

FIFTEEN YEARS OF THE ESTONIAN KROON

INTRODUCTION

By 2007, 15 years had passed since the re-introduction of the Estonian kroon. During this period, the Estonian economy, financial system and the central bank have undergone considerable development.

In 1992, the foreign reserves of the central bank amounted to approximately 2.5 billion kroons only, out of which the excess reserve comprised approximately 590 million kroons. In fifteen years (by 2007), the monetary reserve of Eesti Pank has grown to 33.7 billion kroons and the excess reserve to 4.2 billion kroons. Today, Eesti Pank is a modern and effective national central bank of a small economy.

The time following the monetary reform in 1992 was difficult for both the Estonian economy and financial system. Average monthly wages reached just over 1,000 kroons in 1992 (over 12,000 kroons in the fourth quarter of 2007) and the inflation rate reached 1,077 per cent. It was necessary to reorganise the banking environment and create a legal framework that would function in the conditions of market economy.

By now, Estonia is an EU Member State and has set itself the goal of becoming a full member of the

Economic and Monetary Union. Our financial environment is strong and has earned the confidence of international investors. After the extremely strong growth period, Estonia's economy has now reached a more stable and less risky path. In 2007, growth was not as rapid as in the last couple of years, but this is actually beneficial with regard to sustainable development. Prices grew faster in 2007 compared to recent years, but a more detailed analysis of the underlying factors shows that the temporary acceleration of inflation was well expected (for more details see page 111). This reflects the ongoing convergence of income and price levels towards the EU average. In addition to comparing the economic data of the last couple of years, one should look back a little further to understand what the Estonian economy has gone through during the fifteen years of the kroon (see Figure 1).

What has been the role of Eesti Pank in all that?

The principal tasks of Eesti Pank are and will be the same as described about 90 years ago by the then Governor of Eesti Pank, Jüri Jaakson.

The cornerstone of each and every economy is a firm monetary unit, which is a gauge of economic

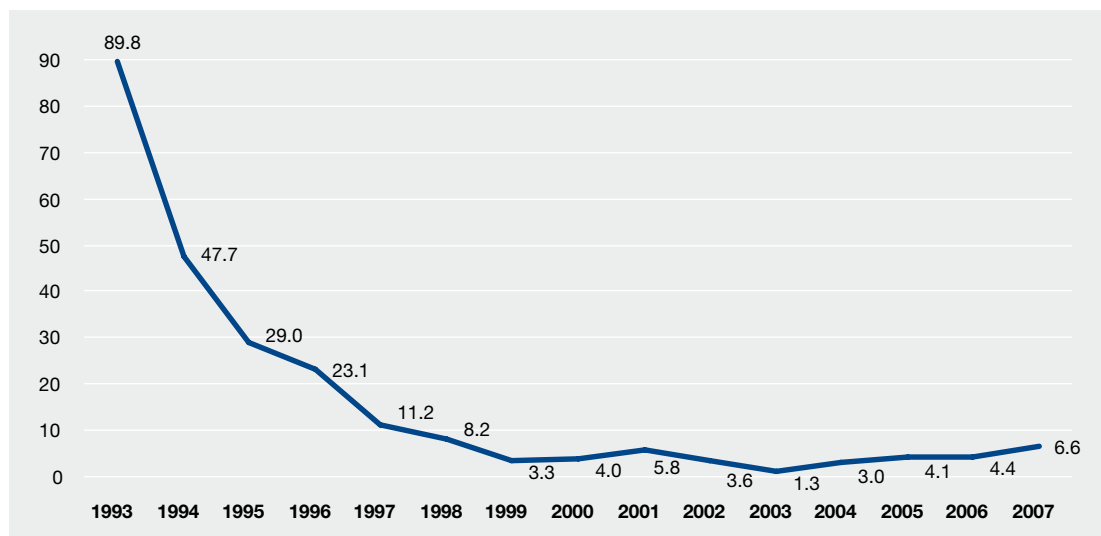


Figure 1. Consumer price index in the years after the monetary reform

values. This monetary unit must not fluctuate, it must not be dependent on random external factors, or else it will lose its value as a stable gauge. Each industrialist, every merchant and any other entrepreneur who creates economic assets or obtains them for reselling must have the opportunity to make a definite pre-calculation as to the cost of these assets to him and the price at which he will have to pass them on in order to make both ends meet. /.../ Therefore, maintaining the firm value of a monetary unit is an enormous, difficult, and very responsible task in every country.

Above all, the central bank has the right – and obligation – to bring stability to the economic environment. The Estonian kroon that has remained stable for fifteen years is the prime example of the appreciation of stability. The same can be said about the Estonian monetary system, which has served as the basis for central bank activities both in good and bad times.

A stable monetary system requires a stable and efficient financial system. In the course of financial sector reorganisation in the first half of 1990s, the central bank did not hesitate to liquidate poorly managed insolvent banks. Neither did the Government hesitate when it was necessary to liquidate poorly managed insolvent enterprises that were manufacturing for stock. The privatisation of public enterprises by core investors for “real cash”, and, if necessary, the liquidation of state enterprises that were operating in the red laid the foundation for the emergence of a strong business sector with free competition.

The right and obligation of the central bank to contribute to shaping Estonia’s economic policy has been set down in the Eesti Pank Act. But this task can only be performed in cooperation with the Government and other constitutional institutions. Eesti Pank has always stressed the importance of economic reforms and a stable, predictable budget in ensuring the stability of the kroon’s exchange rate and the financial system. Looking back to

the past fifteen years, we can say that economic policy cooperation has been smooth and has also produced good results.

The following is a brief insight into the most significant events of the fifteen years of the kroon within the Estonian monetary and financial environment.

1992–1994: MONETARY REFORM AND REORGANISATION OF THE BANKING SYSTEM

Monetary reform

The monetary reform in Estonia, which was the first of the former rouble zone countries to introduce its own national currency, took place on June 20, 1992. The Estonian kroon was declared the sole legal tender in circulation and Eesti Pank the only regulator of monetary relations in Estonia. The official exchange rate of the Estonian kroon against the German mark was set at DEM 1 = EEK 8. Within three days, every resident natural person could exchange 1,500 roubles for kroons at the rate of EEK 1 = RUB 10 (the exchange rate corresponded to the market rate of the German mark and the Soviet rouble at that time). Almost the total amount of roubles in circulation in Estonia (deposits, money held by enterprises, etc.) was exchanged for kroons at that rate. All the laws and other regulations scheduled for the beginning of the monetary reform took effect. Eesti Pank started to publish the daily exchange rates of the Estonian kroon against the major foreign currencies.

Since the monetary reform, Estonia’s monetary policy has been based on the strict principles of the **currency board arrangement**. In order to maintain the fixed exchange rate of the kroon, the central bank’s liabilities, including the monetary base in the economy, must be fully guaranteed by gold or foreign exchange reserves. The reserves backing the kroon were composed of pre-war gold deposits of the Republic of Estonia returned by the Bank of England and the Bank for International Settlements, and of foreign currency with which Sveriges

Riksbank (State Bank of Sweden) compensated for the gold of the Republic of Estonia deposited in Sweden before the war.

Eesti Pank operates independently of other state authorities. Under the currency board arrangement, the law prohibits the central bank to credit the central government and local governments either directly or indirectly. In accordance with the law on the security of the Estonian kroon that took effect on the day of the monetary reform, Eesti Pank has no right to devalue the exchange rate of the kroon.

The most important monetary policy instruments are the standing facility of buying/selling foreign currency and the reserve requirement for banks. Arising from the currency board framework, the reserve requirement ratio is considerably higher in Estonia (currently 15% of the reserve) compared to other exchange rate mechanism countries.

First years after the monetary reform

In the years after the monetary reform, the main objective of Eesti Pank was to **create a stable financial environment and general credibility of the financial system and to develop a banking system that would meet the requirements of a market economy.**

To increase the efficiency and credibility of the monetary system and improve the ability of the financial system to absorb liquidity, Eesti Pank allowed commercial banks to maintain an unlimited German mark open position. This showed again the complete security of the Estonian kroon and the expectation for the long-term stability of the system.

In April 1994, the central bank started to conclude up to seven year futures transactions between the Estonian kroon and the German mark. This helped to further increase the credibility of the Estonian kroon and to reduce speculations on devaluation. The conclusion of futures transactions was ended

in March 1995 when the need for such instruments ceased to exist.

The legislative system that entered into force with the monetary reform and regulated foreign currency transactions (included restrictions on capital account transactions and imports and exports of foreign currency; prohibited exchange of non-convertible foreign currency; required the registration of foreign loans, etc.) was gradually loosened. With the repeal of the Foreign Currency Act in April 1994, the restrictions were completely abolished. Estonia was one of the first Eastern and Central European transition countries to abolish restrictions on the free movement of capital.

For more efficient functioning of the financial system, banks' reserve requirements were specified for several times in 1993-1994. The special reserve ratio of Hoiupank was also reduced.

In order to reduce unjustified expectations related to refinancing by the central bank, Eesti Pank launched a short-term money market project in 1993, which gave banks the opportunity to solve their liquidity problems and also increased trust between banks. For the same purpose, the bank started to issue short-term (28-day) certificates of deposits (CD). The decreasing margin of both the overnight rates and interest rates on certificates of deposits against the short-term interest rates of the German mark indicated the stability of the kroon exchange rate.

Furthermore, multilateral netting was introduced in the interbank settlement system administered by Eesti Pank, allowing banks to optimise their settlement account balance.

Banking crisis and the beginning of the reorganisation of the banking sector

In November 1992, a serious **banking crisis** erupted. Moratorium was declared on the three largest banks of that time: Tartu Kommertspank, Põhja-Eesti Aktsiapank and Balti Ühispank.



Measures taken by Eesti Pank to tackle the crisis were recognised also outside Estonia. Tartu Kommertspank's activities resulted in bankruptcy. By merging the rest of the two banks (whose difficulties arose mainly owing to the freezing of external assets, following a Soviet government decision of 1992), a new bank, Põhja-Eesti Pank, was founded. The last major bank closed in that period was Eesti Sotsiaalpank, whose problems peaked in the second half of 1994.

In order to reorganise and stabilise the banking sector, the Supervisory Board was re-established in Eesti Pank. In addition, a supervisory committee was formed and a system complying with modern requirements for the collection of banking statistics was introduced.

By establishing the mandatory renewal of activity licence and the requirement of increasing share capital, Eesti Pank created a situation where insolvent banks were no longer able to continue operating. As a result, the number of banks decreased by almost a half by the end of 1994, that is to 22, compared to the time before the monetary reform. A period of stabilisation was declared (from April 1993 to January 1994) and the issue of activity licences to new banks was stopped.

In order to increase the credibility of credit institutions, new prudential ratios were approved in 1993, and specified and supplemented in 1994. The focus was set on the organisation of supervision that would enable risk prevention and ex-ante control. However, the development of banking supervision was inhibited by the slow preparation of general legislation regulating the field of economy (there was no accounting act, no commercial code or any other necessary legislation). Therefore, the **new Credit Institutions Act** of 1994, which proceeded from the requirements established in the banking legislation of EU countries, became especially important. Moreover, operating procedures for savings and loan associations were established. Banking supervision authorities strengthened contacts with

the Basel Committee on Banking Supervision and the contact group of the Eastern European Banking Supervision as well as with relevant agencies in Latvia and Lithuania.

Eesti Pank Act and Bank Law

In 1993, the Bank Law of the Republic of Estonia (1992) was supplemented and the Eesti Pank Act was passed (18 May 1993). The fixed capital of the central bank was set to 100 million kroons. In addition, the Statutes of Eesti Pank were drafted and the Executive Board was formed. The Eesti Pank Act and the Statutes of Eesti Pank were once again amended in 1994.

First steps towards a modern payment environment

In October 1993, first automatic teller machines of the Baltic States were put into operation in Tallinn. In December 1993, Eesti Pank and five commercial banks joined the international banking and information transmission system SWIFT.

Statistics

In 1992, the first post-war balance of payments of Estonia was compiled by Eesti Pank.

Increasing international contacts

On May 25, 1992, Estonia became a member of the International Monetary Fund (IMF); on June 15, Estonia's membership in the Bank for International Settlements (BIS) was restored. Within the framework of the annual meeting of the IMF and the World Bank, an in-depth seminar on Estonia's economy and banking was held. Later on, the central bank enhanced cooperation with the IMF (Governor of Eesti Pank became a member of the IMF's Joint Procedures Committee) and also the BIS. On August 14–16, 1992, Michael Camdessus, Managing Director and Chairman of the Executive Board of the IMF, visited Estonia.

On December 1, 1992, Suomen Pankki (Bank of Finland) started to quote the Estonian kroon.

At the beginning of 1994, Kansallis-Osake-Pankki – the biggest commercial bank in Finland at that time – was the first foreign bank to open a representative office in Tallinn. At the end of the same year, two foreign banks from Finland, Kansallis-Osake-Pankki and Yhdyspankki, were authorised to open a branch in Tallinn.

Conclusion

In conclusion, these years enhanced the credibility of the Estonian kroon, which helped to stabilise the economy and restore growth. Price inflation in Estonia exceeded significantly the inflation rate of Germany, the country of kroon's base currency, but this was to be expected. The main reason for the divergences between the kroon's internal and external value was the opening of economy under the fixed exchange rate and inevitable changes accompanying the relatively stronger productivity growth, including changes in the price structure.

1995–1998: DEVELOPMENT AND STABILISATION OF THE BANKING SECTOR

Stabilising and developing monetary policy environment

In 1995–1998, the Estonian monetary system continued to be based on the currency board. The rigid pegging of the Estonian kroon to the German mark brought external price stability to the Estonian economy. The development of monetary policy environment proceeded mainly from three key processes:

- continuously large capital inflow to Estonia;
- changes in the exchange rates of major currencies, and
- influence of the interest rates of the German mark on the interests of the Estonian kroon.

In order to increase the credibility and transparency of the monetary policy, reduce the systemic risk arising from the expansion of the financial sector and strengthen the liquidity system, Eesti Pank

made it possible to meet the reserve requirement on a monthly average basis and started to remunerate compliance with the requirement.

As regards transactions between Eesti Pank and commercial banks, the difference between the purchase and selling rates of the German mark was eliminated in July 1996. The domestic inter-bank money market continued to operate but its importance decreased, as the banking system integrated more closely with the international money and capital market. The certificates of deposits issued by Eesti Pank lost their popularity.

The year 1997 was characterised by the relatively rapid growth of monetary aggregates (except cash), while also banks' investment in domestic loans and other equal debt instruments grew fast. Until autumn 1997 (the time of increasing uncertainty on international capital markets), interest rates on both inter-bank money market and loan and deposit market were mostly stable and with a downward trend.

In order to manage risks resulting from economic expansion, Eesti Pank took several measures to strengthen the liquidity system. With regard to the large inflow of external capital, on July 1, 1997 the amounts borrowed by banks from foreign credit institutions were included in the reserve requirement base – to the extent by which the amounts borrowed by banks exceeded their deposits held with foreign credit institutions. As of November 1, 1997 a temporary additional liquidity requirement was established for banks, amounting to 2% (3% as of December) of the reserve requirement calculation base. In addition, the daily reserve requirement was raised to 4% of the calculation base. At the same time, the interest paid on the balance exceeding the reserve requirement was increased to the level of the discount rate of the Deutsche Bundesbank (German Federal Bank) (since January 1999, the deposit interest of the European Central Bank has been used as the reference interest rate).



In order to strengthen the monetary system and increase banking sector credibility, Eesti Pank raised the capital adequacy requirement from 8% to 10%.

Measures supporting the macroeconomic balance were taken also in 1998. As of June, this part of the reserve requirement that could be regarded as met at the account of cash in hand was reduced to 20% of the total reserve requirement, and as of September 1, financial guarantees given to financial institutions and non-resident credit institutions were fully included in the reserve requirement calculation base.

Strengthening financial system's resistance to crises and further organisation of the banking environment

In order to increase the banking system's resistance to crises, the banking regulation was developed further. Thorough amendments were made to the rules for calculating capital adequacy (market risk was included). All prudential ratios were to be implemented also on a consolidated basis. Rules for risk concentration, calculation of currency risk and reporting on off-balance-sheet items were improved. Liquidity reporting was changed significantly and the statement of investments was added.

The security of information systems became one of the priorities of supervision owing to the spread of ATMs and cash dispensing machines and the introduction of telebanking and Internet banking, which started to require increasingly more attention, so as to ensure the highest level of data protection. Thus, the obligation to conduct IT audits and certain requirements for the information systems of credit institutions were established. Moreover, procedural requirements for the prevention of money laundering were established for credit institutions.

These measures contributed to the convergence of the legislation adjusted to Estonian credit institutions with that of developed countries and ensured

the comparability of indicators. The objective was that the legislation implemented in Estonia would meet the requirements of the European Union. Internal integration within the Estonian financial sector and the internalisation of the banking sector led to closer cooperation with different domestic supervisory authorities as well as other countries and international supervisory authorities. In 1998, Eesti Pank, the European Bank for Reconstruction and Development and several Estonian credit institutions formed a joint committee to develop a framework for requirements for the general management system of banks.

The focus was set on the implementation of common financial supervision. The fast development of the banking sector caused a need to continue the organisational and methodical development of complex supervision.

In 1998, several acts were passed, drafted in cooperation with Eesti Pank: for instance, the Deposit Guarantee Fund Act and the Prevention of Money Laundering Act. Moreover, the new version of the Credit Institutions Act was further elaborated to adjust it to EU directives by increasing the rights and obligations of banking supervision authorities.

Stricter requirements for share capital and own funds in 1996–1997 led to mergers of credit institutions (Raepank merged with Forekspank, Keila Pank, Rahvapank and Eesti Maapank merged with Virumaa Kommertspank) as well as to the revocation of the activity licences of several banks (Eesti Sotsiaalpank, Ameerika-Balti Pank, NoWe Pank). Crisis was avoided in the case of Eesti Tööstuse ja Ehituse Kommertspank, which was reorganised and merged with Eesti Hoiupank. Under the conditions of tightening competition, not all credit institutions were able to sustain the required level of risk management and keep their market position. So the owners voluntarily liquidated INKO Balti Pank, and Eesti Innovatsioonipank lost its activity licence. In addition, the merger of Põhja-Eesti Pank with Eesti Ühispank was completed.

Due to liquidity problems, management errors and insolvency, the banking system witnessed several mergers and restructurings also in 1998. The merger of Eesti Hoiupank and Hansapank and that of Tallinna Pank and Eesti Ühispank should be mentioned here. As a result, two major banking groups emerged in Estonia with total market share of 80%. The inflow of Swedish capital to the two large banks (from Swedbank and Svenska Enskilda Banken, respectively) was also a breakthrough that contributed significantly to the whole banking system.

In the new Optiva Pank, which was the result of the merger of Eesti Foreksbank and Eesti Investeerimispank, Eesti Pank acquired a temporary majority holding (the holding was sold in June 2000). Eesti Maapank, EVEA Pank and ERA Pank were declared bankrupt.

As a result of consolidation and liquidation of small banks, five banks and one branch of a foreign bank (Merita Bank) continued to operate.

Payment systems

Eesti Pank began to create a new payment and settlement system between credit institutions that would comply with EU requirements. In order to increase the credibility and operational reliability of the payment and settlement system, the harmonisation of technical solutions was carried on; among other things, paper-based payment orders were replaced with electronic ones. The central bank also started to charge commercial banks for the services provided to them.

Currency circulation

1998 was the first year the central bank did not need to put additional currency into circulation; the amount of currency in circulation even decreased. Eesti Pank stopped the release of one-kroon coins issued in 1992, 1993 and 1995. The new one-kroon

coin (of a new alloy and with different measures) was issued.

Statistics

In addition to the balance of payments, in 1996 Eesti Pank started to prepare another review on the state's foreign trade relations, namely Estonia's international investment position. In the field of banking statistics, the project of payment statistics reports was completed.

First sovereign ratings

Eesti Pank commissioned the first credit ratings for Estonia in 1997¹: Fitch IBCA – BBB; Moody's Investors Service – Baa1; Standard & Poor's – BBB+.

Conclusion

It can be concluded that in the given period, the Estonian economy was characterised by accelerating growth (reaching 6% as the average of the period), constantly decreasing inflation (8% in 1998), continuous economic reforms and reorganisation of banking environment. In autumn 1997, during the so-called Asian crisis, the currency board system demonstrated successfully its ability to be self-regulatory and capability to cope with the decline of confidence on international financial markets and currency speculations. Estonia was included in the first round of the EU enlargement negotiations.

1999–2004: CLOSER INTEGRATION WITH EUROPE

Preparations for EU accession

In 1999–2004, Estonia first enjoyed the status of an EU candidate country, then became an acceding country and finally a member state. In dealing with EU issues, Estonia implemented a decentralised model, meaning that the ministry responsible for the issue in question was also responsible for the compilation and finalisation of the national posi-

¹ Credit rating is an assessment by rating agencies on government's capability and willingness to discharge future debt liabilities taken by the country.



tion. Similar to ministries, Eesti Pank was one of the institutions responsible for accession negotiations. The central bank had a major role in the preparation of issues treated under the chapters of the free movement of services and capital, Economic and Monetary Union, institutions, and statistics.

On January 1, 2002, twelve EU member states (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) adopted the euro as a single currency. In addition to the EU member states, the euro became the official currency also in several small countries such as Andorra, Monaco, San Marino and Vatican.

In 2002, the European Central Bank (ECB) invited the candidate countries' central banks (incl. Eesti Pank) to participate as observers in the work of the General Council of the ECB and the committees of the European System of Central Banks (ESCB) starting from the time of signing the Treaty of Accession. The observer status without the right to vote lasted until the entry into force of the Treaty of Accession.

The European Commission recommended to conclude accession negotiations with ten candidate countries during 2002. The other nine countries besides Estonia were Cyprus, the Czech Republic, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. The European Council was also convinced that these ten EU candidate countries were able to perform the obligations arising from the membership.

In December 2002, the ten candidate countries were officially invited to join the European Union. The treaty was signed on April 16, 2003 in Athens and entered into force on May 1, 2004.

In the referendum held in Estonia in September 2003, 66.9% of the votes were for the accession to the European Union.

Changes in the Estonian monetary system related to the third stage of the Economic and Monetary Union

On January 1, 1999, at the beginning of the third stage of the Economic and Monetary Union, the currencies of 11 member states (including the German mark, which was the anchor currency of the Estonian kroon) were irrevocably pegged against each other and the euro was introduced as their legal tender (first as account money). In December 1998, Eesti Pank established the exchange rate between the euro and the Estonian kroon at EUR 1 = EEK 15.6466, which was equivalent to the official exchange rate of the Estonian kroon against the German mark. Apart from some formal and technical changes in the operational framework of the monetary system, for Estonia, the adoption of the euro did not bring about any direct changes in the exchange rate and monetary policies. The fixed exchange rate of the Estonian kroon against the currency covering a much larger economic area made our financial system more open and efficient, increasing also the integration of Estonian financial and non-financial sectors with the European capital markets.

After the adoption of the euro in the euro area, a new procedure for foreign exchange operations between Eesti Pank and credit institutions was established, which eliminated the difference between the purchase and sale transactions between the euro, the national currencies of the countries that had introduced the single currency and the Estonian kroon.

In April 2000, the Supervisory Board of Eesti Pank approved the strategy for the monetary policy operational framework, with the ultimate goal to harmonise Estonia's current framework with that of the Eurosystem. The short-term objectives were the smooth functioning of the fixed exchange rate under the currency board arrangement and the reduction of market distortions while maintaining the required liquidity buffers.

In May 2000, Eesti Pank stopped the issuing of short-term certificates of deposit.

In July 2000, the additional liquidity requirement was included in the reserve requirement, which then increased to 13%. In 2001, the reserve requirement system became more market-based, allowing credit institutions to invest a part of the deposit held with the central bank in high-quality foreign bonds. However, in 2004, the concession that allowed covering part of the reserve requirement with cash was terminated. In addition, the convergence of methodology for the calculation of the reserve requirement base towards the Eurosystem's framework was continued.

In 2002, the revised procedure for foreign exchange transactions between Eesti Pank and credit institutions operating in Estonia was established, serving as the basis for conducting transactions between the Estonian kroon and the US dollar, the Australian dollar, the Japanese yen, the Canadian dollar, the Norwegian krone, the Swedish krona, the British pound sterling, the Swiss franc and the Danish krone.

Development of the financial system's operating environment and financial supervision

The close integration of the Estonian financial sector accompanied by the rapid growth of non-bank financial intermediaries emphasised the need to unite the financial supervision authorities that had so far operated separately.

In May 2001, the Riigikogu (the Estonian Parliament) adopted the Financial Supervision Authority Act to establish the Financial Supervision Authority – an agency operating at Eesti Pank with autonomous competence and a separate budget. The Financial Supervision Authority started to operate in 2002 to conduct independent supervision over the financial sector. At the same time, the Eesti Pank Act Amendment Act, which the Riigikogu had adopted in summer 2001, entered into force in relation to

the Financial Supervision Authority becoming operational.

Eesti Pank also continued with the development of banking regulations. At the end of the testing period of reports on capital adequacy and risk concentration (in 2002), the new prudential ratios of credit institutions were laid down.

In 2002, Eesti Pank, the Ministry of Finance and the Financial Supervision Authority entered into a cooperation agreement, which laid the foundation for their joint operation as regards exchange of financial information, legislation, the financial sector's safety net, international and public relations, and training.

Payment systems and currency circulation

In January 2002, Eesti Pank launched a new inter-bank settlement system that complies with international requirements. Unlike the previous settlement system, the new one was comprised of two subsystems: the Designated Time Net Settlement System (DNS) for processing retail payments and Real-Time Gross Settlement System (RTGS) for processing express payments.

In 2002, the Cash and Security Department of Eesti Pank was granted the international quality certificate ISO 9001:2000 for the managing, handling, and safeguarding of cash reserves.

Due to the merger of credit institutions, growth in the number and value of payments settled through Eesti Pank slowed. Further development was observed in electronic payment channels, the share of payment cards and the number of ATMs.

Statistics

The central bank's system of statistics reaching an internationally accepted quality level was proved by the fact that Eesti Pank joined the Special Data Dissemination Standard (SDDS) of the International Monetary Fund. Eesti Pank started to implement



the ECB Regulation concerning the consolidated balance sheet of the monetary financial institutions sector. In 1999, a procedure for the disclosure of information of credit institutions or the public disclosure report was developed.

In 2002, Eesti Pank started to publish Estonia's monthly balance of payments. In 2003, a new procedure for the declaration of international payments and new forms for balance of payments reports were introduced.

In addition, reporting on payment statistics on the basis of ECB's system was established.

Credit ratings

In 2002, Estonia's credit rating reached the same level in the estimates of all three major rating agencies. While in 2001 two rating agencies (Standard&Poor's and Fitch) had upgraded Estonia's rating to the group of very credible countries, i.e. to level A, then in November 2002 the third agency – Moody's – did the same.

Legislation

In 1999, the Savings and Loan Associations Act was adopted.

On August 1, 2002, the Eesti Pank Act Amendment Act entered into force.

In 2002, the Securities Market Act took effect.

Conclusion

The broader economic policy objectives of 1999–2004 were as follows:

- to ensure a stable macroeconomic environment,
- to maintain the reliability of the currency board and the entire economic policy, and
- to successfully complete preparations for the EU accession.

At the same time, it was important to maintain sustainable economic growth through increasing productivity, curb the current account deficit and ensure further decrease of inflation. Eesti Pank fully supported these objectives through its activities. The effectiveness of Estonia's monetary and banking policy was indicated by the fact that all international ratings given to Estonia in 1998 remained valid regardless of international crises.

2004–2006: ON THE WAY TOWARDS THE ECONOMIC AND MONETARY UNION AS AN EU MEMBER STATE

Accession to the European Union

In May 2004, Estonia became a member of the EU and Eesti Pank a member of the European System of Central Banks (ESCB). Therefore, Eesti Pank is one of the owners of the European Central Bank. After the accession to the EU, representatives of Eesti Pank have the right to participate and vote in about 70 committees and working groups of the ESCB, the Council of the European Union and the European Commission. Every year, the executive staff and experts of Eesti Pank take part in about 300 meetings of EU committees and working groups.

In June 2004, Estonia became a member of the Exchange Rate Mechanism ERM II. The central rate of the Estonian kroon was fixed at EUR 1 = EEK 15.6466.

In June 2004, Eesti Pank announced a design competition for the national side of the Estonian euro coins. In December, Lembit Lõhmus was named as the winner of the competition. In 2005, Eesti Pank and Suomen Rahapaja (the Mint of Finland) signed a contract according to which Suomen Rahapaja will mint Estonia's euro coins.

In February 2006, Eesti Pank launched Estonia's euro website (euro.eesti.ee). In 2007, Eesti Pank began to write reports on the different aspects of

the adoption of the euro, which are published twice a year at www.bankofestonia.info.

The objective of the Strategic Development Plan of Eesti Pank for 2005–2007 was to ensure readiness to become a full member of the Economic and Monetary Union (EMU) by the second half of 2006 and join the euro area.

Development of monetary policy and financial environment

In order to alleviate problems accompanying rapid credit growth, Eesti Pank raised the risk weighting of housing loans in the calculation of capital adequacy, which increased the capitalisation of banks. Banks' reserve requirement ratio was raised to 15% and the procedure for calculating and complying with the reserve requirement was established.

In order to implement the international capital adequacy framework (Basel II), the new procedure for the application and calculation of the prudential ratios of credit institutions and consolidation groups of credit institutions was developed. (Thus in 2007, the procedure for the public disclosure reports of credit institutions as well as reports on the prudential ratios of credit institutions and consolidation groups of credit institutions were amended – see page 50).

Eesti Pank, the Financial Supervision Authority and the Ministry of Finance concluded a three-party cooperation agreement on financial crisis management. Another such cooperation agreement was signed between Eesti Pank and the central banks of Sweden, Latvia and Lithuania.

Payment environment

In January 2004, Estonia became the 28th European country to adopt the International Bank Account Number (IBAN) standard. This helped to speed up international payments.

Eesti Pank updated the interbank Designated Time Net Settlement System (DNS) by launching the

Settlement System of Ordinary Payments (ESTA) in October 2005. The ESTA allows for faster inter-bank settlements and longer operating time of the system, thus making the whole system more efficient.

In November 2006, Eesti Pank together with the Estonian Central Register of Securities and three commercial banks joined the Trans-European Automated Real-time Gross Settlement Express Transfer system (TARGET). In relation to that, the working day of the ESTA was extended by one hour.

Prevention of the circulation of counterfeit cash

In 2005, Eesti Pank and the Police Board entered into a cooperation agreement to prevent the circulation of counterfeit cash and ensure the security of euro cash distribution.

Statistics

In the field of statistics, the balance of payments report forms were established for companies. Eesti Pank launched a portal eAruanne through which companies can submit balance of payments data.

Conclusion

The Estonian economy and banking sector witnessed several fundamental changes in 2004–2006, primarily driven by the accession to the EU and preparations for the adoption of the euro. For further information on the central bank's activities during this period, see the Annual Reports of 2006 and 2005. The following chapters give an overview of the activities and accomplishments in 2007.