SUPPLEMENTARY MEMORANDUM OF ECONOMIC POLICIES OF THE REPUBLIC OF ESTONIA[1]

I. Introduction

1. The economic recovery from the effects of the Russian crisis gained momentum in the first half of 2000, despite a sharp fiscal correction. The recovery was importantly supported by rapid growth of our export markets, but also by our prudent policies and further structural reforms, as outlined in our policy memorandum earlier this year[2]. These policies aimed at laying the basis for rapid economic recovery through maintaining macroeconomic stability and increasing the efficiency and competitiveness of the Estonian economy. In order to achieve sustainable fast economic growth and prepare the economy for accession to the European Union (EU), we intend to continue these policies through 2001 and beyond, and strengthen them where appropriate.

2. The strong growth in our key export markets in Finland, Sweden, and other EU countries and deployment of new investments in the electronics sector and other exporting industries, has led to a rapid increase in exports of goods and services by 39 per cent in the first half of 2000. Together with a recovery of private domestic demand, this resulted in an increase in real GDP by almost 6.5 per cent in the first half of 2000 over the same period in 1999. However, 1999 had been characterised by a recession, and output in the first half of 2000 was only about 3.25 per cent higher than in the first half of 1998. The twelve-month inflation rate rose from 3.8 per cent in December 1999 to 4.7 per cent in September 2000, largely reflecting the weakness of the euro and the sharp increase in international energy prices, as well as the feed-through to transportation fees, and the extension of VAT of 5 per cent to thermal energy in June 2000. Unemployment has started to fall recently with the rapid economic recovery, but remains above the level of 1999. The external current account deficit in the first half of this year was 5.4 per cent of GDP, which is lower than in the same period of 1999, when it had amounted to 6.25 per cent of GDP. The debt service ratio has declined from already moderate levels because of strong non-debt creating inflows financing much of the current account deficit and the increase in net foreign assets of the banking system.

3. The tightening of fiscal policy that had begun in the second half of 1999 was continued in the first half of 2000, with a general government deficit of about 1.7 per cent of GDP, compared with 6.6 per cent of GDP in the same period in the previous year. VAT has performed better than projected, but excise tax collection was initially weak. So far, overall revenue and expenditure performance has been broadly in line with expectations, as the unexpectedly fast growth of exports (which are not taxed) has not yet resulted in revenues exceeding projections.

4. Representing a catch-up after the slow growth in the monetary aggregates in 1998 and much of 1999, broad money grew at about 25 per cent (year-on-year) in the first half of this year, and by 31 per cent in the third quarter. Interest rates are near historic lows. While there has been a slight upward tendency recently, this was less than in euro interest rates. The commercial banking sector remains in a strong financial position, and *Eesti Pank* (the Bank of Estonia) has sold its equity stake in *Optiva Pank* in July 2000.

5. As regards structural reforms, we submitted to parliament a new budget law that will make expenditure control more effective. While, after passage in parliament, the new law will apply only to the budgets from 2002 onwards, we have already framed the budget proposal for 2001 in accordance with the new law. *Eesti Pank* and the government also agreed in June 2000 to establish a unified financial supervision agency and to

[1] This Memorandum of Economic Policies of the Republic of Estonia was conducted to the IMF on November 24, 2000. The Executive Board of IMF approved the Memorandum on December 13, 2000.
[2] See Eesti Pank Bulletin No 1, 2000, pp 19 to 30.

provide strong safeguards to ensure its budgetary and operational independence. Finally, a principal agreement on the partial privatisation of the electricity complex was reached in August 2000.

II. Policy Program through 2001

Macroeconomic Framework

6. While Estonia's economy has improved substantially over the past year, we will remain vigilant to ensure that this improvement will be sustained. To this end, the currency board arrangement will remain the cornerstone of our stabilisation policies, supported by strong fiscal policies to protect our external position.

7. We now expect real GDP to rise by 5.5 to 6 per cent in 2000 (rather than by 4 per cent previously expected), and at a similar rate in 2001. Economic growth will continue to be export-led, even though export growth is likely to slow down somewhat from its very brisk pace in early 2000. We expect that investment will become the second engine of growth. Barring further unforeseen external price increases, the rate of average consumer price inflation is expected to remain between 4 and 5 per cent in 2000 and 2001. With strong economic growth, the rate of unemployment should continue to decline somewhat from its present high level of 13.2 per cent. However, this is likely to be a gradual process, as the rapid transformation of the economy will continue to lead to closures of labour intensive enterprises. Finally, with continued strong export growth, the external current account deficit is projected to remain in the range of 6 to 7 per cent of GDP in 2001, despite the upward push on imports from strengthening domestic demand.

Fiscal Policy

8. As already noted, the economic recovery has been led by a rapid increase in exports, which are not taxed. Therefore, while the recovery has been stronger than expected, this has not yet led to higher revenues, nor to a weaker external position. Thus, the budget outlook for the remainder of 2000 is broadly in line with earlier expectations, and the budget also remains appropriate from a macro-economic point of view. Revenues are likely to meet budget targets, with higher direct taxes and VAT compensating for relative weakness in excise tax collection. The deficit of the central government is expected to be somewhat below earlier expectations, while, with the economic recovery and the freezing of pensions, the Social Insurance Fund will move towards balance after a deficit of close to 1 per cent of GDP in 1999. However, the municipalities may be running a higher deficit than planned. In particular, the City of Tallinn has passed a supplementary budget (0.3 per cent of GDP), the full implementation of which could threaten achievement of our fiscal target this year. We are, therefore, trying to persuade the municipalities to refrain from undermining our fiscal policy. In any case, we will stand ready to cut back expenditure of the central government to compensate for any overspending at the local level, to ensure that our fiscal targets are met. For this purpose, we are already holding back spending until the overall fiscal position becomes clearer toward the end of the year. Moreover, while we expect to recover some of the deposits lost in a bank failure in 1998, we do not intend to rely on these funds for meeting the budget target in consideration of the one-off nature of these receipts.

9. We have submitted a balanced budget for 2001 to parliament. On the revenue side, the ratio of direct taxes to GDP will fall on account of the completion of the phase-out of the corporate profit tax and the introduction of higher exemptions for personal income tax. This is expected to be only slightly offset by higher excise tax collection – as a result of the introduction of excises on fuel components as from September 1, 2000, the introduction of alcohol excise warehouses from January 1, 2001, and improvements in tax administration. Moreover, non-tax revenue will also be smaller, as there will be no repeat of the bank deposit recovery. On the expenditure side, the budget is based on a continuation of the general freeze of nominal pensions and government wages, following the sharp increase in 1999, with the important exception of salaries of teachers and cultural workers. The budget also includes the transfer of education spending and their financing from the central government to the local authorities, but this will not affect the consolidated budget. The continued freeze of pensions, together with the effects of the economic recovery, is expected to move the central government budget (including the Medical Insurance and the Social Insurance Funds) into a slight surplus, covering the expected deficit of the municipalities. Should revenues exceed projections, we intend to generate a fiscal surplus next year, so as to protect our external current account, and prepare for the pension reform starting in 2002. Consistent with the target of fiscal balance for 2001 as a whole, but allowing for seasonal movements, we have set general government deficit targets for March and June 2001 to cover the remainder of the program period (see Table 1).

Table 1. Estonia: Quantitative Performance Criteria under the Program, January 2000 [1]

		December 31, 2000	March 31, 2001	June 30, 2001
		(EEK mn)		
I.	Limit on cumulative general government deficit	1,000	1,150	1,250
		(DEM mn)		
II.	Minimum levels of net international reserves of the Bank of Estonia (January 1 through December 31, 2000) [2]	200	200	200
		(USD mn)		
III.	Ceilings on new external short-, medium-, and long-term debt of general government [3]			
	maturity of 0-2 years	0.0	0.0	0.0
	maturity of over 2 years	250.0	300.0	300.0
	o/w maturity of more than 2 years but less than 10 years	30.0	30.0	30.0
IV.	The government will not accumulate any payments arrears during the period of the arrangement			
V.	The currency board is fully backed with foreign exchange at all times			

[1] Definitions of the concepts were set out in the Annex to the Memorandum of Economic Policies (EBS/00/18), except for the definitions of the performance criteria on the debt ceilings at end-March and end-June 2001, which have been modified in accordance with the IMF Executive Board Decision dated August 24, 2000 (see footnote 3).

[2] The targets for net international reserves will be adjusted for the net proceeds of the sale of Optiva Bank, as specified in EBS/00/18.

[3] The performance criteria on the debt ceilings for end-March and end-June 2001 apply not only to debt as defined in point No 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (August 24, 2000) but also to commitments contracted and guaranteed for which value has not been received. Because of difficulties in ensuring effective monitoring of leasing and import financing by local entities, such transactions by local governments are not included under the external debt limits.

10. The government has made considerable progress in rationalising and streamlining the operations of the central government and the extrabudgetary funds, including through the introduction of a comprehensive Treasury system in 1998 and the submission to parliament of a new basic budget law in June 2000. The government intends to continue the process of administrative reform through the early review of the structure of local government finance. At present, there are 247 separate municipalities, each with its own budget and financial administration. It has long been recognised that this system is expensive, unwieldy, and inhibits effective control over public spending. Accordingly, the government intends to propose by mid-2001 an approach to the restructuring of the system of local governments with a view to reducing substantially the number of independent administrative units.

Monetary Arrangements and Financial Market Supervision

11. As already noted, the currency board arrangement will remain the cornerstone of our economic policies. Within the currency board requirements, we continue to streamline our operational framework to reduce the distorting effect of the high reserve requirement and to bring it in line with that of the Eurosystem central banks. Following the review envisaged in our original MEP, as of July 1, 2000, we have combined the reserve and liquidity requirements into one uniform reserve requirement at 13 per cent of the reserve base. This change had a marginally tightening impact on banks' balance sheets by increasing the level of mandatory intra-day minimum reserves. Moreover, as of January 2001, banks will be allowed to invest up to 25 per cent of their required reserves into highly rated foreign money market instruments. We have also ceased the issuance of *Eesti Pank*'s CDs as of April 20, 2000, as recommended by Fund staff. As described in our earlier policy memorandum, we are carefully monitoring credit and monetary developments. We have already taken recourse to moral suasion with key commercial banks and we are scrutinising their lending plans, credit policy, and risk strategies for the coming year. In addition, we would consider, if necessary, a combination of monetary and financial policy measures to limit credit growth.

12. *Eesti Pank* has completed in June 2000 an assessment of compliance with good practice codes for monetary policy as part of the Financial Sector Assessment Program (FSAP). The FSAP concluded that vulnerabilities in the financial sector had been substantially reduced.

13. The government and *Eesti Pank* agreed in June 2000 on the basic structure of the agency that would unify supervision over the banking, insurance, and securities industries (the Financial Supervision Agency or FSA). It is expected that enabling legislation would be submitted to parliament by March 31, 2001, which would allow the FSA to commence operations on January 1, 2002. It is already agreed that the FSA would have full operational and licensing independence (consistent with the principles set out in the FSAP). In addition, the legislation will also reflect international best practices

in financial supervision, including full protections from legal actions associated with the discharge of its core responsibilities.

14. We recognise that the banking sector plays a key role in ensuring macroeconomic stability and the stability of the currency board, and will therefore ensure that there will be no compromise in the standards of commercial banking supervision during the transition to the FSA and thereafter. We are also mindful of the shortcomings in financial supervision that were identified in the FSAP, in particular in the case of the Securities Inspectorate. Accordingly, and to ensure a smooth transition to the new supervisory environment, we will (i) submit the new Securities Market Law to parliament before end-December 2000; and (ii) proceed with the enhancement of the standards of supervision in the Insurance Supervisory Authority and Securities Inspectorate; this may entail the commitment of additional managerial resources as well as considerable assistance (twinning, training, IT systems) from the EU, especially in the case of the Securities Inspectorate.

Other Structural Policies

15. We now expect that the pension reform proposal to establish a fully funded voluntary second pillar will be submitted to parliament towards the end of December 2000, rather than December 1. This brief delay is needed to reach a broader political consensus and refine the calculations. Under the government's proposal, 4 percentage points of the 20 per cent payroll tax will be redirected from the first to the second pillar for workers who choose to participate, plus a further 2 percentage points to be contributed by the participant. Participants would not be able to opt out of the second pillar after they join. The question whether participation in the second pillar should become mandatory for new entrants in the labour force is still under discussion. The reform is expected to be implemented from January 1, 2002. While much will depend on the actual participation of employees in the system, preliminary estimates suggest that the emerging deficit in the first pillar could initially amount to about 1 per cent of GDP. We will also continue with the reform of the first pillar of the pension system, including by introducing indexation to prices and the wage bill. This will ensure the system's financial integrity over the medium term by removing decisions on discretionary pension increases from the political sphere.

16. The sale of a minority stake in *Narva Elektrijaamad* (Narva Power Station) to a foreign investor is expected to be completed by mid-2001. This will signal the beginning of a major investment program into Estonia's energy sector and should lead to substantial improvements in the productivity of the electricity generation and oil shale mining industries. It will also bring with it a sharp reduction in the harmful environmental impact associated with the production of electricity. A special fund is being created by Narva Power Station to address the social consequences of the restructuring. At the same time, the power purchase agreement associated with this deal implies that *Eesti Energia* (Estonian Energy), buying a substantial amount of the Narva Power Station's output of electricity, maintains a dominant position in this sector. This dominance is enhanced through its simultaneous control over the Estonia's transmission system and most of its distribution network. To ensure that *Eesti Energia* does not abuse its market power and that independent producers enjoy reasonable access to the transmission and distribution networks (as guaranteed under the 1998 Energy Act), the government has already upgraded the functioning of the Energy Market Inspectorate, including by narrowing the focus of its work. The government will continue this process by further enhancing staffing and seeking EU assistance in improving the technical capacities of this agency. Our intention is to proceed with the privatisation of the energy complex after the completion of the sale of the stake in Narva Power Station.

17. The government is also at the final stage of the privatisation of a two-thirds stake in *Eesti Raudtee* (Estonian Railway) – the major freight and transit line. The tender process has identified a number of prospective buyers, and it is expected that a final selection will be made by the end of this year. The government recognises the importance of ensuring that the strategic investor in *Eesti Raudtee* has the experience and the financial capacity to undertake the task of upgrading and streamlining the railway, which plays such a crucial role in the export of transit services.

III. Performance Monitoring

18. Progress in the implementation of the program will continue to be monitored through quarterly performance criteria, which have now been set through the end of the program through June 2001, and are presented in the attached table. The definitions remain those of the Letter of Intent dated February 11, 2000, except for the definitions of the performance criteria on the debt ceilings at end-March and end-June 2001, which have been revised to bring them in line with the IMF Executive Board Decision of August 24, 2000.