failed to meet capital requirements after losses related to the Russian crisis, and merged it with a smaller bank.[9] While Maapank depositors were still compensated on an ad hoc basis through the budget, the **Deposit Insurance Law** became effective on October 1, 1998. The law limits compensation to 90 percent of private deposits up to a maximum of EEK 20,000 per deposit. Deposit compensation associated with the closure of the two smaller banks in October 1998 resulted in payouts by the Deposit Insurance Fund of EEK 121 million, which it was forced to borrow on the strength of a government guarantee since it had just begun its operations.

C. Structural Reforms

17. **Estonia had made substantial strides in its transition to a market economy before 1998** (Table 12). The privatization of large and medium-sized enterprises was largely completed, key market-oriented legislation—including an effective bankruptcy law—was in place, prices and trade were liberalized, the system of budgetary subsidies and government support for failing enterprises largely dismantled, and corporate governance improved,

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[8] See EBS/98/90, Supplement 1 (8/11/98).

[9] This investment led to the Bank of Estonia failing to meet its net international reserve floor for end-December 1998.

including through high levels of foreign participation throughout the economy.[10] The inherent difficulties in a small country in ensuring a sufficient degree of competition were countered by the openness of the economy and the freedom of entry for new enterprises. A new Competition Law, modeled on EU directives and with strengthened anti-trust provisions, came into effect on October 1, 1998.

18. **Progress continues to be made on public sector reforms.** In the **health sector**, the focus is on increased efficiency, cost containment (including through consolidation of hospital facilities and greater reliance on family practitioners), and disease prevention. Reforms in this area are being supported by a World Bank loan and technical assistance. **Pension reform** was advanced with the passage of (i) the Social Tax Law that became effective January 1, 1999, which, inter alia, provides for the individual registration of contributions; (ii) the new Pension Law, which becomes fully effective on January 1, 2000 and links more closely contributions and benefits; and (iii) the Law on Private Pension Funds, which regulates the establishment of private pension funds.[11] The operations of the treasury have been strengthened, but the transfer of responsibility for external loan monitoring and servicing was only partly realized in 1998.

19. **Privatization moved ahead with the sale of Eesti Telekom.** The privatization program in 1998 focused on preparations for the sale of a further 24 percent of the government's equity in Eesti Telekom—the largest provider of telecommunications services in Estonia. Because of unsettled market conditions, the public offering was delayed until February 1999. The offering was oversubscribed and the sale realized a total of EEK 3 billion (4 percent of GDP). The government now retains only 27 percent of the shares of Eesti Telekom.

20. **The privatization of the energy sector continued to progress only slowly.** Energy generation is concentrated, because of its linkage to oil shale mining, in the northeast part of the country, which has been slow to benefit from the transition process. Current plans call for the separate privatization of the power plants, transmission, and distribution companies; two distribution companies and a transmission subsidiary have already been sold to foreign investors. Negotiations with a large foreign energy company on the sale of two generation plants and related oil shale mines have continued into 1999. **Modest progress was achieved in the privatization of the railways,** with the sale of shares in the repair facility and some passenger operations.

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[10]Estonia has consistently scored high on transition indicators (e.g. see *EBRD Transition Report 1998* (Chapter 2).

[11]Contributions to private pension funds are tax-free up to a maximum of 15 percent of income. The first pension fund started operations in March 1999.

21. **Progress was made toward EU accession**. Estonia was included in the first wave of five transition countries to start the accession process to the EU.[12] Accession negotiations started in March 1998 and involved the screening of existing legislation relative to the EU's *acquis communautaire*. Estonia has moved quickly to make the necessary adjustments to its legal, institutional, and financial structures. In this process it has been materially aided by its open trade, exchange, and capital market regimes. Major outstanding issues relate to agriculture, the environment, and external trade (especially the free trade arrangements with the other two Baltic states and Ukraine).

III. Discussions with the Authorities

A. Macroeconomic Issues and External Prospects

22. **In reviewing developments in 1998**, the authorities commented that the fiscal stance in the first half of the year and the decision to increase capital and liquidity ratios had remained appropriate despite the subsequent crisis in Russia and emerging market disturbances. While it was true that because of these unforeseen events bank liquidity and lending were more restrained than had been programmed, the sterilization of substantial privatization proceeds and fiscal surpluses in the SRF had been an important reassuring signal to international markets and investors. As a result, Estonia was able to maintain its favorable credit rating and Estonian entities continued to have access to foreign credits with only moderate increases in spreads. Moreover, exchange markets never seriously tested the currency board arrangement and interest rates have returned to low levels. The shocks experienced by the banking system also confirmed that tightening prudential regulations had been the right decision as it had strengthened the soundness of the banking system, which had been imperiled by excessive risk taking and too rapid an expansion of credit during 1996 and 1997. While the pause in growth was painful, it also accelerated structural changes as it led to the exit of nonviable enterprises and the restructuring of the banking sector.

23. **As to the short-term outlook**, the new government's projections for 1999 for growth (2–3 percent) and inflation (4 percent) closely coincide with those of the Fund staff. As for 2000, growth could reach 6 percent, while inflation is likely to decline marginally further. For 1999, the staff cautiously projects a moderate reduction in the current account deficit to around 8 percent of GDP and the BoE expects a steeper decline to 5–7 percent of GDP.

24. **The growth of exports to the EU is expected to continue**, although EU growth prospects have weakened. The authorities noted that the rapid expansion in trade with the non-CIS area had resulted in 18 percent growth in exports in the second half of 1998, despite the Russian crisis. They were not overly concerned by the possible slowdown in exports in early 1999, as it came after two years of very fast export expansion by over 30 percent per

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[12]Together with the Czech Republic, Hungary, Poland, and Slovenia.

year (in deutsch mark terms). They also noted that export data were preliminary and, based on past experience, subject to substantial upward revision. With foreign investments in Estonian companies coming on-stream, Estonian labor costs low by European and even East European standards, and FDI continuing, exports to the non-CIS area can be expected to continue to grow. The staff agreed that export performance and relative unit labor cost calculations suggest that Estonia remains competitive, particularly vis-à-vis non-CIS partners, and that the private labor market is flexible. The authorities now are less concerned about future trade shocks from events in Russia or the recent devaluation of CIS currencies (Figure 9), because, as of late 1998, exports to the CIS had already declined sharply. They also felt that because of product mix and higher quality standards, Estonian exporters do not compete primarily with CIS producers in third markets, but with other European and particularly with East European producers. Noting the decline in producer prices and the fast productivity growth in the export sector, CPI-based real effective exchange rate calculations were viewed as not particularly useful for assessing changes in competitiveness in transition countries. They expected the divergence between consumer and producer price developments to continue as relative prices of nontraded goods and services can be expected to increase relatively fast once private consumption recovers. They concurred, however, that the recent devaluations in the CIS area may have reduced the substantial undervaluation of the kroon.[13] Unit labor cost calculations, however, suggest continuing gains in competitiveness vis-à-vis major export markets.

25. **After declining early in the year, private sector demand is expected to remain relatively restrained for most of 1999**. Imports are expected to decline and the current account balance to narrow further in 1999, if the budget cuts in the second half of the year are introduced as targeted by the government. The authorities' projections of a deficit for 1999 of around 5–7 percent of GDP (compared to staff projections of 8 percent) is derived from an extrapolation of the decline in the current account deficit to below 7 percent in the first quarter of 1999 and the expectation of a better revenue performance and a smaller budget deficit than projected by the staff for the year. Much will depend on private sector demand, as was demonstrated in the first quarter of this year when the sharp widening of the budget deficit coincided with a continuing reduction in the current account imbalance.

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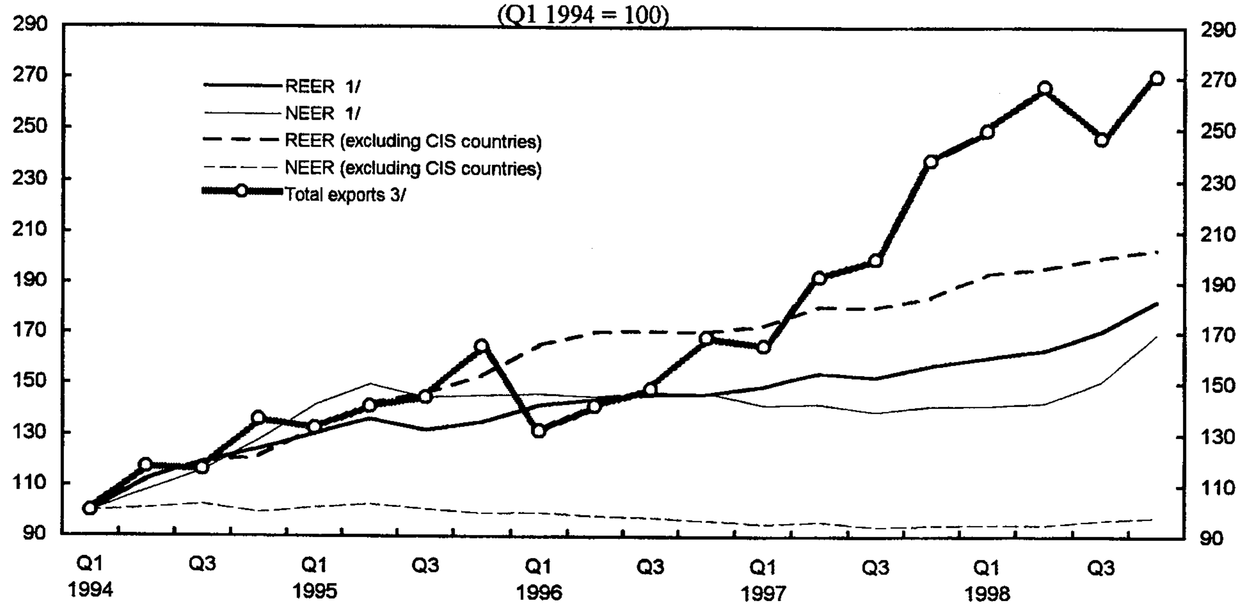
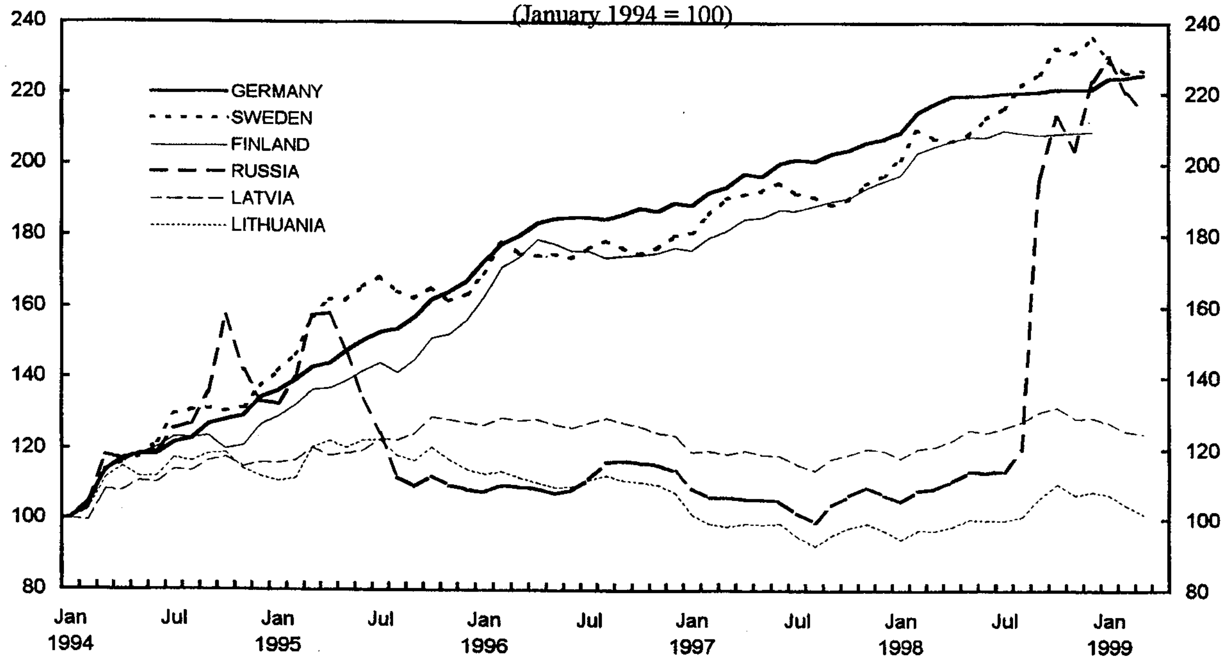
[13]For example, the Estonian Kroon was found to be undervalued by 40 percent in 1996 according to one study. (C. Krajnyak, and J. Zettelmeyer, "Competitiveness in Transition Economies—What Scope for Real Appreciation?" *Staff Papers*, International Monetary Fund, Vol. 45, No. 2, June 1998)

Figure 9. Estonia: Comparison of Cross Exchange Rates Between Estonia and Major Trading Partners, 1994-99

Effective Exchange Rates
(Q1 1994 = 100)



Bilateral Real Exchange Rate 2/
(January 1994 = 100)



Sources: International Financial Statistics, and Estonian authorities.

1/ CPI based. Calculated using INS weights until 1996 and updated weights for 1997-98. Data for March 1999 are not included.

2/ Nominal exchange rate deflated by the relevant CPI.

3/ In DM terms.

26. **The 1999 budget had been at the core of the discussions with the authorities** during the November 1998 and February 1999 missions already. On these occasions, the previous government at first argued that nominal GDP growth and, therefore, revenues would be much higher than forecast by the mission. As evidence of a rapid cooling of the economy mounted, the government indicated that it was politically inopportune to revise the budget shortly before the elections. Moreover, raising pensions sharply was necessary to meet social concerns and the increase in the government's wage bill would permit correcting the low wages in the armed forces, police, health and education. The mission did not fully accept these arguments, but noted that, because of much lower inflation projections, the expected real increases in wage, pension, and other outlays would be much higher than originally intended and not affordable.

27. **The new government did not defend the budget for 1999**, noting that it had been formulated on the basis of overly optimistic revenue projections and spending pressures during the run-up to the election. The wage and pension increases of about 20 percent in real terms were excessive and would also burden the budgets for subsequent years. There were also high real increases in other spending categories. The authorities thought, however, that, at this stage, the room for correcting the 1999 budget was limited. They were formulating a supplementary budget that would cut expenditures by EEK 1 billion (1¼ percent of annual GDP) during the second half of the year relative to the existing budget. Although wage and pension increases would not be touched, some ill-conceived investment outlays would be cut back. They agreed with the mission that, in principle, much more should be done but parliament was likely to resist even the proposed cuts. If parliament passed the proposed supplementary budget, the budget deficit for 1999 as a whole would be in the order of 3½ percent of GDP on the staff's estimate and about 2½ percent of GDP on the authorities' projections, which are based on a faster recovery in revenues. The bulk of this deficit has already occurred early in the year. The financing of the deficit in the second half (about 2¼ percent of period GDP) is expected to take place largely through a reduction of bank deposits. The mission noted that the sharp widening of the budget deficit in 1999 remained a major obstacle to reaching understandings on a program as such a swing in the budget balance did not appear to be justified on cyclical grounds and could eventually undermine the progress already made in reducing the current account imbalance. The staff urged the creation of a framework for regular transfers of BoE profits to the state budget, noting that such transfers would reduce the fiscal deficit.

28. **The mission welcomed the immediate transfer of US$110 million from the privatization of Eesti Telekom to the SRF abroad**. The authorities indicated that the remaining proceeds were used to rebuild the government's cash balances, which had been reduced sharply through the financing of the recent budget deficit and also through earlier losses related to bank failures. Because of the latter, a limit on the maximum amount of government deposits that can be held with domestic banks is now under active debate. (Under the Estonian currency board arrangement, the BoE does not lend to, or take deposits from, the government.) The authorities agreed that further progress toward establishing the legal

framework for the SRF and firm rules regarding the possible use of SRF resources was needed. The government has ruled out the use of SRF resources for general budget financing in 1999.

29. **The authorities aim at a balanced budget for 2000.** The authorities stated that pensions and budgetary wages have now reached levels that would permit the government to resist substantial real increases in the coming years. The discussions established that containing nominal expenditure growth to around 3–4 percent was likely to result—on current tax policies—in a balanced budget for 2000, provided economic growth strengthened as projected. The authorities stated that a declining share of the government sector in GDP and a balanced budget were the key principles they wish to follow in the coming months in formulating the budget for next year. The mission strongly supported these intentions because Estonia has already reached a very high level of government expenditures to GDP for its stage of development and as a increased government savings will be needed to protect against balance of payments pressures that could arise from the expected recovery of private demand.

30. **The authorities believe that a new Fund-supported program will help strengthen fiscal discipline.** The temptation for parliament to spend the SRF balances and large privatization revenues remains a major challenge for the authorities. They said that they will aim to reduce the share of government in the economy over the medium term, notwithstanding spending pressures related to EU and NATO accession.

31. **With the BoE constrained by the currency board arrangement, there remains little scope for an independent monetary policy**. The authorities stressed that the currency board and the peg to the deutsche mark/euro had proved very helpful in the past and remained appropriate. They are firmly committed to this arrangement, which they plan to maintain until Estonia becomes a member of EMU and introduces the euro without a change in parity. The BoE said that it had resisted pre-election pressures for stimulating the economy by reducing solvency and liquidity ratios, as these ratios had been increased for prudential reasons. In any case, liquidity or capital adequacy were not currently a constraint on bank lending and interest rates have fallen sharply. Much will, of course, depend on budgetary developments and the extent to which privatization proceeds held with domestic banks will need to be used for financing the budget. The remuneration of required reserves to strengthen the income position of banks will begin as of midyear. The mission agreed that it would also be appropriate to reduce the relatively high reserve requirements later in the year, if warranted by prudential considerations. The BoE is resisting transferring any of its large 1998 profit (0.75 percent of GDP) to the government, arguing that it needs to build up its capital. The mission stressed the need for establishing clear principles governing profit transfers to the state budget.

32. **Banking supervision has been strengthened.** The authorities said that with the reduction in the number of banks and the hiring of additional well-qualified staff, banking supervision has become more effective. Other concerns raised in the report on Maapank have been addressed by the new law on credit institutions, which has strengthened the hand of bank

supervisors. Measures relating to strengthening loan classification and loan loss provisioning and adding country and transfer risk components to capital adequacy requirements will be implemented later in 1999. New laws regulating the security market and insurance companies are under preparation. A decision has been made to move toward comprehensive financial sector supervision to strengthen supervision of securities market and leasing companies. The mission stressed that it supports such an approach if it does not lead to a weakening of banking supervision.

33. **The quality of banks' portfolios deteriorated as the full impact of the Russian crisis and slowdown of growth was felt**. The authorities stated that the takeover of Forekspank by the BoE was prompted in large part by concerns that, after the closure of Maapank and two smaller banks, it would be risky to permit yet another bank to fail. Moreover, the new bank (Optiva) resulting from the merger of Forekspank with a smaller bank would provide an element of competition in a banking system otherwise dominated by the two, much larger banks. Responding to the staff's concerns about a possible conflict of interest arising from the BoE owning a private bank, the BoE indicated that it remained firmly committed to selling its participation in Optiva bank to a strategic investor before end-1999 if market conditions permit. Although all major banks registered losses in 1998, capital injections have permitted substantial write-offs of nonperforming loans and the buildup of loan loss reserves. The BoE is satisfied that banks' balance sheets now reflect accurately the losses that have occurred, assets on the books of banks are appropriately valued, and general loan loss provisions are adequate. The authorities expect, however, that the weak economy may lead to a need for further write-offs and loan loss provisions in the future.

34. **The authorities do not expect to use Fund resources.** The mission indicated that it supports Estonia's interest in a new precautionary arrangement. For that, the remaining weaknesses in the 1999 budget will need to be counterbalanced with a strong budget for 2000. Preparation for the latter had, however, not yet started. Moreover, there needed to be greater specificity about policy intentions and commitments in a number of structural areas (see below). The authorities hope that program discussions can be concluded by September.

B. Structural Reforms

35. **The authorities intend to complete the privatization process in the near future as there are few enterprises left for privatization**. The authorities attributed the success of their past privatization efforts to the reliance on strategic foreign investors, which resulted in rapid improvements in management practices, corporate governance, and technology, and in enterprise restructuring. Preparations for the privatization of the railroad company and the energy complex are proceeding and the remaining government shares in Eesti Telekom will also be offered for sale. Moreover, land privatization, which had been slowed by the need to settle restitution claims, is expected to accelerate. The authorities saw a need for winding

down the **compensation fund**, noting that it had not been very successful in investing privatization proceeds.[14]

36. One of the most complex issues the authorities hope to address over the medium term is the future of the **oil shale sector**. The authorities said that shifting electricity generation to the use of gas could in the longer run result in lower energy costs and sharply reduced pollution. However, closure of the mines would also leave Estonia fully dependent on imported energy from a single source (i.e. Russia), create very substantial unemployment among ethnic minorities, and, severely damage the economy of the northeastern region. The choices they saw were among (i) continuing the current system of subsidizing the mines through higher electricity costs, (ii) subsidizing the operation of mines directly through the budget, and (iii) closing the mines and paying through the budget early retirement benefits to the miners as well as extending regional budgetary support. The mission acknowledged that these were indeed very difficult choices, which involved sensitive social and political considerations and welcomed the authorities' intent to develop in the coming months a coherent strategy for addressing these issues in a transparent fashion.

37. As to **pension reforms**, the social insurance reform commission is expected to propose by July 1, 1999 a conceptional framework for the implementation of the fully funded second pillar. A decision by government on this issue is expected to be taken in August. The mission noted that preliminary calculations had not led to useful conclusions regarding the costs of the fully funded element of the system and that more work needed to be done. The authorities said that SRF balances could potentially provide part of the funding for this system.

38. **The authorities noted that in many areas the structural reform agenda will be driven by the need to meet the requirements for EU membership**. Very comprehensive efforts have already been made in adapting the Estonian legal framework. Further harmonization with EU legislation will address the operations of state monopolies in electricity supply and competition in telecommunications and transport. Also, as Estonia will form part of the outer border of the EU, it will need to put in place customs, health, and safety inspection procedures consistent with EU standards. The authorities regretted that adopting the EU's complex system of tariffs, quantitative restrictions, and agricultural pricing will constitute a major step away from the present unrestricted trade system. While the timing of the introduction of these measures remains to be determined, the EU reportedly expects Estonia to take these steps about two years before accession. The authorities have not yet quantified the medium-term budgetary costs associated with preparing for EU membership, although these costs will in part be met by support under the Phare program. The authorities project that 2–3 percent of GDP in net annual transfers from the EU will become available after membership.

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[14]A major function of this fund was to exchange outstanding privatization vouchers for bonds, which it issued against its investments.

39. **Negotiations with WTO have been successfully concluded,** and the authorities said that one of the more difficult issues was the need for binding tariffs at, or close to, EU tariff levels, because Estonia has no import tariffs at present. Formal membership is expected later this year.

40. On **health reform**, the authorities expect savings through further consolidation of hospitals and other health care facilities, although the needed accessibility of services and regional considerations limit the scope.

41. On **poverty and the social safety net**, the authorities believe that the sharp real increases in pensions and in the incomes of traditionally poorly paid workers in the health and education sectors have gone some way toward addressing these problems. Regional issues, of course, still pose major challenges. The staff noted that means tested, or otherwise targeted, support needs also to be strengthened.

42. In addition to the oil shale issue discussed above, Estonia has inherited a **major environmental burden** from the pollution of soil and water associated with military installations of the former Soviet Union. The clean-up is time consuming and costly, and Estonia is seeking assistance from its Scandinavian neighbors.

43. **As to Y2K issues**, the government is confident that its compliance program will ensure that its own systems will not experience serious disruptions. The authorities believe that the same will hold true for the banking system and for most private industries.

C. Medium-Term Scenario

44. **The mission commended the reduction in the current account deficit despite the Russia crisis and the intentions of the authorities to aim for gradual further reduction in the deficit over the medium term** (Table 13). Despite the expectation of increased public sector savings, the current account deficit can be expected to widen somewhat in 2000 if the economy and private sector demand recover as projected.[15] From 2000 onward, the current account deficit is expected to reflect only a private sector imbalance. The current account deficits can be expected to be primarily financed with non-debt creating flows in the years

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[15]The factors underlying the sharp increase in private savings in 1998 and early 1999 may prove not to be as temporary in nature as assumed by the staff. Should the change in savings behavior prove more permanent, the current account deficit would be narrower over the medium term. In addition, some aspects of pension reform may lead to a sustained strengthening of private savings. Weaker consumption demand may, however, put the projected strong recovery of output at risk.

ahead (including pre-accession support from the EU).[16] Although privatization proceeds are expected to decline over time, other FDI and capital inflows are expected to pick-up as Estonia moves closer to EU membership and continues to be seen as a preferred alternative to investing in the CIS. While some dependence on portfolio investment and short-term credit exposes Estonia to risks from external shocks, any shortfall in foreign direct investment would be largely mirrored in reduced import demand and a narrowing of the current account deficit. Private sector investments and linked imports (which are both very high) are projected to decline marginally over the medium term as percent of GDP, while rising in absolute terms. (Net) debt to GDP and debt service to export ratios have declined from already low levels with the further buildup of balances in the SRF in early 1999 and are expected to stay low over the medium term.

IV. Staff Appraisal

45. **After growth of over 10 percent in 1997 and a pronounced widening of the current account deficit, aggregate demand and the economy were targeted to cool in 1998**. Under the Fund-supported program, the sterilization of budget surpluses and privatization proceeds in the SRF, together with higher prudential ratios, resulted in the first half of 1998 in a welcome slowing of growth and reduction in the current account deficit. Subsequently, however, disturbances in emerging markets and the Russian crisis, combined with the underlying weakness in the banking sector, reenforced the slowdown in domestic demand. With banking sector weaknesses largely overcome as a result of consolidation and foreign capital injections, a recovery of growth in the second half of 1999 is likely, although the strength of the recovery remains uncertain.

46. **Reflecting primarily the weakening of the economy, the budget balance shifted to a substantial deficit in the second half of 1998**, and fiscal performance criteria, which were no longer appropriate because of the changed cyclical situation, were missed by large margins. There was, however, also some weakening of expenditure policies and real outlays were allowed to rise much faster than targeted. The authorities are to be congratulated for withstanding strong political pressures for spending SRF resources. The budget deficit widened considerably in the first quarter of 1999 as the economy stayed weak, high real wage and pension increases came into effect, election-related spending accelerated, and important one-time factors reduced tax collections.

47. **The budget for 1999 was formulated on the basis of unrealistic revenue projections** and entails sharp real increases in expenditures, particularly on wages and pensions. Taking account of the proposed expenditure cuts in the supplementary budget, the

[16] Consistent with the new balance of payments manual, capital grants are shown as part of the capital account rather than included in the current account. Moreover, the staff has been more cautious in projecting EU transfers than the authorities.

budget is likely to result in an uncomfortably high deficit of 3½ percent of GDP. This projection reflects a cautious assessment of revenue prospects for the balance of the year. The authorities are encouraged to consider cutting expenditures further, including through a second supplementary budget, and to resort to tax increases only as a last resort.

48. **At this stage, the scope for reducing the budget deficit in 1999 is limited.** It is, therefore, of paramount importance that an appropriate budget be formulated for 2000 that reverses the rising trend in the share of government in the economy and does not add to pressures on the balance of payments as private sector demand recovers. It is most welcome that the authorities are aiming at a balanced budget for next year.

49. **There has been a substantial reduction in the current account deficit.** Moreover, in large part because of major capital injections by foreign strategic investors, FDI exceeded the current account deficit in 1998 and early 1999. Public sector external debt remains very low and the maturity structure of private sector debt was lengthened. The intention of the authorities to further reduce, over the medium term, the current account deficit is sound, although in the short term even relatively high deficits could be financed without excessive recourse to debt-creating financing. The addition of a substantial portion of privatization proceeds from Eesti Telekom to the SRF is welcome as it clearly demonstrates the determination of the authorities to strengthen Estonia's external position.

50. **The authorities should be commended for having resisted protectionist pressures and for maintaining a trade and payments system free of restrictions, including tariffs.** This has contributed very importantly to an efficient resource allocation, creating a basis for sustainable and high quality growth.

51. **Estonia has benefited greatly from the currency board and the stable exchange rate vis-à-vis the deutsche mark and, more recently, the euro.** Estonia remains highly competitive vis-à-vis the non-CIS area, which is the recipient of most of Estonia's exports, and the flexibility of the Estonian labor market is high. Moreover, the reliance on strategic foreign investors in privatization has resulted in strong export linkages. Growing exports, low debt and debt service ratios, the buildup of substantial balances in the SRF, and continued access to foreign borrowing on very favorable terms, suggest that the currency board arrangement is serving Estonia well. Over the medium term, it will, however, be important that Estonia's balance of payments position be further strengthened through a return to the traditionally conservative stance of fiscal policy. If necessary, the government should be prepared to act quickly and decisively to counter any renewed private spending boom through a more restrictive fiscal stance.

52. **The recent consolidation of the banking system was entirely appropriate and, as a result, the banking system is now much stronger.** However, further write-off of nonperforming loans may be needed as the full impact of the Russian crisis and the slowdown in growth on the quality of banks' portfolios continues to be felt. The efforts made to

strengthen banking supervision were much needed. Moreover, the decision to make public the report on the failure of Maapank is indicative of the willingness of the authorities to address problems in a transparent fashion. The staff supports the intention to move toward supervising the financial sector on a unified basis, provided that it does not lead to an even temporary weakening of banking supervision. The intention to sell off Optiva bank by end-1999 is most appropriate.

53. **Estonia remains a leading reformer among transition countries.** With parliamentary elections out of the way, it will be important to accelerate efforts in areas where progress has been slow. With first stage reforms largely completed for some time already, the reform agenda ahead will focus increasingly on meeting requirements for EU membership. The initiation of pension and health reforms are important steps in this direction. The authorities are urged to continue their efforts in these and related areas. The staff also supports the intention to develop a comprehensive and transparent solution to the difficult economic, environmental, regional, and social issues related to oil shale mining.

54. **The staff commends the provision of high quality and timely core and other data necessary for surveillance, including on web sites, and the publication of the letter of intent for the now expired arrangement.**

55. **The staff welcomes the intentions of the new government to intensify discussions on a new arrangement that is intended to be precautionary**. It is recommended that Estonia remain on the 12-month consultation cycle.

Table 2. Estonia: Selected Macroeconomic Indicators, 1996-2000

(In units as indicated)

	1996	1997	1998	1999 1/				2000 2/
				Q1	1st half	2nd half	Year	Year
			Prel. Act.	Prel. Act.	Proj.	Proj.	Proj.	Proj.
National income and prices								
Nominal GDP (in millions of kroons)	52,446	64,324	73,213	17,613	37,999	40,202	78,200	85,824
GDP (in millions of U.S. dollars)	4,356	4,634	5,201	1,243	2,648	2,770	5,421	5,924
Real GDP (change in percent)	4.0	10.6	4.0	0.0	0.8	4.6	2.7	6.0
CPI (change in percent, period average)	23.1	11.2	8.2	4.2	4.0	4.1	4.0	3.5
CPI (change in percent, end of period)	14.8	12.5	4.4	3.8	4.0	4.4	4.4	3.2
Average monthly wage, end-of-period, in U.S. dollars	292	257	291	...	...	...	...	...
Saving-investment balances (in percent of GDP)								
Domestic saving	19.2	18.5	20.7	17.0	18.3	17.8	18.0	19.1
Private	15.7	12.7	16.9	22.4	19.7	15.6	17.6	15.4
Public	3.5	5.8	3.9	-5.4	-1.5	2.2	0.4	3.7
Foreign saving	9.7	13.2	8.6	6.7	7.2	8.7	8.0	8.9
Domestic investment	28.9	31.7	29.3	23.7	25.5	26.5	26.0	28.0
General government (in percent of GDP)								
Revenue 3/	39.0	39.6	39.5	32.1	35.7	40.7	38.3	39.2
Expenditure 4/	40.6	37.7	39.6	40.1	40.5	42.9	41.8	39.2
Fiscal balance	-1.5	2.0	-0.3	-8.2	-5.0	-2.3	-3.6	0.0
External Sector								
Exports (in millions of U.S. dollars)	1,788	2,090	2,689	568	1,274	1,389	2,663	2,975
Imports (in millions of U.S. dollars)	-2,832	-3,275	-3,804	-764	-1,784	-2,019	-3,803	-4,297
Trade balance (in millions of U.S. dollars)	-1,044	-1,185	-1,115	-196	-510	-631	-1,140	-1,322
Current account balance (in millions of U.S. dollars)	-423	-610	-449	-83	-191	-241	-432	-526
Gross international reserves								
In millions of U.S. dollars 5/	640	760	813	817 6/	735	872	872	948
In months of imports	2.2	2.3	2.1	2.2	2.0	2.1	2.2	2.1
Over short term debt (gross, ratio) 7/	...	0.9	0.9	...	...	...	...	...
Over short term debt (net, ratio) 7/	...	1.4	1.2	...	...	...	...	...
Exchange rate, kroon per U.S. dollar (period average) 8/	12.0	13.9	14.1	14.2	14.3	14.5	14.4	14.5
Official external debt (in percent of GDP)	6.9	5.9	5.2	5.1	5.1	5.0	5.0	5.0
(Net of SRF holdings)	(6.9)	(4.9)	(3.6)	(1.3)	(1.3)	(1.3)	(1.3)	(1.7)
Money and credit 9/								
Domestic credit to nongovernment	70.0	83.9	14.0	5.2	...	...	4.0	...
Base money	21.6	37.7	6.4	2.5	...	...	9.4	...
Broad money	36.8	38.0	7.0	5.6	...	...	9.4	...
Velocity of broad money (annual average)	4.3	3.8	3.5	...	...	...	3.6	...
Base money multiplier (end of period)	2.3	2.3	2.3	2.8	...	...	2.4	...

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

1/ Based on expectation that parliament will pass by June 1999 budget cuts amounting to EEK 1 billion (1.3 percent of GDP).
2/ Active policy scenario based on balanced budget.
3/ Excludes privatization receipts.
4/ Includes net lending and the balances of the Environment and Forestry Funds.
5/ Excludes foreign assets of the central government's Stabilization Reserve Fund.
6/ April 1999.
7/ Gross short-term debt includes trade credits, loans, currency and deposits.
Net short-term debt excludes banks' short-term assets from the gross figure.
8/ The Estonian kroon has been pegged to the deutsche mark at EEK 8=DM 1 since June 20, 1992.
9/ Change in percent over same period previous year.

Table 3. Estonia: Summary Balance of Payments, 1995-99

	1995	1996	1997	1998				1999 projection			
				Prog. 1/	1st half	2nd half	Year	Q1 (prel.)	1st half	2nd half	Year
				(In millions of U.S. dollars)							
Current account	-185	-423	-610	-582	-262	-187	-449	-83	-191	-241	-432
Trade balance	-692	-1,044	-1,185	-1,373	-563	-552	-1,115	-196	-510	-631	-1,140
Exports	1,861	1,788	2,090	2,416	1,306	1,382	2,689	568	1,274	1,389	2,663
Imports	-2,553	-2,832	-3,275	-3,789	-1,869	-1,935	-3,804	-764	-1,784	-2,019	-3,803
Services	378	518	608	750	294	311	604	97	287	358	644
Receipts	876	1,108	1,317	1,533	686	779	1,465	297	704	854	1,557
Transportation	374	441	658	803	337	369	706	142	321	410	732
Travel	357	484	473	526	241	293	534	100	268	321	589
Other	145	183	185	204	108	117	226	55	114	123	237
Payments	-498	-590	-709	-783	-393	-469	-861	-200	-417	-496	-913
Transportation	-222	-267	-332	-357	-193	-219	-412	-100	-195	-208	-403
Travel	-90	-101	-115	-127	-56	-76	-133	-22	-60	-86	-146
Other	-185	-222	-256	-300	-143	-173	-316	-78	-162	-202	-364
Income 2/	3	2	-148	-99	-63	-24	-87	-18	-35	-35	-71
Transfers	126	100	115	140	70	78	148	34	68	68	135
Capital and financial account	259	545	821	656	317	176	492	-25	109	378	487
Capital account	-1	-1	--	2	1	1	2	1	1	1	2
Financial account	260	546	821	654	316	175	490	-26	108	377	485
Direct investment	202	110	132	192	145	421	565	270	325	105	430
Of which:											
Proceeds from privatization	...	...	21	35	--	--	--	200	200	...	200
Portfolio investment	-16	145	263	169	160	-167	-6	-71	-35	140	105
Other long-term	48	161	275	204	56	2	59	32	63	64	127
Short-term	27	147	173	110	-36	-69	-105	-255	-240	74	-166
Of which:											
Transfers to the SRF	--	--	-49	-151	-27	-9	-36	-110	-110	...	-110
Monetary authorities	-1	-18	-22	-19	-10	-12	-21	-2	-5	-6	-11
Errors and omissions	32	-21	-32	-30	4	10	14	--	--	--	--
Overall balance	106	101	179	44	59	-2	57	-108	-82	137	55
Change in official reserves 3/	-106	-101	-179	-44	-59	2	-57	108	82	-137	-55
				(Units as indicated)							
Memorandum items:											
Exchange rate (kroon/US$)	11.5	12.0	13.9	14.3	14.4	13.7	14.1	14.2	14.3	14.5	14.4
GDP (US$ million)	3,601	4,356	4,634	5,504	2,511	2,697	5,201	1,243	2,648	2,770	5,421
Trade balance/GDP (in %)	-19.2	-24.0	-25.6	-24.9	-22.4	-20.5	-21.4	-15.8	-19.2	-22.8	-21.0
Current account/GDP (in %)	-5.1	-9.7	-13.2	-10.6	-10.4	-6.9	-8.6	-6.7	-7.2	-8.7	-8.0
Gross international reserves											
(US$ million) 3/	583	640	760	804	819	817	817	709	735	872	872
In months of imports	2.3	2.2	2.3	2.1	2.2	2.0	2.1	2.2	2.0	2.1	2.2
Relative to (ratio) 4/											
short-term debt (gross)	...	...	0.9	...	0.9	0.9	0.9	...	...	...	...
short-term debt (net)	...	...	1.4	...	1.4	1.2	1.2	...	...	...	...
Government debt/GDP (in %) 5/											
Excluding SRF	6.7	6.9	6.0	4.9	5.4	5.0	5.2	5.1	5.1	5.0	5.0
Including SRF	6.7	6.9	4.9	1.3	3.9	3.4	3.6	1.3	1.3	1.3	1.3
Debt service/exports (in %) 6/	0.7	1.5	0.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

Sources: Bank of Estonia; and Fund staff estimates.

1/ As revised at midterm review in September 1998.

2/ Including interest income and reinvested profits.

3/ Excluding foreign assets in the government's Stabilization Reserve Fund (SRF).

4/ Gross short-term debt includes trade credits, loans, currency and deposits.
Net short-term excludes banks' short-term assets from the gross figure.

5/ Including government guaranteed debt.

6/ Public debt service; exports comprise goods and nonfactor services.

Table 4. Estonia: Summary Balance of Payments, 1997-2004

	1997	1998 Program 1/	1998 Estimate	1999	2000	2001	2002	2003	2004
				Projections					
				(In millions of U.S. dollars)					
Current account	-610	-582	-449	-432	-526	-529	-555	-556	-599
Trade balance	-1,185	-1,373	-1,115	-1,140	-1,322	-1,428	-1,567	-1,711	-1,913
Exports	2,090	2,416	2,689	2,663	2,975	3,380	3,823	4,333	4,875
Imports	-3,275	-3,789	-3,804	-3,803	-4,297	-4,808	-5,391	-6,044	-6,788
Services	608	750	604	644	705	802	912	1,037	1,178
Receipts	1,317	1,533	1,465	1,557	1,702	1,924	2,174	2,456	2,776
Payments	-709	-783	-861	-913	-997	-1,122	-1,262	-1,420	-1,597
Income 2/	-148	-99	-87	-71	-74	-78	-84	-82	-95
Transfers 3/	115	140	148	135	165	175	185	200	230
Capital and financial account	821	656	492	487	602	627	702	681	741
Capital account 3/	--	2	2	2	5	10	20	50	60
Financial account	821	654	490	485	597	617	682	631	681
Direct investment	132	192	565	430	340	345	380	305	335
Of which:									
Proceeds from privatization	21	35	--	200	100	100	100	...	...
Portfolio investment	263	169	-6	105	80	80	85	90	95
Other long-term	275	204	59	127	149	161	181	200	215
Short-term	173	110	-105	-166	35	35	40	40	40
Of which:									
Transfers to the SRF 4/	-49	-151	-36	-110	...	...	...	...	...
Monetary authorities	-22	-19	-21	-11	-7	-4	-4	-4	-4
Errors and omissions	-32	-30	14	--	--	--	--	--	--
Overall balance	179	44	57	55	76	98	148	125	142
Change in official reserves 5/	-179	-44	-57	-55	-76	-98	-148	-125	-142
				(Units as indicated)					
Memorandum items:									
Exchange rate (kroon/US$)	13.9	14.3	14.1	14.4	14.5	14.5	14.0	14.0	14.0
GDP (US$ million)	4,634	5,504	5,201	5,421	5,924	6,448	7,279	7,918	8,587
Trade balance/GDP (in %)	-25.6	-24.9	-21.4	-21.0	-22.3	-22.2	-21.5	-21.6	-22.3
Current account/GDP (in %)	-13.2	-10.6	-8.6	-8.0	-8.9	-8.2	-7.6	-7.0	-7.0
Gross international reserves									
(US$ million) 5/	760	804	817	872	948	1,046	1,194	1,319	1,461
In months of imports	2.3	2.1	2.1	2.2	2.1	2.1	2.2	2.1	2.1
Relative to (ratio) 6/									
short-term debt (gross)	0.9	...	0.9	...	...	...	...	...	...
short-term debt (net)	1.4	...	1.2	...	...	...	...	...	...
Government debt/GDP (in %) 7/									
Excluding SRF	6.0	4.9	5.2	5.0	5.0	5.1	5.2	5.3	5.3
Including SRF	4.9	1.3	3.6	1.3	1.7	2.1	2.5	2.8	3.0
Debt service/exports (in %) 8/	0.5	1.0	1.0	1.0	1.4	1.4	1.4	1.4	1.4

Sources: Bank of Estonia; and Fund staff estimates.

1/ As revised at midterm review in September 1998.
2/ Including interest income and reinvested profits.
3/ Including transfers from the EU.
4/ Government transfers to the Stabilization Reserve Fund (SRF) in 1999 reflect the expected proceeds from the partial privatization of Eesti Telecom minus the government's allocation to the budget. Interest revenues from SRF holdings are reinvested.
5/ Excluding foreign assets in the SRF.
6/ Gross short-term debt includes trade credits, loans, currency and deposits. Net short-term excludes banks' short-term assets from the gross figure.
7/ Including government guaranteed debt.
8/ Public debt service; exports comprise goods and nonfactor services.

Table 5. Estonia: Summary of General Government Operations, 1997-2000
(In millions of EEK)

	1997	1998			1999			2000	1998				1999		
					Year			Year	1st half		2nd half		Q1	1st half	2nd half
		Budget 1/	Prog. 1/	Prel. Act.	Budget	MOF Proj 2/	Staff Proj. 2/	Staff Proj.	Prog.	Actual	Prog. 1/	Prel. Act.	Prel. Act.	Staff Proj.	Staff Proj. 2/
Revenue 3/	25,481	28,630	30,400	28,887	33,145	30,984	29,895	33,685	13,903	14,120	16,497	14,767	5,651	13,547	16,349
Tax revenue	24,072	26,831	29,004	27,126	31,325	29,164	28,305	31,940	13,349	13,240	15,655	13,885	5,331	12,803	15,502
Direct taxes	14,473	16,246	17,696	17,320	18,939	18,080	17,652	19,692	8,375	8,593	9,321	8,726	3,576	8,173	9,479
Corporate profits tax	1,228	1,160	1,391	1,914	1,650	1,493	1,493	1,500	854	1,249	537	665	322	811	682
Personal income tax	5,240	6,113	6,637	6,233	6,768	6,621	6,696	7,357	2,993	2,907	3,643	3,326	1,542	3,214	3,483
Social security tax	4,637	5,275	5,660	5,303	6,173	5,842	5,537	6,350	2,643	2,598	3,017	2,705	1,012	2,433	3,105
Medical insurance tax	3,097	3,425	3,675	3,573	4,013	3,798	3,599	4,127	1,738	1,727	1,937	1,846	649	1,572	2,027
Land tax	270	273	334	297	335	326	326	358	146	111	188	186	51	143	183
VAT	6,686	6,841	7,489	6,413	7,800	6,887	6,720	7,571	3,349	3,184	4,140	3,229	1,157	2,975	3,744
Excises	2,397	2,953	3,074	2,787	3,843	3,453	3,190	3,862	1,231	1,160	1,843	1,627	457	1,313	1,877
Other taxes (incl. on intern. trade)	516	791	789	606	743	743	743	815	394	304	394	302	141	342	401
Nontax revenue 3/	1,409	1,800	1,387	1,761	1,820	1,820	1,590	1,745	554	880	833	881	321	744	846
Expenditure 4/	24,247	28,902	28,522	29,016	33,657	32,658	32,658	33,634	13,455	13,403	15,067	15,613	7,057	15,402	17,256
Current expenditure	21,768	25,830	25,429	25,923	30,179	29,548	29,548	30,429	12,245	12,331	13,184	13,592	6,568	14,042	15,506
Expenditure on goods and services	14,669	17,746	17,399	17,820	20,542	19,911	19,911	20,548	8,365	8,384	9,034	9,436	4,221	9,271	10,640
Wages and salaries 5/	5,308	6,834	6,483	6,775	8,233	8,233	8,233	8,496	3,293	3,465	3,190	3,310	1,623	3,873	4,360
Other goods and services	9,361	10,912	10,915	11,044	12,309	11,678	11,678	12,052	5,071	4,919	5,844	6,125	2,597	5,397	6,281
Current transfers and subsidies	6,885	7,814	7,811	7,865	9,391	9,391	9,391	9,635	3,767	3,841	4,044	4,024	2,269	4,638	4,753
Subsidies	196	231	311	311	382	382	382	382	176	134	135	177	95	190	192
Transfers to households	6,689	7,583	7,500	7,554	9,009	9,009	9,009	9,253	3,592	3,707	3,908	3,847	2,174	4,448	4,561
of which: Pensions	4,628	5,234	5,392	5,200	6,451	6,451	6,451	6,657	2,642	2,587	2,750	2,613	1,610	3,221	3,230
Other current expenditure	214	270	219	238	246	246	246	246	112	106	107	132	78	133	113
Capital expenditure	2,479	3,072	3,093	3,093	3,479	3,110	3,110	3,205	1,210	1,072	1,883	2,021	490	1,360	1,750
Env./Forestry Funds 6/	-18	-50	28	-12	20	20	20	22	80	121	-52	-133	0	7	13
Financial surplus (+) / deficit (-)	1,216	-322	1,906	-141	-492	-1,654	-2,743	73	528	838	1,378	-979	-1,406	-1,849	-894
Net lending (-)	50	36	36	-112	-66	-66	-66	-72	0	-34	36	-78	-30	-42	-24
Overall surplus (+) / deficit (-)	1,266	-286	1,942	-253	-558	-1,719	-2,808	1	528	804	1,414	-1,057	-1,436	-1,890	-918
Borrowing requirement	-1,266	286	-1,942	253	558	1,719	2,808	-1	-528	-804	-1,414	1,057	1,436	1,890	918
Domestic financing (net)	-1,198	122	-1,807	12	234	1,396	2,485	...	-528	-901	-1,414	913	1,368	1,737	748
o/w: privatization proceeds	--	--	--	--	234	...	...	...	--	--	--	--	628	...	...
Foreign financing (net)	-68	164	-135	241	323	323	323	...	--	97	--	144	68	153	170
Memorandum items:															
Balance in Stabilization Reserve Fund 7/	700	1,900	2,800	1,224	...	...	...	...	1,100	1,100	2,800	1,224	2,764	...	...

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

1/ Includes a supplementary budget of EEK 314 million adopted in June 1998 and additional local government capital outlays of EEK 205 million approved during 1998.
2/ Based on expectations that parliament will pass by June 1999 budget cuts amounting to EEK 1 billion (1.3 percent of GDP).
3/ Excludes all privatization receipts.
4/ In 1998, excludes about EEK 500 million of government deposits lost due to bank closures.
5/ Wages and salaries of a number of budgetary institutions are included under "other goods and services".
6/ Change in the balances of the Environment and Forestry Funds.
7/ Represents the sterilization of government savings, which include previously accumulated government deposits. In 1999, includes the transfer of EEK 1.5 billion from the privatization of Eesti Telekom.

Table 6. Estonia: Summary of General Government Operations, 1997-2000
(In percent of GDP)

	1997	1998			1999			2000	1998				1999		
					Year			Year	1st half		2nd half		Q1	1st half	2nd half
		Budget 1/	Prog. 1/	Prel. Act.	Budget	MOF Proj 2/	Staff Proj. 2/	Staff Proj.	Prog.	Actual	Prog. 1/	Prel. Act.	Prel. Act.	Staff Proj.	Staff Proj. 2/
Revenue 3/	39.6	37.4	38.2	39.5	39.6	39.6	38.2	39.2	39.1	39.2	38.1	39.7	32.1	35.7	40.7
Tax revenue	37.4	35.0	36.6	37.1	37.4	37.3	36.2	37.2	37.5	36.8	36.2	37.3	30.3	33.7	38.6
Direct taxes	22.5	21.2	22.3	23.7	22.6	23.1	22.6	22.9	23.6	23.9	21.5	23.4	20.3	21.5	23.6
Corporate profits tax	1.9	1.5	1.8	2.6	2.0	1.9	1.9	1.7	2.4	3.5	1.2	1.8	1.8	2.1	1.7
Personal income tax	8.1	8.0	8.4	8.5	8.1	8.5	8.6	8.6	8.4	8.1	8.4	8.9	8.8	8.5	8.7
Social security tax	7.2	6.9	7.2	7.2	7.4	7.5	7.1	7.4	7.4	7.2	7.0	7.3	5.7	6.4	7.7
Medical insurance tax	4.8	4.5	4.7	4.9	4.8	4.9	4.6	4.8	4.9	4.8	4.5	5.0	3.7	4.1	5.0
Land tax	0.5	0.4	0.4	0.6	0.6	0.4	0.4	0.4	0.4	0.3	0.4	0.5	0.3	0.4	0.5
VAT	10.4	8.9	9.4	8.8	9.3	8.8	8.6	8.8	9.4	8.8	9.6	8.7	6.6	7.8	9.3
Excises	3.7	3.9	3.8	3.8	4.6	4.4	4.1	4.5	3.5	3.2	4.3	4.4	2.6	3.5	4.7
Other taxes (incl. on intern. trade)	0.8	1.0	1.0	0.8	0.9	1.0	1.0	1.0	1.1	0.8	0.9	0.8	0.8	0.9	1.0
Nontax revenue 3/	2.2	2.3	1.5	2.4	2.2	2.3	2.0	2.0	1.6	2.4	1.9	2.4	1.8	2.0	2.1
Expenditure 4/	37.7	37.7	35.8	39.6	40.2	41.8	41.8	39.2	37.8	37.2	34.8	42.0	40.1	40.5	42.9
Current expenditure	33.8	33.7	32.0	35.4	36.0	37.8	37.8	35.5	34.4	34.3	30.5	36.5	37.3	37.0	38.6
Expenditure on goods and services	22.8	23.2	22.0	24.3	24.5	25.5	25.5	23.9	23.5	23.3	20.9	25.4	24.0	24.4	26.5
Wages and salaries 5/	8.3	8.9	8.2	9.3	9.8	10.5	10.5	9.9	9.3	9.6	7.4	8.9	9.2	10.2	10.8
Other goods and services	14.6	14.2	13.8	15.1	14.7	14.9	14.9	14.0	14.3	13.7	13.5	16.5	14.7	14.2	15.6
Current transfers and subsidies	10.7	10.2	9.7	10.7	11.2	12.0	12.0	11.2	10.6	10.7	9.3	10.8	12.9	12.2	11.8
Subsidies	0.3	0.3	0.3	0.4	0.5	0.5	0.5	0.4	0.5	0.4	0.3	0.5	0.5	0.5	0.5
Transfers to households	10.4	9.9	9.4	10.3	10.8	11.5	11.5	10.8	10.1	10.3	9.0	10.3	12.3	11.7	11.3
of which: Pensions	7.2	6.8	6.8	7.1	7.7	8.2	8.2	7.8	7.4	7.2	6.4	7.0	9.1	8.5	8.0
Other current expenditure	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.4	0.4	0.4	0.3
Capital expenditure	3.9	4.0	3.8	4.2	4.2	4.0	4.0	3.7	3.4	3.0	4.4	5.4	2.8	3.6	4.4
Env./Forestry Funds 6/	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	-0.1	-0.4	0.0	0.0	0.0
Financial surplus (+) / deficit (-)	1.9	-0.4	2.4	-0.2	-0.6	-2.1	-3.5	0.1	1.5	2.3	3.2	-2.6	-8.0	-4.9	-2.2
Net lending (-)	0.1	0.0	0.0	-0.2	0.0	-0.1	-0.1	-0.1	0.0	-0.1	0.1	-0.2	-0.2	-0.1	-0.1
Overall surplus (+) / deficit (-)	2.0	-0.4	2.5	-0.3	-0.7	-2.2	-3.6	0.0	1.5	2.2	3.3	-2.8	-8.2	-5.0	-2.3
Borrowing requirement	-2.0	0.4	-2.5	0.3	0.7	2.2	3.6	0.0	-1.5	-2.2	-3.3	2.8	8.2	5.0	2.3
Domestic financing (net)	-1.9	0.2	-2.3	0.0	0.3	1.8	3.2	...	-1.5	-2.5	-3.3	2.5	7.8	4.6	1.9
o/w: privatization proceeds	--	--	--	--	0.3	...	...	...	--	--	--	--	3.6		
Foreign financing (net)	-0.1	0.2	-0.2	0.3	0.4	0.4	0.4	...	--	0.3	--	0.4	0.4	0.4	0.4
Memorandum items:															
Balance in Stabilization Reserve Fund	1.1	2	3.6	1.7	...	...	...	...	3.1	3.1	6.5	3.3	...	...	...
GDP (in million of kroons)	64,324	76,600	78,820	73,213	83,733	78,200	78,200	85,824	35,550	35,989	43,270	37,215	17,613	37,999	40,202
Average annual CPI inflation (in percent)	11.2	10.1	11.1	8.2	5.5	4.7	4.0	3.5	...	...	...	...	...	...	...

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

1/ Includes a supplementary budget of EEK 314 million adopted in June 1998 and additional local government capital outlays of EEK 205 million approved during 1998.
2/ Based on expectations that parliament will pass by June 1999 budget cuts amounting to EEK 1 billion (1.3 percent of GDP).
3/ Excludes all privatization receipts.
4/ In 1998, excludes about EEK 500 million of government deposits lost due to bank closures.
5/ Wages and salaries of a number of budgetary institutions are included under "other goods and services".
6/ Change in the balances of the Environment and Forestry Funds.

Table 7. Estonia: Quantitative Performance Criteria Under the 1997–98 Program 1/

	Performance Criteria		Outcome
	(In millions of kroons)		
I. Minimum level of general government balance (surplus:+,deficit:-):			
From January 1-December 31, 1997	280		1,326
From January 1, 1998 to:			
March 31, 1998	300		197
June 30, 1998	520		804
September 30, 1998 2/	1,100		694
December 31, 1998 2/	1,900		-253
	(In millions of kroons)		
II. Minimum level of general government balances invested abroad in the Stabilization Reserve Fund for:			
December 31, 1997	700		700
March 31, 1998	900		1,000
June 30, 1998	1,100		1,100
September 30, 1998 3/	1,800		1,224
December 31, 1998 3/	2,800		1,226
	(In millions of deutsche marks)		
III. Minimum levels for net international reserves of the Bank of Estonia:			
September 30, 1997	197		197
December 31, 1997	205		207
March 31, 1998	210		234
June 30, 1998	215		239
September 30, 1998	225		254
December 31, 1998	235		224
IV. Ceilings on external short-, medium-, and long-term debt of general government, Bank of Estonia 4/	Maturity of 0-1 years 5/	Maturity of over 1 year	of which: Maturity of 1-5 years
	(In millions of U.S. dollars)		
Cumulative changes from September 30, 1997 to:			
December 31, 1997	0 (0)	40 (0)	20 (0)
March 31, 1998	0 (0)	70(16.4)	40 (16.4)
June 30, 1998	0 (0)	100 (16.4)	70 (16.4)
September 30, 1998 6/	0 (0)	130 (34.7)	100 (34.7)
December 31, 1998 6/	0 (0)	150 (34.7)	130 (34.7)
V. The government will not accumulate external payments arrears during the period of the arrangement	No external arrears were accumulated.		
VI. The currency board is to be fully backed with foreign exchange at all times 7/			

Sources: Estonian authorities and Fund staff estimates.

1/ Definition of the concepts to be measured are included in the annex to the Memorandum of Economic Policies(EBS/97/202).
2/ Excludes privatization receipts from revenues.
3/ For September 30, 1998 and December 31, 1998, these amounts can include government balances in the SRF held at the Bank of Estonia.
4/ Figures in parentheses show outcome.
5/ Except for normal import financing.
6/ For September 30, 1998 and December 31, 1998 debt ceilings have been changed so that the first column describes debt ceilings for debt with maturity 0-2 years; the second column describes debt ceilings for debt with maturity over 2 years; and the third column refers to debt with maturity between 2-5 years.
7/ The gross foreign reserves of the Bank of Estonia did not fall below the currency board's liabilities through March 1999.

Table 8. Estonia: Status of Implementation of Measures under the 1997–98 Program

Measures	Period of Implementation		Status on March 16, 1999[1]
	Original program	Revised program	
Fiscal Measures			
1. Government will propose to parliament that the sale of services to offshore companies be taxed at a rate of 15 percent.	End-January-98		Rejected by Parliament in September 1997. Not yet resubmitted.
2. Raise excise tax on gasoline and tobacco by 39 percent and 50 percent, respectively.	January 1, 1998		Implemented.
3. Extend to the whole country the current car tax applied in the city of Tallinn as of July 1, 1998.	January 1, 1998		Not implemented.
4. Apply 16 percent stumpage tax to all timber sales by the Forestry Fund.	January 1, 1998		Implemented.
5. Implement a fuel coloring scheme to discourage evasion of the excise on diesel for transport.	January 1, 1998		Implemented.
6. Require commercial bank groups to obtain in advance, a letter of no objection from the Ministry of Finance for each acquisition of financial claims on local governments.	December 1, 1997		Implemented.
7. Complete a detailed study of the long term finances of the pension system.	December 1997	Summer 1998	Not implemented. But a model has been developed and presented to the Cabinet of Ministers.
8. Submit the Social Tax Law to Parliament.	January 1, 1998	Summer 1998	Passed by Parliament on June 10, 1998. The law on private pension funds was passed at the same time.
9. Submit Pension Law to Parliament.	April 1, 1998	July 1998	Law was passed by Parliament in June 1998.
10. All foreign and domestic debt service payments of the central government to be handled by the State Treasury.	January 1,1998		Not implemented.
11. The State Treasury to be responsible for monitoring all foreign loan disbursements to the central government as well as repayments of foreign loans onlent by the central government.	January 1, 1998		Only partially implemented. So far, documentation of 7 out of 19 foreign loans has been handed over to the State Treasury.
12. Limit pension increases to inflation.	March and September 1998	March 1998	Pensions increased in March by more than inflation. No increase in September.
13. Increase excise taxes on alcohol, tobacco and motor vehicles.		October 1998	Implemented.
14. Transfer Social Tax collection to National Tax Board.	July 1, 1998	January 1, 1999	Implemented.
15. Start paying sick leave benefits from the fourth day, and make employers responsible for the first 2 weeks, with a view to generating annual savings of EEK 250 million.	September 1998		Under pressure from trade unions and employers' associations following publication of the MEP, the government backed down. No current plans for implementation.

Table 8. Estonia: Status of Implementation of Measures under the 1997–98 Program

Measures	Period of Implementation		Status on March 16, 1999[1]
	Original program	Revised program	
16. Reduce number of sickness funds from 17 to 4.	September 1998		Not implemented. However, this objective may be achieved by centralizing administration of sickness funds.
17. Implement first tier of pension scheme	January 1, 1999		Not implemented.
18. Submit legislation to Parliament establishing the SRF as a legal entity.		September 1998	Not implemented.
19. Establish an independent committee to oversee the SRF.		December 31, 1998	Not implemented.
20. Starting with 1999 budget, prepare budgets on general government basis.	1999 budget		Not implemented.
Monetary Measures			
1. Raise capital adequacy ratio from 8 percent to 10 percent.	October 1, 1997		Implemented on October 1, 1997.
2. Raise banks' minimum capital requirement to EEK 75 million (equivalent to ECU 5 million).	January 1, 1998		Implemented on January 1, 1998.
3. Notify banks of the introduction of a market risk component to the capital adequacy ratio, in line with the EU directive on capital adequacy.	End-1997	June 1998	Banks notified individually in October 1997 and instructions on methodology of calculations sent in March 1998; measure became effective July 1, 1998.
4. Introduce country and transfer risk components to capital adequacy calculations.	March 1998	September 1998	Not implemented.
5. Review impact of 1998 changes to CAR and determine if further increases to minimum level are warranted.	March 31, 1998	September 30, 1998	Reviewed and decided that no change was warranted.
6. Introduce additional reserve requirement of 3 percentage points.	November 1, 1997		Implemented in two steps (November and December 1997)
7. Reduce cash component of banks' required reserves from 30% of total to 20%.		July 1, 1998	Implemented on July 1, 1998.
8. Include guarantees provided by banks to other financial institutions in banks' reserve requirement calculation.		July 1, 1998	Implemented on July 1, 1998.
9. Limit absolute net open foreign exchange position of banks for all OECD currencies to 15% of banks' own funds (DM/EEK considered as a joint position).		July 1, 1998	Implemented on July 1, 1998.
10. Complete a review of loan classification and provisioning practices applied by commercial banks.	December 31, 1997		Review completed in March 1998.
11. Implement new uniform loan classification procedures.	March 31, 1998	July 1, 1998	Not implemented.

Table 8. Estonia: Status of Implementation of Measures under the 1997–98 Program

Measures	Period of Implementation		Status on March 16, 1999[1]
	Original program	Revised program	
12. Enforce bank prudential regulations on a consolidated basis.	Q1, 1998	Q2 1998	Required new guidelines for calculation of prudential ratios issued to banks in January 1998. Implemented from July 1, 1998.
13. Submit a new draft Securities Law.	March 31, 1998	June 1, 1998	Not implemented.
14. Submit to parliament the revised Credit Institutions Law.	November 1997	December 1998	Passed in February 1999 to be effective July 1, 1999.
15. Law on Deposit Insurance.	December 31, 1997		Law was passed in April 1998 and became effective October 1, 1998.
Structural Measures			
1. Raise electricity tariffs by 8 percent for residential consumers.	January 1, 1998		Implemented.
2. Privatization of enterprises.	Complete by end-1998 privatization of Kiviter, Rakvere and Moe distilleries, and the Liviko alcohol beverage company. Begin privatization of Eesti Energia and Eesti Raudtee (railways) in mid-1998	Start sale of 49 percent of Eesti Telecom by October 98. Begin selling by end-1998 the majority of shares of all five of Eesti Raudtee's subsidiaries; complete by end-1998 the privatization of Liviko and Moe distillery	Privatized: Kiviter -100% ; Rakvere Spirit-100%, Eesti Telekom - 74%. Eesti Energia and Eesti Põlevkivi have been restructured. Eesti Energia to be privatized by year 2000. Liviko and Moe Spirit to be 100% privatized in 1999. Privatization of Eesti Raudtee is in process and expected to be completed in 1999.
3. Harmonize amendments to the Competition Law with EU regulations.	Early 1998		Adopted in April 1998.
4. Harmonization of Land laws to meet EU standards.	End-1998		Amendments are necessary to the 1996 Land Reform Law and Real Estate Acquisitions Law. Not implemented.
5. Land privatization.	17% of total land in private hands by end-1997, and 35 % by end-1998	27% of total land in private hands by end-1998.	16% of total land in private hands by end-1997. The 25% level was reached by end-1998.
6. Subscribe to the Statistical Data Dissemination Standards.	September 30, 1998		Implemented.

1/ The date that the 1997-98 stand-by arrangement expired.

Table 9. Estonia Banking Survey: 1997-99
(in millions of EEK)

	1997	1998								1999		
		March		June		September		December		March	April	December
		Program	Actual	Program	Actual	Program	Actual	Program	Actual	Actual	Actual	Proj.
Net foreign assets 1/	**5,091**	**9,249**	**6,114**	**9,474**	**6,843**	**8,790**	**5,126**	**8,500**	**5,114**	**6,611**	**6,979**	**6,666**
Foreign assets	18,980	...	19,257	...	20,171	...	17,792	...	17,389	20,467	20,380	...
Foreign assets (BOE) 2/	10,902	...	9,788	...	11,836	...	10,541	...	10,909	10,324	12,084	...
Foreign assets (banks)	8,078	...	9,469	...	8,335	...	7,250	...	6,481	10,144	8,297	...
Foreign liabilities	-13,889	...	-13,143	...	-13,328	...	-12,665	...	-12,275	-13,857	-13,401	...
Foreign liabilities (BOE)	-798	...	-760	...	-905	...	-556	...	-413	-1,140	-417	...
Foreign liabilities (banks)	-13,090	...	-12,383	...	-12,423	...	-12,109	...	-11,862	-12,717	-12,984	...
Net domestic assets	14,418	12,830	14,278	13,456	14,303	13,610	15,622	15,100	15,683	14,915	15,106	16,092
Domestic credit	19,184	...	20,754	...	21,789	24,910	22,285	27,300	23,622	22,308	22,331	25,092
Net credit to general government	**-2,762**	**...**	**-2,347**	**...**	**-2,552**	**-2,243**	**-2,851**	**-2,463**	**-1,469**	**-1,999**	**-1,915**	**-901**
Credit to government (BOE)	4	...	4	...	3	...	3	...	3	3	4	...
Credit to government (banks)	1,087	...	978	...	995	...	856	...	946	860	885	...
Government deposits (BOE)	-424	...	-72	...	-116	...	-129	...	-7	-5	-10	...
Government deposits (banks)	-3,429	...	-3,256	...	-3,434	...	-3,581	...	-2,412	-2,857	-2,794	...
Credit to nongovernment	**21,946**	**22,969**	**23,101**	**25,019**	**24,341**	**27,153**	**25,136**	**29,763**	**25,092**	**24,307**	**24,247**	**25,993**
Credit to nonfinancial public enterprises	320	...	240	...	107	...	107	...	226	267	252	...
Credit to private sector	16,646	...	18,001	...	18,634	...	19,262	...	18,540	18,097	18,003	...
Households & individuals	4,114	...	4,148	...	4,174	...	4,254	...	4,181	4,255	4,258	...
Enterprises	12,506	...	13,825	...	14,427	...	14,972	...	14,319	13,802	13,703	...
Credit to nonbank financial Institutions	4,980	...	4,860	...	5,600	...	5,767	...	6,326	5,943	5,992	...
Other items (net) 1/	-4,766	...	-6,476		-7,486	-11,300	-6,663	-12,200	-7,939	-7,394	-7,225	-9,000
Broad money	**19,509**	**22,080**	**20,392**	**22,929**	**21,146**	**22,400**	**20,749**	**23,600**	**20,798**	**21,525**	**22,086**	**22,758**
Memorandum items:												
Base money multiplier	2.29	2.63	2.69	2.65	2.27	2.70	2.53	2.65	2.29	2.77	2.16	2.36
Currency-to-deposit ratio	0.31	...	0.28	...	0.30	...	0.28	...	0.28	0.31	0.31	...
Bank reserves-to-deposit ratio	0.26	...	0.20	...	0.27	...	0.22	...	0.28	0.19	0.32	...
Velocity (period average)	3.75	...	...	...	...	...	...	...	3.52	...	...	3.59
(percentage change from same period in preceding year)												
Net foreign assets	-29	23	-18	17	-16	6	-38	67	0	8	10	30
Net domestic assets	106	65	84	51	60	34	54	5	9	4	1	3
Credit to nongovernment	84	67	68	55	50	38	28	14	14	5	1	4
Credit to enterprises	63	...	62	...	55	...	33	...	15	0	-5	...
Credit to households	129	...	88	...	45	...	16	...	2	3	1	...
Credit to nonbank financial institutions	146	...	94	...	60	...	30	...	27	22	13	...
Broad money	38	45	34	35	24	21	12	21	7	6	4	9

Source: Bank of Estonia and Fund staff estimates

1/ The authorities revised the data on deposit money banks' foreign liabilities in December 1998 by including substantial amounts of bonds issued in foreign liabilities that had hitherto been included in other items (net).
2/ Excludes foreign assets of the Stabilization Reserve Fund

Table 10. Estonia: Monetary Authorities, 1997-99
(in millions of EEK)

	1997	1998								1999		
		March		June		September		December		March	April	December
		Program	Actual	Program	Actual	Program	Actual	Program	Actual	Actual	Actual	Proj.
Net foreign assets	**10,104**	**9,841**	**9,028**	**10,173**	**10,931**	**10,669**	**9,986**	**11,130**	**10,496**	**9,184**	**11,667**	**11,348**
Foreign assets 1/	10,902	10,400	9,788	10,664	11,836	11,093	10,541	11,500	10,909	10,324	12,084	...
of which:												
Currency board cover 2/	8,526	8,440	7,593	8,715	9,298	8,310	8,207	8,950	9,070	7,780	10,206	...
Foreign liabilities	798	559	760	492	905	424	556	370	413	1,140	417	...
Net domestic assets	**-1,577**	**-1,441**	**-1,435**	**-1,509**	**-1,633**	**-2,369**	**-1,779**	**-2,230**	**-1,170**	**-1,404**	**-1,461**	...
Net claims on Government	-352	...	-2	...	-113	...	-126	...	-4	-3	-6	...
Claims on financial institutions	23	...	25	...	17	...	17	...	270	281	281	...
Claims on non-financial public enterprises	0	...	0	...	0	...	0	...	0	0	0	...
Claims on private sector	26	...	27	...	33	...	36	...	40	40	42	...
Other	-1,275	...	-1,486	...	-1,570	...	-1,706	...	-1,476	-1,723	-1,778	...
Base money	**8,526**	**8,400**	**7,593**	**8,664**	**9,298**	**8,300**	**8,207**	**8,900**	**9,070**	**7,780**	**10,206**	**9,922**
Currency issue	5,439	...	5,260	...	5,773	...	5,322	...	5,391	5,233	5,355	...
Deposits of commercial banks	3,035	...	2,330	...	3,521	...	2,855	...	3,676	2,513	4,829	...
of which: required reserves 3/	2,798		2,944		3,205		3,720		3,653	3,468	3,463	...
Other deposits at BOE	52	...	3	...	4	...	30	...	4	34	22	...
Memorandum items:												
Gross international reserves (in millions of US$) 1/	**760**	**718**	**662**	**746**	**819**	**779**	**787**	**804**	**813**	**709**	**818**	**872**
Net international reserves (in millions of DM) 4/	207	210	235	215	239	225	254	235	224	224	229	...
Net international reserves (in millions of US$) 4/	116	114	127	117	132	126	152	132	134	123	124	...
Transfers to SRF	700	200	300	200	100	700	126	1,000	--	1,540	--	...
Cumulative Balance in the SRF 5/	700	900	1,000	1,100	1,100	1,800	1,226	2,800	1,226	2,766	2,766	...

Source: Bank of Estonia and Fund staff estimates.

1/ Excludes foreign assets of the central government's Stabilization Reserve Fund.
2/ Currency board cover is equivalent to the sum of base money and the kroon liabilities of the Bank of Estonia in its correspondent accounts.
3/ Requirement to be met on the basis of daily average of deposits over month. Includes liquidity requirement equivalent to 3 percent of the reserve requirement base (imposed since December 1997).
4/ Net of currency board cover (program definition).
5/ Excludes interest income.

Table 11. Estonia: Selected Financial Indicators, 1996-99

	1996	1997				1998									1999			
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
	(In percent of total deposits)																
1. Commercial bank reserves	15.6	15.4	14.0	16.9	21.2	16.2	22.3	16.8	23.8	18.1	18.8	18.7	24.2	21.7	19.2	16.4	27.4
Cash	5.8	5.1	4.9	3.9	4.6	4.1	4.6	3.7	4.7	3.8	3.8	3.8	4.6	3.7	3.6	3.7	3.7
Reserves held at the BoE 1/	9.8	10.3	9.1	13.0	16.6	12.2	17.7	13.1	19.8	14.2	15.1	14.9	19.6	17.9	15.6	12.5	23.8
Of which: Required reserves	6.4	6.9	7.7	10.4	11.7	11.0	11.7	11.8	12.8	13.8	14.5	14.3	14.3	14.3	12.8	12.7	12.5
2. Average risk-weighted capital adequacy ratio 2/	12.1	12.2	11.0	11.2	13.4	15.2	13.1	11.3	11.5	12.4	12.4	16.1	16.9	16.9	16.6	16.8	16.8
3. Non-performing loans 3/	1.3	1.9	1.7	1.1	1.2	1.2	1.1	0.9	1.3	1.3	1.3	1.4	1.4	2.1	2.3	3.2	-2.8
4. Leverage ratio 4/	8.4	8.1	8.6	8.5	7.3	6.2	6.8	6.4	6.4	6.2	5.9	5.1	4.8	4.8	4.9	5.0	-5.0
	(In EEK millions)																
5. NFA of commercial banks	214	292	366	-686	-5,013	-2,914	-4,088	-3,378	-5,658	-4,859	-5,345	-4,324	-5,381	-4,790	-3,385	-2,573	-4,687
6. Net open foreign exchange position of banks 5/	1,111	1,282	2,740	3,019	-1,930	2,082	1,218	1,606	-628	525	874	4,149	3,562	4,777	5,920	5,164	-4,763
(In percent of total liabilities)	4.8	4.9	9.0	8.4	-4.8	4.9	2.8	3.7	-1.3	1.3	2.2	10.2	8.7	11.5	13.9	12.0	10.9
of which: net foreign assets	958	1,720	3,374	4,572	1,641	5,028	4,985	6,157	4,754	5,777	5,454	7,640	6,926	6,813	7,846	8,742	6,485
net forward contracts 6/	154	-438	-634	-1,586	-3,570	-2,946	-3,677	3,209	-5,382	-5,252	-4,580	-3,491	-3,364	-2,036	-1,927	-3,578	-1,722
7. Bank net external obligations maturing within 30 days 7/	979	1,621	1,241	333	731	1,665	1,599	634	161	740	1,024	2,359	255	-2,594	3,003	1,491	-3,359
8. Net international reserves of BoE 8/	1,154	1,190	1,328	1,578	1,658	1,876	1,915	1,879	1,949	2,035	1,750	1,788	1,794	1,876	1,780	1,793	1,828
9. Interest spread (in percent per annum) 9/																	
Domestic currency	10.3	7.6	5.6	5.6	7.6	4.7	8.6	10.3	7.5	4.9	5.3	6.6	8.6	7.8	9.6	8.2	9.0
Foreign currency	8.1	6.7	6.5	5.9	5.7	3.4	7.1	8.0	7.9	7.9	7.9	6.5	4.6	6.9	8.4	9.6	6.6
10. Growth of domestic credit to non-government 10/	70.0	75.3	82.3	94.3	83.9	68.4	50.5	42.8	37.5	27.6	18.6	14.9	14.3	9.7	9.9	5.2	0.7

Source: Bank of Estonia.

1/ Banks must meet reserve requirements on the basis of average reserve holdings over each reporting period.
2/ The minimum risk-weighted capital adequacy ratio was increased from 8 to 10 percent on October 1, 1997.
3/ In percent of total loans. 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.
4/ Defined as the ratio of total liabilities to total capital; a decline in the ratio indicates improvement.
5/ A (-) sign indicates a short position and includes forward contracts. Switches from positive to negative positions are normally associated with short-lived speculation against the kroon in the form of forward sales (e.g., December 1997 and August 1998).
6/ Also includes other minor off-balance sheet commitments.
7/ Commercial banks only.
8/ Excludes currency board cover and 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.
10/ Percentage change over same month in the preceding year.

Table 12. Estonia: Selected Transition and Demographic Indicators, 1993-98
(In units as indicated)

	1993	1994	1995	1996	1997	1998
Privatization and Enterprise Reform						
Share of private sector in GDP (in %) 1/	...	55	65	70	70	...
Share of privatized small-scale enterprises (in %) 2/	80	99	99	100	100	100
Share of privatized medium- and large-scale enterprises (in %) 3/	11	55	80	90	95	98
Share of private housing (in % of total housing stock)	...	15	40	80	95	...
Social Safety Net						
Poverty ratio 4/	...	...	...	...	12.8	12.3
Social transfers (as % of GDP) 5/	2.9	3.2	3.6	3.2	2.9	2.9
Number of benefit recipients as a % of population	...	15.7	15.9	16.2	16.3	16.1
Registered unemployed (period-average, in % of labor force)	2.4	2.1	2.1	2.6	2.7	2.6
Education						
Enrollment ratios (in % of relevant age group)						
Primary	96	95	96	96	97	97
Secondary	80	84	85	87	87	88
Higher	23	24	26	28	31	34
Education expenditure (in % of GDP) 5/	3.1	3.5	3.5	3.5	3.3	3.3
Teacher per student ratio	0.07	0.07	0.08	0.08	0.08	0.08
Health						
Health expenditure (in % of GDP) 6/	...	...	...	4.9	4.6	4.9
Hospitals beds, per 1,000 persons	9.5	8.4	8.1	7.7	7.5	7.3
Life expectancy at birth (in years)						
Male	62	61	62	64	65	...
Female	74	73	74	75	76	...
Infant mortality rates (per 1,000 live births)	15.8	14.5	14.8	10.4	10.1	9.3

Source: Estonian authorities, EBRD reports, World Bank, and Fund staff estimates.
1/ According to EBRD reports.
2/ Relative to total number of small-scale enterprises.
3/ Relative to total number of medium- and large-scale enterprises.
4/ Percentage of population below poverty line.
5/ Central government expenditure.
6/ Health Fund expenditures, including transfers from the central government.

Table 13. Estonia: Macroeconomic Framework, 1996-2004 1/
(in percent of GDP, unless otherwise indicated)

6/3/99 8:39 AM	1996	1997	1998		1999	2000	2001	2002	2003	2004
			Prog.	Prel. Est.	Proj. 2/	Proj.	Proj.	Proj.	Proj.	Proj.
Foreign Saving	9.7	13.2	10.6	8.6	8.0	8.9	8.2	7.6	7.0	7.0
Domestic Saving	19.2	18.5	19.6	20.7	18.0	19.1	19.6	19.9	20.3	20.3
Private	15.7	12.7	13.4	16.9	17.6	15.4	15.8	16.2	16.6	16.6
Public	3.5	5.8	6.2	3.9	0.4	3.7	3.7	3.7	3.7	3.7
Investment	28.9	31.7	30.2	29.3	26.0	28.0	27.8	27.5	27.3	27.3
Private	24.0	27.8	26.4	25.1	22.0	24.3	24.0	23.7	23.6	23.6
Public	4.9	3.9	3.8	4.2	4.0	3.7	3.7	3.7	3.7	3.7
Memorandum items:										
Fiscal balance	-1.5	2.0	2.5	-0.3	-3.6	0.0	0.0	0.0	0.0	0.0
Revenues 3/	39.0	39.6	38.2	39.5	38.3	39.2	39.2	39.2	39.2	39.2
Expenditures 4/	40.6	37.7	35.8	39.6	41.9	39.2	39.2	39.2	39.2	39.2
Foreign direct investment	2.3	2.8	3.5	10.9	7.9	5.7	5.4	5.2	3.9	3.9
GDP real growth (in percent)	4.0	10.6	8.0	4.0	2.7	6.0	6.0	6.0	6.0	6.0
CPI inflation (average year-on-year)	23.1	11.2	11.1	8.2	4.0	3.5	2.7	2.7	2.6	2.3
CPI inflation (end of year)	14.8	12.5	8.8	4.4	4.4	3.2	2.7	2.7	2.5	2.3
GDP (in millions of kroons)	52,446	64,324	78,820	73,213	78,200	85,824	93,413	101,687	110,620	119,965

Sources: Estonian authorities, and Fund staff estimates.

1/ For 2003 and 2004 includes the impact of net official transfers and lending related to EU accession, which are expected to be about 1 percent of GDP per year.
2/ Based on expectations that parliament will pass in June 1999 budget cuts amounting to EEK 1 billion (1.3 percent of GDP).
3/ Excludes privatization receipts.
4/ Includes the balance of the environmental and forestry funds, and net lending.

FUND RELATIONS[1]
(As of April 30, 1999)

I. Membership Status: Joined May 26, 1992; Article VIII

II. General Resources Account:	SDR Million	Percent of Quota
Quota	46.50	100.0
Fund holdings of currency	66.84	143.7
Reserve position in Fund	0.01	0.0

III. SDR Department:	SDR Million	Percent of Allocation
Holdings	0.22	n.a.

IV. Outstanding purchases and loans:	SDR Million	Percent of Quota
Systemic Transformation	20.34	43.8

V. Financial Arrangements:[2]

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	12/17/97	3/16/99	16.10	0.0
Stand-by	7/29/96	8/28/97	13.95	0.0
Stand-by	4/11/95	7/10/96	13.95	0.0

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

	Forthcoming				
	1999	2000	2001	2002	2003
Principal	1.9	3.9	3.9	3.9	3.9
Charges/Interest	0.6	0.6	0.5	0.3	0.2
Total	2.5	4.5	4.4	4.2	4.1

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

[2]Estonia has in the recent past agreed to stand-by arrangements with the stated intention not to draw upon them. These are called "precautionary arrangements" and further information on this type of arrangement can be found on the IMF's web site (http://www.imf.org/external/np/exr/facts/surv.htm).

VII. Exchange Rate Arrangement

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that date, the Bank of Estonia has guaranteed the conversion of kroon bank notes, coins, and reserve deposits of commercial banks at a fixed rate of exchange of EEK 8 per deutsche mark (and EEK 15.6466 per euro). The kroon is fully convertible for all current and capital account transactions.

VIII. Article IV Consultations

The 1997 Article IV consultation was concluded by the Executive Board on December 17, 1997.

IX. Technical Assistance

Mr. David Allen assumed the position of the Fund's Statistical Advisor for the Baltic States in January 1997, replacing Mr. Edward Saunders who had held the position from December 1993–December 1995. Mr. Jorma Aranko has been Resident Advisor to the Bank of Estonia since August 1998. Appendix II provides information on the Fund's other technical assistance activities in Estonia.

X. Resident Representative

Mr. Dimitri Demekas assumed the position of resident representative in Estonia and Latvia starting January 1, 1997. He replaced Mr. Basil Zavoico, who had served as the second resident representative of the Fund in Estonia since July 1994.

XI. Legislation Related to the Fund

Eleventh General Review of Quotas:	Passed in April 1999
Fourth Amendment to Articles:	Passed in April 1999

ESTONIA: FUND RELATIONS—TECHNICAL ASSISTANCE, 1996–99

Department	Subject/Identified Need	Action	Timing	Counterpart 1/
			1996	
MAE	Bank supervision	Expert	Jan.-April (5 visits)	BoE
MAE	Payments system	Expert	July	BoE
MAE	Bank supervision	Expert	August	BoE
MAE	Bank supervision	Expert	November (2 visits)	BoE
MAE	Bank supervision	Expert	December	BoE
			1997	
MAE	Bank supervision	Expert	Jan., Apr. (2 visits)	BoE
MAE/LEG	Bank supervision and legislation	Mission	October	BoE
			1998	
MAE	Bank supervision	Expert	Jan.-July (3 visits)	BoE
MAE	Bank supervision, analysis and research	Mission	March	BoE
MAE	Bank supervision	Short visit	September	BoE
MAE	Bank supervision	Resident Advisor	August (1 year)	BoE
			1999	
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Source: International Monetary Fund.

1/ BoE: Bank of Estonia; MOF: Ministry of Finance; SOE: Statistical Office of Estonia.

Relations with the World Bank

1. Estonia became a member of the World Bank on June 23, 1992. The first Bank study, a country economic memorandum (CEM) entitled "Estonia: The Transition to a Market Economy," provided a comprehensive overview of the Estonian economy following independence. The study was followed by a series of policy notes that provided advice to the government on various macroeconomic and structural reform issues. In 1994, the Bank prepared a Public Expenditure Review that was discussed with the government and other donors in May, and published in July of that year. The review formed the basis for further work on the development and implementation of the Government's Public Investment Program. In 1995, the Bank concluded a study on Local Government Financing that reviewed the country's program of fiscal decentralization. The report focused on revenue and expenditure assignment among different levels of government, local governments' investment programs, and borrowing by sub-national governments. In 1996, the Bank finalized a report entitled "Living Standards During the Transition." The report assessed the impact of the economic transition on living standards, examining the potential for improvements in living standards under the ongoing economic recovery as well as policy options to bridge the remaining poverty gap. In June 1997, the Bank completed a Public Expenditure Review Update. The report emphasized reforms to contain sources of fiscal pressure and measures to increase public sector efficiency, and reforms in the budget process. It gave particular attention to reforms in the pension system, health financing, civil service, and local government borrowing.

2. The Board of Executive Directors approved the first World Bank lending operation in Estonia, a Rehabilitation Loan for US$30 million, in October 1992. The loan aimed to support the government's reform program and to help maintain output in key sectors. A US$38.4 million District Heating Rehabilitation Loan was approved by the Bank's Executive Directors in May 1994. The main objective of this loan was to increase energy efficiency and improve environmental conditions. In May 1994, a Highway Maintenance Loan (US$12 million) was also approved, with the main objective of preserving the Estonian road network and avoiding costly rehabilitation or reconstruction. The Bank's Board of Executive Directors also approved a US$10 million Financial Institutions Development Loan (FIDL) in October 1994 with the objective of supporting the government's reforms in the enterprise and financial sector. A Health project (US$18 million) was approved in January 1995, with the aim of improving the health of the Estonian people through health sector reform. The Board also approved an Environment Loan (US$2 million) in April 1995 to improve environmental quality in the Haapsalu and Matsalu Bays. In March 1996, the Bank's Board approved an Agriculture Loan (US$16 million) that supports the government's efforts to promote ruralentrepreneurship, private ownership, technical transformation of production systems, and to re-establish a rural land market.

3. The World Bank has recently completed a CEM examining issues related to Estonia's EU accession.

Data Disclosure

1. The frequency of data collection and dissemination in Estonia varies greatly among sectors. 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. However, more detailed data are available to Fund staff for purposes of program monitoring. The following is a summary of both the frequency and the timing of key data as made available to Fund staff:

A. Monetary

2. 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 Sector

3. 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]
- Average capital adequacy ratios are available on the thirteenth banking day from the beginning of the month.[2]
- 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.

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

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

[3]Data for individual banks is also available upon request.

- Liquidity ratios are available on the eighteenth banking day from the beginning of the month.
- NFA of commercial banks is available on the seventeenth banking day from the beginning of the month.[2]
- Net open foreign exchange positions are available on the twelfth 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

4. 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.[2]
- 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.

D. Fiscal

5. All fiscal data are published by the Ministry of Finance (MoF).

- Monthly central government operations data are available with a lag of up to four weeks after the end of the month.[2] 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 two-month lag.

E. Real Sector

- Data on *GDP* (quarterly, by semester, and annually) is currently being issued by the Statistical Office of Estonia (SOE) with a lag of five months past the end of the quarter. There is a new system being implemented which is expected to reduce the lag time to two months.[2]
- Monthly CPI inflation data are available seven days after the end of the previous month, and are received directly from the SOE. Monthly PPI and Export Price Index data are available four weeks after the end of the previous month.[2]
- 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 period.[2]
- 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.[2]

Statistical Data Matrix

(As of May 31, 1999)

	Exchange Rates 1/	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Date of latest observation	5/30/99	4/30/99	4/30/99	4/30/99	4/30/99	4/30/99	4/99	3/99	Q4 98	4/99	Q4 98	Q1 99
Date received	5/30/99	5/8/99	5/8/99	5/8/99	5/19/99	5/24/99	5/7/99	5/15/99	4/15/99	5/25/99	5/15/99	4/30/99
Frequency of data	D	M	M	M	M	M	M	M	Q	Q	Q	Q
Frequency of reporting	D	M	M	M	M	M	M	M	Q	Q	Q	Q
Source of data	N	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	O 1/	O 2/	O 2/	O 1/	O 1/3/	O 1/	C 2/	O 1/	O1/	C,V 2/4/	C,V 2/	V,O 1/2/
Frequency of publication	D	M	M	M	M	M	M	M	Q	...	Q	Q
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C

Source: Fund staff.

1/ Via electronic mail or Internet.
2/ Through the resident representative's office.
3/ Broad money computed by staff based on balance sheets received (consolidated commercial banks balance sheet and central bank balance sheet).
4/ General government balance computed by staff based on separate data provided by the Ministry of Finance.

Explanatory Notes

Frequency of data: D-daily, W-weekly, M-monthly, Q-quarterly.
Frequency of reporting: M-monthly, Q-quarterly, V-irregularly in conjunction with staff visits.
Source of data: A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release.
Mode of reporting C-cable or facsimile, V-staff visits, or O-other.
Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

Statement by the Staff Representative on the Republic of Estonia
June 24, 1999

Since issuance of SM/99/130 (6/7/99), the following information became available.

1. The authorities revised their estimate for GDP growth in the last quarter of 1998 from 0.2 percent to minus 0.7 percent.[1] Preliminary official estimates suggest a decline of GDP by 5.8 percent in the first quarter of 1999, as domestic and foreign demand weakened. Twelve-month inflation at end-May was, at about 3½ percent, in line with earlier staff projections.

2. Reflecting the larger than expected decline in the economy, budget revenues in April and May of 1999 increased somewhat less than expected. However, this was offset by expenditure restraint and the staff maintains its budget deficit projections.

3. Parliament completed on June 21 the second reading of the supplementary budget, which, as indicated in the staff report, entails expenditure cuts of over EEK 1 billion. The authorities expect the supplementary budget to be passed by the end of this month.

4. Recently released official data confirm the staff's balance of payments estimates. Because of the pronounced weakening of import demand, the current account deficit narrowed in the first quarter of 1999 to about 7 percent of GDP, even though exports declined by 10 percent. Exports to Russia fell by around 50 percent, which was about in line with the overall shrinking of Russian imports. Exports to neighboring Baltic states also declined sharply as their economies slowed. By contrast, exports to EU markets rose by a brisk 10 percent.

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[1]All comparisons in this statement are with the same period one-year earlier.

Public Information Notice (PIN) No. 99/55
FOR IMMEDIATE RELEASE
July 1, 1999

IMF Concludes Article IV Consultation with Estonia

On June 24, 1999, the Executive Board concluded the Article IV consultation with Estonia[1].

Background

Since regaining its independence in 1991, Estonia has consistently pursued strongly market and stability oriented economic and financial policies, including an open tariff-free trade policy, full convertibility for current and capital account transactions, a currency board tying the exchange rate for the kroon to the deutsche mark, and an active privatization program that has resulted in the transfer into private ownership of virtually all state-owned enterprises. The combination of conservative financial policies and a strong commitment to structural reform created the conditions for an early recovery of output growth (beginning in 1995) and a decline in the inflation rate.

After increasing by nearly 12 percent in 1997, real GDP growth slowed to 4 percent in 1998. Tighter macroeconomic policies (introduced in late 1997 as part of the program supported by the Fund), the decline in the stock market, and banking difficulties in the wake of the Russia crisis in August 1998 dampened domestic consumption and investment. Output growth in early 1999 has remained weak. Overall, the direct impact of the Russia crisis on growth was relatively modest, mainly because Estonia had reoriented most of its trade to the West and the exposure of Estonian banks to Russian financial markets was limited.

Inflation continued to abate in 1998 and early 1999, with the 12 month CPI inflation falling to 3.6 percent in April 1999. The weakening of domestic demand combined with continued good export performance resulted in a marked improvement in the current account deficit, which narrowed from 13 percent of GDP in 1997 to 8 ½ percent of GDP in 1998. This deficit was financed mainly by foreign direct investment, which reached 11 percent of GDP in 1998, due largely to major purchases of Estonian bank shares by Swedish banks. Net official external debt, at around 1 ½ percent of GDP at end-March 1999, remains very low.

After a large surplus in the first half of 1998, the general government's fiscal position weakened significantly in the second half as revenue collection fell short of expectations because of the slowdown in the economy. Although nominal expenditure targets were only moderately exceeded, the sharp decline in the inflation rate resulted in real government expenditures increasing substantially, reflecting, inter alia, new public investment, compensation for depositors of a failed bank, and support for agriculture, which had been seriously affected by the Russia crisis and poor weather. As a result, the ratio of general government expenditures to GDP rose and the consolidated budget swung from a surplus of 1.8 percent of GDP in 1997 to a deficit of 0.3 percent of GDP in 1998. In 1998 the government transferred EEK 524 million to its Stabilization Reserve Fund (SRF) from surpluses generated early in the year and, in February 1999, added a further EEK 1,510 million (US$110 million) from the partial further privatization of a telecommunications company. SRF balances -- which are invested in liquid prime assets abroad -- totaled EEK 2.8 billion at end-March 1999 (US$190 million) and are over and above the foreign exchange reserves held by the Bank of Estonia as cover for the currency board.

The currency board and the fixed peg to the deutsche mark (and euro as of January 1, 1999) continued to provide a transparent and credible framework for financial operations and the formation of economic expectations. As foreign funding, which had fueled the rapid credit growth in 1997 tapered off, the growth of broad money slowed to 7 percent in 1998. Consolidation in the banking system continued, with the number of licensed banks falling from 11 to 5 in 1998 as a result of mergers involving four major banks and the failure of three smaller ones. The purchase by two major foreign banks of substantial shares in the two largest Estonian banks during the second half of 1998 provided both fresh capital and management expertise. The Bank of Estonia continued to improve banking supervision in 1998. The passage of a new law on credit institutions in February 1999 will materially strengthen the central bank's authority in exercising its supervisory functions. The new Deposit Insurance Law, which became effective on October 1, 1998, provides important protection for bank clients and further strengthened confidence in the domestic banking system.

The government's medium-term economic program is to (i) restrain budgetary expenditures and to enhance revenues through improved administration with the aim of achieving substantial budget balance from 2000 onward, (ii) maintain the currency board and current exchange rate peg until Estonia joins the European Monetary Union, and (iii) proceed with the implementation of second generation structural reforms, including pension and health sector reforms, and the resolution of complex economic, social, and environmental issues associated with the energy and oil shale mining sector.

Executive Board Assessment

Executive Directors welcomed Estonia's progress in narrowing the external current account deficit, reducing inflation, and implementing essential structural reforms. However, Directors noted that the economy had slowed significantly in 1998—and appears to have contracted in early 1999—largely because of the situation in neighboring countries and related banking system difficulties. Partly as a result, a fiscal deficit had emerged in the second half of 1998 and was likely to widen in 1999. Directors recognized that the immediate difficulties in the banking system had now been successfully overcome, and considered that Estonia's economy was well positioned for a recovery. Nevertheless, they stressed the need for the authorities to strengthen public savings to avoid any permanent weakening in the fiscal position. They also favored accelerating the implementation of the remaining structural reforms which, they considered, should result in a reduction of the overall size of the government in relation to the economy. They noted that further steps in many of these areas would be required as part of the conditions for qualifying for European Union membership.

Directors were concerned that unrealistic growth and revenue projections, coupled with real increases in pensions and budgetary wages of 20 percent and some one-time factors, had led to a sharp widening of the fiscal deficit in early 1999. They welcomed the expenditure cuts envisaged in the supplementary budget, which would assist in offsetting this deterioration. They also welcomed the intentions of the new government to aim at a balanced budget for 2000. As regards fiscal adjustment in a longer term perspective, Directors were of the view that the emphasis should be on additional spending restraint, inter alia by increasing the efficiency of government operations.

Directors took note of the rapid changes in the Estonian banking system. They agreed that inadequate risk management had accompanied the rapid growth of bank lending in 1997, which had been fueled by foreign funding. Directors considered that the banking system had been very substantially strengthened by its recent consolidation, including bank closures and mergers, and by the large participation of foreign strategic investors. They supported the ongoing strengthening of banking supervision and the authorities' intention to improve the supervision of the insurance and leasing sectors. They urged the Bank of Estonia to sell its shares in Optiva Bank as quickly as possible.

Directors noted that exports had continued to grow rapidly in 1998, and that the reduced current account deficit had been more than covered by foreign direct investment. They nevertheless considered that further reduction over the medium term in the still relatively high current account imbalance would be warranted. In this connection, and while recognizing that the traded goods sector remained competitive, Directors stressed the need for continued labor market flexibility and strong budgetary performance.

Directors welcomed the stable and predictable framework provided by the currency board and viewed the fixed exchange rate peg to the deutsche mark (and now the euro) as appropriate. They commended the fact that Estonia's exchange and trade systems were free of restrictions, which had supported the rapid restructuring of the economy and an efficient resource allocation.

Directors considered that Estonia has made excellent strides in essential structural reforms. The reliance on strategic foreign investors in the privatization process had resulted in the rapid transfer of management skills and technology, in strong corporate governance, and the development of close ties with export and capital markets. Directors supported the authorities' intention to privatize the few remaining large, infrastructure-related, state enterprises. They encouraged the authorities to continue to transfer most privatization revenues to the Stabilization Reserve Fund, and to create a clear legal basis for the operation of this fund. They also urged the authorities to establish an appropriate framework for profit transfers from the Bank of Estonia to the budget.

Directors welcomed the progress already made in preparation for European Union membership. They noted that, to a considerable extent, the agenda for further structural reform would be driven by considerations related to European Union membership. Directors recognized that more time would be needed to finalize plans, but urged the authorities, in formulating the next stage of reforms, to give careful consideration to the longer term budgetary implications of European Union membership, to health and pension reforms, to the need to phase out remaining administered prices, and to the complex economic, social, and environmental issues related to electricity generation and oil shale mining.

Directors commended Estonia's transparency regarding policy decisions and the publication of high-quality and timely statistical data and other economic and financial information. They welcomed Estonia's participation in the pilot project for the publication of staff reports.

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

Republic of Estonia: Selected Economic Indicators

	1994	1995	1996	1997	1998 1/
Real Economy	*Changes in percent*				
Real GDP	-2.0	4.3	4.0	11.4	4.0
CPI (period average)	47.7	28.9	23.1	11.2	8.2
Unemployment rate (in percent)	7.6	9.7	10.0	9.7	10.3
Domestic saving 2/	20.3	22.3	17.8	17.9	20.5
Domestic investment 2/	27.6	26.7	27.5	30.8	29.1
Public Finance	*In percent of GDP*				
General government balance	1.3	-0.5	-1.5	1.8	-0.3
General government debt 3/	7.3	6.7	6.9	4.7	3.3
Money and Credit	*Changes in percent*				
Base money	11.5	19.1	21.6	37.7	6.4
Broad money	29.6	31.3	36.8	37.8	6.6
Domestic credit to nongovernment	57.0	54.0	70.0	83.9	14.3
Balance of Payments	*In per cent of GDP*				
Trade balance	-15.5	-19.2	-24.0	-25.1	-21.4
Current account	-7.3	-4.4	-9.7	-12.9	-8.6
Gross international reserves (in millions of US$)	447	583	640	760	813
Exchange Rate					
Exchange rate regime	Currency Board Arrangement				
Present	EEK 8 = DM 1				
Real effective exchange rate (1995=100)	85.5	100.0	108.0	115.1	153.8
Of which: Non-CIS related	113.9	133.2	144.3	153.4	169.3

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

1/ Staff estimates.

2/ In percent of GDP.

3/ Net of general government deposits abroad.

Statement by Mr. Lehmussaari on Republic of Estonia
June 24, 1999

1. Let me begin by expressing my appreciation to the staff for the candid dialogue and the well-focused report on the Estonian economy. My Estonian authorities have requested the inclusion of Estonia into the pilot project for the release of Article IV reports to the public. I can confirm that the decision to participate in the pilot project did neither alter the candor nor the conduct of the discussions.

ECONOMIC DEVELOPMENTS

2. The Estonian economy has faced major challenges during the past 18 months. This era can be characterized by two phases. The first period which started in 1996 and lasted through early 1998 was characterized by buoyant economic activity which resulted in a widening of the current account deficit with some transitory speculative pressures on the currency because of the Asian crisis. In the second phase, which took hold in mid-1998, the Estonian economy contracted sharply in the wake of the Russian crisis and disturbances in the international financial markets. This first economic downturn since the beginning of the transition period is expected to abate soon, as the factors that contributed to the recession are fading. These developments created stress on the fiscal and banking sectors, and brought along a sharp increase in interest rates for a short period. The experience showed that a small and open economy, such as Estonia, is very much influenced by changes in the external environment. Under these circumstances, the Estonian authorities had to find an appropriate policy mix to balance the need for reducing external imbalances while, at the same time, mobilizing public support for continuing the reform effort.

POLICY RESPONSE

3. In recent years, economic policies in Estonia have been aimed at continuing the "second generation" structural reforms, improving competitiveness and maintaining macroeconomic stability in general. The currency board arrangement has remained the cornerstone of Estonia's monetary system and, supported by other domestic policies, has allowed interest rates to react in an appropriate manner to restore stability on foreign exchange markets.

4. During the two phases, the intermediate policy objectives changed markedly. During the first period, the main aim of economic policies was to reduce unsustainable growth rates and to create a cushion in the fiscal and financial sectors to withstand the anticipated slowdown of the economy. To that end, the fiscal policy was tightened, and a substantial part of the government surplus was sterilized through the Stabilization Reserve Fund (SRF). On the monetary side, prudential ratios of the banking sector, and capital requirements in particular, were increased, and supervision practices upgraded.

5. In the early stages of the cyclical downturn, the emphasis of economic policies was shifted to contain the adverse effects of the changes in the external environment, and to maintain

confidence in the financial system. The automatic fiscal stabilizers were allowed to absorb part of the impact of the shock. Because of lower inflation and weaker growth, government expenditures rose in relation to GDP. Nevertheless, the general government registered only a small deficit by the end of 1998 despite a sharp shortfall in revenues. In the financial area, the Bank of Estonia acted decisively in response to the emerging weaknesses in the banking sector by closing three failing banks and injecting additional capital to another bank for a transitional period. Banking supervision was also strengthened and broadened. While the authorities established few budgetary short-term measures to offer some relief to enterprises affected by the Russian crisis, the government resisted the protectionist pressures to establish trade restrictions, to use the SRF funds in reviving the economy, and to increase state aid for bailing out ineffective enterprises.

6. By now, it appears that the Estonian economy has been able to sustain external shocks fairly well. The real sector withstood the sharp hikes in interest rates, and demonstrated remarkable flexibility, as can be witnessed by the developments in the labor market, private sector wage developments and the closing of inefficient enterprises. Moreover, confidence indicators have picked up, and interest rates have fallen substantially. There has been a continuous foreign direct investment inflow throughout 1998 and early 1999, thereby financing the current account deficit in full. All these factors have allowed Estonia to maintain its competitiveness in the EU markets and in general, regardless of major devaluations in some other emerging economies over the last year. Due to the strong export performance in the EU markets, total export growth in 1998 remained strong regardless of the Russian crisis. Despite moderate decline in exports during the first quarter of 1999, the current account deficit had narrowed to 7 percent of GDP by March 1999.

7. As a result of the continuous enhancement in supervision and adherence to open financial market policies, the Estonian banking system went through the second consolidation phase by end-1998, characterized by two major mergers and the entry of Scandinavian strategic investors. The consolidation of the banking sector resulted in a significant strengthening of banks' capital base and liquidity. It also served as the main basis for the successful refinancing of outstanding foreign liabilities with medium term instruments, thereby doubling the average maturity of the debt to non-residents as compared to the previous year. In addition, risk management and corporate governance practices were reviewed. All these developments led to the renewed increase of profitability in the banking sector in 1999, despite a weaker economy.

8. However, the fiscal policy stance slipped more than warranted by the economic situation during the run-up period to the parliamentary elections. Certain increases in outlays were justified by the need to adjust the salaries of public sector professionals and raise pensions to protect the most vulnerable groups of the population. However, some increases in government expenditures, together with the overly optimistic revenue projections for the current year, and the combination of the one-off shortfall in revenue collection due to the changes in tax administration, widened the budget deficit.

GENERAL POLICY OBJECTIVES FOR 1999 AND 2000

9. The accession to the EU, and the respective Copenhagen criteria, provide broad guidelines for Estonia's economic policies over the medium term. On the macro side, relatively high and sustained growth rates should be achieved to warrant the gradual convergence of the economy towards the level in the EU. On the structural front, privatization efforts will be strengthened to maintain Estonia's competitiveness. In addition, the administrative capacity of the public sector will be strengthened to provide an adequate legal and regulatory environment for the proper functioning of market economy.

10. Estonia's exchange rate peg in the form of a currency board arrangement, supported by other domestic policies, remains the cornerstone of economic policy, providing a transparent and credible framework for economic development. In the wake of the introduction of the euro in January 1999, the kroon's link to the deutsche mark became de facto the link to the euro. The Bank of Estonia will, by end-1999, in cooperation with the EU institutions, prepare a medium term action plan for joining the European Monetary System and, eventually, the common currency area. In that context, the currency board provides a sound monetary policy framework for the preparation for the adoption of the euro, and also provides the right signals for the real economy during the pre-euro period.

11. The new government which took office in March 1999 has taken an active approach in maintaining economic growth by giving new impetus to further restructuring of the economy. The government will revise the medium term economic program for the years 1999 through 2003, which will provide broad economic guidelines for macroeconomic policies as well as a timetable for further structural reforms. That program will also serve as a basis for the Joint Assessment between Estonia and the European Commission on Estonia's Medium Term Economic Policies to be signed later this year. In addition, the accession negotiations with the EU are well on track.

FISCAL POLICY

12. The Estonian authorities fully recognize that fiscal policy will continue to play a key role in ensuring economic growth and supporting the chosen exchange rate regime. Fiscal tightening has been the first and most important issue for the new government. As room for substantial corrections for the first half of the year 1999 was limited, the government now targets a balanced budgetary outcome for the second half of the year, based on the expected recovery in the economy. For that purpose, the government formulated a negative supplementary budget that contained expenditure cuts in the amount of 1.2 percent of GDP during the second half of the year, with the majority of the retrenchment coming from administrative outlays and postponement of non-priority investments. This supplementary budget is expected to be passed in the Parliament on June 28, 1999. While the government has indicated that it would be difficult to find room for further expenditure cuts this year, it has also ruled out the use of SRF resources for budget financing.

13. The authorities are aiming for a balanced general government budget in 2000. A tighter budgetary position is accompanied by an administrative reform in order to reduce the share of the government in GDP by 2 percentage points. The government has also formulated an enhanced medium-term framework which would contain budgetary projections for the three-year period ahead. In addition, the government is reviewing the legislative basis of the budgetary framework to ensure its compliance with the Code on Fiscal Transparency and other international standards. They have requested technical assistance from the Fund for this purpose.

14. The Stabilization Reserve Fund (SRF) continues to be an essential part of the medium-term budgetary framework. The government will submit to the parliament a law that would institutionalize the reserve fund, define sources of the transfers to SRF, create an advisory council, and set rules of investment and disbursement of its resources by August 3, 1999. While the authorities have stated that the SRF assets could be used to provide a financial cushion in the event of severe financial and economic distortions in the future, the main purpose of the SRF will be to finance the remaining structural reforms, notably the cost of the transition to a fully funded pension system.

FINANCIAL SECTOR POLICIES

15. The Estonian authorities are focussing their efforts on strengthening the legislative basis for effective supervision and further development of banking supervision practices, thereby creating preconditions for the stability of the financial system over the medium term. In addition to the wide range of measures that the Bank of Estonia has implemented in 1997 and 1998 to improve the supervision of the banking sector, many important improvements are also planned to take place this year. Enhanced reporting requirements for off-balance sheet exposures were already introduced in February. The revised Credit Institutions Law, which will become effective in July, harmonizes Estonian banking legislation with EU requirements, strengthens the authorities' ability to enforce prudential standards and brings supervisory standards into better compliance with the Basle Committee standards (Estonia already adheres, in principle, to 24 out of 25 Basle core principles). Simultaneously, the Bank of Estonia will introduce new regulations on loan classification and provisioning, as well as disclosure of financial statements.

16. In order to enhance the efficiency of financial supervision over the medium term, the authorities are planning to establish a new integrated financial supervisory authority, which would cover all of the current banking, insurance and securities supervision functions. The integration process of supervisory authorities will start with the legislative reform by adopting the revised laws on securities market and insurance during this year. The unified authority is planned to start its operations in January 2002 at the earliest. However, my Estonian authorities have explicitly stressed that the quality of banking supervision will not be compromised at any stage of the process.

17. The Bank of Estonia has also started to make preparations for self-assessment procedures in order to identify Estonia's compliance with the principles of the Code of Good Practices on Transparency of Monetary and Financial Policies after its adoption.

STRUCTURAL REFORMS

18. The privatization process is now in the final stage, with only a few large public enterprises left in state ownership. Restructuring of the energy sector is by far the biggest challenge for the authorities in that respect. As the staff points out, this is an extremely complicated issue, as it also entails, in addition to several aspects of mining and electricity production, a question of potential social impact in the North East region. The government is currently developing a comprehensive strategy in addressing the issue in its entirety. In addition, the new government will finalize the privatization plans for the Estonian Railways and the remaining shares of Eesti Telekom.

19. Efforts are being made to advance with the comprehensive pension reform to a three-tier system. The Social Tax Law, Public Pension Law and Law on Private Pension Funds were passed by parliament in 1998. The new government reviewed the Social Insurance Reform Committee in May, and has given it the task to develop a framework for the second tier (mandatory contributions) by end-July. The Estonian authorities have acknowledged that the most difficult part would be to estimate the total cost of the transition and to establish financing sources. They are seeking assistance from the British Know How Fund and the World Bank in this process. The government intends to present a law which determines eligibility rules and formulas for the calculation of second-tier benefits to the parliament before end-1999.

20. Finally, my authorities have indicated their readiness to conclude discussions on a policy memorandum for a new precautionary stand-by arrangement during the Fund mission in the fall.