

Statement by Mr. Lehmussaari on Republic of Estonia
June 24, 1999

1. Let me begin by expressing my appreciation to the staff for the candid dialogue and the well-focused report on the Estonian economy. My Estonian authorities have requested the inclusion of Estonia into the pilot project for the release of Article IV reports to the public. I can confirm that the decision to participate in the pilot project did neither alter the candor nor the conduct of the discussions.

ECONOMIC DEVELOPMENTS

2. The Estonian economy has faced major challenges during the past 18 months. This era can be characterized by two phases. The first period which started in 1996 and lasted through early 1998 was characterized by buoyant economic activity which resulted in a widening of the current account deficit with some transitory speculative pressures on the currency because of the Asian crisis. In the second phase, which took hold in mid-1998, the Estonian economy contracted sharply in the wake of the Russian crisis and disturbances in the international financial markets. This first economic downturn since the beginning of the transition period is expected to abate soon, as the factors that contributed to the recession are fading. These developments created stress on the fiscal and banking sectors, and brought along a sharp increase in interest rates for a short period. The experience showed that a small and open economy, such as Estonia, is very much influenced by changes in the external environment. Under these circumstances, the Estonian authorities had to find an appropriate policy mix to balance the need for reducing external imbalances while, at the same time, mobilizing public support for continuing the reform effort.

POLICY RESPONSE

3. In recent years, economic policies in Estonia have been aimed at continuing the "second generation" structural reforms, improving competitiveness and maintaining macroeconomic stability in general. The currency board arrangement has remained the cornerstone of Estonia's monetary system and, supported by other domestic policies, has allowed interest rates to react in an appropriate manner to restore stability on foreign exchange markets.

4. During the two phases, the intermediate policy objectives changed markedly. During the first period, the main aim of economic policies was to reduce unsustainable growth rates and to create a cushion in the fiscal and financial sectors to withstand the anticipated slowdown of the economy. To that end, the fiscal policy was tightened, and a substantial part of the government surplus was sterilized through the Stabilization Reserve Fund (SRF). On the monetary side, prudential ratios of the banking sector, and capital requirements in particular, were increased, and supervision practices upgraded.

5. In the early stages of the cyclical downturn, the emphasis of economic policies was shifted to contain the adverse effects of the changes in the external environment, and to maintain

confidence in the financial system. The automatic fiscal stabilizers were allowed to absorb part of the impact of the shock. Because of lower inflation and weaker growth, government expenditures rose in relation to GDP. Nevertheless, the general government registered only a small deficit by the end of 1998 despite a sharp shortfall in revenues. In the financial area, the Bank of Estonia acted decisively in response to the emerging weaknesses in the banking sector by closing three failing banks and injecting additional capital to another bank for a transitional period. Banking supervision was also strengthened and broadened. While the authorities established few budgetary short-term measures to offer some relief to enterprises affected by the Russian crisis, the government resisted the protectionist pressures to establish trade restrictions, to use the SRF funds in reviving the economy, and to increase state aid for bailing out ineffective enterprises.

6. By now, it appears that the Estonian economy has been able to sustain external shocks fairly well. The real sector withstood the sharp hikes in interest rates, and demonstrated remarkable flexibility, as can be witnessed by the developments in the labor market, private sector wage developments and the closing of inefficient enterprises. Moreover, confidence indicators have picked up, and interest rates have fallen substantially. There has been a continuous foreign direct investment inflow throughout 1998 and early 1999, thereby financing the current account deficit in full. All these factors have allowed Estonia to maintain its competitiveness in the EU markets and in general, regardless of major devaluations in some other emerging economies over the last year. Due to the strong export performance in the EU markets, total export growth in 1998 remained strong regardless of the Russian crisis. Despite moderate decline in exports during the first quarter of 1999, the current account deficit had narrowed to 7 percent of GDP by March 1999.

7. As a result of the continuous enhancement in supervision and adherence to open financial market policies, the Estonian banking system went through the second consolidation phase by end-1998, characterized by two major mergers and the entry of Scandinavian strategic investors. The consolidation of the banking sector resulted in a significant strengthening of banks' capital base and liquidity. It also served as the main basis for the successful refinancing of outstanding foreign liabilities with medium term instruments, thereby doubling the average maturity of the debt to non-residents as compared to the previous year. In addition, risk management and corporate governance practices were reviewed. All these developments led to the renewed increase of profitability in the banking sector in 1999, despite a weaker economy.

8. However, the fiscal policy stance slipped more than warranted by the economic situation during the run-up period to the parliamentary elections. Certain increases in outlays were justified by the need to adjust the salaries of public sector professionals and raise pensions to protect the most vulnerable groups of the population. However, some increases in government expenditures, together with the overly optimistic revenue projections for the current year, and the combination of the one-off shortfall in revenue collection due to the changes in tax administration, widened the budget deficit.

GENERAL POLICY OBJECTIVES FOR 1999 AND 2000

9. The accession to the EU, and the respective Copenhagen criteria, provide broad guidelines for Estonia's economic policies over the medium term. On the macro side, relatively high and sustained growth rates should be achieved to warrant the gradual convergence of the economy towards the level in the EU. On the structural front, privatization efforts will be strengthened to maintain Estonia's competitiveness. In addition, the administrative capacity of the public sector will be strengthened to provide an adequate legal and regulatory environment for the proper functioning of market economy.

10. Estonia's exchange rate peg in the form of a currency board arrangement, supported by other domestic policies, remains the cornerstone of economic policy, providing a transparent and credible framework for economic development. In the wake of the introduction of the euro in January 1999, the kroon's link to the deutsche mark became de facto the link to the euro. The Bank of Estonia will, by end-1999, in cooperation with the EU institutions, prepare a medium term action plan for joining the European Monetary System and, eventually, the common currency area. In that context, the currency board provides a sound monetary policy framework for the preparation for the adoption of the euro, and also provides the right signals for the real economy during the pre-euro period.

11. The new government which took office in March 1999 has taken an active approach in maintaining economic growth by giving new impetus to further restructuring of the economy. The government will revise the medium term economic program for the years 1999 through 2003, which will provide broad economic guidelines for macroeconomic policies as well as a timetable for further structural reforms. That program will also serve as a basis for the Joint Assessment between Estonia and the European Commission on Estonia's Medium Term Economic Policies to be signed later this year. In addition, the accession negotiations with the EU are well on track.

FISCAL POLICY

12. The Estonian authorities fully recognize that fiscal policy will continue to play a key role in ensuring economic growth and supporting the chosen exchange rate regime. Fiscal tightening has been the first and most important issue for the new government. As room for substantial corrections for the first half of the year 1999 was limited, the government now targets a balanced budgetary outcome for the second half of the year, based on the expected recovery in the economy. For that purpose, the government formulated a negative supplementary budget that contained expenditure cuts in the amount of 1.2 percent of GDP during the second half of the year, with the majority of the retrenchment coming from administrative outlays and postponement of non-priority investments. This supplementary budget is expected to be passed in the Parliament on June 28, 1999. While the government has indicated that it would be difficult to find room for further expenditure cuts this year, it has also ruled out the use of SRF resources for budget financing.

13. The authorities are aiming for a balanced general government budget in 2000. A tighter budgetary position is accompanied by an administrative reform in order to reduce the share of the government in GDP by 2 percentage points. The government has also formulated an enhanced medium-term framework which would contain budgetary projections for the three-year period ahead. In addition, the government is reviewing the legislative basis of the budgetary framework to ensure its compliance with the Code on Fiscal Transparency and other international standards. They have requested technical assistance from the Fund for this purpose.

14. The Stabilization Reserve Fund (SRF) continues to be an essential part of the medium-term budgetary framework. The government will submit to the parliament a law that would institutionalize the reserve fund, define sources of the transfers to SRF, create an advisory council, and set rules of investment and disbursement of its resources by August 3, 1999. While the authorities have stated that the SRF assets could be used to provide a financial cushion in the event of severe financial and economic distortions in the future, the main purpose of the SRF will be to finance the remaining structural reforms, notably the cost of the transition to a fully funded pension system.

FINANCIAL SECTOR POLICIES

15. The Estonian authorities are focussing their efforts on strengthening the legislative basis for effective supervision and further development of banking supervision practices, thereby creating preconditions for the stability of the financial system over the medium term. In addition to the wide range of measures that the Bank of Estonia has implemented in 1997 and 1998 to improve the supervision of the banking sector, many important improvements are also planned to take place this year. Enhanced reporting requirements for off-balance sheet exposures were already introduced in February. The revised Credit Institutions Law, which will become effective in July, harmonizes Estonian banking legislation with EU requirements, strengthens the authorities' ability to enforce prudential standards and brings supervisory standards into better compliance with the Basle Committee standards (Estonia already adheres, in principle, to 24 out of 25 Basle core principles). Simultaneously, the Bank of Estonia will introduce new regulations on loan classification and provisioning, as well as disclosure of financial statements.

16. In order to enhance the efficiency of financial supervision over the medium term, the authorities are planning to establish a new integrated financial supervisory authority, which would cover all of the current banking, insurance and securities supervision functions. The integration process of supervisory authorities will start with the legislative reform by adopting the revised laws on securities market and insurance during this year. The unified authority is planned to start its operations in January 2002 at the earliest. However, my Estonian authorities have explicitly stressed that the quality of banking supervision will not be compromised at any stage of the process.

17. The Bank of Estonia has also started to make preparations for self-assessment procedures in order to identify Estonia's compliance with the principles of the Code of Good Practices on Transparency of Monetary and Financial Policies after its adoption.

STRUCTURAL REFORMS

18. The privatization process is now in the final stage, with only a few large public enterprises left in state ownership. Restructuring of the energy sector is by far the biggest challenge for the authorities in that respect. As the staff points out, this is an extremely complicated issue, as it also entails, in addition to several aspects of mining and electricity production, a question of potential social impact in the North East region. The government is currently developing a comprehensive strategy in addressing the issue in its entirety. In addition, the new government will finalize the privatization plans for the Estonian Railways and the remaining shares of Eesti Telekom.

19. Efforts are being made to advance with the comprehensive pension reform to a three-tier system. The Social Tax Law, Public Pension Law and Law on Private Pension Funds were passed by parliament in 1998. The new government reviewed the Social Insurance Reform Committee in May, and has given it the task to develop a framework for the second tier (mandatory contributions) by end-July. The Estonian authorities have acknowledged that the most difficult part would be to estimate the total cost of the transition and to establish financing sources. They are seeking assistance from the British Know How Fund and the World Bank in this process. The government intends to present a law which determines eligibility rules and formulas for the calculation of second-tier benefits to the parliament before end-1999.

20. Finally, my authorities have indicated their readiness to conclude discussions on a policy memorandum for a new precautionary stand-by arrangement during the Fund mission in the fall.