



RAHANDUSMINISTEERIUM



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Tallinn, June 3, 2010

Mr. Jean-Claude Juncker,
President of the Eurogroup

Ms. Elena Salgado Méndez,
President of the ECOFIN Council

Mr. Olli Rehn,
European Commissioner for Economic and Financial Affairs

Dear Colleagues,

Adoption of the euro has been a long standing objective of Estonia and the overarching anchor for sustained convergence and macroeconomic policies in line with the provisions of the Treaty. As a part of our consistent policy framework, Estonia has adhered to currency board arrangement for almost two decades. Against this backdrop, we were pleased to receive a positive opinion from the Commission in the context of the 2010 Convergence Report.

Estonia's small and open economy has undergone significant adjustment in 2008 and 2009 while being severely affected by global financial crisis. The economy has by now turned the corner and we expect the output expansion to be around 1% for 2010, and to increase to around 4% in the following year. Nevertheless, we are cognizant that this is not the time for complacency. In the challenging global environment, Estonian authorities will pursue decisive policy measures in 2010 and beyond.

Estonian authorities are fully aware that euro adoption requires an unwavering commitment to stability and strong policies. In particular, we will address the key issues and implement policy recommendations of the Commission's and ECB's convergence assessments as outlined below.

The overarching goal of Estonian authorities is to ensure economic environment conducive to sustained output and employment growth in the medium term in a context of balanced macroeconomic conditions and price stability. Our policies will also promote a continuous shift of productive resources towards high value-added activities, a precondition of sustainable development and convergence.

To this end, Estonian authorities remain firmly committed to a three-pronged framework consisting of (i) further fiscal consolidation, (ii) continuing our structural reform agenda, and (iii) further strengthening financial sector policies. This policy framework is envisaged in the Medium Term Budget Strategy for 2011-2014 adopted on May 20, 2010 and in the next National Reform Program to be adopted under the EU2020 framework, and is fully in line with Estonia's updated Convergence Program.

Fiscal policy

Estonia's fiscal policies will be firmly directed at achieving a nominal fiscal surplus by 2013 and a structural surplus by 2012, fully in line with our commitments under the Convergence Program for 2010-2013. The structural balance will improve by ½ to 1% of GDP annually over the period of 2011-2013. We stand ready to take additional measures without delay to ensure macroeconomic stability and fiscal consolidation if needed.

The overall size of budgetary expenditures will be kept unchanged in 2011 (except for resuming government co-payments to the 2nd pillar pension funds and the use of EU funds) and 2012. Current operating expenditures of the state budget remain unchanged throughout the program period. We have already implemented nearly all planned fiscal consolidation measures for 2010, including increases in excise taxes on electricity and fuels. On the expenditure side, the freeze of operational expenditures is reinforcing a significant carry-over impact of large cost-cutting measures in 2009 amounting to nearly 9 per cent of GDP. State expenditures will be further streamlined and their efficiency increased by the consolidation of administrative services that was initiated in 2010.

Estonia has already done a lot to secure the long term fiscal sustainability, as also acknowledged in the recent Commission Sustainability Report. Nevertheless, to further increase the quality of public services and to ensure long term fiscal sustainability, we intend in 2011 and 2012 (i) to improve the efficiency of social protection systems, including by use of means-tested spending where warranted; (ii) to review the system of special pensions; and (iii) to commence the analysis of financing sources of health insurance and the publicly financed component of the three-pillar pension system. The parliament has approved in April 2010 the changes to the pension system by gradually increasing the statutory pension age to 65 years.

In line with the Council opinion of Estonia's Convergence Program, we will strengthen the medium-term budgetary framework. Estonia's fiscal planning and yearly budgets are already based on a rolling four-year medium term strategy that consists of overall macroeconomic fiscal targets (including the targeted fiscal position and nominal expenditure levels) from one side, and of the costing of strategic plans of line ministries from the other side. Against this backdrop, we will further develop strategic budgetary planning, including by setting binding fiscal targets over a medium term horizon. We will also further strengthen the system of monitoring the strategic goals and reporting on them, and increase the flexibility of the fiscal framework by reducing spending rigidities.

Structural reforms

The goal of the structural reforms is to promote competitiveness and sustainable broad-based and non-inflationary growth that relies on high value-added sectors. To that end, the structural reform agenda is aimed at supporting the long-established principles of open economy, favorable business climate and market flexibility by *inter alia* (i) further improving the functioning of our already relatively flexible labor markets, (ii) ensuring the efficient functioning of markets for products and services; and (iii) supporting investment in research and development activities, and in education.

Changes to the Employment Contracts Act introduced in mid-2009 increased considerably labor market flexibility. Against this backdrop, the authorities will continue to support job creation and reducing unemployment by targeted active labor market policies, including by wage co-payments to SMEs, start-up support to small entrepreneurs, sponsoring on-the-job training opportunities, and providing for training and re-training facilities for unemployed.

Sustainable demand for and supply of labor will be supported by keeping the public sector wage bill firmly under control, in conjunction with the overall nominal freeze of operating expenditures, and by the review of public sector wage policies that was initiated in 2010. Furthermore, the authorities will continue to shift the tax burden from labor to indirect taxation during the program period. We expect that these measures support flexible market structures and will result in a reduction in unemployment and a sustained increase in employment ratio. The respective targets will be specified in the National Reform Program, fully in line with the EU2020 framework.

Open and flexible markets for goods, services and production factors are essential to sustained increase in competitiveness and to move the economy up the value added ladder. Competition on product and services markets will be enhanced by (i) strict application of competition rules, (ii) low entry costs for firms, (iii) providing nearly all public services on line via the internet, and (iv) maintaining flexible wage formation mechanisms. With Estonia's markets already almost fully opened, the opening up the wholesale electricity market (for retail consumers by 2013) and further physical integration of Estonia's electricity grid into Nordic markets was the major step forward in 2010.

The government has already initiated a number of measures to support research and development. Expenditures on R&D will achieve the level of 1.44% of GDP in 2010 and are set to increase to 3% as a target under the EU2020 framework. The government will continue and strengthen a number of initiatives to support R&D on company level, including by the use of EU funds. Furthermore, government has markedly increased (over tenfold in course of the last five years, to over 0.7% of GDP) the targeted support to enterprises' applied research, product development and innovation.

Estonia's education system has earned relatively high marks in international comparison. Looking forward, increasing the share of people with tertiary (higher) education and upgrading vocational education facilities will contribute to reducing skill mismatch and adding to the productivity of the labor force, and the relevant targets will be specified in our National Reform Program. Public appropriations to education increased by over 10% in 2010 budget and will remain the priority area in the years ahead.

Finally, public sector investments have been used to reduce the remaining bottlenecks to growth and to increase production factor mobility, notably by efficient use of EU structural funds. Public investment is expected to increase by 10% in 2011 to nearly 5 to 6 % of GDP, before leveling off thereafter. While the bulk of public investment is used to upgrade road infrastructure, the combined share of health care and education infrastructure, R&D and IT-infrastructure now account for approximately 45% of all public investment.

Financial sector policies

Financial sector policies will be aimed at ensuring financial stability and avoiding build-up of possible risks, including excessive credit growth in future.

As a main policy tool to mitigate these potential risks, Estonia authorities will stand ready to apply stricter requirements under Pillar I if imbalances start to build up in financial sector or on credit markets. Minimum capital adequacy requirement in Estonia has been higher than required by the Basel framework and also risk weights were increased in 2006. In addition, the authorities intend to use the possibilities available under Pillar II of Basel framework to target specific potential risks more accurately.

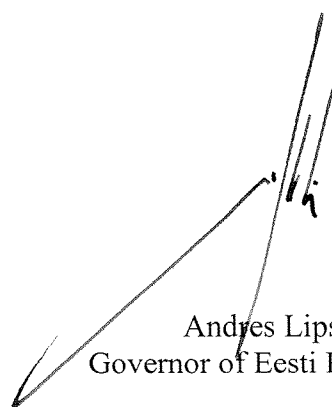
Considering the high share of branches and subsidiaries of foreign banks in Estonia, effective cross-border cooperation is essential. The EU initiatives to reduce financial sector risks and steps to improve supervisory and crisis resolution framework will play a crucial role in strengthening cross-border cooperation and improving financial stability. The role of cross-border supervisory colleges has already increased in everyday supervisory work. The planned introduction of the Cross Border Stability Groups, European Supervisory Authorities and the ESRB will further strengthen supervisory cooperation.

In addition, we will use regulative measures and other instruments, including taxation, as appropriate, (i) to reduce incentives for excessive risk taking by borrowers, (ii) to ensure that banks apply more careful credit risk assessment and (iii) to support balanced pattern of savings.

Yours Sincerely,



Jürgen Ligi,
Minister of Finance



Andres Lipstok,
Governor of Eesti Pank