BACKGROUND INFORMATION

HARMONISATION OF MONETARY POLICY OPERATIONAL FRAMEWORK (RESERVE REQUIREMENT REFORM)

Currency Board and Strategy to Join the Euro Area

The monetary and banking policy of Eesti Pank is oriented to preparations to the accession of Estonia to the Economic and Monetary Union (EMU). This will encompass three distinct phases:

1. *pre-accession or preparatory phase;*
2. *the status of "Member State with a derogation" after joining the EMU;*
3. *full EMU membership.*

The constitutional responsibility of Eesti Pank to uphold the stability of the national currency means long-term price-stability-oriented monetary policy. In the current economic policy environment the exchange rate system accompanied by conservative fiscal policy should support smooth nominal and real convergence of Estonia's economy with the euro-zone.

Harmonisation of Operational Framework with EMU

In monetary policy area the harmonisation of the monetary policy framework with that of EMU holds a significant place in Eesti Pank's upcoming strategy. As the accession will take place in different phases, the central bank has since the second half of 1999 focused on solutions that help to maintain current safeguards of monetary policy confidence and facilitate integration of our monetary system into European standards.

Slight differences in monetary policy instruments of Eesti Pank and the European Central Bank (ECB) arise from the monetary policy strategies chosen that have laid different needs and possibilities for setting operational objectives (eg interest rate). Despite of inevitable differences in Estonia's and ECB framework due to differences in strategies, in both cases efficient liquidity system is considered important.

The EMU exchange rate regime presumes ECB's active monetary policy aimed at influencing short-term money market interest rates. With the currency board arrangement Estonia's monetary policy cannot be aimed at active interest rate management as under fixed exchange rate and free movement of capital short-term kroon interest rates are largely determined by the euro's benchmark rate, ie ECB's monetary policy. Eesti Pank's primary function is to develop such a framework, which in the best possible way could facilitate stability and efficient functioning of an automatic-stabilisers-based system.

Both domestic and foreign liquidity buffers of Estonian banks have significantly strengthened over the last years and foreign strategic investors as owners have increased the confidence in the entire banking system. Current experience shows that under the currency board arrangement adequate liquidity buffers and assurance of their smooth functioning offer the best results in neutralising temporary risks threatening the settlement system and also in achieving financial stability in its broader sense. Compared to the euro-zone, standing facilities and reserve requirement system play an important role in Estonia's monetary policy operational framework.

According to the three-phase EMU accession scheme, differences in monetary policy instruments (in the Eurosystem the main stress is on open market operations, in Estonia – on standing facilities and reserve requirement) remain until full participation in *the EMU. Regardless of the specificity of the currency board arrangement, Eesti Pank foresees good prospects for final integration at the beginning of the third phase.* ***A significant step towards the integration is an introduction of high quality foreign securities as eligible assets for meeting the reserve requirement (up to 25%) beginning from 1 January 2001, expanding banks' possibilities for more active liquidity management on money and capital markets of the euro.***

Foreign Assets in Meeting Reserve Requirement

The basic change in the reform of the reserve requirement system lies in permitting to meet 25% of the reserve requirement by holding foreign high quality and liquid fixed income securities. The securities should be denominated in euros and have high credit rating (at least AA- by S&P or Aa3 by Moody's). Only fixed income securities issued by governments of developed countries or supranational credit institutions (the World Bank, the European Bank for Reconstruction and Development, Nordic Investment Bank, etc) can be used.

Establishing high quality requirements the point is that acceptable foreign assets should be close substitutes to demand kroon deposits with the central bank. Adherence to the above principle helps to maintain liquidity buffers of the monetary system on the current level and underlies a possibility to sell foreign assets to Eesti Pank.

In January the majority of Estonian credit institutions used the option to partially meet the reserve requirement by holding foreign assets. By end-January they held in foreign assets about 1.4 billion kroons in order to meet the reserve requirement (see Figure 4b). Their impact on monetary system's liquidity buffers, including net international reserves (NIR) remained neutral. This is visible in the stable share of reserves in credit institutions' assets. The reform led to an increase of high-quality bonds in banks' bond portfolio.

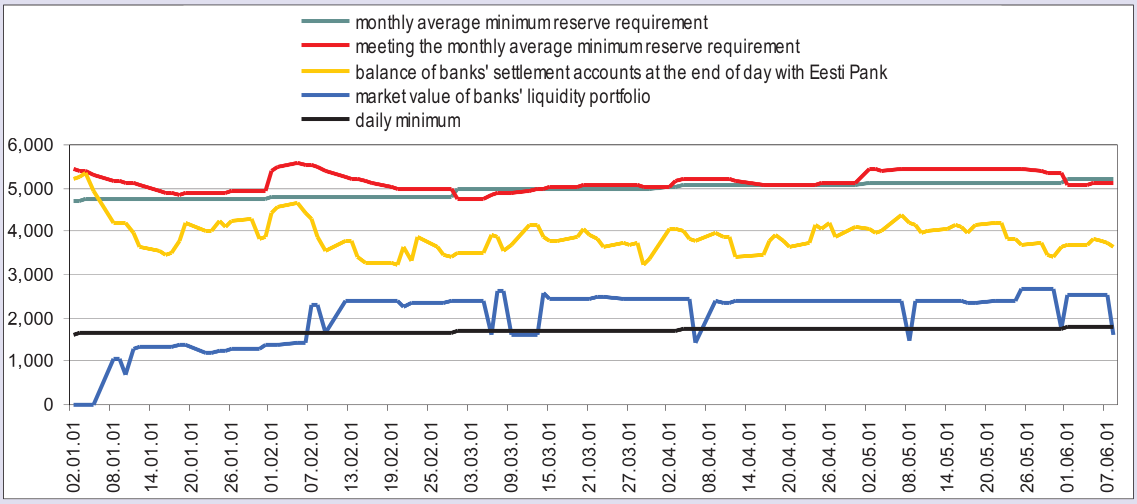

Figure 4b. Meeting the minimum reserve requirement (EEK mn)

Within the second phase of the reform as of 1 July 2001 the limitation to use foreign securities to meet the reserve requirement will be raised from 25% to 50% of the reserve requirement. The 13% reserve *requirement remains unchanged and just a structural shift from mandatory kroon deposits to high-quality foreign assets will take place.*

Improvement of foreign-assets-based liquidity management means is a significant step towards increased efficiency of the currency-board-based monetary system. Thereby a substantial property of reserve requirement is met – maintenance of sufficient liquidity buffers. Although the EMU framework foresees reducing of the reserve requirement to 2% level in longer term, the new framework provides a gradual approach without reducing control over liquidity buffers of the monetary system.

An integral premise of broad liquidity management lies on the openness of the capital movements and on the integration of domestic money and capital markets with international markets. More active liquidity management in money and capital markets by Estonian banks is a positive process, increasing the competitiveness of the financial sector and deepening transmission of ECB's monetary policy signals into Estonia.

In longer term the reform will facilitate growth in high-quality bonds as collaterals that is important for intended upgrading of payment systems and for money market developments. Besides the reserve requirement reform is in harmony with future goals of operational convergence that would set a firm basis for further structural changes and upgrading of monetary policy instruments.