

February 26, 2000

Statement by Mr. Lehmuusaari on Republic of Estonia Request for Stand-By Arrangement

March 1, 2000

At the time of the last Article IV discussion on Estonia in June 1999 my Estonian authorities affirmed their interest in concluding discussions for a new precautionary stand-by arrangement (SBA) during the fall of 1999. This commitment has materialized, and I want to thank the staff on behalf of my Estonian authorities and myself for their efforts and frank, as well as constructive, discussions which helped the authorities to develop this ambitious program.

Economic developments and outlook

Following "irrational exuberance" in the Estonian financial markets in 1997 and the outbreak of the Russian crisis a year later, Estonia has experienced its first cyclical slowdown since the beginning of the transition. The GDP growth dropped from nearly 11% in 1997 to an estimated -1% in 1999, the fiscal balance turned from a surplus of 2% of GDP in 1997 to a deficit of about 4.7% of GDP in 1999. Financial assets were priced sharply downwards, domestic credit contracted and the banking sector passed through a wave of consolidation. Nevertheless, the external current account narrowed substantially, despite the contraction of the CIS markets and the widening budget deficit.

The Asian contagion, the sharp contraction of eastern export markets after the Russian crisis, and volatile international financial markets put the economy and economic policies in Estonia to a real test. The Estonian economy proved its resilience, the economic policies withstood pressures, and adjustment occurred in an orderly way. While the growth of total exports turned negative at the end of 1998, exports to the European Union (EU) continued to grow. The Currency Board Arrangement (CBA) successfully passed market tests and, although the fiscal policy missed the set targets, largely because of recession, the budget deficit was reduced in the second half of 1999. The financial sector emerged from the crisis stronger than ever, with more than 90% of the banking market controlled by Nordic banks. Moreover, the supervisory framework was strengthened and Estonia maintained favorable credit ratings.

The Estonian economy has by now largely completed the adjustment process induced by external shocks and economic activity is picking up. The exporting sector started to revive in the third quarter of 1999. The first signs of recovering domestic demand became evident in the last quarter, as credit growth was edging up and imports of investment goods surged. Increasing demand in the EU supports the recovery in the exporting sector, which is the main engine for sustained growth. Given an improved outlook for the global economy, and having undergone a domestic restructuring process, Estonian exporting industries are well placed for a new expansion. On balance, for the year 2000, Estonia expects its economy to grow by 4%, CPI inflation to be around 4%, and the current account to widen somewhat.

Why the SBA?

The authorities see the main objectives of the SBA as three-fold:

- to support their stabilization efforts, in particular in restoring fiscal balance and underpinning key second generation reforms;
- to strengthen the domestic economic policy dialogue; and
- to ensure the consistency of short-term policies with the medium-term EU accession strategy.

Main policy commitments embodied in the SBA

Let me now turn to the main policy commitments the authorities have undertaken. In this connection, the authorities want to emphasize that the policies embodied in the SBA and briefly discussed below are also an integral part of the Medium-Term Economic Program for the period 1999-2003 which sets out Estonia's economic policy framework of the national EU accession strategy.

Monetary and financial policies

The Currency Board Arrangement has served Estonia well for almost 8 years, and remains the cornerstone of Estonia's economic policies. Estonia has already been conducting active accession negotiations with the EU for two years, and this process will end with a full membership in the Economic and Monetary Union (EMU). My authorities believe that the CBA remains the most suitable monetary framework up to that time, ensuring the real and nominal convergence of the Estonian economy with that of the eurosystem by the time of the actual transition to euro.

The Estonian authorities see two arguments supporting this proposition. First, the CBA has proved its robustness during the full economic cycle and has successfully withstood various shocks in the course of the past years. The real sector has demonstrated remarkable flexibility in adverse economic conditions and thus supported the resistance of the existing monetary arrangement against internal and external economic shocks. Second, the CBA is, in principle, consistent with the ERM2 requirements for exchange rate stability and also with the EMU principle of exchange rate policies being a matter of common concern, as it excludes the use of monetary and exchange rate policies as an adjustment channel to shocks.

My authorities also want to stress the bilateral nature of this process. A changeover from the CBA to the euro will take place according to a mutually agreed accession strategy between Estonia and the EU institutions. Initial discussions have been held on the issue of the suitability of a CBA as a compatible monetary framework for joining the EMU, including at two seminars organized last November by the European Central Bank and the European Commission. We are also pleased to note the staff's firm support of the authorities' position, as can be seen from the staff reports.

As a part of EU accession process, the authorities are committed to completing the detailed analysis of Estonian monetary legislation during the course of 2000 to ensure its compatibility with the EU *acquis* and to submit necessary amendments to the legislature by the end of 2001. While the CBA remains unchanged, they are also actively working on the review of the current monetary framework, with the aim to reduce market distortions and to achieve full compatibility with the eurosystem over the medium term. The review specifically addresses the current structure of reserve and liquidity requirements, as well as the rate of remuneration.

The authorities intend to further strengthen the regulatory framework and the financial sector safety net. To this end, Estonia is participating in the FSAP/FSSA pilot project. We expect the initial assessment to be completed by the end of March. In order to adapt the supervisory framework to market developments, the authorities aim to finalize the organizational and legal principles of a unified supervisory agency by the end of June 2000. A formalized framework for addressing systemic risks in the financial sector, including the division of specific responsibilities between the Government and the Bank of Estonia, will be established by the end of this year.

Fiscal policy

Fiscal consolidation and streamlining of public finances are at the heart of the program. The fiscal policy slippage in 1999 was largely due to a combination of two factors. In the run-up to local and parliamentary elections, growth forecasts for 1999 were overly optimistic and, as the recession was steeper than expected, fiscal targets turned out to be unattainable. The new government implemented expenditure cuts, including a "negative" supplementary budget, and the fiscal position improved significantly in the second half of 1999. The authorities have expressed their firm intention to return to fiscal balance by 2001, and will, in the meantime, limit the deficit to 1.25% of GDP for 2000. This will gradually reduce the government's share in the economy. The authorities are also ready to implement contingency measures should revenues fall short of the targeted level. Over the medium term, my Estonian authorities aim at a broad budget balance.

Effective January 1, 2000 the corporate income tax on retained earnings was eliminated. Impact of the abolition of corporate income tax is compensated by the tax policy and administration measures. Authorities believe that this will eliminate inefficiencies stemming from the double taxation of profits and boost investments.

The SBA foresees a continuation of the comprehensive reform of public finances. Reforms are driven by EU accession requirements and aim at strengthening the administrative capacity of the government sector. The government has already made progress in this area. The Ministry of Finance periodically publishes general government accounts and has considerably strengthened the reporting and risk management of the Treasury. Submission of the draft of the State Budget Act, which reflects the requirements of the Stability and Growth Pact, to Parliament by July 1, 2000, is among the authorities' top priorities. The draft legislation stipulates that all government revenues and expenditures, including those financed by foreign loans and transfers, are included in the budget. The new State Budget Act would also strengthen the central government's ability to better control the general government operations. The Government has already submitted a draft legislation to the Parliament which will increase the transparency of public employment and remuneration.

The Stabilization Reserve Fund (SRF) continues to be an essential part of the medium-term budgetary framework. In 1999 the Parliament passed legislation which institutionalized the SRF effective January 1, 2000, and stipulates the sources and use of SRF balances, as well as its governing structure. The authorities anticipate that the bulk of the SRF resources will be used to finance the pension reform. However, the SRF also continues to serve as a cushion against unexpected and severe macroeconomic shocks.

The authorities are aware of the increase in expenditures which is associated with the EU accession. While the outlays are particularly sizable in the area of the environment, energy and transportation, they will be financed in substantial part through grants under the different EU programs. As a result of preparations for joining NATO, Estonian defense expenditures will increase to 1.6% of GDP in 2000 and could require some further increase over the medium term.

Structural reforms

Implementation of the pension reform is a key for ensuring long-term fiscal sustainability. Financing options of the second fully funded pillar, which has the largest macroeconomic implications, will be discussed in Government

shortly. The authorities are committed to present relevant legislation to Parliament by December 2000 at the latest, and full implementation is expected in late 2001 or early 2002. The authorities have also requested technical assistance from the World Bank and the IMF in connection with the pension reform. In combination with health care reforms, this will lead to a more efficient social safety net.

Estonia has reached the final stage of privatization. My authorities are committed to divest their remaining shareholdings in Estonian Telecom. Also, the privatization of the major freight and transit line Estonian Railways is expected to be concluded by the end of 2000. Moreover, the authorities have put major effort into privatizing the complex power generation and distribution network. Negotiations with the US based energy company NRG Energy are proceeding well and are expected to be completed by the end of June 2000. In this regard, the authorities also seek to ensure a high degree of competition among energy producers and are committed to provide the Energy Inspectorate with sufficient regulatory powers and resources. The authorities are well aware of the economic dislocation which is accompanying the rationalization of an inefficient energy system, and are seeking assistance from the World Bank to develop a framework for the development of northeast Estonia, the region which is mostly affected by restructuring.

Transparency initiatives

Finally, my Estonian authorities wish to confirm their commitment to adhere to the best standards and practices of transparency of economic policies. Estonia has subscribed to the SDDS and is participating in the pilot project of the publication of Article IV staff reports. The authorities have planned to initiate an assessment of compliance with the Code of Good Practices in Fiscal Policies by July 2000. An assessment of compliance with the Code of Good Practices in Monetary and Financial Policies is already underway in the framework of the FSAP exercise.