III. INTERNATIONAL ENVIRONMENT OF THE CENTRAL BANK'S ACTIVITIES

Estonia is a part of geographical, economic and cultural Europe. Thus, it is only natural that Estonia's integration into the European Union (EU) is constantly deepening[1]. All economic and political processes of the EU have a direct impact on Estonia. In 2001, the EU Member Countries passed important decisions concerning the expansion and starting a debate on the future of the EU, the launch of the euro cash at the beginning of 2002 attracted wide attention. Deepening integration broadens Estonia's prospects of economic co-operation but, at the same time, also forces to contribute more and more to furthering co-operation between countries and introducing internationally acknowledged good practices. After the 11 September terrorist attacks in the USA, fight against terrorism became the key word in international co-operation. Financing of terrorism and the related aspects of money laundering have come under close scrutiny of the UN, International Monetary Fund (IMF) and the European Union.

Economic and Financial Policy of the European Union

The economic and financial policy of the EU proceeds from the long-term goals set down at the Lisbon meeting of the European Council[2] in March 2000. The strategic goal of the next decade is to make the EU the most competitive and dynamic, science and research-based economic region of the world. The means of achieving this goal include the creation of new jobs, economic reforms and social cohesion or modernisation of the European social model. The key issue is completing the creation of the internal market, which covers integration of the EU financial markets as well as liberalisation of a number of other spheres, including electricity and gas markets. The creation of the internal market is facilitated by the final changeover to the euro, which will increase price transparency of the Member Countries and; thus, further harmonisation of economic policies. The Financial Services' Action Plan, which was adopted in 1999 and made a priority at the Lisbon meeting of the European Council, serves as the main tool for the integration of financial markets.

An important part of the EU economic policy is its regular co-ordination between the Member States, proceeding from the observance of the Stability and Growth Pact and based on the convergence programmes (for countries outside the euro area) and stability programmes (for euro area countries). The co-ordination of economic policy is based on the understanding that in the conditions of the common market, and in particular, common monetary policy, the economic policy of one country affects the entire region.

Final Changeover to the Euro

The year 2002 marked the end of an important stage in the development of the EU common market and economies of the Member States – the euro began circulating as cash in 12 Member Countries of the European Economic and Monetary Union. Three members of the EU (Sweden, Great Britain and Denmark) did not change over to the euro as yet.

---

[1] See Eesti Pank's Role in European Integration, pp 77–79.

[2] The European Council is made up of heads of states and governments and president of the European Commission. Informal meetings of the Council take place at least once during the presidency period in the presiding country.

The final transition to the euro is deepening the processes that began with the introduction of the common account money in 1999 – greater price transparency encourages competition and more effective placement of resources, widens the investment opportunities of the euro area and furthers economic co-operation between countries. It has a positive impact on the development of the euro area economy. Considering Estonia's close links with the EU economic space, these positive signals are carried over to Estonia as well, through foreign trade and financial markets.

Goals and Activity in Financial Market Integration

Intra-EU integration in other economic spheres becomes particularly important in the conditions of common monetary policy. Therefore, the recent EU priorities include structural reforms and integration of financial markets, especially the securities market integration the lack of which can complicate the smooth implementation of monetary policy. The 1999 Financial Services Action Plan of the European Commission has been approved and this should guarantee full integration of the EU financial markets by the year 2005 and integration of the securities markets by the year 2003.

The action plan consists of 42 points and foresees adoption of legal instruments (directives, regulations), as well as research and recommendations in several areas of the financial sector. According to the report presented to the European Council in December 2001 in Laeken, 25 points of the plan have been carried out. A new anti-money laundering directive was adopted in the second half of 2001, an agreement was reached on the harmonisation of service fees charged on payments in euro, and a political consensus was reached on the mechanism allowing fast-track processing of the securities market legislation.

An important role in the Financial Services Action Plan belongs to measures aimed at guaranteeing financial stability, in particular, strengthening of the financial sector supervision so as to bring it up to international standards. The key words here are the mandatory implementation of international accounting standards (IAS) for all listed companies, tighter supervision over financial conglomerates (groups engaged in different spheres of financial services), stricter prudential ratios and more efficient mechanisms against potential malicious market manipulations.

The deepening of financial markets integration has tightened co-operation between different financial sectors as well as supervision institutions of the Member Countries. Besides world forums, EU Member States attach great importance to inter-EU activities, which focus on committees uniting the banking, insurance and securities market supervisors of the Member States. The importance of supervision co-operation is stressed in the 2000 Brouwer Group[3] report, which states that financial supervision of the Member Countries has been successful in guaranteeing the financial stability of the EU and that there is no need for centralised supervision. In addition to supporting the creation of the single financial market and supervision standards, the committees play an important role in the exchange of information and discussions on the development of the financial market. More importance has been given to co-operation based on the view that the different segments of the financial market form a single market, and principles of preventing and solving financial crises.

Framework of Economic Policy Co-operation between the EU and Candidate Countries

As the integration process proceeds, the economic policy co-operation of Estonia and other candidate countries with the EU and its Member States deepens, thus preparing new members for active participation in the EU economic policy co-ordination mechanism. In 2001, the forms of co-operation

[3] The Brouwer Group is a working group of the Economic and Financial Committee (EFC) that submitted economic and financial ministers the EU supervision report in April 2000.

developed further and improved. **For the first time, the candidate countries attended the extended meeting of the EU Economic and Financial Affairs Council (Ecofin). Since 2001, a regular dialogue is going on between members and substitute members of the EU Economic and Financial Committee and representatives of the candidate countries.** The goals of the dialogue between the EU and candidate countries include:

- preparation of candidate countries for the multiple observance process of the EU members;
- assessment of the candidate countries' fiscal, economic, financial, monetary and exchange rate policy suitability;
- supervision of the future members in the creation of institutions necessary for the EU economic policy dialogue.

The economic policy dialogue is based on the framework document – **Pre-accession Economic Programme –** drawn up by a candidate country. This programme includes the medium-term perspective (five years) economic targets such as fiscal goals and the schedule of economic reforms. The pre-accession programme is mostly aimed at meeting the Copenhagen criteria. At the same time, candidate countries also make preparations for meeting the Monetary Union criteria in order to achieve readiness to join the Monetary Union in the status of countries with a derogation. The economic programme is a document drawn up strictly by the candidate country itself and its results are evaluated by the EU structures. In essence, the pre-accession programme is a predecessor of convergence and stability programmes[4]. The economic dialogue between the EU and candidate countries takes place according to a fixed timetable.

Schedule of Economic Dialogue between the EU and Candidate Countries from 2002

Candidate countries are to submit their pre-accession programmes to the European Commission by **15 August.** The Commission gives an evaluation of the submitted programmes in **mid-October**. The evaluations are to be co-ordinated on the level of the EU Economic and Financial Committee substitute members and representatives of the candidate countries by the **end of October.**

Meeting between the EU Economic and Financial Committee members and representatives of candidate countries will take place in **November** and focus on the pre-accession programmes.

In **December**, ministers of candidate countries are to take part in the work of the European Economic and Financial Affairs Council (Ecofin).

Besides the pre-accession economic programmes, the European Council expects the candidate countries to notify it (fiscal notification) about all major changes and tendencies of economic policy (concerning fiscal deficit, state debt, capital investments, etc). A similar requirement applies to the EU Member States.

Since 2000, the European Council publishes biannual economic forecasts on the candidate countries. Since 2001, forecasts rely on regular co-operation with experts from candidate countries.

[4] Convergence programmes are submitted to the European Commission and Council of Ministers by member countries outside the euro system, stability programmes by members of the euro system. The aim of convergence programmes is to meet the Maastricht criteria, stability programmes are aimed at the observance of Stability and Economic Growth Pact.

Progress Made by Candidate Countries

In the summer 2001 in Göteborg the Council set the goal of concluding accession talks with those candidates which are ready by the end of 2002, in order to allow new members to participate in the 2004 elections to the European Parliament. In December 2001 the Council named ten candidates, who could be ready to finish preparations for entry by the end of 2002, provided that talks and reforms continue as successfully as so far: Estonia, Cyprus, the Czech Republic, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. The Estonian government has set its aim at concluding the accession talks by the end of 2002.

The European Council notes in its 2001 autumn report on the progress made by candidate countries in the accession process that **political criteria have been met by all candidates except Turkey.** Cyprus and Malta fully meet the economic criteria. **Estonia, the Czech Republic, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia have functioning market economies that should be able to manage in the internal market of the EU, provided that reforms continue.**

The most important tasks of the candidate countries are gradual harmonisation of the economic structure and development level with the EU, completion of the legislation transposition and the effective implementation of legislation that, first and foremost, requires improvement of administrative capacity.

Real and Nominal Convergence

Harmonisation of the economic structure and level of development with the EU countries or stable real convergence is the economic policy priority for candidate countries in the coming years.

Harmonisation of real income is not and cannot be a precondition for EU membership. Still, it is easier to co-ordinate economic policy in the conditions where there are no big differences between the income and price levels of the Member States. Therefore, great attention is paid to processes guaranteeing real convergence. In 2001, Estonia's economic growth outstripped that of the EU and the gap between real incomes narrowed (see Table 3.1). In its 2001 regular progress report of the candidate countries the European Commission singled out the achievements of Estonia, Hungary, Latvia, Poland, and Slovenia in this area.

Table 3.1. The most important economic indicators of EU candidate countries in 2000

Country	Population (million inhabitants)	GDP per capita in Purchasing Power Standards			GDP change (%)	Foreign trade with EU countries (% of all foreign trade)	
		in euro	% of EU average				
		2000	1999	2000		Export	Import
Bulgaria	8.2	5,400	22	24	5.8	51.2	44.1
Estonia	1.4	8,500	36	38	6.9	76.5	62.6
Cyprus	0.8	18,500	81	83	4.8	47.7	55.9
Latvia	2.4	6,600	27	29	6.6	64.6	52.4
Lithuania	3.7	6,600	29	29	3.3	47.9	43.3
Malta	0.4	11,900	…	53	5.0	33.5	59.9
Poland	38.6	8,700	36	39	4.0	69.9	61.2
Romania	22.4	6,000	27	27	1.6	63.8	56.6
Slovakia	5.4	10,800	46	48	2.2	59.1	48.9
Slovenia	2.0	16,100	71	72	4.6	63.8	67.8
Czech Republic	10.3	13,500	59	60	2.9	68.6	61.9
Turkey	65.3	6,400	28	29	7.2	52.3	48.8
Hungary	10.0	11,700	51	52	5.2	75.1	58.4

Source: Making a Success of Enlargement, Strategy Paper and Report of the European Commission on the Progress towards Accession by Each of the Candidate Countries, November 2001

Unlike real convergence, nominal convergence can be measured through inflation, exchange rate and other indicators. In the EU economic policy, nominal convergence also has a direct political outlet – it decides membership in the Economic and Monetary Union and the Eurosystem. For this, the Maastricht criteria have to be met, which means keeping inflation and interest rates close to the EU average and achieving the stability of the exchange rate against the euro.

Emphasis on Administrative Capacity

In the present stage of negotiations, when candidate countries have already transposed a large part of the EU legislation, **administrative capacity** is becoming the key issue: the candidates have to guarantee full and effective enforcement of legislation. According to the Council's decision, the European Commission will assess the status of the candidates in early 2002 in the priority areas specified in the accession partnership document. If necessary, the Member States will render additional assistance to candidates for solving the problems.

One form of assessing the administrative capacity of candidate countries is the **Peer Review Programs of the European Commission**, drawn up by experts of the Member Countries. Besides the correspondence of regulative acts, the involvement of experts allows to assess such enforcement aspects in which the Commission might lack adequate experience. The Peer Review Program has already been launched in such areas as financial supervision, legal and internal issues, fiscal and agricultural matters, atomic energy safety and environmental issues.

Relations between the European Central Bank and Candidate Countries

The European Central Bank (ECB) and the European System of Central Banks (ESCB) have an important role in the economic policy dialogue between the European Union and Member States. Since 2001, the ESCB is involved in the negotiations between the candidate countries and the European Commission. However, this dialogue is not part of the accession talks but prepares participants for the implementation of unified monetary policy. The co-operation of the candidate countries with the ECB covers both economic policy and technical issues.

Economic policy dialogue has focused on the issues of the financial sector and monetary and exchange rate policy from the aspect of real and nominal convergence. At the December 2001 meeting of the ECB and governors of the central banks of the candidate countries in Berlin and the preparatory working meeting of top experts the focus of attention was on the financial sector[5].

In the creation of inter-central banks technical competence and co-operation network experts and specialists participate in workgroups and courses that cover the structure of payment systems, legal issues, economic statistics and banking supervision. Since 2000, more than 600 such gatherings have been organised. In 2001, co-operation related to the reparations for the changeover to the euro in the Member States was added.

[5] See Co-operation with European Central Bank, pp 79–80.

Monetary and Exchange Rate Policy upon Accession to the European Economic and Monetary Union – General Framework

Prior to accession there are no direct restrictions or obligations for the candidates on the choice of monetary policy or the exchange rate regime. However, there are a number of conditions that have to be met before membership, including those related to preparations for the status of a future Monetary Union member.

Upon joining the EU, the candidate becomes a member of the EMU with a derogation. This status involves several rights and obligations:

- the governor of the national central bank will participate in the work of the General Council of the ECB;
- a convergence programme is drawn up every year, focusing on meeting the Maastricht criteria;
- the country has to follow the fiscal constraints[6] applied to the EU members;
- the exchange rate policy will be subordinated to the common interests of the EU[7].

After EU membership, but not necessarily immediately – the exact time depends on the readiness of the new member – the exchange rate against the euro will be fixed according to the agreement between the euro area members, the ECB and the new Member State, and the new member will join ERM2, the exchange rate mechanism of the euro and the currencies of EMU members with a derogation. The largest fluctuation band against the euro is 15% of the fixed central rate, but narrower bands can also be arranged.

The new member has to participate in ERM2 for at least two years. If the member with a derogation meets all the criteria for full participation by the end of the two-year period and submits a request for accession, the European Council will make a decision on the country's full EMU membership. The country accepted to full membership will start implementing common monetary policy through the European System of Central Banks and has to observe the criteria of the Stability and Growth Pact.

International Monetary Fund as Designer of Monetary and Banking Policy Environment

In 2001, the International Monetary Fund (IMF) continued focusing of the stability of the financial system, which had priority already in previous years. Regular monitoring of the economic situation of the Member States continued, with emphasis on the financial sector and stability of the international financial system. An important achievement of 2001 is the elaboration of early warning indicators for both micro- and macroeconomic level. Also, more and more IMF Member States are joining the financial sector transparency and stability assessment projects launched by the IMF.

The elaboration of the early warning indicators for assessing the stability of the financial sector as well as financial and real economy stability analysis have been on the IMF agenda before, but the need for them increased after the financial crises in Asia and Russia. Problems originating mostly from the economic or political instability of the emerging markets quickly reach the financial sector and

[6] However, no sanctions are used against the Member Countries with a derogation for the violation of fiscal constraints.
[7] The EU is of the opinion that it is not possible to work out a common mandatory exchange rate model for this stage; the choice of the exchange rate strategy depends on the economic situation of each country. However, the so-called crawling peg, with the currency depreciating or appreciating against some other currency according to a prearranged schedule, and pegs against anchors other than the euro fall out of line with the principles of *acquis communautaire*. Both the European Commission and the ECB have assured Estonia that our currency board arrangement is perfectly suitable for this stage.

inadequate supervision, accounting practices that do not meet international standards and inadequate transparency can lead to the insolvency of the financial sector companies. The early warning indicators would help to detect potential problems and analysis would identify the relations between the real economy and the financial sector and potential channels for problem transmissions. In order to facilitate this work, the IMF has drawn up collections of basic indicators and recommended economic indicators, relying on the experience of the IMF Member States. The Board of the IMF approved those in June 2001. The next stage involves elaboration of instructions for analysing the relations between those indicators.

The financial sector stability assessment and good practices observance programmes are gaining popularity as it is understood that financial crises are cheaper to prevent than to overcome. The Financial Stability Assessment Program, carried out jointly by the IMF and the World Bank, is one way to help countries to define their problem areas and suggest possible changes in legislation and market regulation. Estonia was among the first 12 countries where such assessment was successfully carried out in 2000. By the end of 2001, 36 countries had passed such assessment process.

In recent years the IMF has had to deal with the huge aid packages of Russia, Argentina and Turkey. On the strength of these experiences, the IMF has begun elaborating the framework for **involving the private sector creditors in the restructuring of state debt.** Countries whose debt burden has become unbalanced must have the opportunity to negotiate with the creditors of their own private sector according to a certain procedure, the way it is done with institutional investors. The situation has become more complicated with the widening of the circle of investors, ranging from private individuals to large international banks, and it is nearly impossible to achieve a simultaneous decision of all these creditors on the restructuring of debts.

In co-operation with the World Bank and other international creditors the IMF has made considerable progress in recent years in implementing the aid programme of Heavily Indebted Poor Countries. The precondition of the debt reduction of poor countries is that they follow the requirements of the Poverty Reduction Strategy Paper aimed at supporting economic growth and facilitating the development of civil society. The donor countries are monitoring this closely. The aid programme enables to balance the world's economic development, reduce poverty and the number of potential crisis centres.

There are 42 heavily indebted poor countries in the world. The aid programmes are estimated to cost approximately 33 billion US dollars and relieve the poor countries of 54 billion dollars of debt. The IMF has established a special fund for supporting the programme. 93 Member Countries have decided to support the programme, including Estonia[8]. The countries to have sped up reforms and followed the agreed-upon economic programmes include, for example, Uganda, Tanzania and Bolivia.

International Anti-money Laundering and Terrorism Financing Prevention Activity

After the 11 September 2001 terrorist attacks in the USA the entire international community rallied against the repetition of such events in the future. Still, it would be wrong to say that heightened attention to preventing money laundering and terrorism financing is something new that began in the second half of 2001. In the spring of 2001, for example, the IMF and the World Bank decided to expand their activities in this area. Anti-money laundering measures have been constantly developed also in the European Union and other international organisations.

[8] See Estonia's Participation in the Initiative for the Heavily Indebted Poor Countries, p 81.

Financial Action Task Force on Money Laundering

The Financial Action Task Force on Money Laundering (FATF), set up by G7 countries in 1989 under the aegis of the OECD, is the main international organisation focusing on suppressing money laundering that works out respective policies and methodological recommendations. The FATF unites 29 countries and territories[9], and besides FATF, regional organisations based on similar principles have been set up. Estonia is a member of the respective committee working at the Council of Europe.

The FATF 40 recommendations on curbing money laundering are the most important international standard in this sphere. Since 2000, FATF publishes the list of countries and territories where authorities are paying insufficient attention to fighting money laundering[10] and thus transactions with those regions can entail greater money laundering dangers. If necessary, the FATF members apply measures against such countries and territories. In December 2001 it was decided to take measures against Nauru.

At their extraordinary plenary meeting on 29–30 October 2001 FATF members decided to extend the mandate of the organisation so that it would cover the issues of fighting financing of terrorism. At the same extraordinary meeting FATF members adopted eight recommendations on preventing financing of terrorism.

FATF 40 Recomendations on Combating Money Laundering and Special Recommendations on Preventing Terrorist Financing

The current version of the 40 recommendations on combating money laundering was adopted in 1996. The recommendations cover the following aspects:

- general framework (ratification of the 1988 UN Convention and modification of the financial institution secrecy laws so that they would not inhibit fight against money laundering);
- legislative aspects (constitute money laundering a criminal offence in accordance with the 1988 UN Convention; legislative measures allowing to freeze and confiscate dirty money);
- anti-money laundering framework covering the entire financial system (customer identification and record-keeping requirements that in addition to banks apply the non-banking financial sector; fixation of internal procedures by financial institutions; increased attention on transactions with regions where authorities apply anti-money laundering policies insufficiently, etc);
- efficient internal and international co-operation.

On 31 October 2001 FATF members at their extraordinary plenary session adopted eight special recommendations against financing of terrorism that include the following requirements:

- ratification of the 1999 UN Convention and implementation of the respective resolutions of the UN Security Council (particularly resolution 1373/2001);
- constituting the financing of terrorism a criminal offence and legislative measures to freeze and confiscate such funds;
- the financial sector has the obligation to report transactions suspected of being related to terrorism financing;
- international co-operation;
- increased attention to non-banking organisations and non-profit organisations providing money transfer services.

[9] Main OECD members plus major financial centres of Asia and Latin America.
[10] *Non-Cooperative Countries and Territories List.*

United Nations

The UN has adopted several conventions on suppressing money laundering and terrorism. These are the main international legal acts in this area. In order to combat legalisation of proceeds acquired through criminal activity (money laundering) the **Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances** (the Vienna Convention)[11] was adopted in 1988. From the point of terrorism financing the most important legal act is the **International Convention for the Suppression of the Financing of Terrorism**[12] adopted by the UN on 9 December 1999.

Besides conventions, the UN Security Council has adopted several resolutions on combating terrorism. Under Security Council Resolution No 1373, adopted on 28 September 2001, countries report to the respective UN committee on the measures implemented in the country. Estonia sent its report to the UN by 27 December 2001 and it is available at the UN web site[13] alongside similar reports of other countries.

International Monetary Fund

As fight against money laundering is directly related to good practices and transparency of the financial sector policy, this issue has been on the agenda of the IMF for the last couple of years. Co-operation of different organisations in suppressing money laundering and financing of terrorism tightened after the terrorist attacks against the USA. At its 17 November meeting in Ottawa, the International Monetary and Financial Committee (IMFC) decided to enhance anti-money laundering monitoring. Since 2002, the IMF strengthens monitoring of anti-money laundering activities in the course of annual economic policy consultations. Special attention is devoted to money laundering and financing of terrorism in offshore regions, but money laundering is under scrutiny in all countries. The IMF is also planning a pilot survey on suppressing money laundering and financing of terrorism in a few selected Member Countries. Estonia too has agreed to take part in this project.

European Union

After the 11 September terrorist attacks the European Union joined all international actions of combating terrorism. Co-operation with international community covers security, economic and financial issues, humanitarian aid and foreign policy, with the EU policy complementing the measures taken by the individual Member Countries in areas where common co-ordinated activity is more efficient. At the Laeken meeting in December 2001 the European Council adopted common principles on fighting terrorism. These principles were also joined by the candidate countries, including Estonia[14].

These common principles are based on the action plan adopted by a special European Council session held in Brussels on 21 September 2001, which includes adoption of a European arrest warrant and introducing a common definition of terrorism and common penalties in the legislation of the Member States, elaboration of a common list of terrorist organisations (to supplement the lists provided by the US security bodies on terrorist organisations operating on the territory of Europe) and other measures.

[11] The ratification of this convention is the first of the FATF anti-money laundering recommendations. Estonia ratified the convention in 2000. Estonia has also ratified the Council of Europe Convention on Detection, Freezing and Seizing Money Laundering and Criminal Proceeds.
[12] The draft law on the ratification of the conventions has been submitted to the Estonian parliament.
[13] http://www.un.org/Docs/sc/committees/1373/
[14] See Arrangements for Combating Money Laundering and Terrorism in Estonia, p 59.