II. THE CHANGING EUROPEAN UNION AND ESTONIA

On 1 May 2004 the accession countries are to become full members of the European Union and a significantly larger number of parties will have a say in shaping the EU policy. In order to successfully integrate into the everyday operations of the EU, the new Member States began to participate in the work of most of the EU institutions as observers immediately after signing the Accession Treaty in April 2003. This means that in several issues these countries have the right and obligation to participate in the discussions on an equal basis with the Member States while having yet no right to vote. Also, citizens of the accession countries now have the opportunity to work for the EU institutions. Eesti Pank's main partners are the European Central Bank and the national central banks of the countries that are members of the European System of Central Banks[1], but in some issues related to economy, finance, and the financial sector the central bank of Estonia has also been involved in the work of the committees and working groups of the Council of the European Union and the European Commission. The Bank also actively participates in national cooperation bodies and in preparing economic policy programme documents concerning monetary policy and the financial sector.

EU ENLARGEMENT

Signing the Accession Treaty on 16 April 2003 was the highlight of the year not only for the accession countries but also for the whole European Union. The condition for the Treaty to enter into force was its ratification by the parliaments of all current member and accession countries. All accession countries, except Cyprus, also decided to ask for the public opinion regarding the upcoming accession, and the outcome of all referenda was positive. The Estonian referendum was held on 14 September and 66.8% of the voters were in favour of accession to the EU. **As of 1 May 2004 the European Union has 25 Member States:** Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, the United Kingdom; and the new members – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. With the addition of the new Member States the population of the European Union grows from 380 million to over 450 million while the EU GDP increases by 5%. Along with the expansion of the EU also the European Economic Area[2] broadens, which was a subject of separate negotiations in 2003.

The year 2003 was the last time when the EU was holding a dialogue with the accession countries based on the Europe Agreement. In November the last Monitoring Reports of the accession countries were published, which in principal confirmed their readiness to join the EU. Meanwhile the European Commission

[1] The European System of Central Banks (ESCB) comprises the European Central Bank (ECB) and all the national central banks (NCBs) of the EU Member States.
[2] Besides the EU Member States, also Iceland, Liechtenstein, and Norway are members of the European Economic Area.

is continually monitoring the preparations of the accession countries until they join the Union to make sure that the commitments made in the accession negotiations are met, thus ensuring equal conditions to all the members of the expanded EU.

INSTITUTIONAL IMPACT OF THE ENLARGEMENT

The so far biggest enlargement in the history of the European Union has created a need for changes also within the Union. Institutional changes required for efficient functioning of the Union were agreed upon by the European Council in Nice in 2000 and the respective Treaty entered into force on 1 February 2003[3]. However, the stipulations of the Treaty of Nice offer just a temporary solution and, therefore, work has started on drafting a new Constitutional Treaty.

Upon accession to the EU the new Member States are to become members of the Economic and Monetary Union with a derogation and the ESCB is to grow by ten central banks. Due to the growing number of members the ECB has been engaged in institutional and technical preparations besides analysing the economic impact of the enlargement. Among other things, an adjustment of the voting modalities in the Governing Council of the ECB has been agreed on and was approved by the Council of Ministers, meeting in the composition of the Heads of State and Government on 21 March 2003.

CONSTITUTIONAL TREATY

The enlarging and changing European Union also needs a new treaty. The principal goals of the new Treaty on European Union, also called the Constitutional Treaty, are to simplify the current system of treaties, specify the competencies of the member countries and the EU in more detail, and reach new agreements in institutional and voting issues.

In order to prepare the Constitutional Treaty, the Convention on the Future of Europe was set up in 2001 with the aim of reaching as many agreements as possible before the Intergovernmental Conference entitled to change the treaties[4] was convened. Considering the fact that the Constitutional Treaty would enter into force in the enlarged European Union, the future Member States were granted the opportunity to participate in the Convention as well as in the Intergovernmental Conference on an equal basis with the current Member States. The Convention on the Future of Europe finished its work in the summer of 2003 and **the Intergovernmental Conference was launched last October** with the aim of completing the work by the end of the year. At a meeting between Heads of State and Government held on 12–13 December the agreement was not reached in all the required issues and after success achieved at bilateral negotiations the Conference will continue in 2004.

ECONOMIC AND FINANCIAL POLICY OF THE EUROPEAN UNION

The EU economic policy focuses on the goal set by the European Council in Lisbon to become the most competitive knowledge-based economy in the world by 2010. This is the objective that the overall economic policy activities of the EU follow. The economic issues are very important in the programmes of the countries holding the presidency in 2004, Ireland and the Netherlands, since economic growth in Europe

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[3] The most significant changes made by the Treaty of Nice and adjusted by the Accession Treaties are as follows: as of 1 November 2004 the total number of votes in the Council of Ministers shall be 321, of which Estonia holds 4. During the transition period from 1 May to 31 October 2004, the old model shall be applied according to which each country holds 2–10 votes. As of 1 November 2004 each country shall have one Commissioner in the European Commission; to date, five larger countries have had two Commissioners. Besides, the distribution of the seats in the European Parliament was agreed upon. In the composition of 2004–2009 Estonia shall hold 6 seats out of 732.

[4] All Member States must then ratify all the agreements concluded at Intergovernmental Conferences.

has significantly underperformed its potential in recent years. Also the review of the year 2003 shows that the EU Member States must make serious efforts in order to reach the goal because the countries have not made enough progress in many areas, e.g. employment (primarily the issue of active aging), corporate competitiveness as well as research and development and infrastructure. In order to promote the latter two areas the European Action for Growth was adopted in the European Union, which includes a range of projects in infrastructure and research and development. The projects are co-financed by the private and public sectors.

The Broad Economic Policy Guidelines are the centre of the EU economic policy coordination, and include both general as well as country-specific recommendations on activities that are needed to meet the goals that have been agreed on. Since many reforms require considerable time to be implemented and to make their impact, guidelines are drafted for three years, and in the meantime the countries focus on the implementation. The economic policy priorities for 2003–2006 are as follows:

- promoting economic growth;
- increasing employment;
- sustainability of public finance.

According to the Implementation Report on the Broad Economic Policy Guidelines, success was achieved in labour market and pension reforms in 2003. Meanwhile, the problems with labour market flexibility persist, there has been little reform of the benefits system, the efficiency of active labour market policy has received little boost, and legislative regulation has not been considerably reduced. Neither has there been sufficient activity in research and development investments, nor in channelling research initiative into entrepreneurship, nor promoting the social and natural environment. The biggest problem the EU faces is the fiscal situation, due to the need to reform the pension systems and in particular the healthcare systems in the light of long-term sustainability and on account of the budgetary positions of the Member States that deteriorated in 2003[5]. For example, as a consequence of exceeding the maximum budget deficit allowed under the Stability and Growth Pact, the excessive deficit procedure[6] was initiated against two countries – Germany and France. At the same time, the situation initiated a discussion regarding sufficient flexibility of the Stability and Growth Pact, first and foremost in the context of a weaker economic situation.

Several studies have shown that a significant possibility for the EU to promote economic growth is integration of the financial markets. This is why the Financial Services Action Plan was worked out in 1999 to be completed in 2004. In order to spot the bottlenecks in the integration of the financial sector, the EU carries out detailed studies of the situation in different parts of the financial sector. For that purpose an extensive range of respective indicators is being applied, and new Member States have been involved in providing evaluations.

In 2003, considerable headway was made upon implementing the Financial Services Action Plan, of which the adoption of the following legal acts can be regarded as the most significant:

- Directive on the prospectus to be published when securities are offered to the public or admitted to trading;
- Directive on insider dealing and market manipulation;
- Directive on taxation of savings income in the form of interest payments;
- Directive on takeover bids.

In order to implement the Action Plan it is imperative that the following legal acts are approved or respective draft legislation submitted:

[5] The average budgetary deficit of the EU Member States in 2002 stood at 1.9%, and in 2003 it was 2.7% of GDP.
[6] If the budget deficit of a Member State rises above 3% of GDP and it is considered to be neither temporary nor exceptional, the European Commission shall initiate the excessive budget deficit procedure. Based on the report of the Commission and the opinion of the Committee on Economic and Monetary Affairs, the Council of Ministers shall decide whether an excessive deficit exists. If excessive deficit does exist in a country, the Council shall make recommendations to the Member State concerned with a view to bringing that situation to an end within a given period. If the Member State does not comply with the suggestions, the Council can apply different measures, of which the strictest is imposing a fine on the country.

- Directive on capital adequacy of banks and investment firms;
- Directive on the harmonisation of transparency requirements with regard to information on issuers whose securities are admitted to trading on a regulated market;
- New directive on investment services;
- New legal framework for payment systems;
- New draft directive on the prevention of money laundering.

Fast development and implementation of legislation regulating the activities within the financial sector is certainly upheld by the upcoming expansion of the so-called Lamfalussy[7] committees from the securities market also into the banking and insurance sector. The clumsiness and high time consumption of the current co-decision procedure of the Council of the European Union and the European Parliament in addition to the positive experience in the area of securities served as an impetus to implement the new system. According to the Lamfalussy plan, in place of the Council and the Parliament, drafting laws and monitoring their implementation is the responsibility of expert committees, which is a more flexible arrangement. The co-decision procedure must be consistently applied in the case of framework laws, but developing, approving, and monitoring implementation of legal acts of more technical nature based on such laws falls into the committees' competence.

According to the Treaty establishing the European Community and the Statute of the European System of Central Banks and of the European Central Bank, the primary objective of the ESCB is to maintain price stability. Based on the decision of 13 October 1998 the monetary policy strategy of the European Central Bank comprises three parts: a quantitative definition of price stability, a prominent role for money in the assessment of risks to price stability (including M3 reference value), and a broadly-based assessment of the outlook for price developments. According to the strategy, price stability has been defined as less than 2% year-on-year growth in the Harmonised Index of Consumer Prices over the medium term. **In 2003 the European Central Bank carried out a thorough evaluation of its monetary policy strategy to date.** On 8 May the Governing Council of the ECB confirmed continuation of the hitherto strategy and it was agreed that the inflation rate over the medium term should be below, but close to 2%. Such a specification highlights the commitment of the European Central Bank to provide a sufficient safety margin to guard against the risks of deflation. Besides, the Governing Council of the ECB decided not to review the M3 reference value every year since the monetary policy analysis characterises long-term price development.

ECONOMIC POLICY DIALOGUE AND COOPERATION BETWEEN THE NEW MEMBER STATES AND THE EU STRUCTURES IN THE NEAR FUTURE

The new EU Member States are to become involved in coordinating the economic policy of the Union step-by-step. Prior to joining the EU, pre-accession procedures are in force. This is followed by a smooth changeover to the procedures applied in the member countries as a result of which economic policy dialogue with the EU will become considerably closer. **In August Estonia submitted its traditional Pre-accession Economic Programme to the European Commission, whereafter it** was discussed with the EU member countries in the Economic and Financial Committee and in the dialogues between the Ministers of Economy and Finance of the Member States and the acceding countries. Pre-accession Economic Programmes are similar to the Stability and Convergence Programmes[8] applied in the EU member countries. **The new Member States are expected to submit their Convergence Programmes in May 2004.** At the end of

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[7] Alexandre Lamfalussy headed the so-called Committee of Wise Men, which suggested a reform for a faster procedure of the legal acts regulating the securities market

[8] The Stability Programme is drawn up by Member States of the euro zone. The EU Member States that do not belong to the euro zone draw up the Convergence Programme.

2003 the acceding countries had a voluntary option to submit a Report on Economic Reforms (the so-called Cardiff Report). The countries that submitted the Report, including Estonia, were analysed in the Annual Report on Structural Reforms of the Economic Policy Committee on an equal basis with the current Member States. Immediately prior to joining the Union the new Member States will be given country-specific Broad Economic Policy Guidelines, and as of 2005 the situation in the new Member States is to be evaluated in the Implementation Report of the Broad Economic Policy Guidelines. **Also, similarly to other Member States, the new Member States will submit the required budget statistics in their fiscal notifications in spring and autumn.** Based on this and the information included in the Convergence Programme, the European Commission shall initiate the excessive deficit procedure if needed, and provide respective suggestions. As of spring 2004 the acceding countries, including their central banks, are to participate in the macroeconomic dialogue (the so-called Cologne process) twice a year in the course of which pay issues are discussed with social partners from the viewpoint of the macroeconomic situation.

The acceding countries became involved in most of the EU structures as of the moment the Accession Treaty was signed. As regards shaping the EU economic policy, their participation has intensified since the autumn of 2003. **The most important economic policy decisions are made at the meetings of the Economic and Financial Affairs Council (ECOFIN) held once a month.** Twice a year informal meetings of the ECOFIN involve also the governors of central banks. Besides the Council meetings, different committees and working groups play a very important role in the EU since they discuss and prepare decisions to be made by the ministers on expert level. In the area of economic policy the most important committees are the Economic and Financial Committee and the Economic Policy Committee.

The European Central Bank and the European System of Central Banks play an important role in the economic policy dialogue between the EU and the Member States. Besides implementing the single monetary policy, there are many other areas in which the activities of the ECB play a very important role in working out common EU policies and regulative acts: areas such as financial stability, payment systems, issuing of euro cash, and security of banknotes as well as many fields of statistics. The ECB did not officially take part in the accession negotiations with the candidate countries, but its representatives participated in the most important meetings between the current and future Member States and the EU institutions. The role the ECB has played upon preparing the central banks of the accession countries to join the EU and the Eurosystem is of particular significance. Similarly to the committees and working groups of the Council of Ministers and the European Commission, the representatives of the central banks of the acceding countries have participated as observer members in the work of the General Council of the ECB as well as in the committees and working groups of the ESCB since May 2003.

EUROPEAN SYSTEM OF CENTRAL BANKS

The European System of Central Banks is composed of the European Central Bank located in Frankfurt and the central banks of the European Union Member States. The ESCB and the ECB were set up on 1 June 1998. The ECB together with the national central banks of the countries which have adopted the euro and the single monetary policy is called the Eurosystem. As of 2003 the Eurosystem comprises 12 countries: Austria, Belgium, Finland, France, Germany, Greece, Luxembourg, the Netherlands, Ireland, Italy, Portugal, and Spain. The euro and the single monetary policy have not been implemented in Sweden, Denmark, and the United Kingdom.

The primary objective of the ESCB is to maintain price stability. In addition, without prejudice to this objective, the ESCB also supports implementation of the economic policies of the European Union. To meet its objective the ESCB has the following tasks:

- *to define and implement the single monetary policy;*
- *to conduct foreign exchange operations;*
- *to hold and manage the official foreign reserves of the Member States;*
- *to promote the smooth operation of payments systems;*
- *to support other European Union institutions in working out financial stability and banking policies.*

The decisions to be taken in order to carry out these tasks are made by the ECB so that the single monetary policy is developed bearing in mind the euro zone in its integrity. The principal decision-making body of the ECB is the Governing Council that meets twice a month. The Governing Council comprises the governors of the central banks of the Eurosystem and the Executive Board of the ECB. All heads of the EU central banks, the President and Vice-President of the ECB comprise the General Council of the ECB, which meets four times a year to discuss the monetary and financial issues concerning all the EU countries. Implementation of the decisions made by the Governing Council and the General Council as well as daily operations of the ECB are handled by the six-member Executive Board. Meetings of the Governing Council and the General Council are prepared by 13 advisory committees that comprise representatives of the national central banks of the ESCB and staff members of the ECB.

Besides participating in the decision-making process of the ESCB the competencies of the national central banks also include implementation of the decisions pertaining to monetary policy transactions, maintenance of payment systems, gathering and analysing statistics, holding the money reserve, and circulation of information on the national level. This way the operations of the ESCB enable to pass common decisions while making maximum use of the network and know-how of the national central banks.

CHANGES IN ESTONIA'S INTERNAL COORDINATION SYSTEMS OF EU ISSUES

Evolving from a candidate country into an acceding country and subsequently into a Member State has changed the character of Estonia's internal coordination system of EU issues. The earlier dialogue with the EU concerned mainly monitoring Estonia and the activities needed to become a member, whereas now Estonia can and must have a say in shaping the policies of the European Union. Since Estonia is a small country, efficient operations require joint activities with focus on the most important areas. Therefore, a document regarding the government's European Union policy for 2004–2006 was drafted at the beginning of 2004. The parties involved in compiling the document included the ministries, Riigikogu, and the third sector. Eesti Pank contributed as well.

Due to the close integration of EU policies, cooperation within a country has become even more important than before. Estonia has opted for the decentralised model in dealing with EU issues, according to which the ministry in whose sphere of responsibility a respective issue rests also holds the responsibility for establishing the national position and its integrity. Eesti Pank holds responsibility according to the same principle. In order to coordinate their standpoints the central authorities may apply the best possible solutions from their point of view; however, most of the work is carried out either in permanent or ad hoc working groups, which can involve the private sector or non-governmental institutions if necessary. Solutions to most problems are sought for in expert-level working groups. If no common ground is found in such groups, the issue moves to the next level – the Council of Senior Officials (CSO) whose work involves representatives of the State Chancellery, all ministries, and Eesti Pank. If no agreement is reached there, the substantive issues are referred to the government level. The government must approve all Estonia's positions that are presented to the Council of Ministers of the European Union.

There are two other parties in the national coordination scheme: the Ministry of Foreign Affairs as the central connecting link between the government and the permanent representation of the EU; and secondly the EU Secretariat subordinated to the Prime Minister[9], whose principal tasks include offering secretariat services to the CSO, preparing issues on the government agenda that are related to the EU, and resolving differences in forming standpoints on expert level.

ON THE WAY TO THE ECONOMIC AND MONETARY UNION

The accession countries that are to become members of the European Union on 1 May 2004 will also become members of the Economic and Monetary Union with a derogation. In order to become full members of the EMU, the new Member States, including Estonia, must adopt the euro in the future, i.e. join the Eurosystem. The earliest time for this is 2006. A solid economic foundation for Estonia's integration both with the EMU and the Eurosystem has been established by a close link of the Estonian economy with the economies of the EU Member States, and by the fact that our monetary policy has been strongly tied to the monetary policy decisions of the Eurosystem (earlier of Germany) (see, e.g. Figure 3.1, Chapter III).

[9] Successor to the former European Integration Bureau.