FOR AGENDA

SM/03/340
Correction 1

October 21, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Estonia—Staff Report for the 2003 Article IV Consultation**

The attached corrections to SM/03/340 (10/6/03) have been provided by the staff:

Page 8, Selected Indicators table, stub Fiscal Balance, last column: for "-0.3" read " 0.3"

Page 11, Box 1, first para., line 14, for "Norwegian" read "Finnish-Swedish"

Page 21, Table, for stub"Keep central government wages expenses..."
read "Keep central government operational expenses..."

Page 23, para. 28, lines 2 and 3: remove "(entry into ERMS2...central parity)" and replace with footnote 13 to read "Entry into ERM2...case-by-case basis." Subsequent footnotes renumbered.

Page 27, para. 35, lines 4–10: for "Based on...to be minor.[20]"
read "The government intends...to be minor.[21]"

Page 29, para. 47, first line: for "current" read "currency".

Page 47, last para., line 8, remove "which in turn is driven by the exchange rate system."

Questions may be referred to Mr. Haas (ext. 35630), Mr. Schipke (ext. 34569), Mr. Stavrev (ext. 38732), and Mr. Rasmussen (ext. 39713) in EU2.

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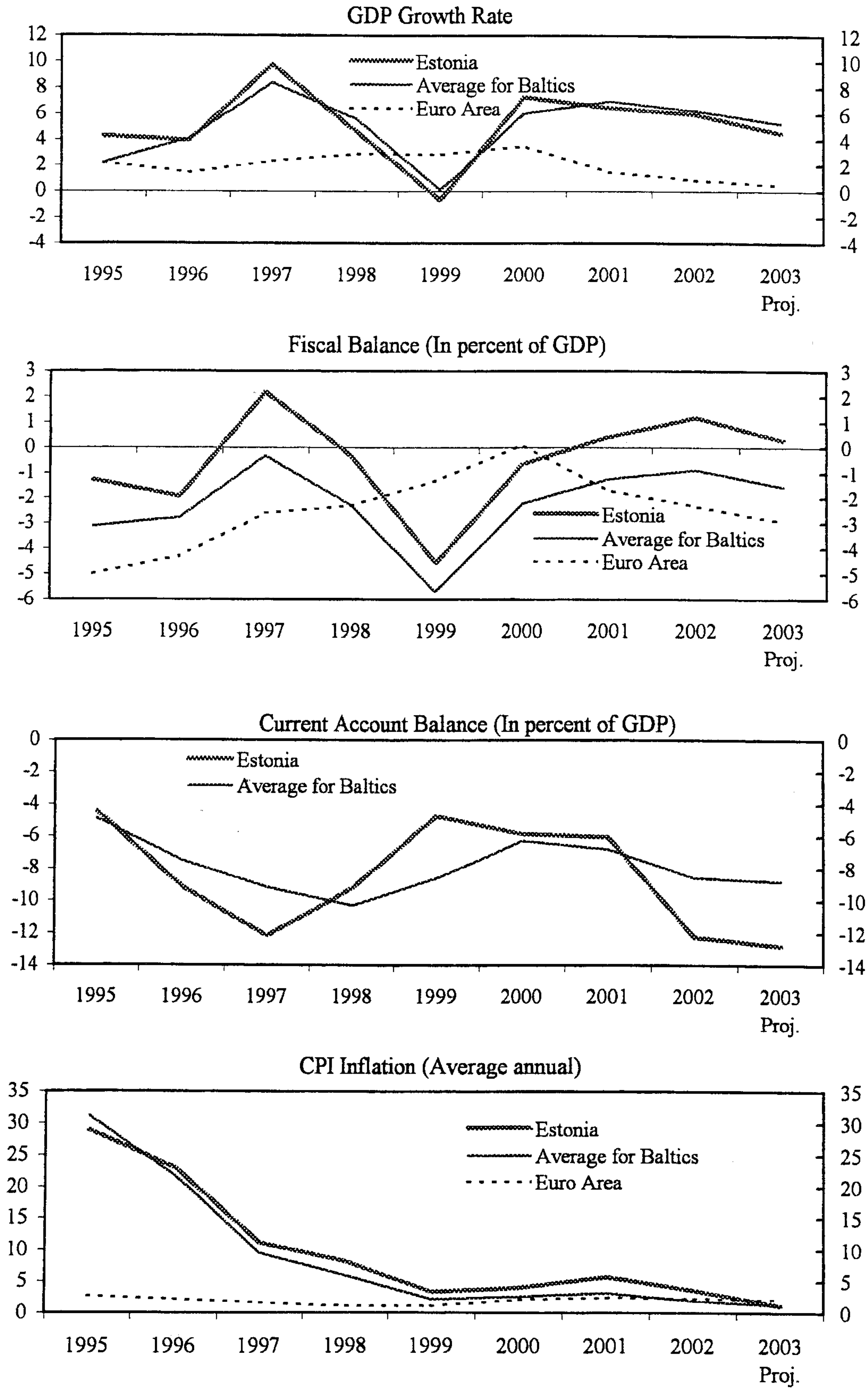
Figure 1. Baltic Countries and Euro Area: Selected Economic Indicators, 1995-2003



Sources: Country authorities; and Fund staff estimates.

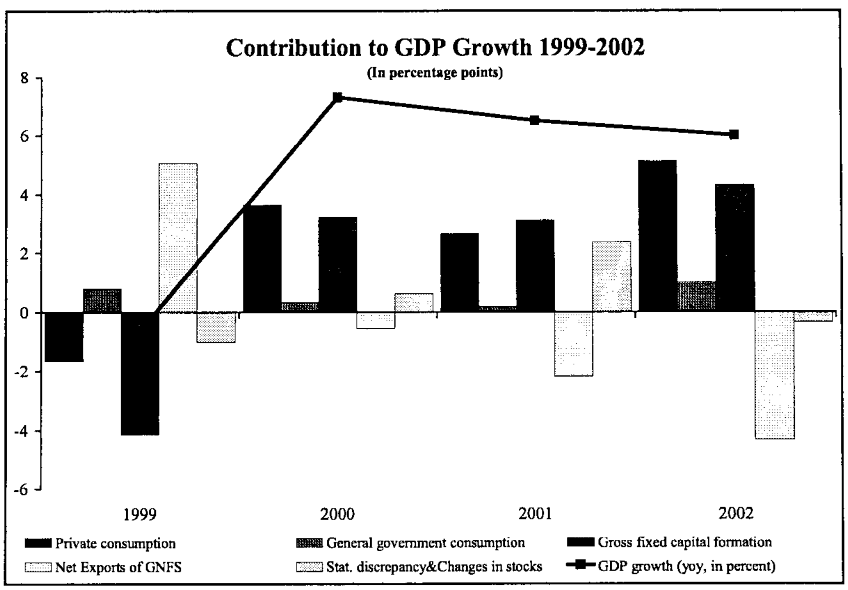
were also positive, as employment increased while unemployment fell to 10.3 percent in 2002 from 12.6 percent in 2001. Estonia's inflation rate declined to 2.7 percent at end 2002 from 4.2 percent in 2001; however, the 2002 average inflation rate of 3.6 percent would have exceeded the Maastricht criterion. Declining import prices and positive "one-off" factors such as lower food prices during the first half of 2003 contributed to a further temporary fall in the inflation rate.

Selected Indicators, 1999-2003

(In units as indicated)

	1999	2000	2001	2002	2003 Proj.
Real GDP (year-on-year in percent)	-0.6	7.3	6.5	6.0	4.5
Private consumption	-2.9	6.5	4.8	9.3	6.0
General government consumption	3.8	1.5	0.9	5.0	5.0
Gross fixed capital formation	-14.8	13.3	12.2	16.1	8.0
Exports	0.5	28.6	-0.2	6.0	6.8
Imports	-5.4	27.9	2.1	10.2	8.3
Average CPI (year-on-year in percent)	3.3	4.0	5.8	3.6	1.7
Unemployment rate (ILO definition, percent)	12.2	13.7	12.6	10.3	...
Fiscal Balance (in percent of GDP)	-4.6	-0.7	0.4	1.2	0.3
Current Account Deficit (in percent of GDP)	4.7	5.8	6.1	12.3	12.8

Sources: Estonian authorities and Fund staff estimates and projections.



Main Components of Current Account 1996-2003

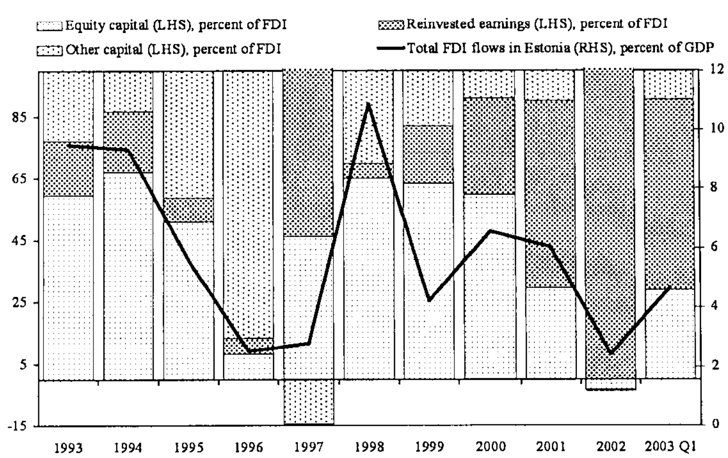
	1996	1997	1998	1999	2000	2001	2002	2003 Proj.
	(In percent of GDP)							
Current Account	-9.2	-12.2	-9.2	-4.7	-5.8	-6.0	-12.3	-12.8
Primary Current Account, excluding interest and reinvested earnings	-8.8	-10.1	-8.3	-3.9	-3.7	-2.1	-9.5	-10.2
Trade Balance	-23.4	-24.4	-21.4	-15.8	-15.1	-14.1	-16.9	-17.9
Services	11.9	12.9	10.9	10.9	11.0	10.4	7.5	8.0
Goods and Non-factor Services balance	-11.5	-11.6	-10.4	-4.9	-4.1	-3.7	-9.4	-9.9
Income	0.05	-3.1	-1.6	-2.0	-4.0	-5.0	-5.1	-5.1
Reinvested earnings	0.1	1.9	0.5	0.8	2.0	3.7	2.5	1.9

Sources: Bank of Estonia and Fund staff estimates.

Box 1. Foreign Direct Investment

The flow of foreign direct investment (FDI) in Estonia has been substantial over the last decade, averaging more than 6 percent of GDP per year. At the beginning of the transition period, FDI inflows were driven largely by privatization and the consolidation and restructuring of the banking sector, with the latter attracting a quarter of the FDI stock. In 2002, as bank restructuring and privatization drew to a close, FDI declined substantially to 2.5 percent of GDP, with most investments in existing rather than new enterprises. FDI increased to 4.5 percent of GDP in Q1 2003 (4-quarter moving average at an annual rate) due to the purchase of a large Estonian timber company (with a 50 percent share of the industry) by a Finnish-Swedish enterprise, but nonetheless remains below the last decade's historical average of 6 percent of GDP.

FDI and Its Composition



Since 1999, the reinvested earnings component of FDI inflows has grown rapidly, increasing to 60 percent of FDI in 2001from around 5 percent in 1998. The increase coincides with the exemption of reinvested earnings from corporate income tax since 2000. Overall, although FDI inflows may not be sustained at levels seen in the past, the prospects for growth are good. Over the medium term, Estonia is expected to remain an attractive destination for foreign investors. According to business surveys of foreign investors, the importance of potential market growth in the region, low production costs, political and exchange rate stability, the absence of capital controls, and the rapid pace of economic reform are the main factors driving foreign investment. Geographical proximity and historical ties with Finland and Sweden have been also beneficial for Estonia, as these countries, which account for two-thirds of the stock of FDI in Estonia, use the country as a bridge into the Baltic market.

7. **A further easing of monetary conditions and, more recently, more aggressive lending behavior by some banks, contributed to continued strong money and credit growth in 2002 and the first half of 2003 (Figure 3).** Given the high level of integration of money and credit markets with those of the Euro area, the country was confronted with an expansionary monetary shock due to a fall in Euro area interest rates. Interest rates fell further as a result of a decline in the country's risk premium.[4] Furthermore, foreign financial institutions, such as Nordea, started to lend more aggressively to increase their market share, putting additional downward pressure on lending rates, especially in the real estate sector. Credit grew by about 28 percent in 2002 and remained strong during the first half of 2003. Lease financing, which is a substitute for standard bank financing, continued to grow especially rapidly, increasing by about 41 percent in 2002.

8. **Estonia's banking system remains financially very sound.**[5] Despite an increase in competition driven by some smaller banks, as well as by larger financial institutions that are headquartered in the EU but have become more active in Estonia, indicators of profitability were strong. This reflects increases in efficiency and the ability of some Estonian banks to generate sizeable profits from operations in other Baltic states with higher spreads between lending and deposit rates. Non-performing loans fell from 2.3 percent in 2001 to 0.9 percent in 2003, partly reflecting the strong performance of the economy.

Banking Indicators, 1999-2003
(in percent, unless otherwise indicated)

	1999	2000	2001	2002	2003 1/
Capital Adequacy					
Capital adequacy—risk-weighted average	16.1	13.2	14.4	15.3	14.6
Liquidity					
Liquidity ratio	58.3	64.4	72.5	57.5	51.9
Total reserves/total deposits	28.1	25.4	14.5	14.4	16.6
Excess reserves/total reserves	43.3	19.0	16.7	1.5	1.5
Asset quality					
Nonperforming loans (in millions of domestic currency)	792.0	716.0	590.0	408.4	508.1
Nonperforming loans/total loans	4.0	3.2	2.3	0.8	0.9
Loan-loss provisioning/gross loans	4.4	2.6	2.1	1.0	0.9
Loan-loss provisioning/nonperforming loans	118.3	81.4	91.7	123.3	106.7
Profitability					
Return on equity	9.2	8.4	20.9	12.4	12.5
Return on assets	1.5	1.2	2.7	1.6	1.5
Net interest margin	4.6	4.7	4.1	3.8	3.5
Loans and deposits					
Loans/deposits	100.9	98.5	95.3	102.4	109.3
Loans/total assets	56.6	59.2	59.5	61.2	64.7
Nonresident deposits as a share of total deposits	16.9	16.0	14.3	13.1	11.3
Nominal interest rate spread	4.5	3.9	5.4	3.7	3.5
Foreign currency deposits as a share of total deposits	31.1	34.0	30.1	28.7	26.4
Foreign currency loans as a share of total loans	76.1	77.9	78.7	82.6	81.9
Concentration					
C3	92.0	91.0	91.0	90.0	90.3
C5	99.0	99.0	99.0	99.1	99.4
Memorandum Items		(in percent of GDP)			
Total assets	28.7	33.5	48.0	75.6	80,2
Deposits (resident)	22.5	26.1	30.1	39.3	40,6

Source: Country authorities and Fund staff estimates.

1/ Most recent data.

[4] Estonian Eurobond spreads have fallen from 45 basis points in 2002 to 34 basis points in 2003.

[5] Banking sector reserves held at the BOE fell in 2001 because commercial banks were allowed to fulfill up to 50 percent of their reserve requirement by holding high quality euro-denominated assets instead of cash reserves.

Expected Impact on 2004 Budget of Policy Changes and EU Accession 1/		
	(In percent of GDP)	(In millions of EEK)
Policy Changes	-0.4	-559
Costs	-1.6	-2,056
Reduction in the income tax rate and higher threshold	-1.2	-1,495
Higher parents benefits	-0.3	-370
Pension increase from July 1, 2003	-0.2	-191
Gains	1.2	1,497
Keep central government wages at 2003 level	0.4	514
Keep central government operational expenses at 2003 level	0.3	361
VAT gain due to change in treatment of finance leases	0.3	400
Discontinue subsidies to student loans	0.1	100
Income tax on higher parents benefits	0.0	62
Introduction of tax on heavy vehicles	0.0	60
EU-Related Changes	0.4	481
Costs	-1.6	-1,952
VAT loss due to change in declaration date for imports from the EU	-0.6	-700
Payments to the EU	-0.7	-902
EU-related bridge financing needs	-0.3	-350
Gains	1.9	2,433
Introduction of VAT on EU projects	0.3	400
Harmonization requirements	0.6	759
Increase in excises on tobacco, alcohol, and fuel	0.3	350
Abolishment of tax-free trading on trips within the EU	0.3	325
Custom duties on imports from third countries and other	0.1	85
Lumpsum grants from the EU	0.2	274
Use EU funds to save on expenditure financed by domestic sources	0.8	1,000
Net Total	-0.1	-78

Source: Estonian authorities and Fund staff estimates
Note: Items may not sum due to rounding.
1/ Changes relative to baseline with unchanged policy.

24. **EU accession also has substantial fiscal implications.** Upon accession, VAT on intra-EU acquisitions will be treated in line with domestic purchases rather than paid at the border, implying an additional time lag of approximately half a month and an estimated onetime cost of about 0.6 percent of GDP. With the payments to the EU budget and additional bridge-financing needs, this implies combined expenditures of about 1.6 percent of GDP. This cost, however, is expected to be more than offset by EU-related gains of about 1.9 percent of GDP. Included in this figure is 0.3 percent of GDP in extra revenue from the introduction of VAT on EU-funded projects, and 0.6 percent of GDP due to harmonization requirements. In addition, Estonia will receive 0.2 percent of GDP in lump-sum grants that may be used to cover budgetary expenditure, and will save an expected 0.8 percent of GDP by using EU grants to replace expenditure currently relying on national funds (Box 3).

25. **Staff discussed with the government the planned policy initiatives and the draft budget proposal for 2004.** Although the Ministry of Finance had drafted a balanced budget for 2004, staff expressed concern that the draft is predicated on potentially over-optimistic assumptions, especially regarding EU grants and the ability to institute a complete freeze on central government outlays for wages and operational expenses. Past experience suggests that it is difficult to absorb all available EU funds, and holding the wage bill unchanged in nominal terms may also prove difficult, given the need to increase administration capacity in

Box 3. EU Grants

EU accession, scheduled for May 2004, will involve a significant increase in EU-related income and expenditure. The inflow of grants under pre-accession programs has been rapidly increasing and is expected to reach 1.5 percent of GDP in 2003. In 2004, with availability of new EU funds, the Estonian authorities are expecting EU grant receipts to increase by 2.7 percent of GDP. These funds will support a wide range of areas, including infrastructure investment, agriculture, and education, stimulating economic growth and helping to raise income levels. EU-related expenditure will increase with the initiation of payments to the EU budget and higher co-financing requirements. In addition, higher grants will imply higher expenditure since the grants are generally tied to project financing. The lump-sum budget support is an exception. In 2004, however, lump-sum budget support funds will be more than offset by higher bridge financing needs (mostly due to upfront payments for agricultural support) so that expenditure will exceed receipts. This brings the total increase in expected EU-related expenditure to 3.7 percent of GDP.

Fiscal Impact of EU Acession, 2003-06

	2003	2004	2005	2006
		(In millions of EEK)		
Net cash flow	1,696	4,305	3,113	4,202
EU grants	1,696	5,206	4,519	5,746
Pre-accession instruments	1,696	1,850	1,377	1,080
Post-accession instruments	...	2,733	2,742	4,266
Lumpsum budget support	...	274	50	50
Other	...	350	350	350
Payments to the EU (-)	...	-901	-1,407	-1,544
EU-related expenditure	2,196	6,854	6,446	7,591
Payments to the EU	...	901	1,407	1,544
Disbursement of grants	1,696	5,252	4,369	5,245
Co-financing	500	700	670	802
		(In percent of GDP)		
General government revenue and grants	41.5	42.6	40.8	40.6
Of which: EU grants	1.5	4.2	3.3	3.9
General government expenditure and net lending	41.2	42.6	40.8	40.6
Of which: EU-related	1.9	5.5	4.7	5.1

Sources: Estonian authorities and Fund staff estimates.

The increase in EU-related expenditure does, however, not necessarily imply a corresponding increase in overall public spending. EU-related outlays may, to some extent, replace expenditures financed from national funds. EU funds are subject to the principle of additionality, which, as a general rule, requires that national outlays not be decreased as a result of increased use of EU funds (measured as an annual average over certain program periods). Nevertheless, with underlying expenditure growth and possibilities for redistributing expenditure between different years, this leaves some room for reducing the reliance on national funds. The draft budget for 2004 is based on EEK 1 billion of such replacement taking place in areas including road building and enterprise support programs. Similarly, the expected increase in co-financing of EEK 200 million is expected to be accommodated within the existing expenditure envelope. In 2004, the combined saving, amounting to 1 percent of GDP is thus expected to cover the difference between the rise in EU-related expenditure and the rise in receipts of EU grants.

relation to EU accession. Staff also expressed the concern that without an overall spending cap, the cost of higher parents' benefits might well exceed projections. In order to relieve budget tensions, the mission suggested possible revenue-raising measures, including gradually eliminating the tax deductibility of mortgage interest payments and the tax exemption on interest income from bank deposits. The authorities reiterated their firm commitment to balancing the budget and noted that any shortfall in EU grant receipts would require ministries to institute additional expenditure cuts.[12]

[12] Staff encouraged the government to take advantage of a scheduled FAD technical assistance mission that would focus on multiyear expenditure planning, operational risk management in budget execution, and the development of performance-based budgeting.

26. **Staff indicated to the authorities that some recent fiscal transactions could undermine Estonia's high standard of fiscal transparency and the credibility of the government**. Estonia's past performance and advanced standing among all EU accession countries is directly related to its prudent and easily understood fiscal policy. However, one of the mission's findings was that the government may be taking its own stated fiscal objectives less seriously, as reflected by the off-budget transfer of EEK 350 million to a publicly owned real estate company. The same applies to municipalities. Staff pointed out that it has taken Estonia a decade to achieve a record for fiscal transparency that is the envy of the world and that it would be a step in the wrong direction if a reversal is allowed.

D. Exchange Rate Issues and EMU Membership

27. **Estonia's competitive position remains relatively strong, supporting the country's strategy of maintaining a fixed exchange rate system.** Price-based indicators of competitiveness, including unit labor costs, have remained broadly unchanged over the last couple of years. Furthermore, Estonia was able to increase its market share in the EU by more than 10 percent in 2002 (Appendix III).

28. **The authorities indicated that it was their intention to join ERM2 immediately after EU accession, with the currency board as an unilateral commitment.**[13] Staff concurred with the authorities that they should avoid a double regime shift prior to the adoption of the euro, given that the currency board has served the country well, provided a nominal anchor, and withstood adverse external shocks (such as the international financial crises in the second half of the 1990s). The authorities indicated that they wanted to adopt the euro at the earliest possible date. Staff agreed that an early adoption of the euro would solidify Estonia's successful economic convergence and the overall reform process, while eliminating remaining exchange rate risks (Figure 4). To ensure that the conditions for an early adoption of the euro are in place, staff urged the authorities not to become complacent and to continue moving forward with the remaining structural reforms while using fiscal policy resolutely to address macroeconomic imbalances.

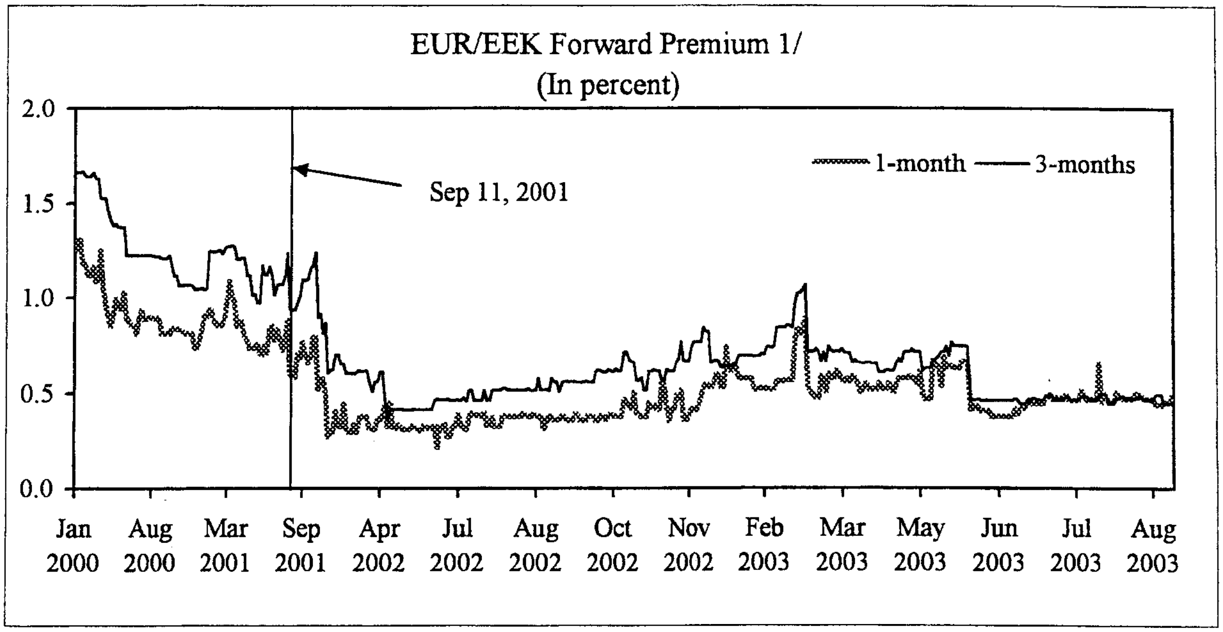
E. Monetary and Financial Sector Issues

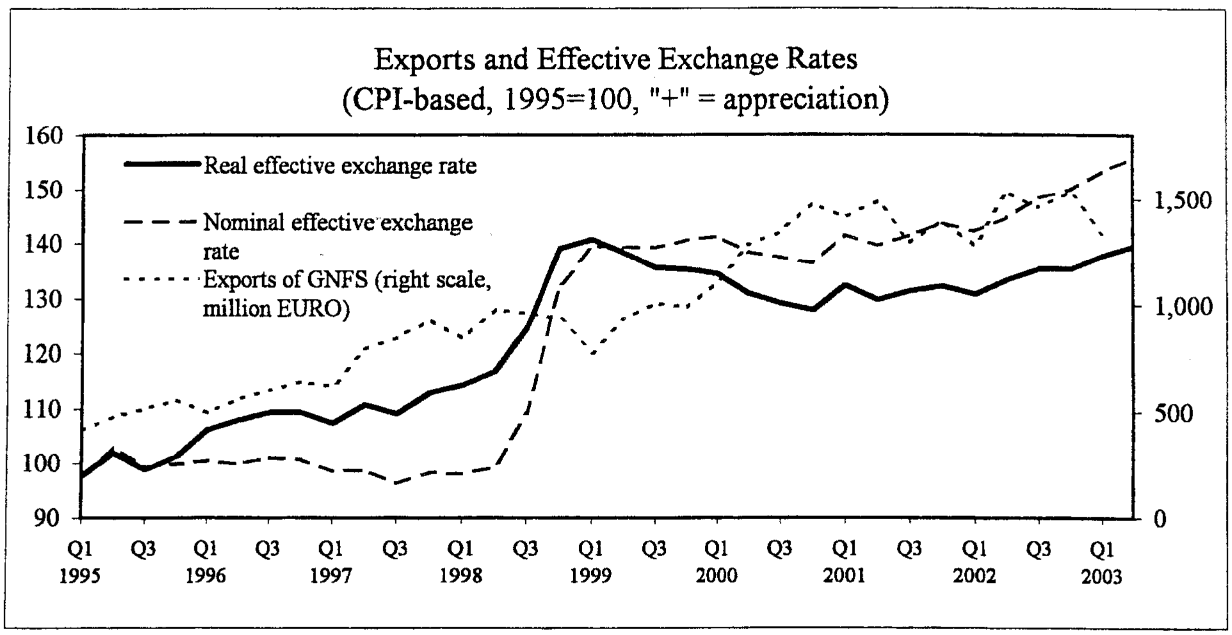
29. **The mission encouraged the authorities to consider increasing prudential regulations in sectors that experience particularly strong credit growth, such as real estate.**[14] While some of the determinants that contributed to the strong credit and money growth in the past are likely to be less pronounced in the future, additional competitive

[13] Entry into ERM2 would require a multilateral agreement with the euro area Member States, the ECB and the other Member States participating in the mechanism about the key modalities of participation in ERM2, especially the central parity. Furthermore, the appropriateness of currency board frameworks as a unilateral commitment complementing ERM2 membership will have to be assessed in the course of the ERM2 entry procedure on a case-by-case basis.

[14] This would introduce a macroprudential element that would have the advantage of tightening capital requirements during economic upswings and loosening them during downturns. This feature is particularly useful—given Estonia's currency board system— during the period leading to EMU membership.

Figure 4. Estonia: External Sector Financial Indicators, 1995-2002





Sources: National authorities, Reuters; and Fund staff estimates.

1/ Difference between EEK and Euro money market rates.

35. **The new government does not have any firm plans for additional privatizations in the near future.** The central government maintains shares in Estonian Air (34 percent) and the Estonian telecom (27.3 percent) and fully owns the Port of Tallinn, the national post office, and Estonian Energy. The government intends to re-evaluate the sale of its remaining shares in these strategic enterprises and intends to continue with the sale of assets such as land and buildings; the potential receipts from the sale of such assets are expected to be minor. [21]

36. **Persistent unemployment remains a problem in Estonia.** The strong growth performance over the past two years led to a fall in the unemployment rate, although the decline was not observed in the northeastern part of Estonia. Regional differences in property prices, aggravated by language barriers faced by non-Estonian speaking residents, contributed to the problem of low labor mobility. The government has embarked on a program of vocational training reform and enhanced active labor market programs, which will benefit from EU post-accession funding (Appendix VI). At the same time, the EU will not bring significant changes to the Estonian labor market code, which is already comparable to EU standards. However, the social charter of the EU—which is not legally binding for Estonia—may intensify the political pressure to tighten the labor code and to increase unemployment benefits and the minimum wage. This could exacerbate the problem of long-term unemployment.

37. **The energy market continues to be dominated by a single state-owned company (Estonian Energy), which has a monopolistic position in energy production, transmission, and distribution.** A new law governing the sector—which entered into force in July 2003—requires legal separation of the three sectors. However, the activities will be carried out by subsidiaries of Estonian Energy, which has a monopoly in energy production, transmission, and distribution. In negotiations with the EU, Estonia's energy market has been granted a transition period allowing for gradual liberalization due to adverse socio-economic implications of the reforms and the restructuring of oil shale-based electricity production.[22]

38. **Reform efforts to streamline the structure of the government at the local level has been very slow**. The mission pointed out that despite some mergers, which have reduced the number of municipalities from 253 to 241, the number of local governments remains too large for a country of this size. Staff encouraged the authorities to accelerate the reform

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[21] The Government has retained for 5 years special powers ('golden share') in Estonian Telecom, which will expire in May 2004. Also, under the Security Service Act, the Government may restrict participation of foreign investment in security service enterprise. Foreign capital in aviation and maritime transport sectors have been restricted to 49 percent; this will be abolished upon accession to the EU.

[22] Currently, 10 percent of energy customers are free to choose electricity providers. This share will be increased to 35 percent in 2008 and the market will be fully liberalized by 2012.

process, pointing out that the excessive number of municipalities constituted a waste of scarce resources. While the authorities agreed with staff's position, they indicated that mergers at the local level would be voluntary, but that the central government would encourage mergers through small financial incentives.

39. **The Estonian trade system remains fully liberal, with Estonia having free trade agreements with Ukraine and all EU accession countries except Romania.** In terms of legislation, the Estonian trade system is harmonized with the EU trade system, but the implementation is currently different: the EU trade system will be fully applied starting May 1, 2004. However, the implementation of the EU trade system is not expected to have a major effect on Estonian trade pattern, since approximately 90 percent of Estonian trade is with the EU and EU accession countries. Nevertheless, EU accession is expected to have a negative impact on a few imports like steel, grain, and fertilizers, which are imported mostly from Russia and Ukraine. At the same time, the EU accession will have a positive effect on some exports, mainly to Russia, since Russian tariffs on Estonian exports will halve after EU accession. An exception is the export of fishery products to Ukraine, but Estonian firms are already searching for alternative markets in this sector.

IV. Other Issues

40. **Staff discussed with the authorities the use of Collective Action Clauses in sovereign bond issues**, pointing out that the Executive Board encourages the use of such clauses. The authorities indicated that given the balanced budget policy and the very low level of public debt outstanding, they were not considering issuing new debt in the medium term. In addition, the authorities pointed out that the country's first international bond issue in 2002 is governed by English law, which includes a provision for majority restructuring. Staff encouraged the authorities to continue with this practice in the future.

41. **Overall, Estonia continues to be at the forefront of transparency efforts**. The country subscribes to the Fund's Special Data Dissemination Standard and provides the key data for surveillance on a timely basis. Estonia has also made substantial progress in addressing outstanding issues that were identified in the original ROSCs and updated the ROSCs in 2002. The adoption of the organic budget law in 2002 addressed several of the outstanding recommendations from the fiscal ROSC. Among others, the law introduced a new unified definition of the general government and (from the beginning of 2003) a new budget classification in line with ESA95 and GFS 2001.

42. **The mission made its views public and engaged in a number of outreach activities by meeting with representatives of both the local electronic and print media.** The authorities confirmed that they would, as in the past, publish the staff report.

V. Staff Appraisal

43. **Expectations of EU membership have provided the foundation for continued confidence and strong growth driven by domestic investment and consumption demand.** Estonia's positive economic performance took place despite sluggish economic developments in the country's major export markets. The short- and medium-term outlook remains positive.

44. **But developments of the current account have increased the vulnerability of the economy.** The sudden increase in the current account deficit from 6 percent of GDP in 2001 to above 12 percent of GDP from 2002 onward, combined with a simultaneous fall in FDI coverage, has rendered the economy more susceptible to adverse shocks. While the financing of the deficit in the immediate term does not pose any difficulties, the size of the deficit raises questions of sustainability over the longer term. These developments are taking place at a critical time when the country is preparing itself for ERM2 membership and the adoption of the euro.

45. **Although Estonia has pursued a conservative fiscal policy, which is reflected in the country's balanced budget policy and the corresponding low level of public debt, given the increasing external imbalances and the currency board arrangement, fiscal policy should be used more pro-actively to maintain macroeconomic stability.** As a first step, the authorities should allow the automatic stabilizers to operate fully. The government's public announcement that it will not pass an additional supplementary budget in 2003, even if revenues were to over-perform, is a welcome step in the right direction. However, given the size of the current account deficit—and in order to signal to market participants that the government is willing to tighten policies in the face of increased vulnerabilities—the authorities should postpone planned, but not yet executed, expenditure increases envisaged in the first supplementary budget.

46. **While the government has drawn up a balanced budget proposal for 2004, a number of policy initiatives (such as the large increase in parents' benefits to increase the birth rate) in combination with the sizeable reduction in the income tax rate could put unforeseen pressure on the budget, further increasing the vulnerability of the economy.** Additional budgetary tensions are likely to arise due to an increase in EU related expenditures and potentially lower than planned inflows of EU funds. To avoid any adverse implications, new entitlement programs should be implemented gradually and expenditures need to be capped.

47. **Confidence in the currency board arrangement continues to be strong and the authorities intention to join ERM2 with a fixed exchange rate as a unilateral commitment immediately after EU membership seems warranted as long as it is supported by appropriate fiscal and structural policies.** Indicators of competitiveness suggest that Estonia remains competitive in export markets. The intention of the authorities

to eliminate remaining exchange rate risks by adopting the euro at the earliest possible date is sensible.

48. **Estonia's financial system remains sound and highly capitalized. However, continued strong credit growth needs to be monitored closely and the authorities should be ready to increase prudential requirements on a selective and temporary basis, especially if housing prices were to increase sharply.** The authorities should take the opportunity to eliminate the tax exempt status of income earned from bank deposits as well as the deductibility of mortgage interest payments. In addition to curtailing credit growth, this would offset part of the revenue loss associated with the income tax reform and create a level playing field in financial markets.

49. **Despite a positive outlook, Estonia's economy is faced with risks.** Given Estonia's high degree of openness, a prolonged slowdown in Estonia's trading partners would ultimately impact exports, consumer confidence, and investment activities. At the same time, the continuation of large current account deficits could ultimately call into question the sustainability of the external position. Furthermore, the fiscal implications of the planned policy initiatives for 2004 and beyond have reduced the government's degree of freedom to maneuver to counter adverse developments.

50. **Estonia has achieved a level of transparency in public policymaking including simple fiscal rules that are exemplary.** However, some of the recent fiscal transactions by the central government to increase spending without impacting the publicly visible fiscal deficit and by municipalities to circumvent borrowing limits should be avoided since they could undermine Estonia's high transparency standard. Staff welcomes the authorities' intention to publish this year's Staff Report.

51. **Staff recommends that Estonia remain on the standard 12-month consultation cycle.**

the BOE ahead of EMU membership. However, to ensure that such a facility does not undermine the currency board arrangement and lead to spillovers into the money market, such a facility should initially be set up as an intra-day facility.

In line with all other accession countries, Estonia's banking system has a structural liquidity surplus. The Eurosystem, in turn, was set up with a view to ensuring that the banking system is in constant need of central bank financing, since a system with a structural deficit improves the effectiveness of regular open market operations and ultimately the transmission of monetary policy signals. The main reason for the difference between the structure of the balance sheet of the BOE and the NCBs of the euro area is related to the level of net foreign assets. In the case of Estonia, a higher share of net foreign assets is driven by the fixed exchange rate system. A convergence of the balance sheet of the BOE with those of NCBs is likely to take place gradually after EMU membership. In this respect, Estonia is not an exception from other accession countries.

Foreign Bank Ownership[1]

Foreign bank ownership is often associated with an improvement in the stability and efficiency of a country's financial system. However, the dependence of a domestic banking system on foreign institutions, especially if the banks are owned by institutions of a single country, could make the system vulnerable to shocks generated abroad. In Estonia, about 90 percent of total bank assets are foreign owned, with more than 80 percent of bank capital held by two Swedish groups (SEB and Swedbanken). Estonia's banking system is similar to that of New Zealand, whose banking system is almost fully owned by Australian banks.[2] The high degree of foreign ownership is at least partly the result of the authorities' strategic decision to attract foreign capital in the aftermath of the 1997/98 banking crisis.

Diversification of Swedish Parent and Baltic Subsidiaries (in percent of total assets)

Parent banks		Baltic Subsidiaries					
Swedish		Estonia		Lithuania		Latvia	
Swedbank		*Hansabank*		*Hansabank*		*Hansabanka*	
Sweden	90	Estonia	54	Lithuania 1/	100	Latvia 1/	100
Estonia	4	Lithuania	28				
Other (Norway, Denmark)	6	Other (Latvia)	18				
SEB (Swedish parent)		*Eesti Uhispank*		*Vilniaus Bankas*		*Latvijas Unibanka*	
Sweden	42	Estonia 1/	100	Lithuania 1/	100	Latvia 1/	100
Germany	37						
Baltics	3						
Other	18						

Source: Based on information from respective banks.

1/ No major assets held abroad.

In addition to attracting badly needed capital, foreign ownership has contributed to a fall in the cost of capital due to the high credit rating of the parent banks; led to a more rapid integration with European capital markets; resulted in the transfer of knowledge, especially with respect to risk management; and improved efficiency as a result of economies of scale. The risk is, however, that shocks originating in the country of the parent banks (Sweden) could be transmitted to Estonia. The adverse implications of such a shock are even more pronounced due to fact that Sweden is Estonia's second largest export market, making it more difficult for the country to smooth out any real shocks.

The risk of a potential banking crisis in Sweden, which could spill over into Estonia, depends on —among other things— the exposure of Swedish bank assets to the home country's real economy. Of the two Swedish banks that dominate the Estonian banking system, the lending portfolio of at least one is highly diversified within Europe. The implications of a business-cycle induced downturn in Sweden on the balance sheet of one of the two Swedish parent banks (SEB)—and therefore the probability of spillovers to Estonia—are consequently judged to be limited. The other Swedish parent bank (Swedbank) is regionally less diversified, making transmission of shocks more likely. However, given the probability of future mergers and acquisition within the EU, and hence increased regional diversification, the transmission of adverse shocks to the Estonian banking system should diminish with further EU integration.

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[1] See also Country Report No. 03/115.

[2] Malta is another small economy in which the banking system is almost fully foreign owned.