Eesti Pank
Bank of Estonia

Report on the Adoption of the Euro

September 2010

CONTENTS

SUMMARY

Eesti Pank started to publish a regular report on the adoption of the euro in 2007. The purpose of the report is to share with the public information about Estonia's readiness to change over to the single currency of the European Union, the euro.

By joining the European Union Estonia committed to adopt the European single currency. Owing to the Estonian monetary system, the Estonian kroon has been firmly pegged to the euro for over 18 years. Therefore, the changeover to the euro should be regarded as a natural development for Estonia, given its close integration with the European economy. The euro would contribute to the ongoing economic integration, increase Estonia's credibility for the investors, and enable Estonia to have more say in Europe's economic policy making.

The adoption of the single currency calls for meeting certain economic and legal requirements laid down in the Treaty establishing the European Union – the Maastricht criteria. The aim of these criteria is to ensure that the economy adopting the euro is ready for operation in the Economic and Monetary Union, and thus guarantee the smooth functioning of the monetary union and a stable price level. These criteria include price stability and low interest rates, a stable exchange rate, and sound public finances. In addition, an appropriate legal framework is essential to designing and implementing the single monetary policy.

The European Commission and the European Central Bank assessed Estonia's compliance with the Maastricht criteria in the Convergence Reports of 12 May 2010. Estonia's Finance Minister Jürgen Ligi and Eesti Pank's Governor Andres Lipstok confirmed in their letter to J-C. Juncker, President of the Eurogroup, E. Méndez, President of the ECOFIN Council, and O. Rehn, European Commissioner for Economic and Financial Affairs, that Estonian authorities are fully aware that euro adoption requires a commitment to stability and strong economic policies (see Annex 1). On 13 July, EU finance ministers adopted the final decision on Estonia's accession to the euro area on 1 January 2011. 1 January 2011 had also been set as the target date in Estonia's National Changeover Plan. The exchange rate was fixed at 1 EUR = 15.6466 EEK by the unanimous vote of the euro area finance ministers and Estonia's finance minister.

The National Changeover Plan, adopted by the Government and last updated in April 2010, is the basis for Estonia's preparations for the euro changeover. On 22 April 2010, the Estonian parliament adopted the Law on the Introduction of the Euro. The national working groups re-intensified preparatory work for the changeover in the second half of 2009, and the EU finance ministers' decision of 13 July gave the final impetus to practical preparations. From July 2010 until 30 June 2011 the prices of goods and services must be displayed in both kroons and euros. Eesti Pank has launched training courses for cash handlers, and on 20 July the minting of Estonian euro coins started off. A major public awareness campaign will take place in the second half of 2010.

1. ASSESSMENT OF READINESS FOR EURO AREA MEMBERSHIP

The introduction of the single currency of the European Union, the euro, is obligatory for all Member States of the European Union.[1] The adoption of the single currency and the single monetary policy of the European Union calls for meeting certain economic and legal preconditions. These requirements, known as the Maastricht criteria, have been laid down in Article 121 of the Treaty on European Union and Protocol No 21 annexed to the Treaty. The objective of the Maastricht criteria is to ensure the smooth functioning of the European Monetary Union and a stable price level by means of a single monetary policy. These criteria require price stability and low interest rates, a stable exchange rate, and sound public finances. In addition, an appropriate legal framework is essential to designing and implementing the single monetary policy.

The European Commission and the European Central Bank publish regular convergence reports on the non-euro area Member States of the European Union every two years.[2] The Convergence Reports and the recommendation of a qualified majority of the Eurogroup members[3] provide a basis for the European Commission to submit proposals to the ECOFIN and the European Council listing the Member States ready to launch the euro.

The European Central Bank and the European Commission published regular Convergence Reports on 12 May 2010. In addition to Estonia, the euro readiness of eight other countries were assessed: Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, and Sweden. Estonia was the only one to fulfil all the necessary criteria in the period under review, and the Council of the European Union adopted a decision[4] allowing Estonia to adopt the euro at the beginning of 2011. Consequently, the euro area will comprise 17 European Union members.

1 Denmark and the United Kingdom are exceptional in this case, as at the time of agreement on the principles of the monetary union (at the beginning of the 1990s) they were allowed to choose whether or not and when to adopt the euro. Those who joined later (incl. Finland and Sweden) were not given this option.

2 The Convergence Reports are available on the following websites:
European Commission: http://ec.europa.eu/economy_finance/publications/european_economy/2010/ee3_en.htm
European Central Bank: http://www.ecb.int/pub/convergence/html/index.en.html

3 The entry into force of the Lisbon Treaty on 1 December 2009 increased considerably the roles of the European Parliament and the Eurogroup. Eurogroup's recommendations are now part of making euro area enlargement proposals. The Lisbon Treaty establishes that Eurogroup members have up to six months after receiving a proposal from the European Commission to adopt a decision regarding the enlargement of the euro area.

4 Council Decision of 13 July 2010 in accordance with Article 140(2) of the Treaty on the adoption by Estonia of the euro on 1 January 2011: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:196:0024:0026:EN:PDF

2. ESTONIA'S READINESS TO ADOPT THE EURO

The changeover to the euro must be viewed as a natural development for Estonia. Estonia's EU membership entailed joining the euro area as soon as Estonia would comply with all the necessary criteria. The Estonian economy is closely related to the European single market and also the fundamentals of Estonia's economic policy are very similar to those of the euro area. The fixed peg of the Estonian kroon to the euro has served as the basis for Estonia's economic policy and financial stability for already more than 18 years. In other words, the Estonian economy and entrepreneurs have been operating in an environment similar to the euro area. The adoption of the single currency would further tighten the close relations between Estonia and other EU countries and increase Estonia's credibility for the investors.

The Government and Eesti Pank set the goal to adopt the euro at the first opportunity; that is, as soon as Estonia meets all the necessary conditions. In summer 2009, the Government adopted Estonia's National Changeover Plan, which set 1 January 2011 as the target date for accession to the euro area. On 13 July 2010, the Council of the European Union confirmed Estonia's readiness to adopt the euro.

The following overview introduces the assess-ments of the European Commission and the European Central Bank published in the Convergence Reports with regard to Estonia's compliance with the Maastricht criteria. These were also the last Convergence Reports drawn on Estonia.

2.1. Price stability

According to the Treaty on European Union, a Member State's inflation rate must not exceed the average of the three best-performing Member States in terms of price stability by more than 1.5 percentage points.

The price stability criterion is calculated on the basis of the average inflation rate for the 12 months preceding the evaluation.[5] To this end, the Harmonised Index of Consumer Prices (HICP) of the European Union is used, not the Consumer Price Index of the individual country. It is also analysed whether there exist potential factors that might boost the inflation above the reference value of the criterion in the coming years.

Estonia has not complied with the Maastricht price stability criterion in the previous years because of the relatively high inflation level, caused by robust domestic growth and external price pressures. In 2009, the price pressures eased considerably and in November 2009 Estonia met the inflation criterion. The Convergence Reports published on 12 May confirmed Estonia's compliance with the price stability criterion in the period assessed, that is from April 2009 to March 2010, when Estonia's 12-month average HICP inflation was –0.7%, which is below the 1.0% reference value.

Price and wage developments must be in line with productivity growth also in the future to guarantee a stable economic environment. The European Commission's Spring Forecast of 5 May 2010 does not anticipate a rapid rise in inflation in Estonia during 2009–2011, and thus deems Estonia's inflation indicators as sustainable (see Figure 1). The Commission nevertheless states that Estonia must remain vigilant and keep inflation low, while maintaining ambitious fiscal policy stance and keeping domestic demand in line with fundamentals. The European Central Bank's Convergence

[5] The earlier practice was to include in the calculation of the criterion only the inflation rates of these countries where price growth is positive. However, short-term negative price growth does not contradict the price stability criterion, which is why the criterion's calculation methodology was changed in 2010 to include also the inflation rates of countries with negative price growth, or the so-called outliers. At the beginning of 2010 the majority of EU countries recorded negative price growth indicators, with only Ireland being defined as an outlier with its highly negative and extraordinary domestic-driven inflation rate.

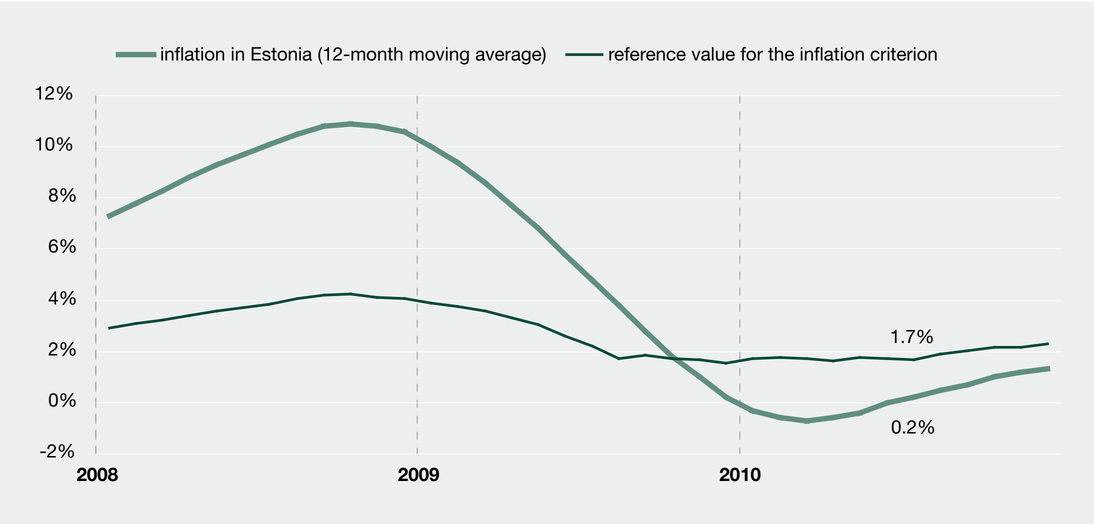

Figure 1. Compliance with the inflation criterion

Source: European Commission forecast (May 2010)

Report expresses concerns regarding the long-term sustainability of the inflation level in Estonia.

Global developments in the past two years have caused greater volatility in terms of economic indicators, including inflation rates. Estonia's inflation has lately been accelerated mostly by an increase in the prices of imported energy and food. External price pressures will raise the inflation forecast also in 2011. Therefore, an upward adjustment in the inflation forecast will be necessary in the autumn forecast. Nevertheless, domestically driven price pressures are still subdued because of weak domestic demand and underutilised production inputs. Excise duties have been brought to the EU minimum levels, and the excise and VAT rises implemented to balance the state budget in 2009 have already passed through to prices. Price and income convergence is another important inflation determinant. The rate of convergence is slowing though, given that Estonia's price levels already constitute 70–80% of EU average levels. According to different estimates, the convergence component accounts for 1–2 percentage points of Estonia's yearly inflation.

2.2. Long-term interest rate

The long-term interest rate of a Member State must not exceed the average interest rate of the three best performing Member States in terms of price stability by more than 2%.

According to the criterion, the interest rate on the long-term (10-year) government bonds denominated in the applicant country's currency must not exceed the average long-term interest rate of the three Member States with the lowest inflation rates by more than 2%. Estonia lacks long-term government bonds denominated in kroon, and there is no directly comparable interest indicator.

The European Commission's Convergence Report also states that the long-term interest rate criterion is not directly applicable to Estonia, as no benchmark long-term government bonds or other appropriate securities are available to assess the durability of convergence as reflected in long-term interest rates. The lack of appropriate securities reflects low public debt. Although the risk perceptions vis-à-vis Estonia of financial market participants increased at the height of the crisis, the country's developments during the assessment period and general estimates regarding the durability of convergence, including prudent fiscal policy, support the Commission's opinion that Estonia complies with the interest rate criterion. Heightened risk perceptions have also been outlined in the European Central Bank's Convergence Report. Market pressures started to ease only at the beginning of 2009 as a result of declining risk aversion in the global markets, developments in public finance, and market expectations regarding Estonia's prospects of adopting the euro.

2.3. Stable exchange rate

The country must, for at least two years, participate in the currency exchange rate mechanism ERM II and keep the exchange rate of its currency stable against the euro (in particular without devaluation on its own initiative).

Estonia joined the ERM II on 28 June 2004 within the framework of the currency board arrangement and undertook a unilateral commitment to preserve a fixed exchange rate. The standard fluctuation band for the exchange rate in ERM II is +/–15%. During ERM II membership, Estonia fulfilled its (unilateral) commitment to maintain the rate of the kroon against the euro within the 0% fluctuation band.

2.4. Public finances

The general government deficit must be lower than 3% of GDP. Government debt must be less than 60% of GDP or approaching the required level at a satisfactory speed.

Estonia has successfully complied with the public finance criterion during the period assessed and also earlier. In the years of rapid economic expansion, Estonia's general government budget used to be in balance or surplus owing to a relatively conservative fiscal policy (see Figure 2). Public debt as a ratio of GDP has been one of the smallest among the EU Member States. However, Estonia's economic situation changed as a result of the global crisis and the 2.7% budget surplus as a ratio of GDP recorded in 2007 turned into a 2.7% deficit in 2008. Regardless of the contraction

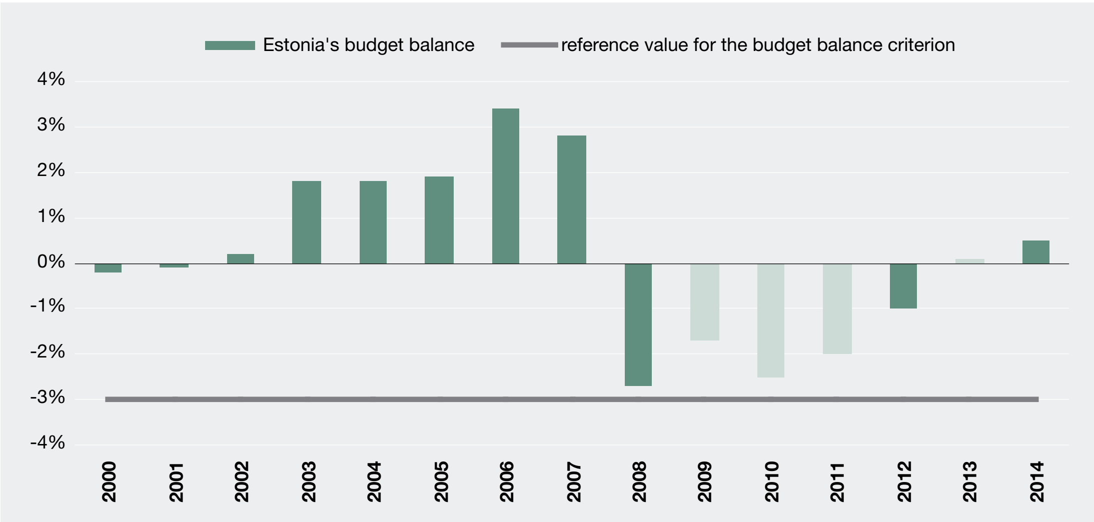

Figure 2. Estonia's budget balance and reference value for the budget balance criterion (% of GDP)

Source: State Budget Strategy 2011–2014 (May 2010) of the economy by around 15%, the 2009 budget deficit was much smaller than expected, standing at 1.7% of GDP as a result of extensive consolidation measures. The European Commission's Spring Forecast expects Estonia's fiscal deficit to be 2.4% of GDP in 2010-2011. Eesti Pank anticipates a fiscal deficit of 2.2% of GDP for 2010 and supports the Government's goal to achieve a nominal fiscal surplus by 2013 at the latest.

2.5. Legal requirements for the adoption of the euro

Assessment of the compatibility of national legislation, including the statutes of the national central banks, with the Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks.

In 2006, the Eesti Pank Act was amended to comply with the Treaty on European Union and the Statute of the European System of Central Banks (ESCB). While drawing the Convergence Reports of 2010, the European Commission considered it necessary to revise the Eesti Pank Act and thus also the Statutes of Eesti Pank. On 22 April 2010, the Parliament adopted the Law on the Introduction of the Euro, which also amended the Eesti Pank Act and repealed the Currency Law and the Law on the Security of the Estonian Kroon, with effect from the date of the introduction of the euro. The Convergence Reports of the European Commission and the European Central Bank, published on 12 May 2010, considered that the Estonian legislation is legally compatible with the Treaty on the Functioning of the European Union and the ESCB Statute.

3. NATIONAL PREPARATIONS FOR THE INTRODUCTION OF THE EURO IN ESTONIA

Upon joining the European Union and the Exchange Rate Mechanism II (ERM II), the Estonian authorities set the goal to be technically ready for the adoption of the euro by mid-2006 and to introduce the euro on 1 January 2007. The assessment of the European Commission, published in autumn 2006 and spring 2008 on the technical readiness of the non-euro area EU Member States to adopt the single currency, was very positive for Estonia. However, as Estonia's inflation rate was higher than allowed by the price stability criterion, the country was not able to change over to the euro as yet. Compliance with the inflation criterion, as well as other Maastricht criteria, was achieved in November 2009, and the necessary preparations are being revised, updated and carried out.

3.1. Arrangements at the national level

To ensure a smooth changeover to the euro and coordinate necessary activities the Government decided, at its cabinet meeting on 9 December 2004, to form the National Changeover Committee. The Committee is chaired by the Secretary General of the Ministry of Finance. The Committee also includes a Deputy Governor of Eesti Pank, the Secretary General of the Ministry of Justice, the Secretary General of the Ministry of Economic Affairs and Communications, the Secretary General of the Ministry of Internal Affairs, the Director for European Union Affairs at the State Chancellery, and an adviser to the Prime Minister.

The committee has established six working groups who address the following issues: cash and settlements (Eesti Pank and credit institutions), business environment, public sector technical readiness, consumer protection, legal matters, and communications. In January 2009, a seventh working group was established, which has been monitoring compliance with the Maastricht criteria. Besides public sector experts, the working groups involve also private sector representatives in the technical preparations for the introduction of the euro.

In order to prepare for the changeover to the euro, the Estonia's National Changeover Plan was compiled under the instruction of the National Changeover Committee, which includes guidelines for government authorities and information for the general public. The latest version of the euro plan is available on the websites of the Ministry of Finance and Eesti Pank[6] and on the euro web[7].

3.2. Preparations of Eesti Pank

The central bank already started preparations for ensuring a smooth changeover to the euro in autumn 2003. Since joining the European Union in May 2004, Eesti Pank has been a member of the European System of Central Banks. Preparations for joining the ERM II in June 2004 were equally important. For that purpose, Eesti Pank engaged in close cooperation with the European Commission, the European Central Bank and other EU Member States.

The objective of Eesti Pank was to be ready by the middle of 2006 in terms of the organisation's everyday operations and for the introduction of the euro area's single monetary policy. The central bank completed all preparations not directly dependent on the date for the adoption of the euro. A number of practical works, however, could be started only after the Council of the European Union's decision on Estonia's accession to the euro area, which was adopted on 13 July 2010. For instance, it was not possible to start minting the Estonian euro coins beforehand. The public awareness campaign will also mainly take place in the second half of 2010.

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6 http://www.eestipank.info/pub/et/EL/ELiit/
7 http://euro.eesti.ee

In addition to the supply and distribution of euro cash, Eesti Pank is responsible for changing the settlement and payment systems over to the euro. Euro area membership also entails major changes in monetary policy and in the economic analysis, reserve management, foreign currency operations and statistics of the euro area (see Annex 2 and Estonia's National Changeover Plan). The public awareness campaign will be carried out together with the Government, with Eesti Pank focussing on cash related issues. Information about the security features of the euro will be delivered through the media, brochures, advertising, direct mail, exhibitions and other euro cash projects. Special training courses are organised for cash handlers.

3.3. How does the changeover to the euro take place in Estonia?

Legal framework

The EU legal framework for the changeover to the euro consists of three Council regulations. Regulation No 1103/97 establishes rules for the continuity of contracts and for the conversion rates and rounding of national currencies. Regulation No 974/98 establishes euro as the sole legal tender of euro area countries, and also covers various aspects of the transition period and euro cash and coins. Regulation No 2866/98 establishes the conversion rates between the euro and the currencies of the Member States adopting the euro.

In addition, Estonia's legislation has been revised to establish the preconditions for changeover to the euro. To this end, three acts have been adopted: the Law on the Introduction of the Euro, an Amendment Act of the Commercial Code and the State Fees Act.

Principles of the adoption of the euro

- The euro will be introduced as account (electronic) money (e.g. accounts and deposits in commercial banks), and in accounting and contractual relations according to the "big bang" scenario on 1 January 2011, the €-day, without a transitional period. Account money will be converted into euro automatically, simultaneously and in full.

- A two-week period of dual circulation of the kroon and the euro will start from the €-day. During that time kroon cash and euro cash are considered equal payment means. Retailers will accept both the euro and the kroon, but change will be given in euro, as a rule. All ATMs will be ready for dispensing euro cash within 48 hours from the €-day. After the period of dual circulation the euro will become the sole legal tender in Estonia.

- In order to simplify the launch of the euro cash into circulation, the credit institutions will exchange kroons to euros at the central exchange rate 1 euro = 15.6466 kroons and without a service fee for a month before and six months after the €-day. Later on, they will continue providing the same service within a limited branch network for at least another six months. When the credit institutions no longer exchange kroons to euros, Eesti Pank will continue to do so at the central exchange rate and without a service fee for an unlimited period of time.

- Eesti Pank will start the frontloading of euro coins to credit institutions in September and the loading of banknotes in November. The purpose of frontloading is to spread the load of transport and guarantee rapid distribution of euro cash all over Estonia. Credit institutions may conclude sub-frontloading contracts to sub-frontload euro banknotes and coins to their major cash customers (primarily retailers). With regard to frontloading and sub-frontloading it is required that euro banknotes and coins will not be distributed to the general public before the €-day.

- From 1 July 2010 to 30 June 2011 retailers are required to display prices in kroons and euros, converting the prices at the official exchange rate of Eesti Pank to help consumers get used to prices in euros and to reduce rounding related price rises. The Government will serve as an example to the private sector by rounding taxes, state fees, environmental charges and allowances down for the benefit of the taxpayers.

- The costs of the changeover will be covered by the market participants themselves.

ANNEX 1. ESTONIA'S ECONOMIC POLICY GOALS IN THE EURO AREA. A letter from Estonia's Finance Minister and Eesti Pank's Governor to the European Commission, the Eurogroup and Ecofin

Tallinn, June 3, 2010

Mr. Jean-Claude Juncker,
President of the Eurogroup

Ms. Elena Salgado Méndez,
President of the ECOFIN Council

Mr. Olli Rehn,
European Commissioner for Economic and Financial Affairs

Dear Colleagues,

Adoption of the euro has been a long standing objective of Estonia and the overarching anchor for sustained convergence and macroeconomic policies in line with the provisions of the Treaty. As a part of our consistent policy framework, Estonia has adhered to currency board arrangement for almost two decades. Against this backdrop, we were pleased to receive a positive opinion from the Commission in the context of the 2010 Convergence Report.

Estonia's small and open economy has undergone significant adjustment in 2008 and 2009 while being severely affected by global financial crisis. The economy has by now turned the corner and we expect the output expansion to be around 1% for 2010, and to increase to around 4% in the following year. Nevertheless, we are cognizant that this is not the time for complacency. In the challenging global environment, Estonian authorities will pursue decisive policy measures in 2010 and beyond.

Estonian authorities are fully aware that euro adoption requires an unwavering commitment to stability and strong policies. In particular, we will address the key issues and implement policy recommendations of the Commission's and ECB's convergence assessments as outlined below.

The overarching goal of Estonian authorities is to ensure economic environment conducive to sustained output and employment growth in the medium term in a context of balanced macroeconomic conditions and price stability. Our policies will also promote a continuous shift of productive resources towards high value-added activities, a precondition of sustainable development and convergence.

To this end, Estonian authorities remain firmly committed to a three-pronged framework consisting of (I) further fiscal consolidation, (II) continuing our structural reform agenda, and (III) further strengthening financial sector policies. This policy framework is envisaged in the Medium Term Budget Strategy for 2011–2014 adopted on May 20, 2010 and in the next National Reform Program to be adopted under the EU2020 framework, and is fully in line with Estonia's updated Convergence Program.

Fiscal policy

Estonia's fiscal policies will be firmly directed at achieving a nominal fiscal surplus by 2013 and a structural surplus by 2012, fully in line with our commitments under the Convergence Program for 2010-2013. The structural balance will improve by ½ to 1% of GDP annually over the period of 2011–2013. We stand ready to take additional measures without delay to ensure macroeconomic stability and fiscal consolidation if needed.

The overall size of budgetary expenditures will be kept unchanged in 2011 (except for resuming government co-payments to the 2nd pillar pension funds and the use of EU funds) and 2012. Current operating expenditures of the state budget remain unchanged throughout the program period. We have already implemented nearly all planned fiscal consolidation measures for 2010, including increases in excise taxes on electricity and fuels. On the expenditure side, the freeze of operational expenditures is reinforcing a significant carry-over impact of large cost-cutting measures in 2009 amounting to nearly 9 per cent of GDP. State expenditures will be further streamlined and their efficiency increased by the consolidation of administrative services that was initiated in 2010.

Estonia has already done a lot to secure the long term fiscal sustainability, as also acknowledged in the recent Commission Sustainability Report. Nevertheless, to further increase the quality of public services and to ensure long term fiscal sustainability, we intend in 2011 and 2012 (I) to improve the efficiency of social protection systems, including by use of means-tested spending where warranted; (II) to review the system of special pensions; and (III) to commence the analysis of financing sources of health insurance and the publicly financed component of the three-pillar pension system. The parliament has approved in April 2010 the changes to the pension system by gradually increasing the statutory pension age to 65 years.

In line with the Council opinion of Estonia's Convergence Program, we will strengthen the medium-term budgetary framework. Estonia's fiscal planning and yearly budgets are already based on a rolling four-year medium term strategy that consists of overall macroeconomic fiscal targets (including the targeted fiscal position and nominal expenditure levels) from one side, and of the costing of strategic plans of line ministries from the other side. Against this backdrop, we will further develop strategic budgetary planning, including by setting binding fiscal targets over a medium term horizon. We will also further strengthen the system of monitoring the strategic goals and reporting on them, and increase the flexibility of the fiscal framework by reducing spending rigidities.

Structural reforms

The goal of the structural reforms is to promote competitiveness and sustainable broad-based and non-inflationary growth that relies on high value-added sectors. To that end, the structural reform agenda is aimed at supporting the long-established principles of open economy, favorable business climate and market flexibility by inter alia (I) further improving the functioning of our already relatively flexible labor markets, (II) ensuring the efficient functioning of markets for products and services; and (III) supporting investment in research and development activities, and in education.

Changes to the Employment Contracts Act introduced in mid-2009 increased considerably labor market flexibility. Against this backdrop, the authorities will continue to support job creation and reducing unemployment by targeted active labor market policies, including by wage co-payments to SMEs, start-up support to small entrepreneurs, sponsoring on-the-job training opportunities, and providing for training and re-training facilities for unemployed.

Sustainable demand for and supply of labor will be supported by keeping the public sector wage bill firmly under control, in conjunction with the overall nominal freeze of operating expenditures, and by the review of public sector wage polices that was initiated in 2010. Furthermore, the authorities will continue to shift the tax burden from labor to indirect taxation during the program period. We expect that these measures support flexible market structures and will result in a reduction in unemployment and a sustained increase in employment ratio. The respective targets will be specified in the National Reform Program, fully in line with the EU2020 framework.

Open and flexible markets for goods, services and production factors are essential to sustained increase in competitiveness and to move the economy up the value added ladder. Competition on product and services markets will be enhanced by (I) strict application of competition rules, (II) low entry costs for firms, (III) providing nearly all public services on line via the internet, and (IV) maintaining flexible wage formation mechanisms. With Estonia's markets already almost fully opened, the opening up the wholesale electricity market (for retail consumers by 2013) and further physical integration of Estonia's electricity grid into Nordic markets was the major step forward in 2010.

The government has already initiated a number of measures to support research and development. Expenditures on R&D will achieve the level of 1.44% of GDP in 2010 and are set to increase to 3% as a target under the EU2020 framework. The government will continue and strengthen a number of initiatives to support R&D on company level, including by the use of EU funds. Furthermore, government has markedly increased (over tenfold in course of the last five years, to over 0.7% of GDP) the targeted support to enterprises' applied research, product development and innovation.

Estonia's education system has earned relatively high marks in international comparison. Looking forward, increasing the share of people with tertiary (higher) education and upgrading vocational education facilities will contribute to reducing skill mismatch and adding to the productivity of the labor force, and the relevant targets will be specified in our National Reform Program Public appropriations to education increased by over 10% in 2010 budget and will remain the priority area in the years ahead.

Finally, public sector investments have been used to reduce the remaining bottlenecks to growth and to increase production factor mobility, notably by efficient use of EU structural funds. Public investment is expected to increase by 10% in 2011 to nearly 5 to 6 % of GDP, before leveling off thereafter. While the bulk of public investment is used to upgrade road infrastructure, the combined share of health care and education infrastructure, R&D and IT-infrastructure now account for approximately 45% of all public investment.

Financial sector policies

Financial sector policies will be aimed at ensuring financial stability and avoiding build-up of possible risks, including excessive credit growth in future.

As a main policy tool to mitigate these potential risks, Estonia authorities will stand ready to apply stricter requirements under Pillar I if imbalances start to build up in financial sector or on credit markets. Minimum capital adequacy requirement in Estonia has been higher than required by the Basel framework and also risk weights were increased in 2006. In addition, the authorities intend to use the possibilities available under Pillar II of Basel framework to target specific potential risks more accurately.

Considering the high share of branches and subsidiaries of foreign banks in Estonia, effective cross-border cooperation is essential. The EU initiatives to reduce financial sector risks and steps to improve supervisory and crisis resolution framework will play a crucial role in strengthening cross-border cooperation and improving financial stability. The role of cross-border supervisory colleges has already increased in everyday supervisory work. The planned introduction of the Cross Border Stability Groups, European Supervisory Authorities and the ESRB will further strengthen supervisory cooperation.

In addition, we will use regulative measures and other instruments, including taxation, as appropriate, (I) to reduce incentives for excessive risk taking by borrowers, (II) to ensure that banks apply more careful credit risk assessment and (III) to support balanced pattern of savings.

Yours sincerely,

Jürgen Ligi
Minister of Finance

Andres Lipstok
Governor of Eesti Pank

ANNEX 2. THE FUTURE ROLE OF EESTI PANK AS A MEMBER OF THE EUROSYSTEM

If Estonia adopts the euro, Eesti Pank will become a **fully-fledged member**[8] **of the European Economic and Monetary Union (EMU) and Eesti Pank will be a member of the Eurosystem**. At present, Eesti Pank is a member of the European System of Central Banks (ESCB). The ESCB consists of the European Central Bank (ECB) and all EU Member States, regardless of whether they have adopted the euro. The Eurosystem includes the ECB and the central banks of countries that have adopted the euro.

When Eesti Pank will join the Eurosystem, the Governor of Eesti Pank will be attending also the meetings of the Governing Council of the ECB[9] (in addition to the meetings of the General Council of the ECB) and participating in the euro area monetary policy decision-making. From 13 July 2010 to 1 January 2011, the Governor of Eesti Pank participates as an observer in the meetings of the ECB General Council. Eesti Pank has representatives in the committees and working groups of the European Central Bank that meet in the composition of the ESCB and, as of 13 July, also observers in the committees and working groups of the Eurosystem.

The tasks and responsibilities of the central banks of the Eurosystem have been determined in the Statute of the ESCB and the ECB. The Eurosystem operates by the principle of decentralisation. National central banks are responsible for almost all operational tasks of the Eurosystem:

- conduct of monetary policy operations
- management of the monetary reserves
- operation and oversight of payment and settlement systems
- issuing of banknotes in cooperation with the ECB
- assisting the ECB in collecting statistics

Until joining the euro area, the task of Eesti Pank as the central bank of Estonia will be the implementation of the national monetary and exchange rate policy, as well as the preparation of the financial system for the single monetary policy and the adoption of the euro. Euro area membership will entail major changes in monetary policy and the euro area's economic analysis, reserve management and foreign currency operations, statistics, cash, and payment and settlement systems. The functions that are not directly connected to the implementation of single monetary policy will be virtually the same: monitoring and analysis of the Estonian economy, compilation of economic forecasts, management of official foreign reserves, ensuring of financial stability, international cooperation outside the European Union (e.g. with IMF and BIS), etc.

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[8] Eesti Pank currently participates in the EMU as a member with derogation.
[9] The ECB Governing Council consists of the members of the ECB's Executive Board and the governors of the national central banks of the euro area.

Monetary policy and economic analysis

The monetary policy of the euro area follows the principle of **centralised decision-making and decentralised implementation**. All monetary policy issues, enforcement of regulations and decision-making fall under the competence of the Governing Council of the ECB. The Governing Council cooperates with the central banks of the Member States to develop the monetary policy framework and set monetary policy goals. Cooperation takes place in numerous committees and task forces of the Eurosystem and the ESCB, where all important issues are discussed before any decisions are made. The ECB Executive Board is responsible for the implementation of the decisions of the ECB Governing Council via national central banks.

The primary monetary policy measures used by the Eurosystem are the regular **repo auctions** to give short-term loans to commercial banks and the **system of reserve requirements**. The ECB and the committees draft the materials on the basis of which the ECB Governing Council sets the specific inflation target and the key monetary policy interest rates that are needed for achieving that target. The current priority of the monetary policy is to maintain the inflation rate close to but below 2% in the medium term. The most important monetary policy interest rate is the interest rate applied to the ESCB's main refinancing operations. Its latest value in August 2010 was 1.00%.

Daily monetary policy is implemented in cooperation with the ECB and the national central banks of the Eurosystem. For instance, the reserve requirement and the amount of regular refinancing operations, the total amount of short-term loans granted to commercial banks in the Eurosystem, are determined by the ECB Governing Council, whereas monetary policy transactions are intermediated by national central banks. The required reserves of commercial banks are held with the national central banks of the euro area. Lending to commercial banks also takes place via the Eurosystem's central banks. In other words, the partner of a commercial bank in a refinancing operation (a loan contract) is generally a national central bank of the euro area, not the ECB.

Achieving the primary monetary policy objective of the Eurosystem would not be possible without monitoring, analysing and forecasting economic developments. The ECB Governing Council makes the interest rate decisions on the basis of comprehensive analyses of the euro area economy and money supply. The analytical work is divided into two major areas. On the one hand, both the ECB and the national central banks of the euro area carry out general monitoring of the euro area economy by analysing total demand, the interest rate level and liquidity of financial markets, the capital and labour market situation, changes in the euro exchange rate and global economic developments. Fiscal policy is also an essential part of the analysis. Economic analyses result in short- and medium-term assessments of inflation developments. On the other hand, the results of economic analyses are cross-checked by focusing on the aggregate indicators of money supply and credit and their long-term impact on inflation.

All this takes place in close cooperation between the ECB and the national central banks of the euro area. This requires extensive “homework” from the national central banks to present their standpoints and participate in the discussions in the relevant committees and working groups of both the Eurosystem and the ESCB.

Reserve management and foreign currency operations

The management of foreign reserves in the Eurosystem is divided into two. Every central bank of the euro area makes a **contribution to the fixed capital and foreign reserves of the ECB**. If needed, these reserves are used for currency market interventions, which are performed exclusively by the ECB, all central banks of the euro area or by a combination of participants. The ECB does not invest its reserves; instead, these are managed by the central banks of the Member States. To this end, the ECB’s reserves are distributed among national central banks according to the so-called capital key[10]. The income on investment belongs to the ECB; the Member States participate in the distribution of the profit and increase the capital of the ECB, if needed.

In addition to the reserves of the ECB, every central bank that is a member of the Eurosystem independently manages their **own national foreign reserves**. No common rules have been laid down to regulate the management of the reserves of the Member States. The function of these reserves in the Eurosystem is to guarantee the feasibility of an additional contribution to the ECB’s reserves, if needed. However, central bank reserves have also a broader role. The central banks of the Member States, including Eesti Pank, are independent legal entities with their assets and liabilities, which is why they need sufficient capital buffers to cover extraordinary losses. Eesti Pank needs a sufficient capital buffer also to fulfil the tasks not directly related to the implementation of the Eurosystem’s monetary policy.

Cash

The regulations pertaining to the circulation of cash are laid down by the ECB Governing Council after consulting national central banks. **The daily management of cash circulation is the responsibility of the Eurosystem’s central banks** and euro cash is launched into circulation (via commercial banks) by national central banks, not the ECB. Therefore, the euro cash in circulation is also a liability of national central banks, not the ECB, and is recorded on their balance sheets.

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[10] Pursuant to Article 29 of the Protocol on the Statutes of the European System of Central Banks and of the European Central Bank, the capital key weighting of each national central bank is equal to the sum of 50% of the share of in the population of the Union and 50% of the share of its respective Member State in the Union’s GDP, as notified to the ECB by the European Commission. The weightings are adjusted every five years or whenever a country joins the EU. Accordingly, on 1 January 2009 the ECB’s capital key was adjusted due to the five-year update on the basis of data provided by the European Commission. On 1 January 2009, the subscribed capital of the ECB totalled EUR 5,760,652,402.58. Estonia’s contribution was 0.1790%. The 11 non-euro area Member States are required to pay up a minimal percentage of their subscribed capital (currently 7%), as a contribution to the operational costs of the ECB. See also http://www.ecb.int/press/pr/date/2009/html/pr090101_1.en.html.